REFORM OF TAXATION SYSTEM

Center for Liberal-Democratic Studies

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Content

Foreword

The taxation system in Serbia has undergone many changes over the last decade. The relatively modern conception of 1991 was changed for the worse until, by 2001, it was in a very poor state; unfair, inconsistent and lacking an underlying philosophy, discouraging for economic activity with too many, often poor fiscal instruments, un-transparent, overly centralized, poorly administered, and so on.

In the spring of 2001 a wave of new reforms began that aimed to establish a modern, fair and encouraging taxation system. Much was achieved, many changes have been made, the taxation system was improved significantly and VAT is to be introduced. However, much important work remains. Certain fiscal instruments have been significantly improved, particularly the most important ones, but others have remained untouched. Tax reform is only half completed.

This document represents an attempt to examine how far the reform has gone, to analyze the current situation, point out weaknesses and suggest solutions that would significantly improve the revenue side of the fiscal system. The emphasis is on suggestions for further reform, which is natural considering that the study was written for the use of the Ministry of Finance and the Economy.

Particular attention has been paid to the administration of fiscal instruments, that is the process of establishing the level of and charging taxes – an area neglected in earlier studies.

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27th September 2003

Boško Mijatović

I Fiscal Instruments

INTRODUCTION

The first step in the analysis of fiscal instruments is to specify the criteria by which certain public levies within the fiscal system of Serbia are defined as fiscal instruments. The Law on Tax Procedure and Tax Administration offers two criteria: 1) that revenue represents public revenue, 2) that public revenues are collected by the Tax Administration (TA). Taking into consideration the economic and legal meaning of the fiscal revenues, first the material and second procedural criteria should be supplemented by a third one: 3) that the duty of payment should be known in advance, and does not represent a fine in any form, even though the TA may have the authority both to impose and to collect fines.

Public revenues are defined by the **Law on Public Revenues and Expenditures**, («Official Gazette of the Republic of Serbia», number 76/91, 18/93, 22/93, 37/93, 67/93, 45/94, 42/98, 54/99 and 22/2001) and divided into four main categories:

1. taxes, fees, charges and public loans,
2. contributions,
3. local public revenues, and
4. other public revenues.

Applying the criteria above to the public revenues as defined by the Law on Public Revenues and Expenditures, it can be concluded that:

First, that local public revenues fall within the classification in category 1 (fees and charges) and in the category 4. The only local public revenue not mentioned as one of the fiscal instruments within category 1 and 2 is the self-imposed local tax levied by the municipality.

Second, other public revenues, although may meet the first two criteria, cannot be considered as fiscal instruments (revenues from fines, sale of confiscated goods, rents, privatization, activities of state bodies, donations, etc.) because they do not meet the third criteria.

As a result it is the intention here to examine the following categories of public revenue from the Law on Public Revenues: 1) taxes, 2) fees, 3) charges. The analysis will be organized as follows; the first section comprises a list of fiscal instruments detailing the tear of the government authorized to collect them, the method of collection and how the revenue is allocated. The second section examines the efficiency of the existing fiscal system, and the third section presents proposals for

reform. The fourth section contains a list of laws and other regulations that should be amended or abolished.

Contributions for mandatory social insurance also meet all three criteria and represent fiscal instruments. However, due to their specific nature they will be discussed in a separate chapter.

LIST OF FISCAL INSTRUMENTS

For the identification of the concrete fiscal forms managed by the Tax Administration, it is necessary to take into account the Law on Public Revenues and Expenditures, and also the provisions of the Regulations on the Standard Classification Framework and Method of Accounting for the Budget System («Official Gazette of the Republic of Serbia», number 92/2002), as well as the Regulations on the Conditions and Methods of Keeping Accounts for Payment of Public Revenues and Resource Allocation ("Official Gazette of the Republic of Serbia", number 64/2003).

The list of main fiscal instruments according to these regulations is shown in the following table.

Table 1
A List of Fiscal Instruments
Classified by Accounts

Account	Public revenue
711000	**TAXES ON INCOME, PROFIT AND CAPITAL GAINS**
711110	Tax on salaries and wages
711120	Tax on business income and income from professional services
711130	Tax on royalty income
711140	Tax on income from property
711150	Tax on individual gains from games of chance
711160	Tax on income from insurance of persons
711170	Complementary annual individual income tax
711180	Self-imposed local tax
711190	Tax on other income
711210	Enterprise profit tax
712000	**PAYROLL TAXES**
712110	Payroll tax
713000	**PROPERTY TAXES**
713110	Special tax on non-cultivated arable agricultural land
713120	Tax on immovable property
713310	Tax on inheritance and gifts
713410	Tax on financial transactions
713420	Tax on capital transactions
713610	Tax on registered shares

Account	Public revenue
714000	**TAXES ON GOODS AND SERVICES**
714110	Value added tax
714120	Single stage sales tax
714130	Cumulative multistage sales tax
714210	Excise duty on oil derivatives
714220	Excise duty on tobacco products
714230	Excise duty on alcoholic beverages
714240	Excise duty on alcohol (ethanol)
714270	Excise duty on non-alcoholic drinks
714410	Taxes on organizing of games of chance
714420	Municipal fee for organization of musical program in catering facilities
714430	Municipal fee for use of billboards
714440	Fire prevention levy
714510	Tax on motor vehicles
714520	Tax on use, keeping and carrying of goods
714530	Republic duty on special products and special activities
714540	Charge for use of goods of public interest
714550	Concessional and tourist fees
714560	Municipal and city fees
714570	Municipal and city public utilities fees
714580	Tolls
716000	**OTHER TAXES**
716110	Local fee on the disclosure of company's name
716210	Funds gathered during the "Children's week"
716220	Funds realized by sale of supplemental postage stamps
719000	**NON-RECURRENT TAX ON EXTRA INCOME AND EXTRA PROPERTY**
719110	Privileged payment of funds from frozen foreign currency savings accounts and savings in pyramidal banks exceeding 10,000 DEM per savings deposit
719210	Utilization of primary and "irregular" issues of money in financial transactions
719220	Purchase of foreign currencies at the official NBY rate while the market rate was higher
719230	Carrying abroad foreign currencies from advanced payments for imports that were later not effectuated, or from invoiced but not effectuated services
719240	Import and export of products on quota regimes
719250	Use of funds of legal entities without paying taxes
719260	Use of resources under privileged conditions
719310	Use of loans for acquiring of business premises, other real estate or equipment under terms easier than the market ones
719320	Performing of business operations with public resources or company funds or their utilization through transfer abroad to the account of the taxpayer or somebody else

Account	Public revenue
719330	Use of funds deposited by citizens in pyramidal banks
719410	Abuses in the process of privatization of companies
719510	Import and distribution of excise products without paying import duties and taxes
719610	Non-recurrent tax levied at other bases
741000	**REVENUES FROM PROPERTY**
741510	Charge for use of natural resources
741520	Charge for use of forest and agricultural land
741530	Charge for use of areas and construction land
741540	Charge for use of river banks and spas
741550	Charge for use of goods of public interest in production of electric power and oil and gas production
741560	Use of airspace
741570	Charge for use of radio frequencies and TV channels
741580	Charge for use of land belonging to the public highways
742000	**REVENUES FROM SALES OF GOODS AND SERVICES**
742210	Federal level fees
742220	Republic level fees
742230	Autonomous Province level fees
742240	City level fees
742250	Municipal level fees
742270	Republic Courts level fees

The list above is not does not cover all specific fiscal forms, because there are some types within certain fees and charges that differ from municipality to municipality, in price or by the type of public service for which they are paid.

Within each fiscal form there are different fiscal instruments; they differ by definition of taxpayers and tax basis, as well as by the level of tax rate/burden. In the following text there is a review by laws as well as by method of assessment. For easy reference of the number of fiscal instruments defined by certain laws, there is a corresponding numerical intervals in each subtitle.

1 – 3) Enterprise Profit Tax Law

1) Enterprise profit tax, assessed by TA Decision;
2) Tax on dividends and shares in profit for legal entities, withholding tax;
3) Tax on royalties and interests accruing to non-resident taxpayers: withholding tax.

Table 2
Taxes

TAXES	Allocation	Law
– on enterprise profit	Republic /Region	**Enterprise profit Tax Law** ("Official Gazette of the RS", number 25/01, 80/02 and 43/03)
– on individual income	Republic/Region /Municipality	**Individual Income Tax Law** ("Official Gazette of the RS", number 24/01 and 80/02)
– on property	Municipality	**Property Tax Law** ("Official Gazette of the RS", number 26/01 and 80/02)
– inheritance and gift tax	Municipality	**Property Tax Law** ("Official Gazette of the RS", number 26/01 and 80/02)
– on the transfer of absolute rights	Municipality	**Property Tax Law** ("Official Gazette of the RS", number 26/01 and 80/02)
– on sales	Republic /Municipality	**Sales Tax Law** ("Official Gazette of the RS", number 22/01, 73/01, 80/02)
– excise	Republic	**Excise Duties Law** ("Official Gazette of the RS", number 22/01, 73/01, 80/20, 43/03, 72/03
– on use, keeping and carrying of goods	Republika	**Law on Taxes on Use, Keeping and Carrying of Goods** ("Official Gazette of the RS", number 26/01, 80/02
– on financial transactions	Republic	**Financial Transaction Tax Law** ("Official Gazette of the RS", number 26/01, 35/02 and 43/03)
– payroll tax	Municipality	**Payroll Tax Law** ("Official Gazette of the RS", number 27/01)

4 – 20) Individual Income Tax Law

4) Wage tax, withholding tax;
5) Income tax on income from agriculture and forestry, assessed by TA Decision;
6) Income tax on income from self-employment assessed by TA Decision;
7) Income tax on revenues from copyrights and industrial property rights (when the tax payer keeps books): withholding tax;
8) Income tax on income stemming from copyrights and industrial property rights (when a payer does not keep books): assessed by TA Decision;

9) Lump sum tax on income from copyrights on performing popular and folk music: assessed by TA Decision;
10) Income tax on income from capital: withholding tax;
11) Income tax on income from real estate (when a lease-holder keeps books): withholding tax;
12) Income tax on income from real estate (when a lease-holder does not keep books): assessed by TA Decision;
13) Tax on capital gains: assessed by TA Decision;
14) Income tax on income from renting movables (when a lease-holder keeps books): withholding tax;
15) Income tax on income from renting movables (when a lease-holder does not keep books): assessed by TA Decision;
16) Income tax on income of sportsmen and sport experts: withholding tax;
17) Tax on income from games of chance: withholding tax;
18) Tax on income from insurance of persons: withholding tax;
19) Tax on other income that constitutes income of physical persons: withholding tax;
20) Annual individual income tax: assessed by TA Decision.

21 – 26) Property Tax Law

21) Property tax on real estate rights – for legal entities and physical persons: assessed by TA Decision;
22) Tax on registered shares for legal entities and physical persons: assessed by TA Decision;
23) Tax on interests of legal entities and physical persons in limited liability companies: assessed by TA Decision;
24) Inheritance tax: assessed by TA Decision;
25) Gift tax: assessed by TA Decision;
26) Tax on the transfer of absolute rights: assessed by TA Decision.

27 – 29) Sales Tax Law

27) Tax on sale of goods: self-assessment;
28) Tax on sale of services (when a taxpayer keeps books): self-assessment;
29) Tax on sale of services (when a taxpayer does not keep books – lump sum taxation): assessed by TA Decision;

30 – 47) Excise Duties Law

30 – 37) Excise on oil products;
38 – 40) Excise on tobacco products;
41 – 45) Excise on alcoholic beverages;
46) Excise on ethyl-alcohol (ethanol);
47) Excise on non-alcoholic beverages;

For excise duty concerning domestic sales self-assessment is required, but excise duty for imports will be assessed by Decision of the customs authority as a part of import procedures.

48 – 52) Law on Tax on the Use, Keeping and Carrying of Goods

48) Tax on the use of motor vehicles: shall be paid on the occasion of registration;
49) Tax on the use of mobile phones: mobile service providers i.e. salesmen of cards account, collect and effect payments to the required account;
50) Tax on the use of boats, marine facilities and yachts: shall be paid when registering boats in the required register; a competent body in charge of the registration collects and effectuates payment to the required account;
51) Tax on the use of aircraft: shall be paid when registering or extending the certificate of navigation in the register of aircraft; a competent body in charge of the registration collects and effectuates payment to the required account;
52) Tax on registered weapons: assessed by TA Decision.

53) Financial Transaction Tax Law

53) Tax on financial transactions: self-assessment.

54 – 58) Payroll Tax Law

54) Tax on payroll (salary and wage fund): withholding tax;
55) payroll Tax for income from copyrights and industrial property rights, (when a payer of income keeps books): withholding tax;
56) payroll Tax for income from copyrights and industrial property rights, (when a payer of income does not keep books): assessed by TA Decision;
57) payroll Tax for income from self-employment: assessed by TA Decision;
58) payroll Tax for income from agriculture and forestry: assessed by TA Decision.

59 – 71) Law on Non-Recurrent Tax on Extra Income and Extra Property obtained by using of special benefits

59 – 71) Non-recurrent tax on extra income and extra property, obtained by using special benefits, comprises 13 different tax-bases, assessed by TA Decision.

Table 3
Fees

Type	Allocation	**Regulation**
Administrative fees:		
– republic	Republic	**Law on Republic Administrative Fees** ("Official Gazette of the RS" 43/03, 51/03)
– regional	Region	Decision
– city	City	Decision
– municipal	Municipality	Decision
court fees	Republic	**Law on Court Fees** ("Official Gazette of the RS", number 28/94, 53/95, 16/97 and 9/02)
public utilities fees	Municipality/City	Decision
registration fees	–	–
tourist fees	Municipality/City	Decision

72 – 76) Administrative and court fees

There is no law regarding regional and municipal administrative fees, that would, according to the Law on Public Revenues and Expenditures, regulate all important issues relating to the introduction of fees (taxpayers, a list of taxable documents and actions, amounts and similar.). The Vojvodina Assembly adopts its own Decision on the level of regional fees, as well each municipality. Hence, they differ substantially between municipalities in terms of their level and basis with no obvious economic justification (Belgrade municipalities provide a good example).

That means that the concrete number of fiscal instruments regarding administrative fees cannot be determined, because there is no evidence on their type, payers and levels of certain fees. That is why administrative and court fees are numbered as fiscal instruments in the following way: 72) republic administrative fees, 73) regional administrative fees, 74) city administrative fees, 75) municipal administrative fees and 76) court fees.

The level of fees shall be determined by a body in charge of solving disputes over administrative procedure in accordance with the Law, or with the decision that introduced the fees in question. At the request of that body, the TA implements enforced collection.

77 – 92) Public utility fees

The Law on Local Self-Government determines types of administrative fees for local public utilities and it is stipulated that the Municipal Assembly will specify the fees, their levels, reductions and terms of payment.

Public utility fees that can be introduced are the following:

77) Utilization of public space or in front of business premises for business purposes, except for sale of newspapers, books and other publications, artistic and traditional craft products and handicrafts;
78) Keeping gaming equipment ("arcade games");
79) Organizing musical performances in catering facilities;
80) Using billboards;
81) Using space for parking motorized road vehicles and attachable vehicles in designed and marked places;
82) Using open areas for camps, the pitching of tents or other forms of temporary use;
83) Using river banks and shores for business and any other purposes;
84) Erecting company signs on business premises;
85) Erecting and writing company signs outside business premises on facilities and surfaces belonging to the municipality (road surface, pavements, green areas, lamp-posts and similar.);
86) Using glass cases for displaying goods outside business premises;
87) Keeping and using marine engines and other appliances used in navigation on water, except for moorings used in border river traffic;
88) Keeping and using boats and rafts on water, except for boats used by the organizations which maintain and mark channels of navigation;
89) Keeping restaurants and other catering and entertainment facilities on water;
90) Keeping motorized road vehicles and attachable vehicles, except for agricultural vehicles and machinery;
91) Keeping pets and exotic animals;
92) Occupation of public area with construction materials.

Local authorities define the procedures for administering, auditing and collecting local public utility fees in different ways. In some cases the authority's decision defines that the overall procedure, from assessment to the enforcement of collection shall be performed by the TA, and in other cases the TA implements only enforced collection at the request of the local authority.

93) Registration fees

The inclusion of registration fees within the system of public revenues creates the possibility of introducing special registration fees for specific purposes. However, the regulations concerning registration (for example of official seals, patents, models, vehicles, pedigree animals and similar), defines them in different ways- registration fees, application fees, fees. Furthermore, in most cases these regulations do not regulate issues concerning the assessment, auditing and collection

of related revenues. As a result, the TA is in charge of enforced collection at the request of a competent body.

94) Tourist fees

The Law on Local Self-Government defines the tourist fees as one of the original local public revenue, but it is not regulated who is in charge of introducing it. In practice, these types of fees are levied by the local authorities (city or municipal assembly) following a Decision and the TA is in charge of enforced collection at the request of the authority.

The following table shows a review of fees by type, revenue allocations and corresponding regulations.

Table 4
Charges

Charges for	Allocation	Law
water use	Republic	**Water Law** ("Official Gazette of the RS", 46/91, 53/93, 48/94 and 54/96)
forest use	Republic	**Forest Law** ("Official Gazette of the RS", 46/91, 83/92, 53/93, 54/93, 60/93, 67/93, 48/94 and 54/96)
road use	Republic / Municipality	**Road law** ("Official Gazette of the RS", 46/91, 52/91, 53/93, 67/93 and 42/98)
purpose change of agricultural land	Republic	**Agricultural Land Law** ("Official Gazette of the RS", 49/92, 67/93, 48/94, 46/95 and 54/96)
use and landscaping of construction land	Municipality / City	**Law on Planning and Construction** ("Official Gazette of the RS", 47/03)
use of natural medicinal resources	Municipality / City	**Law on Spas** ("Official Gazette of the RS", 80/92)
use of mining resources	Republic / Municipality	**Law on Mining** ("Official Gazette of the RS", 44/95)
use of protected natural resources	City / Municipality	**Law on Environmental Protection** ("Official Gazette of the RS" 66/91, 83/92 and 53/95)

According to the Law on Local Self-Government, part of the charges for water and forest use, as well as the charge for purpose change of agricultural land are allocated to the local self-government, but, at the moment, resources are not being allocated to it, because the laws regulating the introduction of these fees establish that all revenues go to the Republic.

95 – 100) Water Use charge

The Water Law stipulates three types of charges for water use that are defined as public revenues. Those are:

95) Water use charge;
96) Water protection charge;
97) Charge for material extracted from water courses.

Every year by Decree, the Government of Serbia defines the level of these charges; and the water management company, organized in regional centers, is in charge of assessment of payers, while the TA implements enforced collection.

The Water Law also defines three different charges as revenues of the Public Water Management Company and these are:

98) Charge for draining;
99) Charge for irrigation;
100) Charge for use of water-management facilities.

There is no legal basis for the TA to assess and collect these three types of charges, since they are not defined as public revenues. But due to the low collection rate, the Ministry of finance ordered the TA to treat these charges as a part of the Decision on assessment for taxation on income from agriculture and forestry for the year 2003. The collection rate of these charges from legal entities that received a Decision from the Public Water Management Company, is very low, so there is great pressure on the TA to start enforced collection procedures. However, to date, there is no legal basis for this.

The level of these charges is determined by the Public Water Management Company by Decision and the approval is given by the Government of the Republic of Serbia.

It is necessary to mention that water use charges are regulated not only by the Water Law, but also by other laws and regulations, so it is essential to reexamine the jurisdiction of different state authorities and institutions in this area for possible overlapping. The duty to pay a charge for the water use is defined in the following regulations:

– Decree on the level of the water use charge, charge for water protection and charge for material extracted from water courses for 2003 ("Official Gazette of the Republic of Serbia", number 2/2003) – jurisdiction: Ministry of Agriculture and Water Management,

– Decree on the level of the charge for the use of mineral resources ("Official Gazette of the Republic of Serbia", number 28/2002) – jurisdiction: Ministry of Mining and Energy – charge for underground and geothermal water,

– Draft Law on the system for environmental protection – in procedure in the National Assembly of the Republic of Serbia from May 2003 – jurisdiction: Ministry of Protection of Natural Resources and Environmental Protection – in the Article 103. The Draft law proposes a charge for use of underground water (mineral and thermal water), but it does not provide for abolition of corresponding provisions of the Law on Spas.

101- 104) Forest Use Charge

The Forest Law defines types, basis and rates (3%) for payment of following forest use charges:

101) Charge for tree felling; basis is the market value of the felled timber;
102) Charge for forest clearance; basis is the market value of felled timber;
103) Charge for forest use and forest land when used as grazing; basis is the amount of the collected charge;
104) Forest land use charge when the land is let; basis is the amount of collected rent.

The TA is in charge of the enforcement collection.

105 – 116) Road Use Charge

The Road Law defines 14 types of charges in total, while the road tax incorporated in the price of oil derivates is no longer levied, due to the method of establishing the prices of oil derivates. A list of these charges, methods of payment and revenue allocation is given in the following paragraphs.

105) The road charge for motor vehicles that use gas or other energy source; it is to be paid at registration and is allocated to the Republic Budget, as ear-marked revenue for the Road Directorate;
106) The annual charge for road motor vehicles, tractors and attached vehicles; is to be paid on the occasion of the registration, it is allocated to the Municipal Budget.

The levels of these two charges are defined by the decree on the level of charge for road motor vehicles, tractors and attached vehicles ("Official Gazette of the Republic of Serbia", number 4/93, 56/93, 84/93, 94/93, 112/93, 8/94, 21/94, 7/96, 9/96, 8/00 and 9/02). The body in charge of the registration shall assess and collect these two charges for all vehicles except for tractors. On request, the TA implements the enforced collection of these charges. By Decision, the TA assesses the road charge for owners of tractors used only in agriculture.

107) The annual charge for motor vehicles not included in the Item 106, a competent municipal/city body shall define the level of the charge; it is allocated to the Municipal/City Budget;
108) Charge for special transport;
109) Charge for erection of roadside signs;
110) Special charge for use of roads, road sections and road facilities;
111) Charge for renting of certain sections of roadside land and other land belonging to the public highway;
112) Charge for use of agricultural or other land belonging to the public road;
113) Charge for connection of an access road to the public road.

114) Charge for placement of installations on the road;
115) Charge for construction and charge for use of commercial facilities directly accessible from the public highway.

The amount of these charges shall be defined by the Republic Road Directorate.

116) Aggregate charge for vehicles with foreign registration.

The law does not define who shall set the level of this charge, it only defines that it represents revenues of the Road Directorate.

117 – 119) Land Use Charge

The Law on Agricultural Land defines that the following revenues be allocated to the Republic Budget:

117) Charge for purpose change of the agricultural land.

The law on planning and construction regulates the following charges that represent revenues for local authorities:

118) Charge for development of building land; the amount and dynamic of payment shall be defined by a contract to be stipulated between the municipality and investor, and on request, the TA implements enforced collection;
119) Charge for use of construction land; detailed criteria, amounts, method and terms of payment of this charge shall be defined by the municipality/city/city of Belgrade and the enforcement collection of this charge shall be performed according to regulations regarding the tax procedure and tax administration. In some cases, local authorities may require that the TA, in addition to enforcing collection, also implements the complete tax procedure and that means assessment and supervision of payment.

120) Charge for use of natural medicinal resources

The Law on spas requires that the level of charges be defined by the National Assembly of the Republic of Serbia; this is the only charge to be defined by the National Assembly, but as of 1992 the level has not been defined, so there is no basis for the payment, although some municipalities with spas in their territory, have decided on the level of this charge and are collecting it.

121) Charge for use of mining resources

The Mining Law introduces the charge for use of mining resources; 80% of these revenues is allocated to the Republic Budget, while the remaining 20% goes to the Municipal Budget. The law regulates that mining resources can be allocated by act of the Government of the Republic of Serbia. The company that has been given mineral resources and the Ministry sign a contract that defines in detail the conditions of on which the mineral resources may be utilized and the

terms of payment of the charge; regulations on enterprise profit tax regulate issues regarding the collection, obsoleteness, interest and supervision and, on request, the TA enforces collection.

The Government of the Republic of Serbia defines the level of the charge. The Government issued a decree on the level of the charge for the use of mineral resources ("Official Gazette of the Republic of Serbia", number 28/2002). Use of resources is for specified purposes – used according to the program aimed at preventing and eliminating the harmful consequences of the exploitation of the mineral resources.

However, since the Mining Law has not replaced the Law on Payment and allocation of resources of the charge for the use of goods of common interest in the production of electric power and in oil and gas production ("Official Gazette of the Republic of Serbia", number 16/90), taxpayers used to pay and probably still pay the charge according to that law, although it is in opposition to the Law on Mining and the Law on Public Revenues and Expenditures, because, according to that law 100% of the charge goes to the municipal budget.

According to the decree on the level of the water use charge, water protection charge and charge for material extracted from water courses for the year 2003, the charge is paid for extracted sand and gravel (Article 9), but according to the decree on the amount of the charge for use of mineral resources, the charge for sand and gravel is paid within the charge for construction material (Article 2), i.e. two charges are paid for the same base.

122 – 126) Charge for use of protected natural resources

By provisions of the Law on the Environmental Protection, it is required that for the use of protected natural resources, a company, other legal entities and citizens (users) shall pay a charge to a company i.e. institution that manages protected natural resources.

The charge for the use of protected natural resources shall be paid for:

122) the use of natural resources;
123) the use of protected natural resources for tourism, trade, filming, etc.;
124) the use of specially developed or suitable areas for certain purposes (parking places, recreation, sports, camp fires, billboards, etc.);
125) the use of name and symbol of protected natural resources;
126) the use of services of companies and organizations managing protected natural resources.

The level and modality of the charge shall be determined by the company or organization in charge of managing of protected natural resources. Furthermore, towns and municipalities may introduce charges aimed at environmental protection and promotion that will be used for environmental protection and promotion.

On request, the TA implements the enforcement collection.

127) Self-imposed local tax

The self-imposed local tax is introduced by Decision of the Municipal Assembly based on a referendum and for defined specific purposes (construction of roads, water supply system, schools, etc.). The tax basis and rates are defined by Decision of the Municipal Assembly. The tax basis can be one of the existing tax bases, but also pensions or this tax could be paid by contributions in kind. Rates are different from case to case. The TA is in charge of the collection. When the tax base for self-imposed local tax is the same as one of the tax basis defined by tax laws, the TA assesses the payment obligation by its Decision (tax on cadastral income, tax on immovable property, tax on income from professional services). In case salaries or another withholding tax are taken to be the tax base, the TA can determine indebtedness only through field audit.

ANALYSIS OF FISCAL SYSTEM EFFECTS

The main conclusion from the previous summary is that, except in case of taxes and partially in case of fees, where basis, rates and taxpayers are defined by the tax laws, the way of regulating the fiscal instruments belonging to other categories of public revenues is very untransparent. Taxpayers, basis, rates i.e. amount of fiscal burden are defined by non-tax laws, government decrees, decisions made by the board of a public enterprise or decisions made by Municipal Assembly.

It is necessary to take into consideration that 127 fiscal instruments that are defined do not include all the list of specific fiscal forms administrated by the TA. Besides contributions for mandatory social insurance with 35 different insurance basis, in the category of fees, municipal charges and self – imposed local taxes, there are numerous taxation forms that differ according to the taxpayer, basis and rates although in principle they represent one fiscal instrument. It is clear that due to this fact, administering and collection are rendered very difficult while it is almost impossible to calculate the average and effective fiscal burden of taxpayers.

The revenue effect of the implementation of the existing fiscal instruments, managing modality and number of taxpayers are shown in the table 5. Given the fact that the sales tax will be substituted by the value added tax, this fiscal instrument will not be separately considered.

Indirect taxes, including custom duties and other custom charges represent the most abundant revenue of the public finance with its participation of 44.6% in total revenues. If we look at them singularly revenues stemming from contributions for mandatory social insurance are relatively the highest: 28.3%. That means that revenues from contributions are higher than the sum of revenues of all direct taxes amounting to 27.1% of all public revenues.

Simultaneously, out of 41 types of public revenue, 24 participate with less than 1% in total tax revenues. Among them there are also two with the greatest number of taxpayers: tax on income from agricultural activity (1,345,850 taxpayers) and tax on immovable property (2,467,591 taxpayers). Tax on income from agricultural activity participates with only 0.02% in total revenues and provides annually 54 dinars per taxpayer. Net revenue from this tax is clearly negative considering the fact that direct and indirect administrative costs for this tax are surely higher than 54 dinars per taxpayer. Revenues from tax on immovable property represent 0.9% of total revenues and annually contribute 1,523 dinars per taxpayer. Supposing that the maximum tax credit (70% of reduced tax obligation) and the lowest tax rate (0.4%) are applied for each taxpayer, the total value of properties of taxpayers in Serbia would amount to 16 billion dinars, or 6,471 per taxpayer. The tax basis is obviously substantially underestimated.

Revenues stemming from the excise on heating oil, other oil derivates (jet fuel and air fuel, motor oil and lubricants, liquid petroleum gas and paraffin oil), ethanol, coffee and non-alcoholic drinks together make up 0.9% of total revenues. Expenses for collection of those revenues are higher at the Customs than in the Tax Administration, considering the fact that except for non-alcoholic drinks and oil derivates, other products are not produced in the country. Furthermore, excise products are defined in a way that does not correspond to custom tariff numbers and this fact additionally renders the procedure more difficult and increases administrative costs. In addition to the obvious inefficiency of these fiscal instruments, another reason for their abolition is the need to harmonize the comprehensive tax policy and therefore also excise policy in Serbia with standards of the European Union, where only oil derivates, tobacco products and alcohol are defined as excise products.

Enterprise profit tax contributes 1.1% to total public revenues. Regardless of the relatively low tax rate and large extent of tax exemptions connected with investments, this fact indicates above all the inefficiency of the economy, but also the method of formation of annual financial statements. The method of assessment by TA Decision which is based on very unreliable data from tax balance sheets that the TA has never systematically audited, and has never had adequate professional capacities to audit, has additionally decreased the fiscal importance of this very significant fiscal instrument. The fact that after reduction of the tax rate in 2002, revenue from this tax increased by 78% in 2003, and even the number of taxpayers who paid the tax increased by more than a thousand, indicates the significant sensibility of the tax base to the tax rates. All that needs to be done with this fiscal instrument is for some forms of tax relief to be clarified to make it impossible for the TA the approve relief at its own discretion and then to move to self-assessment. In the long-term, the system of tax relief and exemptions should be reviewed and emphasis placed on profit tax which would be predominantly neutral in character. Above all, special attention must be

Table 5
Scope and Structure of Public Revenues in 2002 and Number of Taxpayers

Mil. din.	Revenues	Structures			Assessment of obligations[1)]	Number of taxpayers	Revenue per taxpayer	Index nivoa	
Total	**407,461,432**	**100.0**							
Indirect taxes	**181,881,184**	**44.6**	**100.0**				**22,249.4**		**100.0**
Sales tax	**111,095,646**	**27.3**	**61.1**	**100.0**			**508.4**	**100.0**	
Sales tax on goods	75,588,057	18.6	41.6	68.0	S	117,080	645.6	127.0	2.9
Sales tax on services	35,507,589	8.7	19.5	32.0	S	95,650	371.2	73.0	1.7
Excise	**46,073,546**	**11.3**	**25.3**	**100.0**			**43,990.3**	**10**	**0.0**
Oil derivatives	32,748,459	8.0	18.0	71.1	S/R				
– motor gasoline	18,346,101	4.5	10.1	39.8	S/R	107	171,458.9	389.8	770.6
– diesel	12,463,316	3.1	6.9	27.1	S/R	88	141,628.6	322.0	636.6
– heating oil	630,498	0.2	0.3	1.4	S/R	83	7,596.4	17.3	34.1
– other oil derivates	1,308,544	0.3	0.7	2.8	S/R	107	12,229.4	27.8	55.0
Tobacco products	7,639,754	1.9	4.2	16.6	S/R	86	88,834.3	201.9	399.3
Alcohol beverages	4,144,719	1.0	2.3	9.0	S/R	309	13,413.3	30.5	60.3
Ethanol	207,081	0.1	0.1	0.4	S/R	86	2,407.9	5.5	10.8
Coffee	557,001	0.1	0.3	1.2	S/R	0.0			
Salt	23,292	0.0	0.0	0.1	S/R	80	291.2	0.7	1.3
Luxury goods	50,370	0.0	0.0	0.1	S/R	590	85.4	0.2	0.4
Non-alcoholic drinks	702,870	0.2	0.4	1.5	S/R	359	1,957.9	4.5	8.8
Duties and import taxes	**24,711,992**	6.1	13.6		R				

Mil. din.	Revenues	Structures			Assessment of obligations[1)]	Number of taxpayers	Revenue per taxpayer	Index nivoa	
DIRECT TAXES	**110,400,659**	**27.1**	**100.0**				**190.2**		**100.0**
Profit tax	**4,447,110**	**1.1**	**4.0**		R	95,659	**46.5**		**24.4**
Individual income tax	**53,187,011**	**13.1**	**48.2**	**100.0**			**110.9**	**100.0**	**58.3**
Tax on salaries and wages	46,637,429	11.4	42.2	87.7	O	113,409	411.2	370.9	216.2
From agricultural activities	72,560	0.0	0.1	0.1	R	1,345,850	0.1	0.0	0.0
From professional services	2,150,639	0.5	1.9	4.0	R	171,025	12.6	11.3	6.6
From royalty	622,081	0.2	0.6	1.2	R	4,811	129.3	116.6	68.0
Dividends and interests	525,656	0.1	0.5	1.0	R				0.0
Rent of immovable property	259,285	0.1	0.2	0.5	O/R	12,148	21.3	19.3	11.2
Capital gain	33,119	0.0	0.0	0.1	R	2,158	15.3	13.8	8.1
Rent of movable property	23,775	0.0	0.0	0.0	O/R	2,976	8.0	7.2	4.2
Individual gains from games of chance	37,487	0.0	0.0	0.1	O	91	411.9	371.6	216.6
Annual individual income tax	91,451	0.0	0.1	0.2	R	8,266	11.1	10.0	5.8
Other incomes	2,733,529	0.7	2.5	5.1	O/R	31,140	87.8	79.2	46.1
Property tax	**12,519,335**	**3.1**	**11.3**	**100.0**			**9.2**	**100.0**	**4.8**
Tax on immovable property	3,757,052	0.9	3.4	30.0	R	2,467,591	1.5	16.5	0.8
Tax on inheritance and gifts	219,572	0.1	0.2	1.8	R	36,120	6.1	66.0	3.2
Tax on transfer of absolute rights	4,996,736	1.2	4.5	39.9	R	249,262	20.0	217.5	10.5
Tax on use and keeping of goods	3,545,975	0.9	3.2	28.3	R	574,257	6.2	67.0	3.2

Mil. din.	Revenues	Structures			Assessment of obligations[1)]	Number of taxpayers	Revenue per taxpayer	Index nivoa	
Payroll tax	**11,488,593**	**2.8**	**10.4**		O	**112,441**	**102.2**		**53.7**
Tax on financial transactions	**10,126,758**	**2.5**	**9.2**	**80.9**	S	**193,700**	**52.3**		**27.5**
Fees	**9,990,119**	**2.5**	**9.0**	**100.0**					
Administrative fees	4,939,120	1.2	4.5	49.4					
Municipal fees	2,805,892	0.7	2.5	28.1	R	**152,344**	**18.4**		**9.7**
Court fees	2,243,616	0.6	2.0	22.5					
Other fees	1,491	0.0	0.0	0.0					
Charges for use of goods	**8,014,836**	**2.0**	**7.3**		R				
Self-imposed contribution and solidarity resources	**626,897**	**0.2**	**0.6**		R/O				
Contributions for social insurance	**115,179,589**	**28.3**	100.0			**116,091**	**992.1**		**521.6**
For pension and disability insurance	69,809,481	17.1	60.6		O	117,198	595.7		**313.1**
Health insurance	41,535,205	10.2	36.1		O	116,520	356.5		**187.4**
Insurance in case of unemployment	3,834,903	0.9	3.3		O	114,555	33.5		**17.6**

Source: Ministry of Finance and Tax Administration

1) R- decision; O withholding tax, S – self-assessment

paid to advance training in the TA office and among the field workers monitoring this tax.

Concerning ***individual income tax,*** except for the tax on salaries and wages, all other fiscal instruments individually account for less than 1% of total fiscal revenues.

Income from business and professional services and agricultural activities are essentially in the system of taxation of individual income due to the legal status of the taxpayers: they are physical persons.

In case of business income and professional services, the tax basis is essentially equivalent to business profit, so the taxation of this revenue should be excluded from the system of taxation of individual income. The fact that it is related to small economic entities does not mean that in the tax system they should be placed on the same level as individuals. Such a tax status of self-employment and professional services basically represents a hangover from the socialist past, when this form of economic activity was insignificant and socially "undesirable" There is now an additional anomaly due to the fact that "socialist" rules have been abandoned, but the same tax treatment of these activities is maintained. For the volume of activities and their potential fiscal capacities, so-called self-employment and professional services, are often, by local standards, big businesses. Therefore, different tax treatment of these activities must be preceded by different regulation of their status (method and conditions of establishment).

Revenues from the *tax on income from agricultural* activity are insignificant above all because for decades cadastral revenues were underestimated as a taxation basis. This practice is another inheritance from the past, when this numerically strong group of taxpayers was given preferential treatment for political reasons. As a result, farmers pay very little tax, which is unfair in respect to other taxpayers and inhibits structural change in agriculture. In the short term there is a need to re-evaluate cadastre income that has not changed for decades and has become extremely low due to inflation. In the long term there is a need to 1) update the database on cadastre income (owners, and land holdings), because the existing one is very outdated, and 2) solve the problem of taxation of land/households engaged in intensive agricultural production that brings significantly higher income than usual and than that indicated by cadastre income. Radical reform supposes the creation of options for agricultural income taxation through synthetic taxation of individual income and through enterprise profit taxation, possibly with respect for certain specific characteristics of agriculture and depending on level of sales and the size of holdings.

The fragmentation of fiscal instruments relevant to the taxation of income is a result of the legislator's desire to shift the tax burden onto certain sources of income. If the amount of effective tax rates is analyzed, however, the goal of this policy is not completely clear.

There are significant problems concerning the taxation of income from capital (dividends, interest and capital gain), where there are conceptual issues, weaknesses of existing solutions and issues relating to

economic policy (encouraging of savings and discouraging of borrowing, etc).

Concerning the *tax on income from dividends*, the main problem concerns double taxation: the first based on the enterprise profit tax, and second on this tax, but without any additional economic activities. Double taxation has negative economic consequences, discouraging investment and encouraging indebtedness of companies (regarding the profit tax, interest payments are tax deductible), reallocation of dividends into unallocated profit, even when there is no need for this, additional taxation of the corporate sector and similar. Our taxation system has, however, partially taken into consideration the issue of double taxation, so only 50% of income from dividends are considered taxable. But, if we start from the supposition that the aim of lower effective rates on dividends (20% by law, 10% effective) was to avoid an increased tax burden due to the double taxation (once as enterprise profit, and secondly as individual income), we can conclude that it was unsuccessful. Calculation of all tax burdens, 14% for the profit tax and 10% for the effective tax on dividends as income, results in a tax rate of 22.6%. This rate is higher than the effective tax rate on income from interest on loans, deposits and bonds that amount to 20%. Bearing in mind that possession of shares is taxed by property tax, it is clear that the tax system wholly discourages this type of investment. Considering that Serbian economy is in transition, the tax policy regarding dividends should be the opposite. In addition, the amount of tax obligation for this inefficient fiscal instrument, from the point of view of economic policy and revenues, is determined in the administratively most expensive way – by TA Decision – when there is no relevant information for exact definition of obligation. Particular taxation of this revenue should be abolished and income should be included in the basis for taxation of annual individual income, on the principle of self-assessment.

A similar problem exists with *taxation of capital gains*: firstly, even here there is double taxation concerning shares, and that means additional and useless taxation of capital or rather income from capital, which has a negative impact on investment and economic growth. Secondly, the problem is also an asymmetric treatment of capital gains and losses: capital gains are subject to taxation while capital losses may be compensated for with capital gains only in special situations. This is not only unfair, but also discourages taking of risks. Thirdly, the tax on capital gains discourages circulation of capital because it is collected only on the sale of properties which results in the following; 1) encouraging maintenance of irrational resource allocation and 2) a decrease in revenues from this tax. Fourthly, possible abolition of the tax on dividends brings with it the abolition of the tax on capital gains (at least for capital gains from shares) because dividends and capital gains are two standard and equal forms of realization of enterprise profit by owners, so their tax differentiation should not even be considered. Considering the fact that most of the countries in the world (Germany,

Belgium, the Netherlands, Singapore and Hong Kong) do not tax capital gains from individuals, the tax on capital gains in Serbia should be abolished, at least those stemming from the capital invested in the economy.

Given the lack of confidence in savings, in banks and through the legal financial market in general, (loans, bonds), which is the natural consequence of the recent monetary and financial collapse, the shortage of capital for investment and the fact that the negative effective interest rate is regularly taxable (difference between higher inflation and lower nominal interest rate), i.e. that tax is paid on loss of assets; and, fourthly, administrative costs for fiscal instruments that bring very small revenues (the amount of obligation is defined by Decision), it is not clear why the *tax on interest* has special tax treatment with the same tax rate as the tax on individual gains from games of chance (20%). Therefore the taxation of this income should be abolished, and the income according to the principle of self-assessment should be included in the basis for annual individual income.

Industry of games of chance represents an example of the economic activity deserving special tax treatment for both organizers and winners, but within a comprehensive regulation of this activity. Therefore taxation of gains from games of chance at source should be separated from the taxation system of individual income and considered separately within a law that would regulate this industry comprehensively.

From the economic point of view, it is not clear why the actual tax rate on income from rents amounts to 16%, while capital gains are taxed according to an actual rate that goes from 0% to 20% depending on re-investments. From the administrative point of view, a separate procedure of defining obligations for these two fiscal instruments has its own reasons. Because of normative expenses in case of rents, and in case of the capital gains due to automatic defining of basis for the tax on immovable property, where for citizens this form of income almost exclusively appears.

Regarding the taxation on royalty income and rights on industrial properties, that constitutes 0.2% of total revenue, there are 18 different tax basis listed in the law that, from the point of view of the actual tax rate may be grouped into 6 categories with different tax treatments. Concerning this segment, it is very interesting solution of the lump sum taxation of musical performances where the Minister of Finance himself defines the coefficient for determination of the lump sum amount. If we add to this another two effective tax rates that we have within taxation of other incomes and that constitute 0.7%, of overall revenue, it is clear that the overall system of taxation of individual income is inefficient from the point of view of revenues and administration.

Special attention, as to a fiscal instrument, should be paid to *annual individual income tax*. Its insignificance in the total tax revenues amounting to 0.02% is the result of the poor administrative possibilities of the TA to identify the tax basis. Modest administrative possibilities are the consequence of the lack of legally defined procedures

concerning reporting to the TA on the potential tax basis. The Law on Tax Procedure and Tax Administration defines however, that all disbursers of income are obliged annually to report to the TA on all disbursements in the previous year for all individuals regardless of the disbursement basis. With simultaneous prescribing of mandatory annual self-assessment of income, regardless of the source of income and whether it exceeds the tax census, for each citizen who has income, a relevant database would be created in the TA. It would create significant incentive to citizens for their self-assessment and payment of this tax. Furthermore, the existing tax rate should not be increased in order not to provoke the opposite effect.

Simultaneously, all proposed modifications within the system of taxation on individual income would represent a step in the establishment and implementation of procedures of self-assessment and payment of the global tax on individual income, which is the system that all developed countries implement and that will be introduced in Serbia in the future.

The tax on property rights on shares should be excluded from property taxes. Besides previously mentioned reasons why taxation of these properties should be abolished, there is also another one. From administrative reasons and due to the lack of adequate registry of securities, only possession of personal shares is taxed. That means that there is discriminatory tax treatment of different forms of shares exclusively due to the administrative weaknesses, and there are neither fiscal nor economic reasons for that.

Tax on use, keeping and carrying of goods may be interpreted as the legislator's attempt to separately and additionally impose taxes on richer individuals, in the absence of a database and a way to efficiently and progressively tax individual income, and through chosen indicators (proxies). The first problem with this tax is the difficulty to accept such a method of estimation of the tax basis. The second problem is the choice of goods whose use or keeping is to be taxed. It is true that vehicles, mobile phones, boats, yachts, as well as partially weapons are generally possessed and used by relatively richer citizens in Serbia. However, if we exclude vehicles and mobile phones, their number is insignificant and their share in total revenue amounts to 0.9%. For these reasons, if not completely abolished, some of those completely inefficient fiscal instruments that this tax creates should be eliminated.

Payroll tax cannot be considered as a separate fiscal instrument in relation to the tax on salaries and wages because the subject to this taxation is the same basis – gross wages of employees. Separation of this tax was made with the aim to create separate source of revenue for local communities with a significant basis. From the point of view of the tax system the way this was performed has two major weaknesses. Firstly, even in the case of wages, the principle of the equal tax rate on individual income and on profit has not been respected because the tax rate on salaries and wages amounts to 17.5% and not 14% which is the tax rate for profit. Secondly, from the administrative point of view, it has been

additionally complicated because, on the same basis, two types of taxes and three types of contributions are calculated, separately declared and disbursed. Thirdly, this tax burden puts a further strain on wages and salaries which increases the price of labor and encourages its transferal to the gray economy.

This tax additionally increases the already high tax on labor costs as production input. The total tax rate (with contributions) according to the gross principle, amounts to 51.1%, which is 77.2% net. In other words, that means that employers for every ten dinars paid to employees have to pay additional 7.72 dinars in expenses. In conditions where labor is a relatively abundant production resource, i.e. there is a surplus supply, the labor market is in its initial phase of regulation, there is significant surplus of formally employed people in enterprises that are presently in one of the phases of production, organizational and financial transformation, there is a great tendency for employers and employees to avoid formal employment. Besides all the negative consequences of illegal employment, it also directly affects reductions of the contribution basis for mandatory social insurance, and this fact puts additional pressure on budget expenditures.

Continuation of traditional response of decision makers – to increase the contributions rate, will mean establishment of a spiral – greater burden – greater escape to the gray economy – lower basis – higher rates etc. This problem cannot be solved through increase of administrative efforts to collect or sanction illegal employment alone, but through parallel reduction of the overall tax burden on labor input. At the same time this would decrease economic gain from evasion of tax and contributions and increase the costs of evasions. Elimination of the tax on salaries and wages would simplify the payment system and in that way also its auditing, thus additionally reducing costs to taxpayers and the tax administration.

Simultaneously with the elimination of this tax, the law should define a fixed percentage which will accrue to the local authorities from the already existing tax on salaries and wages, defined as direct revenue. In this way, in addition to the new sources of revenue for local self-government arising from the adoption of value added tax, this important tax revenue would become a direct revenue of the local self-government. This modification is politically important because it represents a precondition for ensuring political support for changes that the introduction of value added tax will cause for local government finance.

Tax on financial transactions is a completely unusual fiscal instrument. It has been inherited from the time when total payment operations were done through the Accounting and Payment Authority, so it represented a revenue-efficient fiscal instrument because the basis was easily measurable and collection was automatic. Its economic effect was, however, poor in different ways. Firstly, rental price of an already scarce and expensive input – capital is increased. Secondly, it discourages performance of financial transactions within the legal framework

in a situation where business operations in cash and outside the legal payment system already represent a huge problem. Thirdly, the money turnover is slowed, and expenses are transferred very quickly to the overall legal economy. This tax is expected to yield less than one third of the revenues it did in 2002 (around 3.1 billion dinars) because its rates were significantly decreased by the legal amendments of 2002 and during 2003 numerous exceptions were defined. In this way this instrument has become revenue and fiscally inefficient and complicated to administer (due to numerous exceptions, that the banks, for obvious reasons, do not want to take upon themselves and therefore there is no doubt that it should be abolished.

Administrative and court fees represent a price that taxpayers pay for public services. This field should be regulated as part of local administrative fees (regions and municipalities) with definitions of who is liable to pay the tax at what rate and for what documents and services. At the moment there is considerable variation in this field, and the level of the fees for the same service varies from municipality to municipality without visible economic reason (The municipalities of Belgrade are good examples of this).

Charges as a group of fiscal instruments are the least transparent and the most difficult to administer. The main reason for this is that charges, usually defined in non-taxation laws, are intended to raise revenue from the exploitation of a public resource and simultaneously to provide ear-marked funding for the production of that resource or for a connected public resource. The whole system basically represents an inheritance from the socialist period when those revenues were managed by so-called self-managed units. Modification of this system demands fundamental reform of all regulations within this very diverse field. For example, charges for use of construction land may be directly integrated into property taxation, while the upkeep of dikes as common public good, must be provided for from general tax revenues, and not from special purpose charges for water use. This includes also the regulation of how natural resources are exploited (sources of mineral water, forests, mining resources, and the energetic potential of watercourses). Therefore this issue is far more than purely fiscal. The way this is regulated at the moment is a direct impediment to the fiscal system and represents not inconsiderable expenses for taxpayers and the tax administration. At the same time, moreover, it does not provide sufficient resources for the planned purposes.

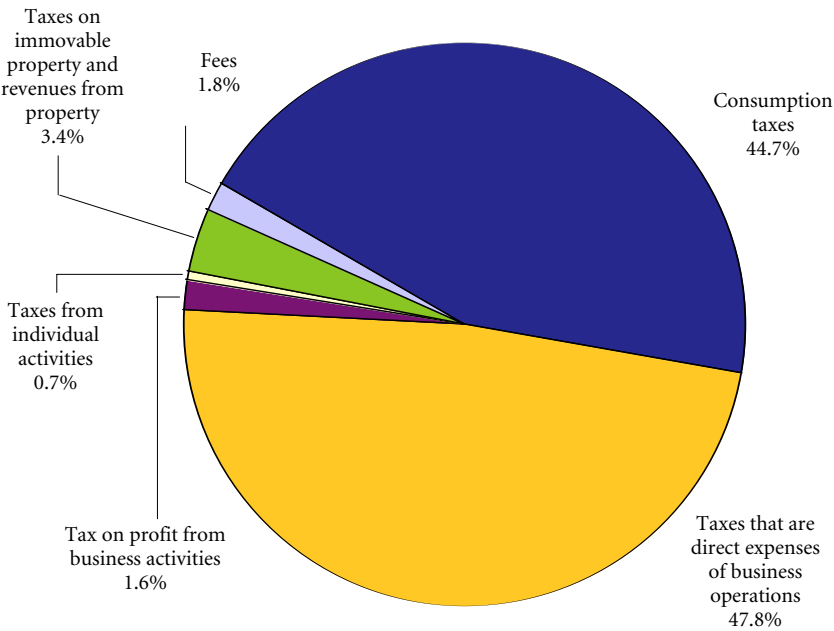
When tax revenues are grouped according to the taxation source, as it is done in table 6, we get a clearer picture of their inadequacy for the development of the goals of the market economy on the one side, and very weak relation between the burden placed on taxpayers and their economic strength on the other. Within the structure of tax revenues thus defined, 49.5% of the basis has some connection with, or is the result of the business activity of economic entities. Within this only 3.3% is tax on the net result of commercial activity (profit, net income from self employment) and 96.7% constitute direct business costs.

Table 6
Structure of Tax Revenues by the Type of Taxation

	Revenue	Structure	
Total	**407,461,432**	**100.0**	
Consumption tax	**181,881,184**	**44.6**	**100.0**
Sales tax	111,095,646	27.3	61.1
Excise	46,073,546	11.3	25.3
Customs duties	24,711,992	6.1	13.6
Tax from business activities	**201,550,303**	**49.5**	**100.0**
Tax on profit from business activities	6,670,309	1.6	3.3
Profit tax	4,447,110	1.1	2.2
Professional services	2,150,639	0.5	1.1
Agricultural activities	72,560	0.0	0.0
Taxes that are direct expenditures of business operations	194,879,994	47.89	6.7
Tax on financial transactions	10,126,758	2.5	5.0
Municipal fee and self-imposed local tax	3,432,789	0.8	1.7
Charges for use of goods	8,014,836	2.0	4.0
Labor costs	173,305,611	42.5	86.0
Tax on salaries and wages	46,637,429	11.4	23.1
Payroll tax	11,488,593	2.8	5.7
Contribution for pension and disability insurance	69,809,481	17.1	34.6
Contribution for health insurance	41,535,205	10.2	20.6
Contribution in case of unemployment	3,834,903	0.9	1.9
Tax on individual activities	**2,862,467**	**0.7**	**100.0**
Annual individual income tax	91,451	0.0	3.2
Tax on other income	2,771,016	0.7	96.8
Property taxes and revenues from property	**13,983,251**	**3.4**	**100.0**
Tax on immovable properties	3,757,052	0.9	26.9
Tax on inheritance and gifts	219,572	0.1	1.6
Tax on transfer of absolute rights	4,996,736	1.2	35.7
Tax on use and keeping of goods	3,545,975	0.9	25.4
Royalties	622,081	0.2	4.4
Dividends and interests	525,656	0.1	3.8
Rent of immovable property	259,285	0.1	1.9
Capital gain	33,119	0.0	0.2
Rent of movable property	23,775	0.0	0.2
Fees	**7,184,227**	**1.8**	**100,0**
Administrative fee	4,940,611	1.2	68.8
Court fees	2,243,616	0.6	31.2

The relative proportions, shown in Chart 1, speak for themselves and there is no need to separately explain their economic implications. It is clear that the result of implementation of existing fiscal instruments places a significant burden on production inputs and that the overall tax burden on individuals is not proportional to their wealth.

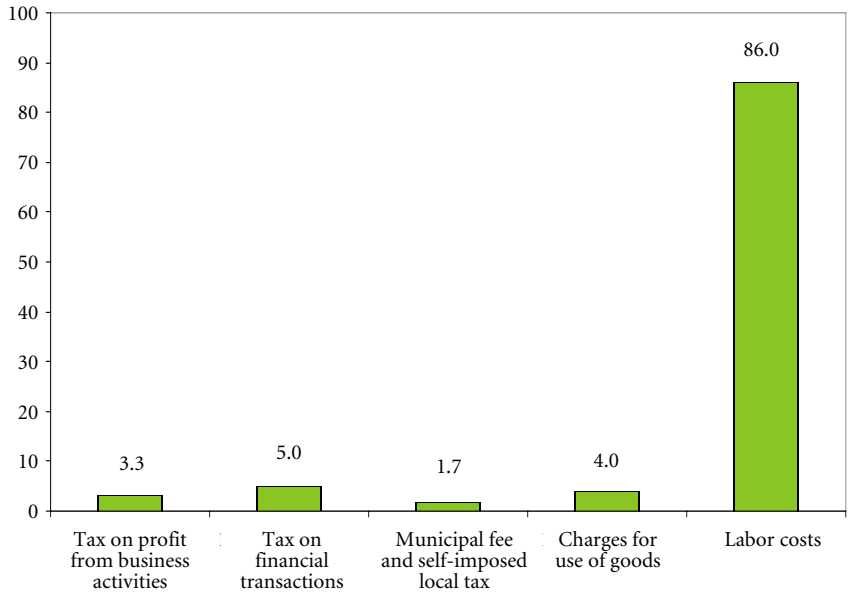
Chart 1
Structure of Tax Revenues by Sources



As can be seen in Chart 2, in the tax structure representing direct expenses of business operations, labor costs are dominant with 86,0%, while the charges for use of goods are more significant than the tax on net business results.

When observing the fiscal system exclusively from the administrative point of view, its cost inefficiency is immediately noticeable. In good part, it is a result of either inadequate or inconsistent legal regulations. Defined by method of collection, the dominant fiscal instruments are those with the most expensive administrative procedure. Out of thirty-five main tax instruments, twenty of them define the level of obligation by Decision, while for thirteen of them it is tax deducted at source, but in only three cases (sales tax, excises and tax on financial transactions) self-assessment is required. The TA, however, lacks quality data on which to define accurately the level of tax obligation due to

Chart 2
Structure of Tax Revenues from Business Activities



the poorly maintained system of accounting and an underdeveloped information system. As a result, the accuracy of the determined obligations is almost equally unreliable whether it is defined by Decision or by self-assessment.

One particularly acute problem which hinders efficient administration and the introduction of vigilant tax accounting for all fiscal instruments and all tax payers, whether they are regestered economic entities or individuals, is the way in which public revenues are to be paid with the transfere of payment operations from the ZOP (Bureau for Clearings and Payments), to the banks. With the intention of imposing GFS classification on the system of public revenue, which basically has no connection with the account into which the public revenue should be paid, an extremely complex process by which to identify the type of public revenue and the local authority to which the revenue should be payed is defined. Practically every fiscal instrument has its own payment account, and taxpayers are obliged to administer analytical data on public revenues uselessly, which should be the obligation of the state, and not of taxpayers.

One of weaknesses of the existing system is that neither the TA nor individuals, in case when taxpayers pay some tax obligation, and are not separately registered by the Tax Administration, have a possibility automatically to check the payment. On the one hand this disables

automatic office control of payment regularity, and on the other hand, renders more difficult possibility of checking by taxpayers. Additionally, even when taxpayers are specially registered in the Tax Administration, it is connected to particular tax instrument and particular municipality. In other words, it is an old system of registering of taxpayers that is not integrated or centralized in the tax administration, as was the case with the registration of economic entities through the tax identification number (PIB) that is unique for each taxpayer. The Rule book on the registration has already defined that the citizen's PIB is their personal identification number, but it is not significant from the point of view of the identification of payments, because in the existing payment order there is no possibility to enter it.

Therefore, one of the necessary steps to be taken, is the modification of the existing form and content of the payment order, so that it contains all necessary data for the identification of who is paying and what is paid and, simultaneously to be user friendly and simple for information processing, for taxpayers, banks, the TA and Public Payments Authority.

PROPOSALS FOR MODIFICATIONS

This chapter contains a summery review of the modifications, called for in the previous analysis, which should be undertaken.

This is the group of fiscal instruments that should be reviewed:

- Excise on oil derivates and alcohol – review of excise amount and harmonization of the way the excise is calculated for alcohol with the standards of the European Union.
- Tax on income from agriculture – review of the amount of the existing tax basis, considering of possible tax basis and defining method for obligations; this issue also requires a different treatment of taxpayers in a legal and economic sense.
- Individual income tax – equalization of basis and homogenization of effective tax rates regardless of methods and sources of income acquiring, review of amount and need of existence of standardized expenditure in each single fiscal instrument where it appears, introduction of mandatory self-registration of annual income, regardless its amount, so calculation of the tax obligation on annual income.
- Tax on income from professional service – separation from the system of the individual income taxation and designing of tax forms in accordance with principles of profit taxation, which represents economic essence of this basis as well as of this activity.
- Profit tax – review and detailed definition of conditions for use of certain tax facilities and introduction of the principle of self-assessment.
- Tax on individual gains from games of chance – separation of taxation of this income at source from the system of individual

income taxes and its special treatment within a law that would regulate this activity.
- Property tax – harmonization with treatment of property transactions within value added tax, review of basis for taxation of immovable property.
- Local administrative fees – defining of taxpayers, documents and actions that are subject to this tax and determining of tariff range.
- Charges – comprehensive reform of the existing regulatory system for payment of use of certain public resources, separation of the regulation of use of a public resource and the method of defining a charge for use of that resource from the financing of general public works that, instead of being financed from the earmarked funds should be financed from general tax revenues i.e. from the budget of the Republic or local communities (depending on jurisdiction division according to the new Constitution).

Fiscal instruments whose elimination is suggested:
- special excise on heating oil – equalization of the excise burden of this oil derivate with diesel;
- excise on motor oil and lubricants, liquid petroleum gas and paraffin oil, ethanol, coffee, and non-alcoholic drinks;
- taxation of shares as property;
- by Decision taxation on income from shares and interest as a special form of taxation of individual income and its inclusion in taxation through annual individual income tax;
- payroll tax;
- tax on financial transactions;
- tax on use, keeping and carrying of goods,
- non-recurrent tax on extra income and extra property – taking into consideration on the one hand aims of the introduction of this tax – non-recurrent taxation of physical persons and legal entities that achieved profit through privileged position during the previous regime, and on the other hand, need for the establishment of permanent institutions and tax instruments as well as their consistent implementation, such type of taxation should cease to exist in the future.

Revenues achieved through the implementation of the fiscal instruments whose elimination is proposed here, represent 7.0% of total revenues in 2002, or 28.5 billion dinars. Their fiscal importance in 2003 is significantly lower, primarily due to the reduction of the tax rate on financial transactions that in 2002 brought 10.1 billion dinars, while its revenues for 2003 are estimated to 3.1 billion dinars. The payroll tax achieved in 2002 the amount of 11.5 billion dinars, while 13 billions are expected in 2003. As the Republic budget and budgets of local governments have also expenditures on the basis of this tax, for salary and wages of employees in the state administration, the net effect of abolishing of this tax is estimated at around 10 billion dinars. At the same time, from widening the basis for value added tax, by including turnover of part of products that were in the regime of sales tax,

unconditionally released into the taxation basis, an increase for nearly the same amount is expected. Abolition of other fiscal instruments is less important from the revenue point of view (6.1 billion dinars, or 1.5%), and along with revenues from the tax on financial transactions may be compensated by insignificant increase of the excise on oil derivates and alcohol. Additionally, one should take into consideration the positive revenue effects on the reduction of the gray economy, which is a consequence of the introduction of value added tax and of other proposed changes, including also revenue increase from the excise on heating oil (modification of the excise on heating oil by the existing excise on diesel).

From the administrative point of view, the efficiency of different methods for determining tax obligations, may be evaluated according to two basic criteria: firstly, the accuracy with which the amount of the tax obligation is determined, and secondly, the scale of the administrative costs which include the procedural costs for determining the amount of tax, registering of the obligation into tax accounts, and monitoring of the accuracy of the amount of the tax charged and of timely payment. It is clear that, regardless of how the amount of tax to be paid is determined, either, by decision or by self-assessment, these two elements, accuracy and costs, are in positive coloration i.e. as accuracy increases, so do costs, and vise versa.

With the obligation to determine by Decision, increases in the accuracy level require higher costs of collection of data concerning the tax basis of each taxpayer and increases in costs of monitoring of taxpayers, while it does not change costs for production of Decision and the obligation of registering in the tax accounts per taxpayer. As for the self-assessment, it implies that each taxpayer calculates his own obligation; there are no costs for defining of the obligation amount, but only costs for registering and monitoring. Therefore the increase in accuracy level causes increases only in the costs of monitoring, so the method of self- registration is significantly more efficient from the point of view of expenses. At the same time, by transferring the responsibility for accuracy for tax obligation from the TA to taxpayers, implementation of the self registration method provides also two positive indirect effects. Firstly, there are fewer possibilities for tax officers to be bribed. Secondly, false registration of the obligation is directly connected with the intention of tax evasion, which is more strictly sanctioned than "simple" late or complete non-payment of by Decision defined tax. The first one belongs to criminal procedure, while the second one is an administrative procedure.

However, this does not mean that the self registration method may be applied to all tax instruments. If the method of calculation of the basis and obligation is too complex for taxpayers, and if it is not possible to establish strong and not simply repressive incentives for self assessment, the tax defined by Decision has advantages over the self-registration method.

Table 7
Review of laws and laws sections that should be changed or adopted

Law	Modification	Deadline	Purpose
TAX LAWS			
Law on Public Revenues and Expenditure	Adoption	IV quarter 2003 IV quarter 2004	First stage: Adjustment to introduction of value added tax: fix percentage of participation in the tax on salaries and wages as a direct revenue for local government. Defining of types of fiscal instrument, jurisdictions for their introduction and beneficiary of revenue. Second stage: Harmonization with solutions from the new Constitution of Serbia.
Law on Budget System	Amendments	IV quarter 2003	Specifying of existing provisions, harmonization with the new Law on Public Revenues and Expenditures.
Value Added Tax Law	Adoption	IV quarter 2003	More efficient taxation of consumption.
Income Tax Law	Amendments	IV quarter 2003 IV quarter 2003	First stage: Harmonization of effective tax rates for taxation of revenues from different sources, review of the level of and need for existing standard expenditure, ceasing of taxation of income from dividends and savings, simplification of procedures, introduction of obligatory yearly tax return regardless of income, introduction of the principle of self assessment. Second stage: Tax on income from agriculture – review of possible taxation basis and method of defining of obligation. Tax on income from professional service – separation from the system of the individual income taxation and designing of tax forms in accordance with principles of profit taxation.

			Separation of the at source income taxation of gains from games of chance from the system of individual income taxes and its special treatment within a law that would regulate this activity.
Law on Contributions	Adoption	IV quarter 2003	Defining of taxpayers and rate within one law. Equalization of basis, defining of rate amount by the law, simplification of the system of payment and control.
Profit Tax Law	Amendments	IV kvartal 2003.	Harmonization with the ÌRS, defining in detail some provisions, especially concerning tax facilities and self-registration.
Property Taxes Law	Amendments	IV quarter 2003 IV quarter 2004	First stage: Harmonization with the value added tax, moving to the proportional tax rate. Second stage: modification of the taxation method for immovable . properties, integration with the charges for construction land, implication of the new Constitution
Law on Tax on Financial Transactions	Abolishment	IV quarter 2003	Reduction of costs for transactions
Law on Non-Recurrent Tax on Extra Income and Extra Property	Abolishment	IV quarter 2003	Termination of need for non-recurrent and non-systematic additional taxation. Having in mind, on the one side, goals of the introduction of this tax – non-recurrent taxation of physical and legal entities that gained profit through privileged status in the previous regime and, on the other hand need to establish permanent institutions and tax institutes and their consistent implementation, this type of taxation should be eliminated in the future.
Law on Taxes on Use, Keeping and Carrying of Goods	Abolishment	IV quarter 2003	General unacceptability of non-direct taxation of wealth. Elimination of inefficient fiscal instruments.
Law on payroll Tax	Abolishment	IV quarter 2003	Reduction of labor costs. Simplification of the method of payment and control.

Law	Modification	Deadline	Purpose
Law on Excise	Amendments	II quarter 2004	Elimination of inefficient fiscal instruments Review of excise amount for oil derivates and alcohols, harmonization of the way of the excise calculation for the alcohols with standards of the European Union. (Calculation by degree of pure alcohol)
Law on Administrative Fees	Adoption	II quarter 2004	Defining of basis for payment of administrative fees at all levels and range of amounts of local administrative fees (defining of taxpayers, documents and actions that may be taxable, whether on the same basis also administrative fees for different levels of authority may be collected, rate range and similar).
Law on Municipal Fees	Adoption	III quarter 2004	Defining of introductory procedures, types of basis as well as rate range for municipal fees. Self imposed local tax – defining of adoption procedures, types of taxation basis and range of rates.
NON-TAX LAWS			
Law on Local Self-Government	Amendments	IV quarter 2003 IV quarter 2004	First stage: Harmonization with changes due to the introduction of value added tax. Second stage: Adjustment of solution from the new Constitution.
Law on Payment Operations	Amendments	IV quarter 2003	Providing of basis for defining of tax order as an instrument of payment operations that could be used also as a general instrument of payment. Providing of basis for including of all by the law on tax procedure and TA required information in the payment order.
Law on Accounting	Amendments	IV quarter 2003	Providing of basis for accounting reports submission for 2003 that for enterprises represent a transitional year till the enforcement of the MRS. This is directly connected to submission of taxable income for profit taxation.

Law on Games of Chance	Adoption	II quarter 2004	Special tax treatment of organizers and winners within the overall regulation of this activity.
Law on Pension Insurance	Amendments	IV quarter 2003	Exceptions, basis and rates from the Law defining entitlements of mandatory insurance.
Law on Health Insurance	Amendments	IV quarter 2003	Exceptions, basis and rates from the Law defining entitlements of mandatory insurance.
Law on Employment and Insurance in case of Unemployment	Amendments	IV quarter 2003	Exceptions, basis and rates from the Law defining entitlements of mandatory insurance.
Law on Water	Amendments	IV quarter 2003	Separation if issue concerning the regulation of use of a concrete public good and price defining method for use of that good from the issue of finance method of general public goods that instead of being financed from the earmarked funds should be financed from general tax revenues i.e. from the budget of the Republic or local communities (depending on jurisdiction division according to the new Constitution).
Law on Forests	Amendments	IV quarter 2003	Same as for the previous Law.
Law on Roads	Amendments	IV quarter 2003	Same as for the previous Law.
Law on Agriculture Land	Amendments	IV quarter 2003	Same as for the previous Law.
Law on Planning and Construction	Amendments	IV quarter 2003	Same as for the previous Law.
Law on Spas	Amendments	IV quarter 2003	Same as for the previous Law.
Law on Mining	Amendments	IV quarter 2003	Same as for the previous Law.
Law on Environmental Protection	Amendments	IV quarter 2003	Same as for the previous Law.

The profit tax is a typical example where all advantages of the self-registration method may be observed. Along with adequate measures of office and field monitoring, and in the situation when collection of external financial resources for business operations and investments significantly depend on the success of the enterprise measured by achieved profit, taxpayers are encouraged to define the basis exactly and in that way also the obligation. The tax on real rights on immovable property is in Serbia an example when Decision as a method of defining of basis, may prove better. For a great number of taxpayers of this tax, calculation of basis is too complicated while information is unavailable or unclear. At the same time creation of a strong motive for making effort for exact calculation and registration of the obligation would be reduced to repressive measures over late taxpayers that considering their number, requires disproportional administrative costs.

Additionally, for all tax instruments for which the obligation would be defined by a principle of self-registration it would be necessary to introduce an obligation for the TA to provide free of charge tax applications that would be easily accessible to taxpayers. This also implies creation of tax applications that would be for their form and content understandable to taxpayers and at the same time usable in tax accounting but not only from the point of view of registering of liability, but also from the point of view of creation of an adequate database for office monitoring.

Aimed at an efficient control and payment of public revenues, it is generally needed to establish clear information flow that can be easily processed. This implies adjustment of the form and the content of existing tax applications to needs of computer processing in tax accounting for the up-dating and more efficient implementation of the office monitoring method. Also, this includes elimination or at least significant reduction of the number of fiscal instruments difficult or impossible to follow in this way. The main goal of these modifications is the creation of a centralized and updated tax accounting that would offer an overall picture about each taxpayer regardless his type of tax obligation.

Over all, the proposed changes should provide a gradual modification of the structure of the tax basis: gradual reduction of the relative importance of taxation of production inputs and consumption, and increases in the relative importance of the tax on the net results of the economic activities of economic entities and individuals and of the tax on property, as well as creation of a clearer link between the tax burden and economic strength of taxpayers.

Table 7 shows a review of the laws with amendments and time frame within which they should be performed, as well as a summary of the reasons for those changes. This review also includes changes that are necessary from the point of view of harmonization of the existing tax system with introduction of value added tax. Laws, whose changes were not subject of special consideration in this chapter, but necessary from the point of view of efficient functioning of the overall system, are also included.

II Financing of Local Communities

INTRODUCTION

During the past decades, financing of local communities in Serbia went through different changes and even now it is in transition from insufficiently financed segment of the state organization and, concerning competences, subordinated, which was in accordance with the concept of centralized state in the previous period toward better financed, more independent and more responsible state level in the future.

The main issue is how to provide enough resources for municipalities and towns in a rational way for activities under their jurisdiction by the Constitution. Rationality of ensuring resources results from the need to establish an arrangement that would be economically efficient (from the point of view of allocation and stabilization), fiscally and administratively effective, simple, transparent, encouraging and fair. It is necessary to secure enough resources, firstly, in order to meet citizens' needs in accordance with possibilities of the local community and the whole country and, secondly, to avoid excessive indebtedness of local communities.[1]

Among numerous principles that are being implemented in a standard manner in financing of local communities, there are also the following:

- local communities cannot have full sovereignty in deciding on introducing of certain taxes and their parameters (rates and similar), and
- practically, all the most important and richest taxes have to be managed by the state level due to the economic efficiency and citizens' equality before the law.[2]

Therefore, the state as the holder of the fiscal sovereignty and as the one that disposes of the richest taxes, has to provide for financing of local communities and, ultimately, be responsible for it.

In the near future, there will certainly be radical changes in financing of local communities in Serbia. There are two main reasons for that:

1 Indebtedness of local communities is not possible at the moment in Serbia, because the bylaw regulation has not been adopted yet, although the relevant legislation allows it. However, it is realistic to suppose that in the future it will be possible.

2 In the text below there will be more about these principles.

- elimination of the sales tax, that now represents the most important instrument of financing of local communities, due to the enforcement of the newly introduced value added tax; this change will enter in force on January 1, 2004 and brings along an important difficulty for the system of financing of local communities – while it is possible to divide revenues stemming from the sales tax collected in the territory of one municipality or town between the republic and the local community in matter, there is no such a possibility with the value added tax, due its technical characteristics (it is not paid in retail sale, but in the occasion of buying and selling within the chain of production and trade and it is not possible to divide it on the basis of the derivation principle), and
- forthcoming constitutional changes will probably bring important modifications into the system of territorial organization of Serbia – creation of regions, modification of municipal and town functions – that will inevitably affect character and level of necessary resources in the financing of local communities.

Considering the fact that it is unknown what solutions will be adopted in the new Serbian Constitution regarding the territorial organization and jurisdictions of local communities,[3] concrete suggestions for the overall reform of financing of local communities cannot and will not be put forward in this study; only a concept of key changes will be discussed. This concept will be operational only after the adoption of the new Constitution.

Main issue in this part of the study is modification of the existing method of providing defined financial resources to local communities during the period of transformation of the sales tax into the value added tax. In accordance with that, this part of the study has three sections 1) existing system of financing of local communities, 2) proposal for short-term changes and 3) concept of the long-term reform.

EXISTING SYSTEM OF FINANCING OF LOCAL COMMUNITIES

Vertical and horizontal division of revenues

Total state revenues and social insurance for the first half of 2003 amounts to 238.3 billion dinars, and their distribution by types and vertical levels is shown in the Table 1.

Local communities achieved 32.3 billion dinars, i.e. they participated in the distribution of total resources with 13.5%. Republic/Federal level[4] is far biggest beneficiary with 82.0%, while 4.5% went to the autonomous region of Vojvodina.

3 For information on financing of the regional organization see *Regionalization of Serbia*, CLDS, 2003

4 Republic and Federation are placed in one group because till April 2003 there were separated, but from then federal institutions are financed from the republic budget.

Table 1
Revenues and Revenue Distribution, January – June 2003 (in Million Dinars)

Mil. din.	Taxes	Contributions	Other	Total
Republic/Federation	121,104	50,142	24,152	195,398
Vojvodina	1,441	9,203	19	10,663
Local communities	24,116	841	7,310	32,267
Towns	11,968	841	5,360	18,169
Municipalities	12,148	0	1,950	14,098
Total	146,661	60,186	31,481	238,328

Source: Public Payment Administration in the Ministry of Finance and Economy

Table 2
Revenues and Revenue Distribution, January-June 2003 (%)

	Taxes	Contributions	Other	Total
Republic/Federation	82.6	83.3	76.7	82.0
Vojvodina	1.0	15.3	0.1	4.5
Local communities	16.4	1.4	23.2	13.5
Towns	8.2	1.4	17.0	7.6
Municipalities	8.3	0.0	6.2	5.9
Total	100	100	100	100

Local communities participate with 16.4% in the totally collected taxes, which is more than participation in the total resources. Their share in the contributions is minimal, because social insurances are mostly on the Republic level, with small part left to the autonomous region of Vojvodina in accordance with the so-called Omnibus Law. In other state revenues, i.e. different dues, fees, revenues from properties and similar, the share of local communities amounts to significant 23.2%, out of which as much as 17% belong to towns.

Table 3
Structure of Public Revenues (%)

	Taxes	Contributions	Other	Total
Republic/Federation	62.0	25.7	12.4	100
Vojvodina	13.5	86.3	0.2	100
Local communities	74.7	2.6	22.7	100
Towns	65.9	4.6	29.5	100
municipalities	86.2	0.0	13.8	100
Total	61.5	25.3	13.2	100

In financing of local communities, taxes participate with 74.7%, contributions with 2.6%, and other revenues with 22.7%. For towns, participation of taxes is lower (65.9%) while participation of other revenues is higher (29.5%) than is the case for municipalities – 86.2 and 13.8%.

Revenues of local communities

Local communities achieve revenues from different sources – from their own taxes and other revenues as well as from taxes belonging to the Republic. Distinction drawn between local and republic sources is important for local communities because it gives them a possibility to follow their own policy of sources that belong to them and in that way to influence their own financial position. This mentioned distinction is not obvious per se and can be done in different ways. Relevant regulations are not defined in the best way, so we will mention alternative formulation, more adequate for analytic purposes.

When considering which taxes belong to which state authority level, it is important to take into consideration four elements: 1) who defines the tax rate or tax amount, 2) who defines taxpayers, basis, relief and exemptions, 3) who administrates collection of taxes and 4) to whom belongs revenues from taxes. If for local taxes, we considered only those for which all these mentioned elements 'belong' exclusively to local communities, then they would not have almost any of their own revenue sources, while the most of them would be joint for the Republic and local communities. Therefore, a better approach is that a tax belongs to a level of the state organization which determines the rate i.e. the amount and to whom revenues belong (Items 1 and 4). Remaining two elements may be considered less important.

From this point of view, local communities in Serbia are financed from two types of revenue sources – their own and from joint source that they share with the Republic.

Own revenues of local communities' are: the payroll tax, local administrative dues, local utility dues, tourist dues, fee for use of construction land, fee for use of natural medical factors, fee for environmental protection and promotion, voluntary local taxes and other revenues (from renting and selling of properties, collected fines, donations, etc.).

Joint revenue sources of the Republic and local communities are numerous and financially richer: sales tax, personal income tax (income tax, income tax from self-employment, copyrights, real estate tax, etc.), property taxes (periodical taxes, death and gift tax, tax on transfer of absolute rights, shares), taxes use of goods (tax on motor vehicles, etc.), as well as some other taxes, dues, fees and revenues from the privatization. For joint revenues, the Republic is entitled to manage taxes or other dues, but one part or total revenues collected on their territory goes to local communities.

Through joint revenues, the Republic performs vertical and horizontal balancing among local communities in Serbia where

- *vertical balancing* means the transfer of resources from the Republic to the local level due to the fact that all local communities, even the richest ones, are not able to finance necessary expenses from their own revenue sources; this balancing is caused by the fact that all richest taxes belong to the Republic, while own revenues of local communities are poor and not able to cover the necessary level of expenses,
- *horizontal balancing* means the transfer of resources from the republic level to the local communities that, due to their underdevelopment and low fiscal capacities, are not able to cover necessary expenses even after the vertical balancing; in fact, this type of transfer represents the solidarity of richer areas with poorer, and the scope is to achieve minimum standard of satisfying citizens' needs for public services.

Laws that essentially regulate financing modalities of local communities and distribution of public revenues on different levels of the state organization are the following:

- *Law on public revenues and public expenditures* defines which revenue sources belong to local communities and, in principle, defines in which republic revenue sources local communities participate;
- *Law on local self-government* in details defines i.e. regulates the exact participation of local communities in certain republic taxes;
- *Law on the amount of resources and share of municipalities and towns in the wage tax and sales tax* represents an annual law that, through prescribed participation of each local community in revenues stemming from the wage tax and additional participation in the sales tax, concretizes the state policy regarding the harmonization of the position of the local communities.

Sales tax on goods and services is a source of taxation whose revenues are to be divided between the budget of the local community and Serbian budget. *1) Law on local self-government* defines the percentage of the sales tax that belongs to the local community and that is 8% to municipalities, 10% for towns, and 15% for Belgrade out of total revenues collected on their territory and reduced by 18%,[5] and 2) *Law on the amount of resources and share of municipalities and towns in the wage tax and sales tax*, regulates additional percentage of revenues stemming from the sales tax levied in their territory.[6] This percentage is very differentiated and, for example, amounts to: Belgrade 4%, Novi Sad 4.9%, Niš 10.6%, Kragujevac 26%, Trgovište 89.3%, Sjenica 72.8%, Medveđa 60.5%, Lebane 44.6%, Krupanj 36.5%, Čoka 24.0%, Žabalj 9.9%, Aranđelovac 5.6%, Pančevo 3.1% etc.

5 This amount belonged to the Federation till April 2003.
6 Except for revenues from sales tax for import.

The wage tax also represents joint revenue of the republic and local communities while local communities participate, in conformity with the *Law on the amount of resources and share of municipalities and towns in the wage tax and sales tax for 2003,* with 5% in the total revenues collected n their territory.

Revenues from other income taxes (tax on income stemming from agriculture and forestry, self-employment, real estates, renting of movables, gains from games of chance, from insurance of persons and other revenues) are completely ceded to the local community on whose territory they are collected.

Revenues from property taxes (property tax, death and gift tax, and tax on transfer of absolute rights) are also completely ceded to the local budget.

Fees for use of goods of public interest (fee for use of mineral resources, for extracted material form water courses, for use of forest, for purpose change of agricultural land) shall be ceded to the budget of the local community in certain percentage. Only the fee for construction, maintenance, and use of local roads belongs completely to the local community on whose territory they are collected.

The local community receives 5% of resources achieved in privatization in its territory and lately this represents an important revenue source for some municipalities and towns.

Also, the revenues stemming from the payroll tax completely belong to local communities. They are entitled to define this rate and the upper limit is 3.5%.

The most important revenues of local communities are shown in the Table 4.

About 40% of total revenues of local communities come from their own sources, while about 60% represent revenues from shared taxes with the Republic.

The most important revenue source of local communities is the sales tax, with more than ¼ of participation in the total revenues, then revenues stemming from payroll tax (1/5), and then from local dues (1/9).

Resource acquisition for local communities

With the aim to analyze financing of local communities and the role of the Republic in it, it is opportune to classify all revenues of local communities in the following way:

- Own revenues,
- Permanently ceded revenues by the Republic (sales tax with share of 5-8-15%, personal income taxes except for the wage taxes, property taxes, etc.), in accordance with *Law on local self-government.*
- Revenues that the Republic cedes to the local communities for a year i.e. each year (graduated rates of share in the sales tax and 5% of the wage tax), and in accordance with the *Law on the amount of resources and share of municipalities and towns in the wage tax and sales tax.*

Table 4
Public Revenues of Local Communities, January – June 2003

Public revenue	mil. din.	%
Wage tax	1,226	3.9
Tax on income stemming from self-employment	958	3.1
Property tax	222	0.7
Payroll tax	6,066	19.5
Property tax (periodical)	1,664	5.3
Tax on capital transactions	2,228	7.2
Sales tax	8,234	26.4
Motor vehicle tax	856	2.7
Voluntary local tax	315	1.0
Other taxes	1,583	5.1
Utility dues on firm	488	1.6
Fee for use of areas and construction land	1,761	5.7
Administrative fees	3,538	11.4
Other	2,010	6.5
Total	31,148	100.0

Source: Ministry of finance and economy

Own revenues of local communities and revenues that the Republic permanently cedes to local communities are, however, not enough for regular financing of local needs. Therefore it is necessary to supplement those resources and, in fact, that is being done from the sales tax and the wage tax, and through the annual *Law on the amount of resources and share of municipalities and towns in the wage tax and sales tax*.

The system of annual transfers functions in the following way:

- Firstly, in the General balance of public revenues and expenses of the Republic of Serbia, adopted by the Government of Serbia, total resources for financing of local communities are planed and amount that will be transferred to municipalities and towns for the following year is defined (for the year 2003 it is the amount of 10,7 billion dinars). There is no precise methodology aimed at defining the volume of transferred resources; it is done on the basis of trend of nominal GDP, policy of public expenditures and negotiation skills of participants (towns managed to increase volume of their expenses, while municipalities are mostly passive);
- Secondly, helped by criteria stated in the Law on Local Self-Government (territory size, number of citizens, number of classes, number of elementary and secondary schools, number of children covered by child welfare and number of child welfare facilities and development degree of municipalities and towns), an amount

from the General balance, designated for transfers, is divided between all local communities;
- Finally, according to the distribution from the previous item and planned trend of revenues from sales tax and wage tax, percentages of totally collected revenues from these taxes that will be left to each local community are determined and written into the *Law on the amount of resources and share of municipalities and towns in the wage tax and sales tax*;
- It is planned to distribute surplus revenues from these taxes that are above planned revenues defined by the Law between the Republic budget and local communities in proportion 50:50; this fact should get municipalities and towns interested in their own fiscal capacities and collection level.

This system has strengths and weaknesses.

Strengths are:

- Local communities are now entitled to decide independently on the volume of their budgets; in this way the practice that was used in previous decades where the Republic defined the amount of the budget of municipalities and towns, has been abandoned; freedom of choice should enable appearance of citizens' preferences on the local level and increasing of responsibilities of local authorities for citizens' lives and health of local finance; on the other hand, the volume of all local budgets is still not large enough to be able to cause destabilization or oversized public expenditures in Serbia,
- According to this system, Republic of Serbia is not obliged to cover *all* differences between locally defined budget revenues and sum of own revenues and permanently ceded revenues in individual budgets; it should only try to cover this difference when it is in accordance with the General balance. In other words, the local community will receive this difference if it plans its budget realistically and in accordance with the general trends of public expenditures in Serbia, but it will not receive this difference completely if defines its budget too ambitiously and runs a deficit as a difference between expenditures and the sum of own revenues and permanently ceded revenues and resources for the harmonization.
- Due to the freedom of choice and current harmonization system, local communities have clear incentives to plan their budget realistically on the one hand and to increase fiscal capacities and collection of fees on their territory on the other hand.
- The Republic holds its right to arrange ceded revenues which represents a good solution both for economic efficiency and for equality of citizens before tax laws in the whole territory of Serbia; in this way, important taxation elements – bases, rates and collection of ceded taxes – are equal on the whole territory of Serbia, which increases the tax system efficiency.

- Sales tax is a steady source of revenues i.e. it depends less on economic trends or local economic structure than some other taxes, which provide necessary stability to local finance.

Weaknesses are:

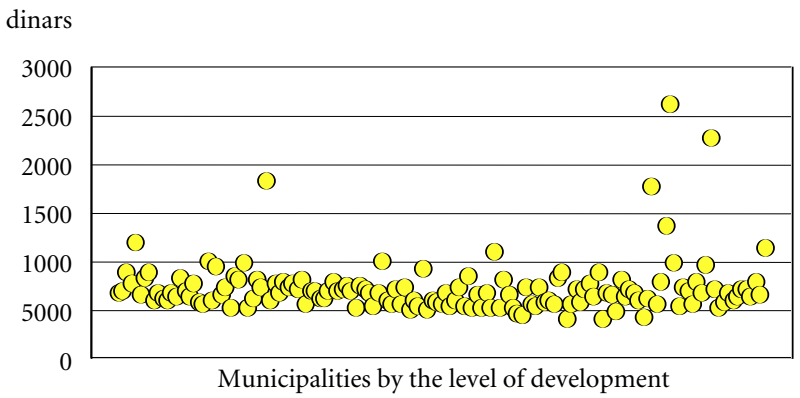
- The most important decision – decision on the total amount of resources to be distributed to municipalities and towns – is not reached on the basis of objective criteria of needs for financing of local communities, but is arbitrarily reached, during formulation of the General balance of public revenues and expenditures, and mostly based on transfer level of previous years and results of political negotiations.
- The distribution system of defined sum to municipalities and towns is based on system of criteria that are not consistent: some criteria should reflect current expenses (education, children protection, culture, physical culture), while others should express objective circumstances (development level, number of citizens, population density); such a combination of criteria means that the division method is not based on one clear concept – it is not based on expenditures, or on needs of local communities.
- 'Expenditure' criteria does not reflect at all actual costs of functions of local communities relative to it (for example, only 2.1 billion dinars are allocated to all local communities in Serbia for elementary and secondary education), but they only serve for distribution of a previously determined amount.
- Weights of some criteria are mostly defined arbitrarily and it is difficult to understand the meaning: why, for example, the criteria for (under)development has the weight amounting only to 9.1%, education 21.5% child protection 23.1%, while delegated duties (which delegated duties?) 18.4%, etc.
- As for all tax sharing the problem concerning divergence is inevitable; in the course of time, the need to change the policy of shared taxes arises at the state level for reasons not connected with financing of local communities – for example, due to economic trends, improvement of taxation structure in the country, adjustment to economic shocks and similar – but those changes affect revenues of local communities both positively or negatively; essentially, it would be better if those changes of the state policy did not influence the financing of local communities, but due to the link between these two levels of the state organization through the shared taxes, the local level shares the same destiny of the mentioned tax revenues; of course, it is possible often to adjust percentages of revenue distribution in order to solve this problem, but in this way additional political decision-making in the process of the financing of local communities is introduced, which is not a good choice,
- Regarding the sales tax, place of residence and paying tax, that are basis for tax collection (according to the derivative principle), often does not correspond, so some local communities (especially

big towns) exports tax burden to others through differentiation of tax rate, which conflicts with the important local finance principle on financing of own needs from own sources.

In the following sections we will see effects of the transfer system. Main tasks of this systems are (or should be) 1) to supplement own revenues to all local communities due to their insufficiency and 2) additional support to those local communities whose fiscal capacities are insufficient i.e. to those that are not able to finance the level of budget expenditures that satisfies necessary standards with reasonable burden.

The most important factor of insufficient fiscal capacity is economic underdevelopment of the local community, so the system of transfer and harmonization should strongly direct resources toward underdeveloped municipalities and towns. Let us see how it works in reality. The following chart shows the amount of transfers[7] per capita in the local community.

Chart 1
Transfers per Capita I–VI 2003



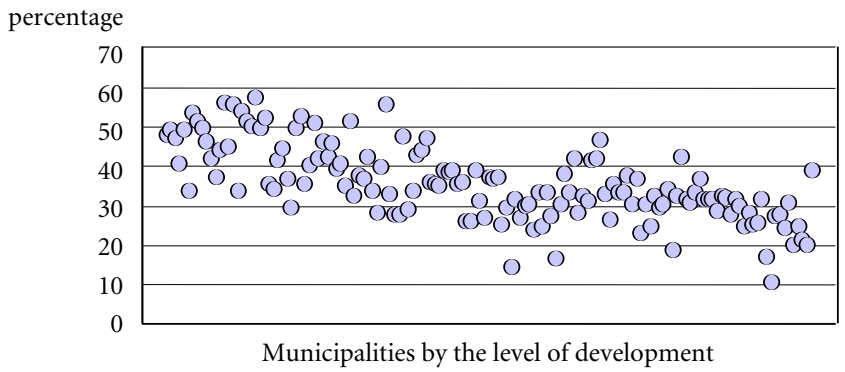
Note: Each point represents one municipality or town; the development level is increasing from the left to the right side, (GDP per capita in 2001).

It is clear that the transfer volume per capita has nothing to do with the development level because almost all municipalities (points on the chart) are between 500 and 1000 dinars, independently from the development level. Cities have higher transfer amount per capita – Belgrade, Novi Sad, Kragujevac and Nis – and only there the transfer is above 1500 dinars per capita. In other words, it is shown that transfers for harmonization do not give more to poorer that to richer local communities; they give to all equally with significant advantage of the biggest cities.

7 The transfer of resource means total revenues of local communities stemming from sales tax and wage tax.

If transfers do not give more to poorer local communities, maybe they mean more to them? The answer to this question is shown in the next chart.

Chart 2
Transfer Share in Total Resources I–VI 2003



Note: Same as for the previous chart

It is clear that participation of received transfer resources in total revenues decreases with the development level of the local community, which means that richer local communities depend less on transferred resources in comparison with less developed communities. This shows that transferred resources are more important to less developed communities than to developed ones. However this decreasing is very slow. An illustration of this is also the relation between the most developed and the least developed local communities: while ten most developed local communities have on average 5.4 times bigger gross domestic product per capita than the 10 least developed local communities but the latter have only two times bigger share of transferred resources in total resources than the first ones. In other words even according to this standard, the harmonization system does not have very efficient impact on the harmonization of the condition of differently developed local communities.

Conclusions

The previous analysis has shown that the existing system of financing of local communities, and above all, vertical and horizontal harmonization, should be changed at least for two reasons: the first one is elimination of the sales tax, that represents the most important element of the state support to local communities, while the second reason is connected to weaknesses of the existing vertical and horizontal harmonization system. The procedure of defining resources for the

harmonization of budget revenues of local communities now is based on a combination of discretional decision-making and numerous, but not best conceived criteria; for sure, they are not transparent. It is necessary to study also the formula and place the overall procedure on an objective basis.

PROPOSAL FOR SHORT-TERM CHANGES

Tax selection

As previously mentioned, from January 1st, 2004 existing sales taxes will be replaced by the value added tax, as a basic taxation instrument of expenses in Serbia. Such an important change of the tax structure immediately raises the issue of how to compensate for loss of revenues from sales taxes that local communities will have, and for which this tax is at the moment the most important revenue source (26.5% of total revenues in the period January – Jun 2003). Besides, there is a plan to eliminate the payroll tax,[8] whose revenues accrue completely to the local communities, so it is necessary to compensate local communities for revenue loss from both taxes.

Loss of revenues from sales tax for local communities cannot be compensated by simple substitution of the sales tax by the value added tax and by maintaining the existing system of division of revenues between the Republic and local communities, due to the collection model for the value added tax. Namely, while the sales tax is single-stage tax in retail sale, so it is possible to fully use division of revenues between the two levels of state authority collected according to the derivative principle (i.e. according to the place of collection), the value added tax is a multi-stage tax i.e. it is collected at each stage of trade and it returns back the collected amount, i.e. subtract collected amount during previous stages, regardless of the location, so certain tax payments cannot be basis for revenue division between the Republic and local community.

There are various possibilities for solving the mentioned problem – for example, earmarking of necessary funds for each local community from the general budget resources of the Republic, or transfer of new sources of financing of local communities – but at this moment it is better to avoid radical changes of the system of co-financing of local communities because the system's duration is probably very limited, it will last till the termination of the existing constitutional changes at latest by the year 2004. Only then will it be possible to formulate a stable mechanism of co-financing of local communities that will have a chance to last longer and according to the new scheme of

8 See reasons in the first chapter.

vertical relations between the Republic, regions and local communities and jurisdiction division between them.

For these reasons, modification of co-financing method of needs of local communities should not be fundamental, but should be based on the following elements:

- The fact that certain revenues belong to local communities and to the Republic shall not be changed i.e. so called unlimited (permanent) ceded revenues should continue to go to local communities,
- The method of determining the amount of earmarked funds to be transferred to local communities from so-called limited ceded resources from the General balance of public revenues and expenditures shall be maintained,
- Distribution method of so-called limited ceded revenues to local communities through criteria shall not be changed;
- There is a proposal for new revenue source that should replace revenues stemming from the sales tax and payroll tax, through which the financial position of local communities is now balanced.

The only tax, considering the amount of collected revenues that can substitute the sales tax and payroll tax is the wage tax. Other Republic revenues having enough volume are not suitable for these purposes:

- Value added tax, due to its mentioned method of collection,
- Excise, because they have to be paid in the place of production, so they are very unevenly distributed throughout the territory of Serbia; in some municipalities excises are not collected at all,
- Customs' duties, because, among other reasons, they are also very unevenly collected in the territory of Serbia.

It seems that there is a problem with the wage tax: it does not reflect in the best way economic strength (or fiscal capacities) of an area because it does not include the gray economy, agriculture, foreign remittances and similar while these elements are unevenly distributed throughout regions. However, this problem is apparent because the basis of the system of balancing in Serbia represents transfers from the Republic to local communities that are only technically implemented through percentage of collection of certain taxes that are left to the local communities. We should mention how the system functions now: funds to be transferred by the Republic are determined, criteria for funds distribution to some local communities are implemented and then the share in collection of sales tax is differentiated to local communities in order to provide the planned funds. From the point of view of fairness or of stimulating reasonable managing or allocation efficiency, there is no difference whether the transfer to the local community is made through cash subsidy or through participation in the tax collection on that territory. There is only one technical difference: if we use cash transfers then the Republic budget will be formally bigger because it would be expressed in the gross amount (it would contain the whole revenue from mentioned taxes, but also transferred expenses). At the moment it is smaller

because revenues for balancing/adjustment are allocated to local communities during the collection, so they do not enter into the Republic budget.

Implementation model

If the proposal to compensate local communities for loss of revenues stemming from sales tax and payroll tax with resources coming from the wage tax is accepted, there will be a problem how to implement that model. There are two possibilities:

1. To differentiate shares of local communities in the collection of the wage tax on their territory to the extend to which is needed to provide necessary revenues to each local community; this method is being in use even now with revenues from the sales tax,
2. To determine and uniform rate of share of local communities in collection of the wage tax on their territory, and to provide the difference up to necessary resources for each local community through cash transfers from the budget of Serbia; there is a possibility to have a sub-model where there would be two rates instead of one – one would be for towns and the other one for the municipalities, with cash transfers – but the difference is formal, not essential.

In order to understand effects of these options a simulation based on data on belonging revenues for 2003 will be shown, providing revenue neutrality.

Table 5
Necessary Substitutions, Mil. Din.

Mil. din.	Porez na promet	Payroll tax	Total
Municipalities	7,240	7,005	14,246
Towns	10,843	6,386	17,229
Total	18,083	13,392	31,475

Note: Given amounts are at the annual level, by revenues divisions for I-VI 2003 with 0.45.

Total revenues that local communities will lose in 2003 due to expiration of the sales tax and payroll tax amount to 31.5 billion dinars. Out of this amount municipalities would lose 14.3 billion (45.3%) and towns 17.2 billions (54.7%). The loss due to the abolition of the sales tax would amount to 18.1 billion (57.5%), and payroll tax 13.4 billion (42.5%).

If the first option is to be implemented i.e. differentiation of rates of the wage tax, the necessary percentage of share of local communities in revenues from collected wage tax on their territory would be between

40.2 and 133.6%[9].There are eleven municipalities with needed percentage bigger than 100%: these are mostly small municipalities with small shares in the formal economy. This is to say that as to date, with the sales tax it could be possible to define the share in revenues stemming from the wage tax that would vary from 42.2 to 100%, while for eleven municipalities cash subsidies from the Republic budget amounting to 49.6 million dinars will be provided. The rest of the money, up to 34.18 billion would be transferred through the participation of local communities in revenues from the wage tax.

According to the second option, there will be determined a uniformed percentage of share of local communities in revenues stemming from the sales tax on their territory, while the positive difference between needed transfer to each local community and revenues provided from the uniform percentage of share would be covered through cash subsidies from the Republic budget.

The uniform share of local communities in revenues coming from the wage tax would be 40% that is necessary percentage of share of revenues from the wage tax in order to compensate the loss of revenues from sales tax and payroll tax for those local communities where that percentage is the lowest. Higher uniform percentage of share would bring to some municipalities or to some towns more revenues than it is necessary for the simple substitution of one source of revenues by the other. The remaining difference between necessary resources and revenues from the wage tax in each local community would be covered by cash transfers from the Republic budget.

Fiscal effects of the second option are shown in the following table.

Table 6
Effects of Substitutions (1), Mil. Din.

	Revenue 40%	Cash
Municipalities	10,727	4,858
Towns	10,932	7,663
Total	21,659	12,521

Out of totally needed transfers amounting to 34.2 billion, that include also the existing transfers from the wage tax (5%), the amount of 21.7 billion would be transferred through ceding of the wage tax while 12.5 billion would be transferred through cash subsidies. Municipalities and towns would have the same amount transferred through ceding of revenues stemming from the wage tax, while towns would achieve much more through cash subsidies (61.2%) in comparison with municipalities (38.8%). Out of total revenues coming from the wage tax, 40% would belong to local communities.

9 Including the existing 5%.

If we want to minimize the amount of cash transfers then we can define two rates of share of local communities in revenues stemming from the wage tax – one for municipalities, and one for towns. 40% would go for municipalities while 65% would be left for towns, considering the fact that needed percentage of share for substitution for towns goes from 67.1 to 73.2%.

The effects of this possibility are shown in the following table.

Table 7
Effects of Substitutions (2), Mil. Din.

	Revenue from the wage tax, municipalities 40%, towns 65%	Cash subsidy
Municipalities	10,727	4,858
Towns	17,764	831
Total	28,492	5,689

Out of total needed transfers amounting to 34.5 billions, 28.5 billion would be transferred through ceding of the wage tax, and 5.7 billion through cash subsidies. Significantly greater amount would be transferred to towns than to municipalities based on ceding of revenues stemming from the wage tax – 62.3 to 37.7% – while municipalities will get much greater amount transferred through cash subsidies in comparison to towns – 85.4 to 14.6%. Local communities will get 52.6% out of total revenues from the wage tax.

Fiscal effects of the proposal

The assumption of revenue neutrality of changing of the system ensures equality of revenues of each local community in the "old" and "new" transfer system. However overall position of local communities will be improved to some extend because their budget expenses will be decreased due of the extinguishing of the payroll tax; so local communities will not have to pay anymore payroll tax for their employees. There is no data that would allow us the exact calculation of this effect, but we can say that these effects will not be of great importance. Hence, they are increasing if we take into consideration the whole public sector in local communities because the abolishing of payroll tax will have the positive financial impact for local public utility companies.

At the Republic budget level there is loss stemming from the abolishing of payroll tax (13-14 billion in 2003), although revenues from this tax belonged to local communities, but the Republic budget will compensate this loss to local communities from its own sources – by ceding to local communities bigger part of revenues coming from the wage tax than it is now. Indeed, this loss of the Republic budget will not be

100%, but less, because payroll tax for its employees will not be paid anymore.[10]

The global natural neutrality, after abolition of the sales tax and payroll tax, will be provided by the value added tax which is equal to the sum of the sales tax and payroll tax reduced by the gain in the budget due to the fact that the payroll tax for its own employees will not be paid anymore. In other words, revenues stemming from value added tax should be about 10 billion higher than the sales tax is now in order to achieve fiscal neutrality of the new arrangement aimed at co-financing of expenditures of local communities.

CONCEPT OF LONG-TERM REFORM

Introduction

Modification of the Constitution of Serbia, that is in progress, will probably bring innovations into the territorial organization of Serbia (introduction of regions) and also into jurisdictions of local communities. Considering the fact that at the moment we are not aware of the course of those changes, it is not possible to propose specific fiscal arrangements that should or could support the new solutions. Therefore, we will take into consideration only those issues that will for sure be relevant when it will come to decision on law and operational solutions.

Main issues

Main and universal issues regarding local finance are the following:

1. which fiscal and other revenues belong to local communities i.e. who decides on which taxes and duties,
2. how is the difference between the necessary level of revenues and own revenues, that commonly appears in local community funding to be covered? – the problem of the vertical imbalance,
3. how and to what extend are poorer local communities to be supported – the problem of horizontal imbalance,
4. how are the capital expenditures to be financed in local communities,
5. whether indebtedness is to be regulated and if so, how.

Ad 1. The first chapter of this study reviews the structure of the fiscal system and proposals for its simplification; therefore we will not deal with this issue here any longer. It should be mentioned that there is a

10 The Ministry of finance estimates that the saving of the Republic budget would be around 3 billion dinars. According to rough estimation the whole public sector in Serbia could save from the abolishing of the wage and salary fund tax around 4-5 billion dinars (it is estimated that total revenue from this tax for 2003 amounts to 13-14 billion dinars).

proposal for elimination of the payroll tax, that was the most important own revenue of local communities, but simultaneously there is also proposal to entitle local communities to determine tax rates for the property tax (immovable property); along with significant increase of the tax basis, this would give local communities the opportunity to pursue a serious fiscal policy and ensure them influence over their own revenues at the margin (i.e. on possible increase of own revenues when necessary and for the necessary amount).

It should be also said that decisions on tax distribution on different levels of the state organization place conflicting goals before the legislators. On the one hand, the important economic and administrative reasons suggest that pro-cyclical taxes (instruments of the macroeconomic policy), taxes with movable basis (in order to avoid local tax wars and moving of tax basis), redistributive taxes (the redistribution is necessarily the central function) and taxes regarding international trade i.e. enterprise profit tax, individual income tax, value added tax and customs' duties, which represent the biggest part of tax revenues in a country, should be left to the central level. Besides, value added tax is, necessarily, the central tax. On the other hand, it would be good to finance local functions from local revenues i.e. from revenues on which the local government decides. This is suitable for several reasons: 1) it increases responsibility of local authorities before the electoral body, that should firmly control amount of taxes and other duties, as well as the expenditure of the collected money i.e. local governments should be accountable to their electoral body, whose money they spend; 2) local governments will be interested in better tax and duties collection, which is very important because, as international experience shows, sub-national governments can show significant financial irresponsibility when they widely depend on transfers from the central state level; and 3) in that way risk of significant indebtedness of local communities is avoided.

Ad 2 and Ad 3. Each level of the state organization should dispose of enough revenues to cover envisaged functions within the necessary scope, but this does not mean that each level has to finance its own expenditures from its own resources (with own taxes and other revenues); it is also possible that some levels have surplus revenues over expenditures, and others have deficit and that those imbalances are covered through transfers or through other models of transferring revenues from one level to the other, as a large body of international and local experience shows. In Serbia there is deficit of own revenues of local communities in comparison to the entirely needed revenues that is covered through ceding of revenues or part of revenues from republic taxes collected in the territory of each local community. That deficit will, without any doubt, exist in the future, as well.

Distinction between the vertical and horizontal imbalance of revenues and expenditures of local communities is necessary for analytic purposes, but both aspects are often solved through a central-level transfer system. Therefore, we will suggest a uniform transfer system in Serbia.

Three main questions when designing a unified transfer system are: how to define the total amount to be distributed, how is that amount distributed to local communities and whether those are unconditional transfers or not.

Amount to be distributed may be basically defined in three ways: (i) as a fixed percentage of some revenues of the central authority, or even better,[11] of total budget revenues, (ii) through ad hoc decision making and (iii) based on the formula according to which the total amount is calculated by local communities.

The strength of the system with fixed participation of local communities in the total Republic revenues is the fact that it is automatic, so it leads to the stability of local finance and to avoidance of negative impacts of political arrangements. A weakness of the system is its inflexibility, so it does not allow the previously mentioned and often desirable divergence of revenues of the central authorities and local communities, even when it is justified. Second weakness is the fact that it is not based on objective criteria, but usually it represents more permanent "frozen" version of the ad hoc method.

Ad hoc system is on the best terms with the maximum political and budget control, because the amount for distribution is considered as any other annual budget item and it is subject to a decision on budget priorities by the legislative body. This system is essentially used in Serbia, but the Government makes decision on the amount through the General balance of public revenues and expenditures. From the point of view of the central authorities, this system is very flexible, which is an advantage. Weakness is that, on the one hand, it is unstable for local communities and does not provide certainty of budget planning, and, on the other side, it is subject to political manipulations. It is clear that even in Serbia there are political negotiations and in last years they have led to variations of final results (after voting for relevant law) from initial objective drafts on transfers.[12]

Conceptually, the best and most popular method is the one based on the formula. It is, or should be, based on objective elements and therefore, superior to discretional methods. The main idea is simple: for each local community the following things are to be calculated: (1) financial needs and (2) financial possibilities, and then the central level covers the difference.

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11 Better – because the central level, as the world experience shows, may increase tax rates that are not shared with local communities, leaving them in that way with relatively small revenues.

12 Motivation issue of some players is complex. To the central authority, the system of political negotiation may be appealing due to possible influence on local communities to their advantage, but even unappealing because of possible too strong influence of lobbies of local communities within political parties and parliament. Among local communities ad hoc method is unequally appealing -bigger and more influencing communities may be interested in it, while smaller, poorer and those with less influences usually prefer less discretional system.

Financial needs primarily depend on number of inhabitants in the local community, and possibly on the structure of the population (for example, number of the young and old, if the education and health are financed at the local level) and physical character of the local community (population density, urban – rural, etc). Therefore, those or similar criteria are included in the formula as variables that determine the need level.

Fiscal capacities of local communities can be approximated through the income level (national income, GDP, with or without additional adjustments) per capita, as measure of the overall tax basis or through some methodologically more complex procedures. One of them is the so-called representative tax system (RTS), where the volume of possible revenues is calculated per singular duty under control of local authorities and for all of them, together with an assumed average tax burden, defined through the combination of tax rates, exemptions and performance quality of the local Tax Authority. In other words, if we know (i) the amount of local community revenues actually collected (ii) the level of local collection effort, then it is possible to estimate also potential fiscal capacities through the quotient i/ii. There is no doubt that the calculation of the fiscal capacities of local communities according to the RTS method is very complex procedure although for simpler alternatives – income per capita – there is an issue of data quality at the local level.

As numerous factors affect the need level and financial possibilities of local communities, the formula, used for its calculation, may be very complex and may have at least partially nonlinear form.[13] On the other hand, there is a need to use a simple formula for purposes of transparency and especially in the political process, which causes a conflict of goals and the need to find a compromise solution.

Some examples of this formula will be mentioned. In Brazil, 22.5% of the income tax and tax on industrial products are distributed to local governments in the following way: 10% are divided between capital cities of federal entities, the criteria for that being the size of the population and inverse of income per capita of that particular federal entity; the remaining 90% are divided between other local communities, applying the same criteria.

The state of Michigan distributes subsidies to local communities using three different formulas and according to each formula 1/3 of resources is distributed. The first one is according to settlement type, where the number of inhabitants and the weight of that type of settlement is combined (three categories with sub-categories according the number of inhabitants); weights go from 1 (for small settlements in rural areas) to 10.75 for big cities; the idea of this distinction according to the settlement type is the supposed difference in their functions. The target of the second formula is to harmonize poorer and richer settle-

13 Exponential functions are widely used in Switzerland.

ments based of the comparison of the tax basis (taxable value); for each settlement an index is made, through division of the amount of total tax basis per capita of the state of Michigan and of the settlement under consideration, and then it is multiplied by the number of inhabitants; on the basis of such weighted values the distribution is made. The third formula guarantees minimal income level for the local tax burden on collection of revenues that the local community shares with the state; the money is distributed only to below-average local communities.

For a certain period, in Spain, a formula of regional distribution was used dominated by the population (share 64%), then (under)development (17%), surface area (16.6%), fiscal efforts 2.7%, population dispersion 2% and insularity 0.4%.

Although conceptually the best solution, the implementation of the formula is facing, in practice, various problems. The first one is political, as was shown in different countries, (for example, in Italy), due to the fact that the ad hoc method may create a coalition of the central authority, that can aspire to award friends and "buy" opponents among local communities and one part of the local power (the rewarded and other privileged). In Serbia, probably due to the young democracy, these and similar mechanism are still not enough developed although they are emerging. The second problem may be data accessibility; however, the statistics are developed enough in Serbia and may provide reliable data about demography and geography as well as relatively reliable data on the income of the population. The third problem is transition from the existing to the new situation i.e. from the existing transfer level to some other where there will be winners and losers among local communities. In order to reduce the potential shock for budgeting, it is possible to introduce the new system gradually – over a couple of years; the technique is simple: the initial transfer level (year T-1) is also included in the formula, so to this variable the value will be gradually decreased (for example 20% in each of five years) till the complete elimination.

The issue of incentives that the transfer system gives to local communities is very important. If the transfer system guarantees to cover ***all*** differences between needed and available resources of local communities, then it surely discourages local communities from exploiting their own tax basis fully and controlling expenditure. Such a guarantee by the central authorities, on the contrary, transfers responsibility for the condition of local finances and, generally, the satisfaction of meeting the needs of citizens to the central level thus amnestying the local government from any responsibility. That is, then, a bad system. Therefore, it is important to create a system that will stimulate the efforts of local communities in the way that local communities are responsible for final results. The central power should not guarantee to cover ***all*** levels of budget expenditure to local communities, but only based on objective criteria, it should provide ***standard*** levels of their revenues, while local authorities should and could provide desired and by them determined level of public expenditures, by increasing their own revenues.

Distribution method of defined funds for local communities, may be ad hoc or according to a formula. The second one is much more common and a lot of countries, including Serbia, implement it.

How is the transfer effectuated? The distribution of revenues from some taxes, with the same percentage for all local communities, is a system often used in the modern world and usually it is applied to sales tax and income tax. It is suitable for solving of the problem of vertical, but not the horizontal imbalance, because local communities with different fiscal capacities will have different luck. For the horizontal harmonization, cash subsidies are more suitable, as is the practice.[14]

General or earmarked resources? If the purpose of the transfer is to provide enough resources for services offered to citizens at the local level, then the right way, without any conditions, is to use general resources. Of course, it is supposed that transfers are directed toward responsible bodies and that there is no need for additional corrective influences. In case the central authority has doubts about the responsible behavior of local authorities or if local authorities only implement programs of high national importance (for example, education, health), then the central level will use earmarked funds i.e. conditioned transfers. The conditionality should ensure that transferred resources are used for planned purposes, for example, for wages for professors or physicians. Additionally, performance criteria may be introduced i.e. evaluation of the extent to which the local authority fulfills the purpose of the transfer, and that means moving from measuring of investments to measuring of products (for example, number of pupils that successfully complete a school year). In Serbia all transfers are of the general type.

Ad 4. Local investments are financially supported from the central level in practically all countries. There are quite a few reasons for this: ensuring the minimum services, harmonization among local communities or respecting of external effects of investments (those that go beyond the borders of one local community).

The main issues concerning the designing of those subsidies are the following:

- *Participation rate of central resources*, that may be equal for all 'locations' of the same investment type, but may be different by investment types (water-supply system, primary health care facilities, etc);
- *decision method* on subsidy allocation – discretional or, according to the system of the matching grant, where the central level leaves decision making to the local authorities, but is obligated to add to the amount provided by the local community previously specified amount (for example, dinar for dinar);
- *open or closed system:* in the open system, the central authority is ready to provide co-financing to each local community that meets

14 As far as we know, Serbia is the only one country that applies differentiated tax rates for vertical distribution of revenues from taxes.

requirements from the program; in the closed system, there is either open competition for specific investments or discretional decision on the part of the central authority.

The whole system of (co)financing of local investments in Serbia is not regulated.

Ad 5. The right of incurring debts of local communities is very sensitive. Borrowing is, on the one side, a good way to finance some expenditures, and especially, year-term investments, and even sometimes to overcome short-term imbalances of expenditures and revenues. On the other hand, there is danger that local authorities will exaggerate with incurring debts either due to the fact that they deliberately have a policy of transferring their own expenditures to the central level believing, usually with reason that the state will not (cannot) allow their bankruptcy,[15] regardless of whether it is about simple irresponsibility or bad planning.

There are numerous possible solutions: 1) that the central level refuses to save excessively indebted regions and to leave them to bankruptcy; this would be the healthiest way, because in that case regions would restrain themselves from excessive indebtedness, but politically it is difficult to achieve; 2) to accomplish high financial autonomy of local authorities including the possibility to use their revenues and assets as collateral for loans; this would increase their responsibility for finances; 3) to limit by law the highest indebtedness level and 4) that the central authority gives approval for each single debt of local authorities.

The most efficient methods of limited indebtedness, as shown by experience, represent the legal limitation of the indebtedness level (for example, percentage of the budget that can be used for debt servicing and need to provide approval by the central authority for each significant debt in the country, and especially abroad.

In Serbia local communities are theoretically capable of borrowing, because there is a legal framework, but on the other side it is practically impossible because the government has not adopted the regulation, required by the law, probably due to the "prohibition" of incurring debt by the state on the commercial market in these three years while the stand-by arrangement with the IMF is in force.

Conclusion

The existing system of support from central authorities to local communities has a lot of good characteristics and should not be completely abandoned; on its basis improvements and amendments by new instruments applied in other countries should be made.

Constitutional change will probably bring changes in the territorial organization of Serbia that together with issues presently un-addressed

15 This is, surely, a classic moral hazard.

or solved, but not in the best way, demand the reexamination of the overall financing of local communities. Main issues are fundamental:

1. jurisdiction of local communities,
2. own revenues of local communities,
3. solving of problems of vertical and horizontal imbalance,
4. (co)financing of local investments and
5. control of indebtedness of local communities.

All these issues are interconnected, and the answer to them will determine the modality and quality of functioning of local communities in the future.

The basic lines of these changes, that are either suggested in this text, or that can be deduced from it, are the following: widening of the sources of own revenues of local communities; improvement of the formula for the distribution of transfers to local communities, including also introduction of fiscal capacity measures and stimulating measures of local efforts; transfer to local communities should be based on a combination of division of shared revenues and cash subsidies from the budget of Serbia; formulating of rules for co-financing of local investments; introduction of modern method of limitation of indebtedness of local communities.

III Excise Duties

CURRENT EXCISE DUTIES SYSTEM

According to the assessment of the Ministry for Finance and Economy of the Republic of Serbia, the gray market in oil derivatives was reduced from 50% in 2000 to less than 5% in 2001 and subsequent years, while gray market in cigarettes was reduced from approx. 90% in 2000 to approx. 16% in 2001 and subsequent years (approx. 35% if only imported cigarettes are considered). It is on account of such good results attained in the fight against contraband of oil derivatives and tobacco products that excise duties became a significant source of tax revenue, as demonstrated by the data shown in Table 1.

Current excise duties system, as introduced on 1st April 2001, is based on specific rates, with the exception of luxury products where rates are defined *ad valorem*. Specific rates are indexed quarterly by the retail price growth rate.

Share of excise duties in total tax revenue in the year 2002 amounted to 16.73%, and in total revenue from taxes and social contributions to 11.84%. In the first six months of 2003, share of excise duties in collected tax revenue amounted to 16.86%, and in the revenue from collected taxes and social contributions it amounted to 11.96%. For the sake of comparison, share of excise duties and earmarked taxes on excisable products in the total revenue from taxes and social contributions amounted to no more than 5.43% in 1999.

Excise duties levied on three "traditional" excise products – oil derivatives, tobacco products, and alcoholic drinks constitute as much as 95.5% (in 2002), or 96.2% (in the first six months of 2003) of the excise-tax based revenue. In July 2003, National Assembly adopted amendments to the Law on Excise duties, thus abolishing excise duties on table salt and luxury products (as well as on *natural* wines) and, consequently, shortening the list of excisable goods. Negative fiscal impact of this shortening is insignificant while administrative and compliance costs are reduced.

Effects of the proposed changes

In order to make assessment of future fiscal effects, it would be necessary to review the strategy of excise taxation of tobacco products underlying the aforementioned Law on Amendments and Alterations

Table 1.
Fiscal Significance of Individual Excise Duties

000 Din.	1 Jan. – 31 Dec 2002		1 Jan. – 30 June 2003	
	Collected, 000	**% of Total Excise duties**	**Collected,** 000	**% of Total Excise duties**
Excise duty on Oil Derivatives	32,748,460	70.3	16,988,424	68.5
Excise duty on Tobacco Products	7,640,298	16.4	4,647,769	18.7
Excise duty on Alcoholic Beverages	4,124,936	8.9	2,226,471	9.0
Excise duty on Ethyl-Alcohol (Ethanol)	206,861	0.4	66,922	0.3
Excise duty on Table Salt	23,291	0.11	6,195	0.1
Excise duty on Luxury Products	48,897	0.1	18,321	0.1
Excise duty on Refreshing Non-Alcoholic Drinks	702,870	1.2	359,462	1.5
Excise duty in Coffee Imports	555,841	1.2	299,010	1.2
Special duty for in-transit goods tax burden leveling	555,049	1.2	183,098	0.7
Total Excise duties	46,606,503	100	24,805,672	100
Total Revenue from Taxes	278,544,026		147,118,659	
Total Revenue from Taxes and Social Contributions	393,723,616		207,361,458	

of the Law on Excise duties. This strategy foresees that the current system of excise duty on tobacco products, which is based exclusively on specific excise duties (there are three types /A, B and C/ of specific excise duties and their levels are quarterly adjusted by retail price growth rate), remains in force until 31st December 2004, to be replaced, beginning with 1st January 2005, with a combined system (specific + *ad valorem* excise tax). From that date onward, cigarettes would be classified solely in two groups – domestic and imported; specific excise duty would amount to 1 dinar per pack of locally produced and 10 dinars per pack of imported cigarettes, while *ad valorem* excise duty would amount to 30%. Beginning with 1st January 2007, specific excise duty on domestic cigarettes would be increased to 2 dinars, and *ad valorem* excise duty to 40%. Finally, beginning with 1st January 2010, differentiation would no longer be made between domestic and imported cigarettes; specific excise duty would amount to 5 dinars per pack, and *ad valorem* excise duty to 50%.

Let us now examine the effects on fiscal revenues which would be produced by the first alteration foreseen for 1 January 2005 – namely, by substituting the "ABC Classification" with a differentiation between domestic and imported cigarettes and introduction of the combined system (specific + *ad valorem* excise tax).

Table 2.
Calculations of the Changes in Prices of Cigarettes and Public Revenues, as Generated by the Excise duty Reform after 1 January 2005

	Zeta (C)	**Best Light (B)**	**Marlboro (A)**	**Marlboro (A)**
	Domestic Product	Domestic Product	Import	Domestic Product
1. Current Retail Price	24.00	35.00	80.00	–
2. Sales Tax (16.67% of 1)	4.00	5.83	13.33	
3. Specific Excise Tax	4.70	9.93	22.17	
4. Trade Margin (10% of 1)	2.40	3.50	8.00	
5. Manufacturing Price + Customs Duty (1-2-3-4)	12.90	15.74	36.50	
6. Customs Duty (0.1342 * 5)	–	–	4.90	
7. Manufacturing Price / Import Price	12.90	15.74	31.60	
8. Retail Price in 2005	32.08	38.63	107.31	75.24
9. Sales Tax (16.67% of 8)	5.35	6.44	17.89	12.54
10. Specific Excise Tax	1.00	1.00	10.00	1.00
11. *Ad valorem* Excise duty (0.3000 * 8)	9.62	11.59	32.19	22.57
12. Trade Margin (10% of 8)	3.21	3.86	10.73	7.53
13. Manufacturing Price + Customs Duty (8-9-10-11-12)	12.90	15.74	36.50	31.60
14. Customs Duty (0.1342 * 13)	–	–	4.90	–
15. Manufacturing Price / Import Price	12.90	15.74	31.60	31.60
Increase of Retail Price, in Percent	33.67%	10.37%	34.14%	–5.95%
Increase of Public Revenues per a Pack in Absolute Amount	7.27 din.	3.27 din.	24.58 din.	–4.29 din.
Increase of Public Revenues per a Pack, in Percent	83.56%	20.75%	60.84%	–10.62%

Domestic market in cigarettes is now estimated at approx. 21,000 tons (1,050 million packs), or at Đ 700,000,000 per year. Share of locally produced cigarettes in the market is now approx. 60%, in terms of the volume, and 38%, in terms of the value. According to the volume, in the current "ABC Classification" Group C Cigarettes are represented by 8,100 tons (405 million packs), Group B Cigarettes by 4,700 tons (235 million packs), and Group A Cigarettes by 8,400 tons (420 million packs). According to the value, share of Group C Cigarettes is approx. 10%, share of Group B Cigarettes approx. 28%, and share of Group A Cigarettes approx. 62%.

Since it may be expected, based on the results of the tender for privatization, that Philip Morris buys DIN, and that BAT buys DIV, and taking into account that these companies have announced the intention to produce in future their international brands in these factories, it is likely that there will be some changes in the structure of cigarette consumption on the Serbian market. Present share of the Philip Morris

Table 3.
Structure of the Excise Tax, Sales Tax, and Custom Duties Collection, as per Groups of Cigarettes in Accordance with Current Regulations

	Total Public Revenues per pack	Number of Packs, 000	Legal Sales, 000	Collected Public Revenues, 000
Group A Cigarettes	40.40 din.	420,000	273,000,000	11,029,200
Group B Cigarettes	15.76 din.	235,000	235,000,000	3,703,600
Group C Cigarettes	8.70 din.	405,000	405,000,000	3,523,500
Total				18,256,300

and BAT brands in Serbian market amounts to 3,590 tons (17.1%), or to € 205.2 million (29.4%). If, *ceteris paribus*, we assume that 90% of those cigarettes will be produced in DIN and DIV, this would mean that consumption of domestic cigarettes on this basis shall rise by 3,200 tons (160 million packs), while import shall fall to a total of 5,200 tons (260 million packs). Total consumption of domestic cigarettes (present Groups B and C and international brands that are locally produced and consumed) would amount, *ceteris paribus*, to 16,000 tons (800 million packs).

Table 4
Structure of Excise Tax, Sales Tax, and Customs Duties Collection, as per Groups of Cigarettes, after 1 January 2005

	Total Public Revenues per Pack	Legitimate Sales, 000	Legitimate Sales, 000	Collected Public Revenues, 000
Domestic Cigarettes Out of which:		800,000		
– Present Group B	19.03 din.	235,000	235,000	4,472,050
– Present Group C	15.97 din.	405,000	405,000	6,467,850
– Locally Produced International Brands (present Group A)	36.11 din.	160,000	160,000	5.777.600
Imported Cigarettes (present Group A)	64.98 din.	260,000	169,000	10,981,620
Total				27,699,120

According to this scenario, the total amount of the collected public revenues would rise by 51%. However, even if the import of cigarettes falls drastically (due to domestic production of international brands) – for example, from 169 million packs to 80 million packs, and assuming that consumption of locally produced international brands rise by 89

million packs, the collected public revenues would exceed those in the present regime by approx. 38%. Also, it can be reasonably expected that excise duty and other revenues from cigarettes would additionally rise due to further shrinkage of contraband, which would be yet another positive effect of having the two world's largest producers of cigarettes in Serbia. A certain increase of revenue may also be expected based on a shift in consumers' orientation from the lower-quality cigarettes (present Group C) to better-quality tobacco products (present Group B and locally produced international brands).

SUMMARY OF THE PROPOSED CHANGES

With the scope of changes proposed with regard to other types of taxes and the obligations arising from the legislative process in mind, it is not particularly necessary to revise the Law on Excise duties at this stage. Upon conclusion of the EU Stabilization and Association Agreement, excise regulations would need to be further harmonized with the corresponding EU regulations – both in view of the level of excise levies and the regulation of bonded warehouses system.

IV Idividual Income Tax

CURRENT INCOME TAX SYSTEM

Individual income tax system in Serbia is in fact dual: all income recipients are liable to schedular taxes, and a small number of taxpayers (8,266 for 2002), whose annual income (after deducting schedular taxes paid) exceeds the prescribed threshold (688,010 dinars for 2002), are liable to a complementary annual income tax. This tax is thus assessed only for the income *exceeding* the threshold, and schedular taxes paid during the year may not be credited against the liability based on the complementary tax. The share of complementary annual income tax in total revenues from individual income tax is quite insignificant (0.17% in 2002; 0.50% in the period January 1 through June 30, 2003[16]).

Schedular taxes

All types of income are liable to schedular taxes, except for those exempt in accordance with Article 9 of the Individual Income Tax Law, but their rates are nevertheless differentiated. If the statutory rates are taken into consideration, then there are two: 14% on the so-called earned income (salaries and wages, business income, and cadastral income from agriculture and forestry), and 20% on capital income (dividends, interests, rent and capital gains) and on certain other incomes (incomes from copyright and industrial property rights, income from single professional service contracts and contracts on temporary and occasional services, remuneration for managing board members, earnings of members of youth and student cooperatives, sportspersons' income, gambling income, personal insurance payments received, etc.). However, the Individual Income Tax Law regulates different prescribed expenses for different categories of income, namely:

- 0% for wages and salaries;
- 50% for dividends;

16 Since annual individual income tax is due in the first half of the year, a more significant rise in revenues from that tax is not to be expected by the end of 2003. Therefore, it is reasonable to expect that for the entire year of 2003 the share of annual individual income tax in the sum of revenues from individual income tax will be between 0.20% and 0.25%.

- 0% for interests;
- 20% for rent;
- 10%; 40%; 45%; 50%; 55%; 65% for income from copyright and industrial property rights;
- 50% for income of sportspersons;
- 40% for earnings of members of youth and student cooperatives;
- 20% for income from single professional service contracts and contracts on temporary and occasional services, for remunerations to members of managing boards, etc.;
- 0% for personal insurance payments received;
- first 10,000 dinars for gambling income;
- the amount of capital gains realized through sale of real property, invested in purchase of the main home of the taxpayer.

Therefore, *effective* rates of schedular taxes are differentiated to a greater extent than could be surmised from the statutory tax rates:

Table 1.
Statutory and Effective Rates of Schedular Taxes on Individual Income

Type of Income	Statutory Tax Rate, in %	Effective Tax Rate, in %
Wages and salaries	14	14
Business income	14	–
Cadastral income from agriculture and forestry	14	–
Dividends	20	10
Interests	20	20
Rent	20	16
Income from copyright and industrial property rights	20	7; 9; 10; 11; 12; 18 (most often: 10)
Sportspersons' income	20	10
Earnings of members of youth and student cooperatives	20	12
Single professional service contract and contract on temporary and occasional services income, remuneration to managing board members, etc.	20	16
Personal insurance payments received	20	20
Gambling income	20	20 (on the amount exceeding 10,000 dinars)
Capital gains	20	between 0 and 20 (depending on reinvestment)

The analysis shows that the individual income tax system in Serbia is characterized by considerable qualitative differentiation in taxation, and that effective tax rates vary from 7% to 20% (overall number of effective tax rates being nine), depending on the category of income

(however, with the capital gain the effective rate may be below 7% – even 0%). The rule "*a buck is a buck is a buck*" is, therefore, not observed in practice, and the effective rate level is often a result of discretionary decisions following negotiations between certain interest groups and the Government (sportspersons – in order to legalize payments previously realized in the gray zone; youth and student cooperatives – because of a strong lobby in the National Assembly, etc).

In such circumstances, a lot of effort is put into classification of certain types of income, since the distribution of tax burden does not depend on the ability-to-pay principle, i.e. on the *amount* of the taxpayer's income, but on the *category* of the income realized by the taxpayer. In that manner, the horizontal equity principle is not observed, since persons with the same income do not pay the same taxes.

Qualitative differentiation of schedular taxation for certain types of income influences complementary individual income tax as well, since the base for this tax is *taxable* income, which depends on the extent of recognized prescribed expenses. The 10% annual individual income tax is payable on the sum of taxable incomes from all sources (except for capital gains and gambling income), after schedular taxes and social security contributions paid by an employee have been deducted, when exceeding the prescribed threshold (for 2002, it was 688,010 dinars).

Bearing all this in mind, it is our suggestion that prescribed expenses should be made uniform at the level of 20% for income from rent, income from copyright and industrial property rights, earnings of members of youth and student cooperatives, incomes from single professional service contracts and contracts on temporary and occasional services, remuneration to managing board members, and other incomes of similar nature. Should actual expenses exceed 20%, it is the taxpayer's duty to present evidence, as the case has been so far. Bearing in mind the specific circumstances (previously nearly total evasion, beginning of the legalization of payment transactions, short duration of the active period in which such incomes may be attained, etc.), prescribed expenses for sportspersons' income may remain at 50%. Tax treatment of dividends, interests and wages and salaries will be discussed in more detail below.[17]

Complementary annual individual income tax

It is possible to find arguments to support the view that annual individual income tax, in spite of the proportional statutory rate, is in fact an *indirectly progressive* tax, since the first 688,010 dinars (+ 68,801 dinars of personal exemption + 22,934 dinars for each dependent family member) of the income are exempt.[18] However, only about 0.2% of

17 See paragraphs 3.2 and 3.3 in this Chapter.

18 The Law prescribes annual indexation of these amounts through applying the rate of wage/salary increase in the Republic.

the taxpayers liable to individual income tax are subject to complementary annual income tax.[19] Therefore it is evident that for about 99.8% taxpayers liable to individual income tax, the tax is both effectively and legally proportional. Thus, due to the absence of progressiveness, the principle of vertical equity is not observed, according to which a person with a higher income should be taxed proportionally more.

As for the alleged advantage of the dual income tax system – that the number of taxpayers having to file the annual tax return is much smaller, implying simpler and cheaper administration of income tax – it must be seen as relative, due to the fact that the Tax Administration in any case has to control also those natural persons failing to file a tax return; if not, it will not be able to fight the most flagrant form of tax evasion – non-reporting of income. Therefore, we are of the opinion that the conditions are ripe for the dual system to be abandoned and replaced by a global (synthetic) individual income tax system.

FISCAL IMPORTANCE OF INDIVIDUAL INCOME TAX

Individual income tax is an important fiscal form in the public revenue system of Serbia. In 2002, the amount of 53,187,015,000 dinars was collected from income tax, which stood for 19.1% of total tax revenue, or 13.5% of total revenue from taxes and social contributions. In the first six months of 2003, the amount of 28,247,487,000 dinars was collected from income tax, which stood for 19.2% of total tax revenue, or 13.6% of total revenue from taxes and social contributions. In the revenue from the individual income tax the major part is from tax on wages and salaries (87.7% in 2002; 87.8% in the first six months of 2003). Table 2 shows relative importance of revenue from certain types of income tax.

In addition to tax on wages and salaries, certain significance also have tax on other incomes (income from single professional service contracts and contracts on temporary and occasional services, remuneration to managing board members, earnings of members of youth and student cooperatives) and tax on business income, as well as tax on income from copyright and industrial property rights, which amounts to slightly more than 1% revenue from income tax.

Let us also look into the data on the number of taxpayers for certain types of individual income tax.

It can be deduced from the table that, except for the tax on income from rent, other withholding taxes are relatively abundant, if they are considered per withholding agent. The Tax Administration does not possess data on the number of income recipients liable to withholding

19 About 0.4% – if the payers of the tax on cadastral income from agriculture and forestry are excluded.

Table 2.
Fiscal Importance of Certain Types of Individual Income Tax

Type of Individual Income Tax	Jan. 1 – Dec. 31, 2002		Jan. 1 – June 30, 2003	
	Collected, 000 Din.	% of income tax	Collected, 000 Din.	% of income tax
Tax on wages and salaries	46,637,431	87.7	24,815,025	87.9
Tax on business income	2,150,639	4.0	962,902	3.4
Tax on cadastral income from agriculture and forestry	72,561	0.1	10,700	0.0
Tax on dividends	394,782	0.7	270,060	1.0
Tax on interests	130,874	0.3	139,307	0.5
Tax on rent from real estate	259,286	0.5	161,803	0.6
Tax on rent from movable property	23,774	0.0	10,142	0.0
Tax on income from copyright and industrial property rights	622,081	1.2	379,652	1.3
Tax on gambling income	37,486	0.1	20,507	0.1
Tax on capital gains	33,120	0.1	15,836	0.1
Tax on personal insurance payments received	230,039	0.0		
Tax on other incomes	2,733,507	5.1	1,321,396	4.7
Annual individual income tax	91,451	0.2	140,117	0.5[20]
Total revenue from individual income tax	53,187,015	100	28,247,487	100
Total tax revenue	278,544,026		147,118,659	
Total revenue from taxes and social contributions	393,723,616		207,361,458	

taxes, but we can estimate that when it comes to the most significant type of the tax – tax on wages and salaries, the average revenue per income recipient – employee is about 24,000 dinars a year, or about 2,000 dinars a month.

Revenues per taxpayer concerning taxes assessed by the decision of the Tax Administration are insignificant, which indicates the necessity of assessing the tax base more realistically.

The tax base is undervalued when it is the case of the tax on business income, where about 60% of taxpayers pay a lump-sum tax, thus providing only about 33% of revenue from that tax. That is why it is necessary to make the law prescribed criteria for granting lump-sum taxation stricter, and particularly to eliminate the possibility that services where potentially significant added value is created (like law practice) be liable to this type of lump-sum tax.

20 See estimate referred to in footnote 1 in this Chapter, stating that for the entire year of 2003 the share of annual individual income tax is expected to be between 0.20% and 0.25%.

Table 3.
Number of Taxpayers for Certain Types of Individual Income Tax in 2002

Type of Individual Income Tax	Number of Taxpayers	Revenue per Taxpayer
1. Withholding taxes		
Tax on wages and salaries	113,409[21]	411,232[21]
Tax on dividends	–	–
Tax on interests	–	–
Tax on rent from real estate	12,148	21,344
Tax on rent from movable property	2,976	7,989
Tax on income from copyright and industrial property rights	4,811	129,304
Tax on gambling income	91	411,934
Tax on personal insurance payments received	–	–
Tax on other incomes	31,140	87,781
Taxes after assessment decision		
Annual individual income tax	8,266	11,063
Tax on business income	171,025	12,575
Tax on cadastral income from agriculture and forestry	1,345,850	54
Tax on capital gains	2,158	15,348

The tax base is *particularly* undervalued in case of the tax on cadastral income from agriculture and forestry, where cadastral income has not been revaluated for almost eight years, which implies that the share of this tax in total revenues from taxes and social contributions is hardly 0.02%, and the share of cadastral income in GDP stands at only 0.04%. Fiscal revenue per decision on tax assessment is 54 dinars, which barely covers the costs of typing, paper and postage.[23] That is why it is our proposal that the revaluation of cadastral income should be carried out in the Republic, which procedure is within the competence of the National Assembly. Since the share of agriculture in the GDP is about 20%, and the share of the individual sector in the national income in agriculture is about 10%, the cadastral yield should – if it was to indicate real economic power – be increased by

21 This refers to employers – payers of wages and salaries. It is our estimate that the number of employees receiving wages or salaries in 2002 was 1,969,446. See paragraph 3.3 in this Chapter.

22 Revenue per taxpayer – employee was 23,680 dinars. For an estimate of number of employees, see paragraph 3.3 in this Chapter.

23 Fortunately, the Tax Administration issues the general tax assessment decision, which, in addition to tax on cadastral income from agriculture and forestry, assesses other public duties as well (property tax, fee for use of waters, social insurance contributions).

about 50 times. Bearing in mind that the position of individual farmers should be assessed in view of the fact that elderly households are predominant, that in the individual agriculture sector exchange in kind is still present to a significant extent, and that the political influence of the "farmers' lobby" is relatively powerful, it is difficult to expect that the fifty-fold increase in cadastral revenue could be applied at once. However, by the end of 2003 half of this road may be traveled.

TRANSITION TO GLOBAL INCOME TAX SYSTEM

Global system of individual income tax is today present in all the member states of OECD, and in most countries of Central and Eastern Europe. This tax is fairer than the schedular model, since it enables the implementation of the *ability-to-pay* principle, and – since it avoids qualitative differentiation of certain categories of income – it implies neutrality, which the schedular system lacks. Before defining the characteristics of the global system of income tax in Serbia, several issues should be considered.

Taxpayer – individual or spouses?

While in the member states of OECD the taxpayers subject to individual income tax with almost the same frequency are individuals and spouses, in less developed tax systems of the countries of Central and Eastern Europe individual taxation is absolutely predominant. The reason for that is the administrative simplicity, since the joint taxation of spouses involves complex mechanisms of income splitting, family quotas or dual tax scales. Bearing in mind the current situation in the tax administration in Serbia, we are of the opinion that individual taxation should continue.

Should all the incomes be globalized?

A number of OECD member states, as well as some countries in transition, have the practice of non-inclusion of dividends in taxable income, as the tax base for global tax: dividend income is subject to special treatment, since attention is paid to the fact that there is economic double taxation (profits to be distributed are firstly taxed through enterprise profits tax, and then, upon distribution, through individual income tax paid by a shareholder). The most frequent mechanisms of tax integration are imputation systems, where the corporate profits tax (fully or partially) is first imputed into the taxable income of a shareholder, and then credited against his assessed income tax. Bearing in mind the relative complexity of the imputation procedures, we are of the opinion that Serbia should implement either the method of exemption of dividends (Greece, Croatia, Baltic countries),

in which case the dividends would be completely excluded from the scope of individual income tax and liable only to corporate profits tax, or the method of taxation of dividends by way of a final withholding tax (its rate being lower than the rate of the global individual income tax), implying that the dividends would not be included in the base of global individual income tax (Denmark). Since the total exemption of dividends would probably bring about a critical reaction from the public, a partial tax relief in the sense of the dividends being subject to a lower final withholding tax seems to be a more acceptable option. A similar solution could be applied with respect to interest.

What kind of progression?

The simplest mechanism of introducing tax progression is the so-called *indirect progression*, meaning the prescribing of a nontaxable threshold, and the taxation of income exceeding that threshold by proportional rate. If a taxpayer has a certain number of family members as dependants, the threshold could be differently assessed for a taxpayer without any dependants, for a taxpayer with one dependant, for a taxpayer with two dependants, etc. However, the threshold must be maximized at a certain level (e. g. for three and more dependent family members).

Starting with the poverty level, which was empirically assessed at 4,489 dinars per month per consumer unit (Krstić, 2003), the amount of basic standard allowance could be at the monthly level of e. g. 4,500 dinars, or 54,000 dinars annually. With regard to *per capita* GDP, amounting to about 130,000 dinars, it is about 42% (Bulgaria – 43%; Croatia – 48%; Rumania – 48%). If **N** is the number of taxpayers – employees, and the data are that the revenue from tax on wages and salaries in the first six months of 2003 was 24,815,025,000 dinars, that the average gross wage/salary was 15,000 dinars, and that the rate of tax on wages and salaries was 14% on the base equal to the gross wage/salary, it equals:

$$N \times 15{,}000 \times 0.14 \times 6 = 24{,}815{,}025{,}000$$
$$N = 1{,}969{,}446$$

In order for the fiscal revenue from tax on wages and salaries to remain at the same level when the tax base is reduced by the amount of basic standard allowance, the tax rate (**t**) would have to be increased:

$$1{,}969{,}446 \times (15{,}000 - 4{,}500) \times t \times 6 = 24{,}815{,}025{,}000$$
$$t = 0.20$$

Should the Government wish to have a more active role in social or demographic policy as related to fiscal policy, by way of granting additional standard allowances for dependants, the tax base would further decrease, which would, *ceteris paribus*, entail further increase in the tax

rate.[24] Bearing in mind the absence of a reliable IT base to ensure that additional standard allowances will not be abused, it is our suggestion that only the basic standard allowance should be introduced into the individual income tax system at this time.

Nonresidents

There are several issues concerning withholding taxes on income paid to nonresidents that call for consideration.[25]

Firstly, the issue of justification of granting tax relief by reducing the tax base for tax on dividends to nonresident shareholders by 50%. It is our opinion that such relief is rational only in the context of alleviation of economic double taxation – therefore, with resident shareholders. The tax base following the allowance deduction for a nonresident shareholder should be 100% of dividends, even more so since that shareholder is liable to global tax on his worldwide income in his country of residence, and therefore there is no personal gain for him from the allowance granted in Serbia.

Article 95 of the Individual Income Tax Law should specify that the taxpayer whose withholding taxes have not been assessed shall file a tax return.

There are no provisions in the Individual Income Tax Law that specify the procedure for realizing the rights of nonresidents to tax treatment in accordance with double taxation treaties. It is our opinion that it is necessary to prescribe that the payer may apply the provisions of a relevant treaty if the nonresident can prove his status as a resident of the country – signatory of the treaty, if he is the final recipient of the income, and if he is entitled to make use of the provisions of that treaty. The income payer – withholding agent would be under obligation to enter in the tax return the data on income realized by the nonresident, on withholding tax paid in accordance with the provisions of the given double taxation treaty, the tax rate applied, etc.

Finally, since the withholding tax should be introduced to apply on some other incomes paid to nonresidents (in addition to existing taxes

24 On the other hand, another tax rate for taxable income exceeding a certain highly set limit (e.g. twenty times annual per capita GDP – about 2,600,000 dinars) – say, in the amount of 30% – may be introduced. Such a solution would make the system directly progressive for the taxpayers whose taxable income is exceptionally high.

25 Also, it is necessary to specify more precisely the provision of Article 107, Paragraph 1 of the Individual Income Tax Law, which stipulates that a taxpayer, receiving earnings and other incomes from abroad, from a diplomatic or consular representative office of a foreign country, or from an international organization, or from representatives or employees of such a representative office or organization, shall within eight days of the day of receipt of the salary or other income, himself assess and make the payment of the withholding tax, if such a tax has not been assessed and the payment made by the income payer – employer. It is our opinion that this obligation should also be introduced in case when a taxpayer receives wages and other income abroad, and the income payer fails to assess and make the payment against withholding taxes.

on dividends, interest and authors' fees),[26] including income from disposal under compensation of the real estate located in the territory of the Republic of Serbia, or from selling shares in such property, a nonresident taxpayer who has proved that such a tax was collected from him, should be granted the right to diminish the tax on the capital gains realized on the sale of the given real estate or shares.

SUMMARY OF CHANGES PROPOSED

To sum up, we propose a system of income tax which would aggregate all the income of the taxpayer (except for dividends and interest,[27] which would be liable to a final withholding tax, at the rate of 10%), with the basic standard allowance of 4,500 dinars per month (54,000 dinars per year), and which would operate the tax rate of 20%. All the income would, therefore, be subject to the statutory rate of 20%, and effective rates would be leveled by way of prescribing unified prescribed expenses at the level of 20% for income from rent, income from copyright and industrial property rights, earnings of members of youth and student cooperatives, income based on contracts for single professional service and contracts on temporary and occasional services, remunerations to members of managing boards and other similar income. The right to the basic standard allowance could be realized through paying tax in advance (e.g. 1/12 of 54,000 dinars at each time of paying tax on wages and salaries, tax on business income, etc.), but the taxpayer would be entitled to advance allowance *solely* based on one type of income. If he does not receive income from more than one source, he would not even have to file an annual tax return for individual income tax. An annual tax return would not have to be filed even when taxpayer receives income from salaries and other sources, provided that he has received 12 salaries (and consequently realized the entire basic standard allowance). Should he, however, during the year fail to realize the entire basic standard allowance (e.g. because he has not received all 12 monthly salaries), it is in his interest to file an annual tax return, so that he can realize the refund of overpaid advance income tax. The fact that standard allowance is to be deducted from certain category of income during the year must be reported to the Tax Administration.

Since all the income payers are obliged to submit to the Tax Administration individual tax returns by January 20, 2004, where the amount of wage/salary (or other income) paid in 2003 to each of the income recipients would be stated, the Tax Administration would have a reliable database for auditing taxpayers who would, following the pending

26 New withholding taxes on incomes paid to nonresidents will be discussed in more detail in the chapter on corporate profit tax.

27 Aggregation would not include cadastral income from agriculture and forestry until the revaluation, which would reflect the actual economic power of farmers.

change to the global income tax, report a smaller income, wishing to use the existence of nontaxable standard allowance.

Possible introduction of standard allowances for dependent family members, as well as certain non-standard allowances (e.g. for paid contributions for voluntary social insurance), should be postponed for a later stage of fiscal reform.

Examples

1) Income solely from wages and salaries

Month	Gross salary		Basic Standard Allowance	Tax Base		Tax (20%)	
	A	B		A	B	A	B
January	12,000	22,000	4,500	7,500	17,500	1,500	3,500
February	11,000	20,000	4,500	6,500	15,500	1,300	3,100
March	13,000	27,000	4,500	8,500	22,500	1,700	4,500
April	13,000	26,000	4,500	8,500	21,500	1,700	4,300
May	12,000	25,000	4,500	7,500	20,500	1,500	4,100
June	14,000	29,000	4,500	9,500	24,500	1,900	4,900
July	14,000	29,000	4,500	9,500	24,500	1,900	4,900
August	13,000	28,000	4,500	8,500	23,500	1,700	4,700
September	16,000	30,000	4,500	11,500	25,500	2,300	5,100
October	17,000	30,000	4,500	12,500	25,500	2,500	5,100
November	17,000	29,000	4,500	12,500	24,500	2,500	4,900
December	17,000	31,000	4,500	12,500	26,500	2,500	5,300
Total	169,000	326,000	54,000	115,000	272,000	23,000	54,400

The tax on wages and salaries now shows progressive effect, in spite of the proportional rate of 20%. Taxpayer A, whose annual gross salary is 169,000 dinars, pays 23,000 dinars in taxes, and thus his effective rate is 13.61%. Taxpayer B, whose annual gross salary is 326,000 dinars, pays 54,400 dinars in tax, and thus his effective rate is 16.69%.

2) Income from wages or salaries (10 months) and from authors' fees

- taxpayer B's salary (data from the above table for period January – October): 266,000 dinars; advance tax on income paid in the amount of 44,200 dinars
- author's fees
  - gross fees: 400,000 dinars
  - prescribed expenses (20%): – 80,000 dinars
  - taxable income: 320,000 dinars
  - advance income tax (20%) – 64,000 dinars
- aggregate income: 266,000 + 320,000 = 586,000 dinars

– basic standard allowance: –54,000 dinars
– taxable income: 532,000 dinars
– income tax liable (20%): 106,400 dinars
– advance tax paid: 44,200 + 64,000 = 108,200 dinars
– for refund: 1,800 dinars

EFFICIENCY OF COMPLIANCE PROCEDURES

The Law on Tax Procedure and Tax Administration came into effect on January 1, 2003, but the Tax Administration could not start operating fully until April, since the internal restructuring of that agency was not completed in time. Therefore, at the time of writing this report, it is impossible to assess the effects of the new organizational structure of the tax administration, though the Law itself was appraised as compliant with the best international practices.

The available data concern 2001 and refer only to taxes assessed by the decision of the competent tax authority, and taxes that could be classified as part of the self-assessment regime.

Table 4.
Realization of the Tax Collection Target of the Republic Public Revenue Administration in 2001

Type of Tax	Percentage of Realization of the Tax Collection Target
Tax on cadastral income from agriculture and forestry	59.2
Farmers' contributions	44.3
Tax on business income	60.1
Tax on income from real estate	49.8
Enterprise profits tax	100.2
Sales tax	105.0
Excise duties	116.6

It can be concluded from Table 4 that when it comes to taxpayers – legal entities, the tax collection target was met even over 100%. The question is, of course, whether the tax collection target was set ambitiously enough. As for taxpayers – natural persons, the tax collection target was met barely around 50%, with the number of decisions issued concerning the first four tax types from the above table being 2,099,996. Therefore, compliance concerning that domain of income tax may be assessed as poor, and the income tax administration system – bearing in mind also the data from Table 3 on collected revenue per taxpayer – as inefficient.

In view of the fact that the collection of withholding taxes until December 31, 2002 was carried out through the ZOP (Bureau for Clearings and Payments), the Republic Public Revenue Administration was not in the position to carry out the tax procedure properly – certainly not in certain important segments like collection and auditing of tax on wages and salaries, and other withholding taxes.

According to the data for 2002, tax audits were conducted by 1,160 inspectors per month on average. The number of tax audits conducted was 76,450 (5.5 audits per month per inspector), and at the annual level 2,265,363 hours was spent, which means 29.6 hours per audit.

Based on the Tax Administration report, it is our conclusion that the criteria for selection of taxpayers to be audited by the end of 2002 were:

- available information and indications on undeclared taxes and taxes not paid in due time;
- volume of gyro-account transactions;
- disproportion between transactions realized (recorded with the ZOP) and taxes paid;
- data on the taxpayer obtained from the Customs Administration and other government agencies;
- information on irregularities established in the audits in the previous period, concerning the taxpayer or a person in business relationship with the taxpayer planned for auditing;
- information that the same person is registered as an sole proprietor and a founder of one or more legal entities;
- requests for auditing by the Ministry of Interior, inspection services, etc.

The new Law on Tax Procedure and Tax Administration stipulates that tax auditing be conducted based on annual or extraordinary plans, drawn by the Tax Administration chief officer, and based on assessing: (a) fiscal significance; and (b) fiscal risk concerning the taxpayer.

It is our opinion that *fiscal significance* of the taxpayer may be assessed based on:

- total annual turnover;
- value of property;
- amount of profits declared;
- number of employees;
- amount of wages or salaries paid;
- whether it carries out production, import or trade in excise products or trade in other products or services estimated to be of special fiscal significance; etc.

Fiscal risk could be assessed based on:

- the extent of discrepancy between the taxpayer's business results and the results of the relevant industry;
- ratio of tax collection in that industry and the assessed business activity of that industry;
- previous compliance with tax regulations on the part of the taxpayer;
- volume of declared tax relief;

- frequency of declaring operational losses;
- whether the taxpayer has, and to what extent, invested capital funds outside the territory of the Republic; etc.

The first field and office audits in accordance with the new Law started only in mid-June of 2003. In the first week of tax audits (June 16-24), 795 field and 2,477 office audits were conducted, while for the period from June 16 to July 16 the number of 6,193 field audits and 18,137 office audits were to be conducted.

Let us summarize. Only the centralization of the entire tax procedure within the Tax Administration has created conditions for a more efficient individual income tax administration, and, generally speaking, tax system administration. In that context, it was important to establish the Large Taxpayers Unit, which ensures a more efficient cooperation with fiscally most significant taxpayers, along with intensified monitoring measures.

According to the data for the first six months of 2003, about 300,000 withholding tax returns are filed per month on average. However, it is of importance that 1,000 largest taxpayers[28] of withholding taxes paid 50.6% of the total amount of collected withholding taxes (over 44 billion dinars). But, within this number of taxpayers, as much as 29.8% of the total amount of collected withholding taxes (over 26 billion dinars) was paid by budgetary spending units (301) and state owned enterprises (87). It can be concluded from the given data that the focusing of the tax audit resources on the 'large' taxpayers might ensure that the volume of tax evasion in that group does not increase. Whether there is room for reducing tax evasion is the question that cannot be easily answered, since almost 30% of the revenue from withholding taxes was collected from 388 'large' budgetary spending units and 'large' state-owned enterprises. As for those taxpayers, their possibilities for tax evasion are anyway slightest, due to the presence of state representatives in the managing bodies. Other 'large' taxpayers, accounting for 18 billion dinars collected (20.8% of the total sum of withholding taxes collected) have an inherent capacity for increased tax collection, since they encompass the enterprises in social ownership, mixed ownership or private ownership.

On the other hand, the remaining 299,000 taxpayers should not be ignored, since they paid 49.4% of the revenue from withholding taxes in the first six months of 2003. Many among them are within the gray economy zone, where they either use the work of employees that are not reported, or report unrealistically low salaries, while the employees receive the remainder of the money due them in some of the prohibited ways. It goes without saying, of course, that the selection criteria shall be applied to this large group of taxpayers in order for the tax auditing to be able to be conducted at all.

28 Large Taxpayer Unit encompasses about 300 taxpayers.

V Contributions System for Mandatory Social Insurance

CURRENT SITUATION

The system of the contributions for mandatory social insurance embraces three different mandatory contributions: for pension insurance, health insurance, and unemployment insurance. Laws governing the rights arising from insurance delineate the insured, the persons liable for insurance payment, as well as the bases. However, the law does not prescribe a level of the rate based on which a contribution is paid. Therefore, the power to determine the level of the rate is given to the funds to which contributions are paid, including four Funds for Pension and Disability Insurance (FPDI)[29], namely the funds for the employed, the self-employed, the individual agricultural producers, and the army pension fund, the Republic of Serbia Health Insurance Agency (HIA)[30], and the National Employment Service (NES)[31].

The lowest bases for different categories of the insured are prescribed by law. However, it is the obligation of the Funds to determine, periodically, levels of the lowest bases. The Law on Pension Insurance and the Law on Employment and Unemployment Insurance, which were both adopted this year, made the lowest bases mutually compliant and defined them as a percent of average earnings in the Republic in the preceding quarter. However, since in the Law on Health Insurance, which was not amended this year, the lowest bases are still determined based on the coefficients, the method of defining the lowest bases in case of the contribution for health insurance is not in line with that in case of other two contributions. Nonetheless, in real life the amounts are in compliance when the basis for insurance is the same. In all three cases, although the contributions are withheld, even if failing to pay out the earnings or some other form of the basis for insurance, the employer is obliged to pay a certain amount in contributions. In all three cases, although the contributions are paid by the person paying the basis for the contribution, both the insured person and the employer are normally mentioned as persons liable for payment. A part of the

29 FPDI – Fund for Pension and Disability Insurance (in Serbian the abbreviation is PIO)
30 HIA – Health Insurance Agency (in Serbian the abbreviation is ZZO)
31 NES – National Employment Service (in Serbian the abbreviation is NSZ)

Table 1
Bases, Liable Persons, and Rates of Contribution for Social Insurance

Basis for Insurance	Base	Person Liable	Pension Insurance	Health Insurance	Unemployment Insurance
Employment	Earnings: eight lowest bases based on qualification degree	Insured Employer	10.30 10.30	5.95 5.95	0.55 0.55
Length of Service, in case of adjusted length of service	Earnings: eight lowest bases based on qualification degree	Employer	3.40 5.20 6.90 10.30	–	–
Nationals Employed Abroad	Earnings: eight lowest bases based on qualification degree, but determined at a higher level	Insured	20.60	11.10	–
Sick Leave at the expense of HIA (ZZO)	Amount of compensation, not less than minimum earnings	HIA (ZZO)	20.60	–	1.10
Maternity and Child Care Leave	Amount of compensation, not less than minimum earnings	Employer	20.60	10.60	1.10
Temporary and Occasional Jobs:					
à) if unemployed	Same as in case of the employed				
b) if insured on other basis: FPDI (PIO) – only retired persons, HIA (ZZO) – persons insuredon other basis	FPDI (PIO): same as in case of the employed HIA (ZZO): agreed compensation	Insured Employer	10.30 10.30	– 1.00	– –
c) through a youth or student employment agency: FPDI (PIO) – a person over the age of 26 years, or a person under the age of 26 years who is not a full-time student NES (NSZ) – a person who is not a full-time student	FPDI (PIO) and NES (NSZ): same as in case of the employed HIA (ZZO): agreed compensation	Insured Employer	10.30 10.30	– 1.00	0.55 0.55

d) through a youth or student employment agency PIO – a person under the age of 26 years who is a full-time student	agreed compensation	Youth or student employment agency	4.00	1.00	–
Compensation to Persons with Occupational Disability	Amount of net compensation	The liable person is paying and afterwards is refunded by FPDI (PIO)	–	10.40	–
Unpaid Leave	Same as in the case of the employed	Employer	–	10.40	–
Pecuniary Compensation Paid by NES (NSZ) for					
a) persons who are made redundant due to bankruptcy or liquidation	Amount of compensation	Insured (calculated and paid by NES (NSZ))	20.60	10.50	–
b) due to other reasons	Amount of compensation	Insured (calculated and paid by NES (NSZ))	–	10.5	–
Self-Employed Persons (if not insured based on employment)					
a) taxed based on net income or lump sum, not including Lump Sum Group IFPDI	(PIO) and NES (NSZ): taxable profit or lump sum, but not less than average monthly earnings in previous half year or exceeding fivefold amount of annual earnings. HIA (ZZO): net income	Insured	20.60	14.40	1.10
b) b) Lump Sum Group I as specified in the Decree on Lump-Sum Taxation	FPDI (PIO) and NES (NSZ): not less than 65% of average earnings in previous quarter HIA (ZZO): net income	Insured	20.60	14.40	1.10

Basis for Insurance	Base	Person Liable	Pension Insurance	Health Insurance	Unemployment Insurance
Independent Artists	Realized income on which the individual income tax is payable, but not less than average monthly earnings in previous half year – FPDI (PIO), or year – HIA (ZZO), or exceeding fivefold amount of average annual earnings	Insured	20.60	14.40	–
Founders of a business entity who have not established employment in such entity	Base for profit taxation, but not less than average monthly earnings in previous half year – FPDI (PIO), or exceeding fivefold amount of average annual earnings	Insured	20.60	14.40	1.10
Priests and Members of the Clergy, if they are not insured based on employment	FPDI (PIO): income, but not less than average monthly earnings in previous half year HIA (ZZO): eight lowest bases according to qualification degree with application of coefficients	Insured	20.60	11.20	–
Monks and Nuns	Minimum monthly earnings for the month in which contribution payment comes due	Insured	–	4.50	–
Compensation based on Single Assignment Contract	Agreed compensation	Insured Employer	20.6 –	– 1.00	– –
Persons undergoing professional training, or training for a different job, etc.	FPDI (PIO): minimum earnings HIA (ZZO): agreed compensation	NES (NSZ)	4.00	1.00	–
Students on Internship	FPDI (PIO): minimum earnings HIA (ZZO): agreed compensation	Schools and universities	4.00	1.00	–

Persons who have, pursuant to the Labor Law, concluded contracts on volunteer work in order for the purposes of postgraduate training, taking of state-board examination, further professional education, or specialization)	FPDI (PIO): minimum earnings HIA (ZZO): agreed compensation	Organization in which a person is volunteering	4.00	1,00	–
Persons serving a prison sentence	Minimum earnings	Institution in which the sentence is served	4.00	–	–
Supplementary work up to 1/3 and participants in public works	HIA (ZZO): agreed compensation	Employer	–	1.00	–
Pensions	Amount of pensions	FPDI (PIO)	–	10.40	–
Pensions and disability allowances acquired abroad	Amount of pension or disability allowance, but not exceeding four average earnings from the preceding month	Insured	–	17.70	–
Foreign nationals – full-time students or undergoing further professional education	Average monthly earnings	Insured	–	10.90	–
Foreign nationals working based on separate international agreements	Average monthly earnings multiplied by the coefficients the level of which depends on qualification degree (eight bases)	Insured	–	10.90	–
Employed in the households of SCG nationals seconded to work abroad	Average monthly earnings multiplied by the coefficients the level of which depends on qualification degree (eight bases)	Insured	–	11.10	–
Individual Agricultural Producers	FPDI (PIO): lowest base for QualificationDegree I and II in December of previous year HIA (ZZO): 50% average earnings in current year	Insured	20.60	4.00 for households with old persons 0.80	–

contribution considered as the insured person's payment obligation is a constituent part of his gross earnings.

Although the aforementioned principles are shared by all three types of mandatory insurance, in reality they are implemented in different ways. This makes the entire system exceptionally complicated, both for the liable persons when making payments due and for relevant TA offices when exercising due control. There are as many as thirty-five different situations concerning mandatory insurance. They may differ in terms of the lowest base level, or the person liable to pay contributions, or the rates for the same social insurance category or among different insurance categories. In addition, sometimes the definitions of the same basis for insurance are different in different types of insurance.

Employment is the major, or prevailing, basis for insurance. Eight lowest bases are determined for this basis for insurance, according to the qualification degree. In case of pension insurance and unemployment insurance, the lowest bases are given as a percent of average earnings in the preceding quarter, while in case of health insurance, the lowest bases are given in the absolute amount. In case of "adjusted length of service", where there are four different rates, the contribution rate for pension insurance is increased depending on the number of months added to a calendar year.

For the sake of clarity, Table 1 shows different kinds of basis for insurance, the base, the liable persons and the contribution rates for all three types of insurance.

RECOMMENDATIONS FOR MAKING CHANGES

As is evident from Table 1, the complexity of the entire system is, in good part, a consequence of the fact that the three laws governing this area are mutually incompatible.

In order to simplify the whole system, to level out labor costs when they differ without visible economic reason, but also to reduce the number of situations which basically encourage, by using different kinds of basis for insurance, evasion of payment of the contributions encumbering regular employment, the following changes are proposed:

- For the "adjusted length of service", determine increase of the rate proportional to the ratio between number of months in the "adjusted" year and number of months in the calendar year. In this manner, levels of the rate will be automatically calculated and there would no longer be a need to determine their specific level.
- Even out the contribution base for SCG nationals employed abroad with the contribution base for the employed in Serbia. Since the level of pension is prescribed by national regulations; namely, since a fact that a person has worked abroad has no effect on the level of pension, the same as it does not affect the rights

arising from health insurance; discrimination of this category of persons seems groundless.

- Even out total level of the rate for health insurance in the following cases:
  – Our nationals employed abroad,
  – Maternity leave and child care leave,
  – Compensations to the persons with occupational disability,
  – Compensations paid by NES (NSZ),
  – For self-employed persons,
  – For independent artists,
  – For the founders of business entity who are not employed in such entity,
  – Priests and members of clergy,
  – Compensations based on Single Assignment Contracts,
  – Pension,
  – Pension and disability allowance acquired abroad,
  – Foreign nationals studying or undergoing further professional education in Serbia,
  – Foreign nationals working in Serbia based on separate contracts,
  – The employed in the households of our nationals seconded to work abroad, and
  – Individual agricultural producers

with the overall level of the contribution rate for health insurance in case of the employed in Serbia. There are no particular reasons for these rates to differ, particularly since no difference is made between these situations in other two types of insurance.

- Bring into line the definitions and treatment of the level of contribution rate for persons involved in temporary and occasional work pertaining to health insurance and unemployment insurance, with the definitions and treatment prescribed for pension insurance. The definitions laid down by the regulations governing pension insurance aim to discourage people form supplying untruthful information about the basis for insurance in order to evade paying the full amount of due contributions.
- Abolish special treatment of unpaid leave. If a person obtains this right in conformity with the regulations governing employment, and if the employer approves it while such a person is in regular employment, the employer should be charged with the full amount of the contribution rate for all three types of insurance.
- Abolish special treatment of the supplementary work, participants in public works, and those employed in the households of SCG nationals seconded to work abroad, which is currently provided by the Law on Health Insurance only.
- Abolish special treatment of independent artists since, with regard to the way in which the lowest base is determined, their treatment is now different from that of the employed.

- Abolish special treatment of individual agricultural producers, which is now present in terms of level of the rate in health insurance (the level is lower).
- Generally speaking: the calculation should be uniformly implemented consistent with the gross principle in all cases, and the base should be defined at the same level in all three types of insurance. The rates for all three contributions should be prescribed by law. The same as in the case of the tax rates, which are prescribed by law and are not, for example, left to be decided by the Government, the contribution rates must also be laid down by law. Since we are here considering mandatory contributions, payment of which is not a matter of free choice, the level of the contribution rates – that is to say the amount of obligation, may not be left to be decided by the implementing institutions, and FPDI (PIO), HIA (ZZO) and NES (NSZ) essentially are such institutions.

The determination of the lowest base should be completely abolished, and the base for contributions should be made equal to the base for tax on earnings, or tax on income in case of self-employment. The reasons are as follows:

First, the lowest minimum base concept is a product of the existing system which is almost untraceable so that it is made difficult to sanction employers who, in order to evade payment of labor costs, and the insured who, in order to receive higher net earnings, choose to conceal the real base.

Secondly, this system is, *inter alia*, the heritage from the past when these lowest bases were primarily intended for the private sector which was, at the time, viewed with particular suspicion. These reasons for determination of the lowest bases should no longer exist in the situation where we have established a new tax institution (Tax Administration) with an already centralized tax accounting system relating to the taxes and withheld contributions, providing the effort is made to further simplify this system.

Thirdly, the lowest bases are now determined based on the presumption that, in all cases, the earnings are positively correlated with level of qualifications; and, moreover, that it is done consistently in all business activities and with all employers. Obviously, this is not a realistic supposition, nor should the earnings be correlated with the level of formal qualifications in all situations.

Fourthly, the incentives are already in place to discourage the employees to, together with the employers, conceal the real level of their earnings. For example, it is impossible to obtain a loan if your earnings are below a certain amount. Although this amount varies in different banks, it is approximate to the prescribed lowest base for the Qualification Level VI (14,040 dinars), which is considerably more than the lowest amount of the base for the Qualification Level I (5,971 dinars).

Fifthly, according to the data for the first six months of the year 2003, budget beneficiaries have paid in 40.5%, while all others made

59.5% of total payments for contributions. The category of the biggest payers includes large public enterprises and a smaller number of bigger private companies. This means that the lowest rate system did not attain its primary goal – to force the majority of those to whom these regulations apply to pay the prescribed amounts.

Sixthly, if the base for payment of mandatory contributions were to extend to all kinds of income from work, it may be expected that a greater part of an individual's income from different activities would be embraced. In such a case, determination of the lowest bases would be absolutely useless if made based on the level of formal qualifications.

The contribution base should be prescribed only in the cases in which there is no basis for taxation, such as:

- Persons engaged in temporary or occasional work who are under the age of 26 years and full-time students,
- Persons undergoing a NES (NSZ) program for gaining other qualification,
- Pupils and students on internships,
- Persons serving a prison sentence, and
- Persons who have, in compliance with the Labor Law, concluded a contract on volunteer work for the purposes of post-graduate training, taking state-board examination, acquiring further professional education or specialization, and it should equal the lowest earnings as currently prescribed by the Law on Pension Insurance.

Even if it were assessed that it is too risky, in terms of collection of contribution payment, to abolish the lowest bases, the present way of determining the bases in accordance with the qualification level should nevertheless be abolished. In such case, it is necessary to define the lowest base at the amount of 40% of the average monthly salary corresponding, in actuarial terms, to the lowest pension amount for the average insured employee. Due to its untraceable nature, the highest base should be determined at the annual level. Five average salaries, that is the option currently adopted for the highest annual base, should be retained.

Payments of contributions for FPDI (PIO) and NES (NSZ) are routed at present to the head offices of these institutions, while payments of the contribution for health insurance are routed to the branch offices whose territorial layout is separately laid down in the regulations governing health insurance.

Therefore, if in HIA (ZZO) the distribution of income based on the territorial principle were organized within the health insurance system, just as is already the case in FPDI (PIO) and NES (NSZ), and if contributions were paid to a single account, it would be much easier both from the administrative point of view, and that of the TA and the contribution payers. If it was like this, all contributions could be paid into a single account and the Administration for Public Payments would automatically route the funds to suitable institutions of FPDI (PIO), HIA (ZZO) or NES (NSZ). Also, in this way it would be easer for the

persons liable to make payments, and for the TA to automatically trace and control those payments.

Contributions for social insurance are withheld, and the employers, or the insured when they are the persons liable for payment, are obliged to submit to the TA a tax declaration for each payment made against the basis for insurance. Since only a total amount of obligation for payment is specified in the tax declaration, it cannot be determined based on the tax declaration whether the obligation for the individual insured person is settled, except when such person is at the same time the person liable for payment. The only way to resolve this problem is through establishment of an IT system which would interconnect the Tax Administration, FPDI (PIO), HIA (ZZO) and NES (NSZ) and feature unique numerical identifiers of the payers and the insured. These should definitely be the Tax Identification Number (TIN), which the TA assigns to legal persons and entrepreneurs, and, in case of the insured, the Unique Personal Number, which is assigned by the Ministry of the Interior and already used as TIN in the taxation procedure. Moreover, present tax declarations do not contain sufficient data for logical control, which could constitute an indication for the TA office and field control.

Finally, the only difference between the contribution for mandatory social insurance and other fiscal instruments is that the person liable for tax payment, who is at the same time the insured person, acquires certain rights. The amount of payment, however, is only moderately (pension rights), or not at all (health insurance and unemployment insurance) related to the scope of these rights.

In conclusion, the issues concerning persons liable for payment of contributions and the base and rates of mandatory social insurance in Serbia are absolutely tax-related and should be regulated by a tax law in conformity with the above recommendations.

VI Enterprise Profits Tax Law

THE SYSTEM OF ENTERPRISE PROFITS TAX

The current enterprise profits tax in Serbia belongs to tax integration systems. Tax relief in the form of deduction from the base of the schedular tax on dividends amounting to 50% of dividends is given to the shareholders for the purpose of elimination of the economic double taxation.

However, complementary annual individual income tax also includes 50% of the dividends, hence economic double taxation is only partially eliminated from the current tax system and by virtue of the nature of the complementary tax (which disallows tax credit for previously paid taxes), and there is *triple* taxing. Let as examine the following example:

1. Profits before taxing	1000
2. Enterprise profits tax (14% of 1)	140
3. Profits for distribution (1-2)	860
4. Taxable base of withholding tax (50% of 3)	430
5. Withholding tax on dividends (20% of 4)	86
6. Net income from dividends (3-5)	774
7. Base of the complementary annual individual income tax (4-5)	344
8. Annual individual income tax (10% of 7)	34.40
9. Total taxes (2+5+8)	260.40

If this were a classical system, the effective tax burden (enterprise profits tax and individual income tax) on dividends would amount to 31.2% (14% + 20% of 86), however in the existing system of partial integration, followed by the complementary annual income tax, effective burden amounts to 26.04%. In other words, effective tax burden amounts to 83.5% of the tax burden that would be achieved in the classical system.

More favorable tax treatment should be given to dividends, since that type of policy could facilitate development of the capital markets and offer incentives to new companies, which cannot rely on accumulated profits as a source for investment financing, but have to attract investors by issuing shares. Let us consider partial tax integration in case of adopting global system of individual income tax, with dividends excluded from income aggregation and subject to a final schedular tax at the rate of 10%:

1. Profits before taxing	1000
2. Enterprise profits tax (14% of 1)	140
3. Profits for distribution (1-2)	860
4. Withholding tax on dividends (10% of 3)	86
5. Net income from dividends (3-4)	774
6. Total taxes (2+4)	226

Due to the absence of complementary tax, the effective tax burden on dividends would be only 22.6%.[32]

TAXABLE BASE

In considering the definition of the enterprise profits tax base several issues are opened.

Tax depreciation

The current system of depreciation for profits tax purposes is based on the provisions from the *Nomenclature of Assets for Depreciation*, which identifies approximately 1,120 different types of fixed assets and corresponding number of depreciation rates. Enterprise Profits Tax Law allows use of *straight-line* and *declining balance* method of depreciation,[33] with depreciation rates prescribed in the *Nomenclature*. Once the method of depreciation is chosen, it cannot be altered until ultimate depreciation of the value of the particular asset is completed and it follows the asset even in case of changed ownership.[34] This is the reason why, in most of the cases when equipment was purchased before 1992 (when declining balance method was not permitted), it is regularly subjected to straight-line depreciation. Even in case of more recent purchases, the straight-line method is applied, since every asset requires separate depreciation bookkeeping, and this method is considered less complex in the, already complicated procedure of keeping records on depreciation.

Instead of this complex procedure for tax depreciation, based on accounting depreciation, we propose a significantly simpler procedure of pooling of assets, which is specifically designed with tax depreciation in mind (H. Nester, "Depreciation Simplification"). All assets would be pooled into five groups, as follows:

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32 Even eventual introduction of the direct progression in the global income tax (i.e. introduction of another rate of income tax above some highly set threshold) would not result in any additional burden on dividends.

33 Exceptionally, under certain condition, per kilometer deprecation method is allowed.

34 The only permissible alteration of the depreciation method is the case of switching over from the declining balance to the straight-line method, in which case – starting from the year in which the amount determined by application of the declining balance method falls below the amount determined by the straight-line method – the remaining value of an asset shall be divided into equal depreciation quotas for the remaining service life.

- Group I: buildings;
- Group II: heavy machinery (locomotives, ships, turbines, elevators etc.);
- Group III: machines and equipment not included in any other group;
- Group IV: light equipment and furniture (tools, lighting, furniture, computers etc.);
- Group V: frequently used short-lived assets (e.g. passenger and freight motor vehicles).

Instead of calculating depreciation for every fixed asset and registering the sum of individual depreciation cost as recognized expenditure into the tax balance, in the pooling system the taxpayer does not calculate depreciation for every individual fixed asset, but rather applies simplified procedure for calculating depreciation for the group as a whole. Simplification is achieved due to the declining balance method of the depreciation calculation for all assets belonging to one group. Every group of assets applies a unique depreciation rate, and depreciation rates differ between the groups. The taxpayer is obliged to keep only one account for every group of fixed assets, regardless of the actual purchasing date of every individual asset.

Instead of the current differentiated determination of the depreciation quotas for purposes of the declining balance method (coefficient 1.5 for assets with a write-off period up to four years; 2.0 for assets with a write-off period between four and seven years; 2.5 for assets with a write-off period over seven years), we propose unified (and thus simplified) coefficient of 1.5. In other words, annual depreciation rate would (in the absence of inflation) be equal to 150% of the rate used for straight-line depreciation (e. g., if an asset has a ten-year write-off period, in case of the straight-line method depreciation rate would be 10%, while in case of the declining balance method depreciation rate would amount to 15%). Furthermore, as opposed to the straight-line method, where the rate is applied to the base equal to the original cost of the fixed asset, in case of the declining balance method, the rate is applied to the written down value of the asset (to the balance left after value of fixed asset is reduced by the depreciation cost).[35]

35 Every asset has its economic depreciation – that is, the period in which it can be productively utilized. The following table presents "standard" rates of the straight-line depreciation for every of the five groups of assets, which accurately reflect economic depreciation, and through application of the coefficient of 1.5 calculated rates of the declining balance depreciation:

The group of assets	Straight-line depreciation rate	Declining balance depreciation rate (150%)
I	2.50%	–
II	4%	6%
III	6.67%	10%
IV	12.50%	18.75%
V	25%	37.50%

The advantage of the declining balance method is in the fact that the taxpayer does not need to keep records on the original value of every particular fixed asset, in order to calculate depreciation (which is obligatory in the case of the straight-line method). The only records he has to keep are about the total value of all the assets belonging to a particular group remaining to be written down. To sum up, the depreciation rate is applied to the remaining value (written down value) for the group of fixed assets taken as a whole. There is no need to make a specific recording of every asset that has been totally written off.

When a taxpayer makes a purchase of a fixed asset, he classifies it in one of the five groups, and acquisition value of that asset is added to the total remaining balance (total written down value of the assets in the group). A further step in the calculation of the depreciation is application of the appropriate depreciation rate to the increased balance for all assets in the group. Therefore, the simplification of the declining balance method, which in contrast to the calculation based on the straight-line balance method, does not require data on original costs, but only data on the remaining balance (written down value) of the assets in the group.

If a taxpayer sells one of the assets, the value of the remaining balance is reduced by the obtained price. In the course of pooling of assets, there is no need to compare obtained price with the written down value of the sold asset in order to calculate capital gains or loss. For example, if the asset is sold for 75,000 dinars without replacement, and the remaining balance amounts to 50,000 dinars, in case of the individual write-off, capital gains would amount to 25,000 dinars, and the future depreciation would be less than 50,000 dinars. In case of pooled assets, group balance would be decreased by 75,000 dinars, without direct effect on the current income (i.e. without expressing capital gain). The taxpayer will have to declare 25,000 dinars higher income (and pay higher taxes), since his depreciation is smaller, but he will not have to pay tax on capital gains of 25,000. If a taxpayer sells that particular asset for 25,000 dinars, group balance would be increased for the obtained price (25,000 dinars), and future depreciation deduction would be higher, instead of immediately expressing capital loss of 25,000 dinars (25,000 minus 50,000 dinars).

Let us consider the example of application of the declining balance depreciation to the group III (machines), with a depreciation rate of e. g. 10%, and the inflation rate for year 2004 of e. g. 9%.

The group I (buildings) would have to apply straight-line depreciation method, since the application of the declining balance method could result in deficient results in case of these assets, which do not depreciate their value significantly in the initial periods of their depreciation (H. Nester, "Depreciation Simplification"). Therefore the buildings would be, as in the current system, depreciated separately– to reiterate, by application of the straight-line method.

Example:

Group balance at the beginning of the 2004	1,000,000
minus: sale of assets during the year	150,000
equals: net balance after calculated sales	850,000
multiplied by: inflation rate (0.09) + 1 = 1.09	
equals: adjusted net balance	926,500
plus: acquisitions of assets during the year	300,000
equals: base for calculating depreciation	1,226,500
multiplied by: depreciation rate (10%)	
equals: depreciation costs for 2004	122,650
Group balance at the end of the 2004	1,103,850

In the course of switching from the old regime of depreciation to the new one, it is sufficient to classify the remaining tax base of the old assets into the five newly established groups and apply the above explained procedure for depreciation determination. This procedure will be somewhat favorable to the taxpayers with new assets, because they will be able to subject them to the accelerated regime of depreciation, and will benefit more than those that have lower remaining depreciation base.

Implications of application of the International Accounting Standards

The Accounting Law, enacted at the end of the 2002, prescribed obligatory application of the International Accounting Standards (IAS), for banks and other financial institutions from January 1st, 2003, and for other legal entities from January 1st, 2004. Regardless of the indications that the beginning of IAS enforcement for other legal entities could be postponed, enacted provisions oblige the legislator to pass amendments to the Enterprise Profits Tax Law in due time and thus circumvent erosion of the tax base, which could occur due to rather strict reliance of the tax balance on the profits and loss statement. In other words, higher degree of freedom in expressing profit and loss, prescribed by the IAS for legal entities, could have negative effects on determination of the taxable profits.

The Ministry of Finance and Economy has, having in mind these possible consequences, already prepared appropriate amendments to the Enterprise Profits Tax Law, regarding banks and other financial organizations, which came into force on April 24, 2003. The following round of amendments should encompass other legal entities – profits tax taxpayers, subject to IAS.

An official Serbian version of the IAS has not yet been published in the "Official Gazette of the RS", but on the internet site of the Ministry of Finance and Economy there is a translation of the basic text, subject to verification by Committee for Monitoring of the Enforcement of

IAS. Analysis of the IAS regarding defining of the taxable base, resulted in the following conclusions:

1) Concerning IAS 2 ("Inventories"), allowing alternative application of the three methods for determination of the cost price of inventories (FIFO, method of the average weighted price and LIFO) – provisions in the Article 8, Paragraph 1 and 2 of the Enterprise Profits Tax Law, prescribing exclusive application of the average weighted prices, should be deleted.
2) Concerning IAS 8 ("Net gain or loss in the period, fundamental errors and alteration of accounting policies"), two limitations should be introduced:
   - Fundamental error concerning previous periods should not be included in the determination of the net gain or loss in the current period, rather, it is necessary to prescribe that errors recognized at a later date should be taken into consideration by way of correction of the gain/loss for the year in which they occurred.
   - In the course of alteration of the accounting policy of the taxpayer, it should be prescribed that the profit adjustment is performed for the year of the alteration (in order to preclude double counting or omission).
3) Concerning IAS 11 ("Construction contracts") which permits different methods of income and expenses recognition based on construction contracts depending on the reliability of estimating the outcome of the contract – it is essential to prescribe mandatory application of the *percentage of completion method* in determining income and expenses based on a construction contract which is not completed within the fiscal year in which it started. As an exception, this limitation should not be applied in case of a contract realized within six months from the date on which work commenced.
4) Application of the IAS 15 ("Information about effects of the price change"), which permits different methods of expressing price change effects on the calculations of gain/loss and determining the financial standing of an enterprise (revaluation), would not be allowed for taxation purposes.
5) Provisions of IAS 16 ("Real estate, installations and equipment") could be applied only to the extent they are not incompatible with the Enterprise Profits Tax Law.
6) IAS 19 ("Remunerations to the employees") should not be applied in course of determining taxable profits inasmuch as it prescribes recognition of some remuneration (for paid leave, severance payment, etc.) as expenses, before their disbursement.
7) Concerning IAS 21 ("Effects of the change in exchange rate of foreign currencies"), applied in case of accounting of transactions in foreign currencies and incorporating gain/loss statements of the operations abroad into the gain/loss statement of the domestic enterprise – it is essential to prescribe that business

operations of the taxpayer conducted by the *foreign permanent establishment* should always be considered as business operations of the taxpayer himself.

8) Considering that IAS 22 ("Business combinations"), which is applicable in case of accounting registration of mergers and acquisitions, allows for registering acquisitions either by the purchase method, or by the fair value method – the purchase method should be disallowed in case of transactions regulated in Article 31 of the Enterprise Profits Tax Law. This Article stipulates *roll-over* of the tax liability based on capital gains in case of mergers and divisions, if "old" shares are exchanged for "new" ones with compensation in cash not exceeding 10% of the par value of acquired shares.
9) IAS 23 ("Costs of lending") stipulates that interest and other costs related to lending of financial assets should be recognized as expenses in the period in which they are incurred, however, leaving the possibility to include these costs in the cost price of the acquisition of the qualified asset (i.e. asset with deferred utilization, /e.g. construction works or production longer than a year/). In our opinion, it should be prescribed that in case of construction works or production longer than a year and with cost price over a certain limit (e.g. 30 million dinars), for the purpose of taxation, costs of lending *must* be included in the cost price (must be capitalized).
10) In order to preserve the principle that the taxpayer is every legal entity as in Article 1 of the Enterprise Profits Tax Law, for taxation purposes it is essential to prescribe that:
    - every company within the group of companies under the control of the parent company (IAS 27);
    - every investor and every associated enterprise (IAS 28);
    - every participant in the joint venture (IAS 31)

    separately determines its profits, regardless of the consolidation prescribed in IAS 27 and IAS 28, application of the *equity method*, stipulated by the IAS 28, or the consolidated treatment of the legal entities, stipulated in the IAS 31. However, it should be born in mind that obligation of separate profit determination does not preclude the application of provisions in articles 55-57 of the Enterprise Profits Tax Law, which regulate so-called "tax consolidation", according to which every member of the group of related companies files its own tax balance, and parent company files a consolidated balance for the whole group, in which losses of one or more members are set off against the profits of the remaining members in the group.
11) Considering that Serbia has controlled inflation (in the zone of approximately 10%), IAS 29 ("Financial reporting in economies with hyperinflation") will not be practically implemented. However, in any case, its effects should be derogated through the tax

law, since in case of occurrence of hyperinflation, taxation should be separately regulated.

12) Regarding IAS 36 ("Impairment of assets"), it is necessary to prescribe that impairment of an asset cannot not be classified as an expense, except for tangible assets which are considerably damaged due to *vis major*.
13) Regarding IAS 37 ("Provisions, Contingent Liabilities and Contingent Assets"), it should be stipulated that provisions and reserves should not be considered expenses, except those particularly listed in the Enterprise Profits Tax Law.
14) According to the IAS 39 ("Financial instruments: recognition and measurement"), for taxing purposes profit or loss from disposal of financial asset is included in the net profit or net loss in the period in which they were gained or incurred.
15) IAS 40 (Investment Property") stipulates that in the fair value model for measuring investment in property,[36] profit or loss resulting from the change of the fair value of the investment in property should be included in the net profit or loss in the period when it was realized or incurred. In order to avoid taxation of the non-realized capital gain, the fair value model should be disallowed for taxation purposes and only alternative model for measuring investment property – the cost price model – should be allowed.

Other deductions

Recognized deductions in the course of determining the enterprise profits tax base are generally adequately regulated in the Enterprise Profits Tax Law. Given that revenues from interests on public loans are exempt from the tax base, we suggest that interest expenses that can be allocated on a *pro rata* basis on the interest proceeds stemming from public loans should not be recognized as expenditure. In the absence of this norm taxpayers will develop methods of tax planning which would result in double tax exemption (e.g. if he takes a loan for acquisition of state bonds, deducts interest paid as a recognized cost, and enjoys interest proceeds from state bonds as exempt from the tax).

TAX INCENTIVES

The policy of tax incentives in the Republic of Serbia was altered two times in the last three years – in mid 2001, and at the beginning of the 2003.

36 Investment property is any building, part of the building or land owned for the purposes of earning rent or increasing the value of capital.

Situation before 2001

The first change was made on 1st July 2001, when two new laws, adopted at the end of March 2001 – Enterprise Profits Tax Law and Individual Income Tax Law – came into force. These changes radically modified the perception of tax relief, characteristic of Milosevic rule. Namely, in the period from 1st January 1992 and 30th June 2001 the tax system was organized around very generous tax incentives. The most important ones were the following:

- reduction of the taxable base for re-invested profits (which could not be higher than 50% of the determined taxable base);
- tax holiday for newly-established enterprises lasting for three years (or five or six years if the enterprise was established in an underdeveloped area);
- five-year tax credit for foreign investment (which in case of 100% foreign investment amounted to 100%, in case of 51% foreign investment – to 51%, and in case of 10% foreign investment – to 10%);
- two-year tax credit for newly employed workers (which amounted to 40% of the gross salaries paid to these newly employed workers); and
- provisions for the cost of capital maintenance (which enabled taxpayers to reduce the taxable base for future costs of capital maintenance, before they were actually incurred).

The data shows that in year 1999 the potential revenue from enterprise profits tax was diminished by 53.46%, and in the year 2000 for 47.18%, based on these tax privileges.

Tax reform of 2001 was based on the conclusion that most of the applied tax incentives were inefficient, while they were cutting potential revenues from enterprise profit tax in half. Every fifth dinar of potential tax revenue was lost due to the recognized re-invested profits deduction. This tax incentive created a triple problem. If the object of reinvestment were fixed assets, given that reduction was limited to 50% of the taxable base, the taxpayer whose investment was over this limit did not have any marginal incentive for any additional investment; he would only get a reduced effective tax rate from 20% to 10%. The taxpayer who invested under the 50% limit benefited from a generous marginal tax incentive. Investment was, for taxation purposes, written off twice – first as a deduction from the taxable base, and then also for depreciation, since the law did not prescribe reduction of the depreciation of the purchased fixed asset in proportion to the investment allowance. The second problem was the legal provision identifying investment in state bonds as a qualified investment: namely, interest based on these bonds is anyway excluded from the taxable base of the profits tax, therefore the deduction based on investment in state bonds constituted a state subsidy to the buyers of these bonds. The third problem was related to the legal provision identifying investment in shares as qualified investment, since the company whose shares were

Table1.
Effects of Tax Incentives According to the Type of Incentive, Before the Year 2000

	Reductions of Potential Tax Revenue, in percentage terms	
	1999	**2000**
Total reduction of the potential tax revenue Out of which:	**53.46%**	**47.18%**
Reduction based on re-invested profits	21.54%	20.14%
Tax credit for foreign investments	11.68%	9.51%
Tax holiday for newly established enterprise	10.03%	7.37%
Provisions for the costs of capital maintenance	7.22%	7.31%
Tax credit for newly employed workers	2.99%	2.85%

acquired by the investor could have demanded reduction of its taxable base if it re-invested its profits, which in fact, doubles the initial incentive. These are the reasons for abandoning the tax relief of reducing taxable base for re-investment.

Tax relief for foreign investments (which implied that every tenth dinar of the potential revenue from profits tax was lost) was easily abandoned, since the assessment showed that there was no need for additional stimulation to foreign investments, particularly in light of the fact that this provision stimulated so called round-tripping (a domestic firm transfers its assets abroad, and establishes a company which comes as a foreign investor to the Serbian market, thus benefiting from the tax incentive for foreign investments).

The tax holiday for newly established enterprises (which was generating almost the same amount of loss in potential tax revenues as the tax credit for foreign investments) was also abandoned, since it was acknowledged that: (a) it favors new companies which are initially highly profitable, and not those with high investments and delayed profit generation; (b) it discriminates against investments with a long write-off period (since the depreciation must be performed even during tax exemption period); (c) there were abuses of this provision through transferring profits from enterprises which were not exempt to associated enterprises that were exempt.

The provision for capital maintenance (which generated a loss of every fourteenth dinar of potential revenues from profits tax) is still in the tax system, with the amendment prescribing that these provisions will be recognized only if they are performed in accordance with the long term plan of capital maintenance of fixed assets, which is subject to approval of the Tax Administration.

Reform in 2001

Tax reform implemented in the first half of 2001 established a different incentive structure. The scope of the tax incentives is reduced and their structure is significantly altered. In the new system for the enterprise profits tax the following list of tax relief provisions was brought into focus:

- investment tax credit equal 10%[37] of the investment in fixed assets (reduction should not exceed 50%[38] of the amount of the tax obligation in the year of investment, but unused tax credit could be carried forward for a maximum period of five years);
- two year tax credit for newly employed workers (equal 40% of the total labor cost of the newly employed workers[39]);
- provision for the costs of capital maintenance, acceptable only if it is performed according to the long term plan of capital maintenance of the fixed assets, approved by the Tax Administration.[40]

Unfortunately, the effects of the new tax incentives could not be assessed, because the Tax Administration does not have necessary data.[41]

The Reliance on the investment tax credit was based on the assessment that in the case of this tax incentive: (a) a company benefits only if it actually carried out the investment; (b) the incentive affects long-term investments; (c) there are no revenue leaks from the budget due to transactions performed between associated entities (as with tax holidays), and it offers no encouragement for the owners of existing capital, who could undeservedly enjoy benefits (as in case of reductions in the tax rate). Moreover, in order to eliminate a potential shortcoming of the investment tax credit – discrimination against newly established firms, which do not earn profits in the year of investment, and thus cannot utilize tax credit in that year – it is permitted to carry forward the unused part of the tax credit within the following five years.

37 30% for small enterprises.

38 70% for small enterprises.

39 Labor cost is equal to the gross salaries, increased for the appropriate public revenues paid by the employer.

40 Apart from already listed, Enterprise Profits Tax Law prescribes several other forms of tax incentives: (1) accelerated depreciation (for a very short list of fixed assets /IT equipment, equipment for R&D, equipment for training of staff, ecologically relevant equipment/); (2) tax exemption for non-profit organizations (that do not realize surplus of revenues over expenses in excess of 300,000 dinars); (3) five-year tax holiday for concession companies; (4) proportional exemption of the enterprise for education, professional rehabilitation and employment of the disabled persons; (5) two-year tax credit based on profits from the newly-established business unit in the underdeveloped regions.

41 It is perplexing that Tax Administration filed data on the scope of the tax reliefs in 2001 and 2002, based on the systematization from the previous Enterprise Profits Tax Law – which is not valid since 30 June 2001. These data are therefore, useless.

Tax incentive regime in 2003

A second amendment of the system of tax incentives came into force on 1 January 2003 – only a year and a half after completion of the first phase of the tax reform. These changes implied enlargement of the scope of the tax incentives, as a result of business circles' warnings to the Government regarding insufficient investment activity in the country (especially lack of foreign direct investments) and the existence of tax competition within the region which must be taken into consideration. Tax incentives implemented in 2003 are not replicas of the incentives from the period before 2001, but it must be noted that the complexity of the tax system was increased through their implementation. Moreover, they show the truth of the saying that tax incentives resemble dessert: they are tasty, but they are of little significance if the main course is missing. Namely, the investment climate primarily depends on other (non-tax) factors – simplifying the procedure for initiating business activity, removing excessive administrative barriers in foreign trade transactions and in case of profit repatriation, reducing corruption, leasing regime for equipment, labor legislation, macroeconomic stability, functioning of the judiciary, bankruptcy procedure, accounting standards, the status of urban building land, (non)existence of comprehensive registers of pledge etc. Although a lot has been done about this during 2001 and 2002, only if all these problems can be eliminated, it is possible that the desired effect will be accomplished through additional tax incentives to investment activities.

The policy of tax incentives adopted in 2003 represents a combination of several tax expenditures.

First, there is a ten year tax holiday for investment into fixed assets worth over 600,000,000 dinars, if it is accompanied by the additional employment of at least 100 workers (hereafter: the "major tax holiday"). A five year tax holiday (hereafter: the "minor tax holiday") is allowed for investments exceeding 6,000,000 dinars into fixed assets, accompanied by the additional employment of five new workers, executed by the taxpayer who performs activity in regions of special interest for the Republic (the "Serbian rust belt").

The third measure is reduction of the enterprise profits tax rate from 20% to 14%, while the forth measure is doubling the investment tax credit (from the previous 10% of value of investment into fixed assets to 20%[42]) and the period through which the unused part of the tax credit (considering the persisting reduction maximum of 50% of calculated tax[43] and possibility that the investor did not realize profits

42 In case of the small enterprises, investment tax credit is increased for one third – from the previous 30% to 40%.

43 70% for the small enterprises.

within the year of investment) could be carried forward (from previously stipulated five, to ten years).

The fifth measure is enlargement of the tax credit for newly employed workers from 40% to 100% of the labor costs.

Third and fourth measures are generally non-problematic. Since the amount of tax rate is the first fiscal parameter which investors take into consideration when choosing the country to invest in, reduction of the enterprise profits tax rate for 30% (from 20% to 14%) could be assessed as a rational move aimed at attracting investments to the country in which non-fiscal parameters still are not fully regionally competitive.

Table 2.
Enterprise profits tax rate in the region in 2003

Country	Enterprise profits tax
Bulgaria	15%
Croatia	20%
Macedonia	15%
Romania	25%
Slovenia	25%
Serbia	14%

However, in the current situation, owners of existing capital benefit from tax incentive quite undeservedly. The other problem is that benefits from low tax rate are evident only in the long run, implying that an immediate influx of foreign capital, based on this incentive, will most probably not materialize.

Even more generous tax credit could also be positively assessed, since its function is focused on particular investments into fixed assets, and those that are not investing are not benefiting from this incentive.

Regarding the tax credit for newly employed workers, the legally prescribed ban on reducing the number of employees within two years of using the tax credit, should be differently formulated. The current formulation of the Article 49 of the Enterprise Profits Tax Law specifies that an employer cannot discontinue the labor contract even in severe cases (if the employee fails to perform, fails to observe work discipline, abuses sick leave etc.), if they wish to retain the right to tax credit or otherwise face the obligation to pay saved taxes to the indexed amount. We believe that it is better to incrementally raise the level of employment, so that the employer should be given the tax credit for raising the total number of employees (average in the current year in comparison with the average for the previous year), instead of conditioning it on the employment of individual employees.

The "Major" and "minor" tax holidays deserve further examination.

The "Major tax holiday" could be implemented until other amendments to the Enterprise Profits Tax Law have been enacted (came into force on 23 April 2003), eliminating the uncertainty created by the Article 50a of the Enterprise Profits Tax Law according to which the incentives could be enjoyed only by those taxpayers who invest "in conformity with the regulations related to giving incentive to investing in the economy of the Republic". This formulation was meaningless since the regulation referred to did not exist, and it was omitted in the amendments, which paved the way for utilization of the "major tax holiday". The tax Administration was given the authority to determine the fulfillment of the requirements for using this tax incentive in the decision determining total annual tax obligation.

These requirements are the following:

- the investment into fixed assets – performed either by the taxpayer himself or by another person investing into taxpayer's assets – should exceed 600,000,000 dinars.
- the taxpayer should use these funds for purposes of the registered activity in the Republic of Serbia;
- the object of investment should be the equipment not previously in use in the Republic;
- the taxpayer should, within the investment period, employ at least 100 new workers for an indefinite period, not including those employed in a (direct and indirect) subsidiary of the investor.

The tax holiday (lasting for ten years) shall be implemented upon cumulative fulfillment of these requirements, effective from the first year in which profit was realized. It is not applicable to the total realized profits, but rather in proportion to the investment: proportion of the exempted profits is calculated as a ratio of investments in the fixed assets and total value of the fixed assets. According to the opinion of the Ministry of Finance and Economy, the value of the fixed assets shall be determined by the taxpayer himself, in conformity with the International Accounting Standards. In the case of a newly established enterprise, the tax exemption, naturally, equals 100%.

Monitoring of the continuous fulfillment of the prescribed requirements during the period of tax exemption additionally complicates the "major tax holiday". There are four groups of data that should be closely monitored.

The first is related to the *employment increase* requirement: if the taxpayer reduces the number of workers additionally employed for an indefinite period below 100, the tax holiday is annulled for the whole period of tax exemption, while the taxpayer becomes liable to pay the saved tax in the indexed amount. The Ministry of Finance and Economy argues that it is not necessary to monitor incremental raise in employment of, at least, 100 newly employed workers, which should not fall below the initial level during the whole period of the tax holiday. The Ministry believes that the sufficient requirement is employment of, at least, 100 new workers for an indefinite period during the period of investment, and that the number of these specified workers

should not fall below 100. In other words, the taxpayer can, without any restriction, fire employees not included in the "specified group of at least 100 new workers"; he is entitled to fire employees from this group that had qualified him for "major tax holiday" to the extent that the number of newly employed persons does not fall below 100. This attitude seems absurd: either the requirement of minimum 100 newly employed workers should be removed (which is, in our opinion, the better solution, since it does not pressurize for economically redundant employment), or monitoring of the incremental raise in employment should be established (in which case total number of employees should not fall below the initial level, including those 100 newly-employed workers, during the whole period of the tax holiday).

The second group of data is related to the *continuity of business operations*, and the third is related to the *use of the fixed assets* in which qualified investment was executed. If discontinuing business operation before end of a ten-year period, or no longer utilizing, or disposing of, such a fixed asset for which a qualified investment was made, while not investing in new fixed assets at worth at least of the same as the market price of the disposed assets, the taxpayer shall no longer be entitled to tax exemption in the entire period. In both of these cases, the taxpayer will be liable to pay tax in the indexed amount.

The fourth type of monitoring aims to prevent the taxpayer enjoying a tax exemption to *abuse* the current provisions. This could be achieved through a merger or division in which the taxpayer would receive all the assets of the legal predecessor, and the shareholders of the predecessor instead of pecuniary compensation could receive shares in the new enterprise – the taxpayer, with the deferring of the capital gains tax liability.[44] In order to discourage this type of tax planning, the newly adopted provision prescribes that if, in a three–year period before fulfilling the requirements for the tax holiday or during the tax holiday period, the taxpayer acquires any assets, due to merger or division (and on these grounds defers tax liability based on capital gains), he shall be liable to pay tax on realized profits in proportion to the value of the assets thus acquired.

To summarize: the "major tax holiday" helped in avoiding some deficiencies in the tax exemption in the Serbian tax system before 2001. Namely, due to the significantly longer exemption period, newly established companies that are highly profitable just in the initial period, are no longer privileged in comparison to those with higher initial investments and delayed profit realization. Furthermore, it decreased the incentive to wind down the old, and establish a new enterprise at the end of the exemption period in order to qualify again for the tax exemption. However, the changes have made the enterprise profits tax

44 Deferring commencement of the tax liability on the basis of capital gains would be permissible even if a part of the remuneration to the "old shareholders" would be in the form of the compensation in cash, but the pecuniary part should not exceed 10% of the par value of newly obtained shares.

system even more complex than before 2001, due to the complicated procedures of monitoring fulfillment of the requirements for tax holiday. Also, the danger of abuse of the *tax holiday* still exists through transferring profits to exempt enterprises from associated enterprises that are not exempt.

The "minor *tax holiday*" is, as well as the "major" one, connected with the decision of the Tax Administration (in which the total annual tax liability of the taxpayer is also determined). The Tax Administration is authorized to assess the fulfillment of the requirements for utilizing this tax incentive. These requirements are:

- investment into fixed assets – performed either by the taxpayer himself or by another person investing in the taxpayer's assets – should exceed 6,000,000 dinars;
- the taxpayer should perform the activity in an area of special interest for the Republic of Serbia and 80% of these fixed assets should be used for purposes of the registered activity in this area;
- the object of the investment should be equipment not previously in use in the Republic;
- the taxpayer should, within the investment period, employ at least 5 new workers for an indefinite period, not including those employed in any (direct and indirect) subsidiary of the investor. In order to qualify as a "qualified employee", the worker should be employed by the taxpayer, and be in residence and domiciled in the area of special interest for the Republic of Serbia, at least nine months in the calendar year;
- at least 80% of the permanent employees should have residence and domicile in the area of special interest for the Republic of Serbia.

Tax exemption (in the duration of five years) is applied to cumulative fulfillment of these requirements, starting from the first year in which taxable profits are realized. This exemption is not applicable to total realized profits, but rather is proportional to the investment made: this proportion is calculated as a ratio between the qualified investment in fixed assets and total fixed assets.

Monitoring of the continuous fulfillment of the prescribed requirements during the period of tax exemption additionally complicates the "minor tax holiday". Again, it is necessary to monitor four groups of data.

The first group relates to data on *employment.* If a taxpayer reduces the number of additionally and for indefinite period employed workers during the five years *tax holiday* below the prescribed five, or if he reduces the number of indefinitely employed persons with residence and domicile in the area of special interest for the Republic of Serbia below 80%, he shall lose the right to tax exemption for the whole period of the tax holiday.

The second group of data to be monitored is related to the *continuity of business operations*, while the third is related to the *use of the fixed assets* in which a qualified investment was executed. If discontinuing

business operations before the end of a five-year period, or no longer using, or disposing of, such a fixed asset for which a qualified investment was made, while still not investing in new fixed assets worth at least as much as the market price of the disposed assets, the taxpayer shall no longer be entitled to tax exemption in the entire period.[45] In all these cases, the taxpayer will be liable to pay taxes at the indexed amount.

The fourth type of monitoring aims to prevent the taxpayer enjoying tax exemption to *abuse* the current provisions. This could be achieved through a merger or division in which the taxpayer would receive all the assets of the legal predecessor, and the shareholders of the predecessor instead of pecuniary compensation could receive shares in the new enterprise – the taxpayer, with the deferring of the capital gains tax liability. In order to discourage this type of tax planning, a newly adopted provision prescribes that if, in the period of three years before fulfilling requirements for the tax holiday or during the tax holiday period, the taxpayer acquires any assets, due to the merger or division (and on these grounds defers tax liability based on capital gains), he shall be liable to pay tax on realized profits in proportion to the value of the assets thus acquired. The solution is identical to the one applied in case of the "major tax holiday".

Application of the "minor tax holiday" is additionally complicated by referring to the regulation defining the area of the "special interest for the Republic of Serbia", since such formulation introduces into the system additional arbitrariness, the consequences of which, as well as the effects of the tax exemptions from 2003, it is impossible to assess – until the tax returns for 2003 are received.

Proposed measures concerning tax incentives

The efficiency of the existing forms of tax relief from enterprise profits tax could, by all means, be reviewed, since they have made the tax system more complex with uncertain effect on additional investments. However, bearing in mind that the Ministry of Finance and Economy proposed the package of the tax incentives explained in the paragraph 3.3, proposing radical changes is not realistic in view of the stability of the tax system. In any case, it seems that some minor changes could be made in the legal text, in order to remove any ambiguity related to fulfilling the requirements for obtaining a particular tax incentive. By this we refer to the provisions stipulating that, once fulfilled, the requirement for tax relief – new employment of 100 workers for the "major tax holiday", five workers for the "minor tax holiday", or a particular employee in the case of the tax credit for new employment – should be

45 Probably by mistake, sanctioning of the taxpayer who within the duration period of the tax holiday reduces the share of fixed assets in the area of special interest for the Republic in the total fixed assets below 80%, is omitted.

monitored during the period in which the tax relief is enjoyed (ten, five or two years, respectively). We suggest that the requirement for additional employment of 100 workers in case of the "major tax holiday" should be omitted, since the investment into fixed assets of 600 million dinars is in itself sufficient incentive for employment. In case of the "minor tax holiday", as well as in case of the tax credit for new employment, it should be prescribed by the law that the employer should not reduce the number of employees below the initial level (number of the newly employed workers included), during the five-year or the two-year use of the tax relief. In case of the "minor tax holiday" it should be prescribed that any taxpayer who, within the duration of the tax exemption, reduces share of the fixed assets in the area of special interest for the Republic in total fixed assets below 80%, forfeits the right to claim tax relief and has to pay the taxes at their indexed amount.

WITHHOLDING TAXES

Analysis of both laws regulating taxation of income showed that the issue of withholding taxes charged on non-residents is, to a great extent, under regulated.

Current situation

The existing solution provided in Article 40 of the Enterprise Profits Tax Law is lapidary: a taxpayer (legal entity – payer of the income) should calculate and pay withholding tax at the rate of 20% on dividends and shares in profits of the legal entity (regardless of whether the recipient is resident or non-resident), as well as on royalties from copyright and industrial property rights and interest (only if the recipient is non-resident).

Suggested amendments

In our opinion, the withholding obligation in case of every profit distribution (to residents, as well as to non-residents) should be kept, however, with more precise determination of the object of taxation ("dividends and other shares in profits of the resident taxpayer, including liquidation surplus and surplus of the amount paid for acquiring shares above the par value, or the issuing price, if it is higher").

If withholding taxes on income paid only to non-residents are concerned, comparative analysis shows that in many countries the scope of these taxes is significantly wider. Since non-residents are, in any case obliged to include all income earned in Serbia into their worldwide income, they could, in principle, credit the withholding taxes paid in Serbia against the tax on the income/profits they are liable to in their country of residence. The absence of taxation would not, in principle, bring any benefits to the non-resident taxpayer – the only result would

be that the Serbian Treasury would cede the revenue to the treasury of the country of residence of the recipient of these types of income.

We suggest that withholding taxes should be introduced on the following types of income paid to non-residents:

- royalties from copyright and industrial property rights paid by the resident;
- rental income from movable property paid by the resident;
- charge for the right to use natural resources (if they are not state-owned) paid by the resident;
- interest paid by the resident, as well as interest paid by the non-resident – in case when it could be deducted from the base of the enterprise profits tax liable in the Republic;
- rental income from the real estate in the territory of the Republic;
- insurance premiums against risk in the territory of the Republic;
- compensation for international telecommunications, transport and freight services, in case when communications, transport or freight are initiated or terminated in the Republic;
- income from management, consulting, legal, accounting, engineering, advertising, marketing, and IT services, technical assistance and other similar services, or personnel providing services, provided to the non-resident doing business in the Republic through a permanent establishment, when these services are related to this permanent establishment, if these services are completely or partly provided by performing activity in the territory of the Republic;
- income from disposing under compensation of the real estate located in the territory of the Republic, or from selling of shares in that property, including income from realization of shares in the capital of the enterprise, with at least 50% of the value of assets directly or indirectly related to the real estate located in the territory of the Republic.

The rates of these withholding taxes could in some cases be lower than the "standard" 20% (e.g. for insurance premiums, compensation for international telecommunications, transport and freight services and income from the sale of real estate).

In cases when payment of the income liable to the withholding tax is not executed before the end of the fiscal year, but the payment obligation originated in that fiscal year, the withholding tax should be considered due on the 31 December of the fiscal year.

VII Property Taxes

CURRENT SITUATION

Property taxes include all taxes whose levying and collection is related to real estate, with special emphasis on:

- real estate sales tax (absolute rights transfer tax);
- inheritance and gift tax;
- property tax (for real estate).

Absolute Rights Transfer Tax (Real Estate Sales Tax)

Real estate sales tax is levied based on proportional rate of 5%. Proportional tax rate is justified in this case, but even at first glance, it seems excessive.

According to the data for year 2002, total revenues from collection of this tax amounted to 4,119,191 thousand dinars, or approximately 1.5% of the total amount of collected tax revenues, which is higher than revenues from collected property tax. This anomaly is a consequence of: (a) excessive tax rates, (b) realistically assessed tax base (market value of transaction), (c) high level of tax collection, i.e. low tax evasion.

Tax base consists of the contract price at the commencement of tax liability (the moment of transaction materialization), if not lower than the market value. Since a taxpayer has an incentive to report a lower contract price, the tax authorities are entitled to assess whether the reported price, or value, is below the market value. Tax authorities have to act quickly (within ten days from receipt of the contract, or in case of an official decision on extension, within another ten days; all in all, within twenty days from the receipt of the contract). Assessment of the market value, or the real value of transaction, could be accomplished by analyzing: (a) regular real estate sales contracts; (b) prices quoted by the real estate agencies; (c) by comparison.

Filing an appeal does not delay enforcement of the decision on tax payable. The second instance authority is the regional center of the Tax Authority. After that, there is a possibility of judicial administrative review before the Supreme Court. Annulment of the decision entails costs for the Tax Administration: (a) for additional on-site re-assessment of the real market value of the transaction; (b) for paying interest on the excess of tax collected. Additional on-site assessment is a requi-

site in case of family houses, while in case of apartments in the block apartment buildings it is not necessary. Costs of additional on-site assessment, specifically opportunity costs of time are high indeed, especially in view of the fact that taxpayers have an incentive to present their property in an unfavorable light, in order to decrease the assessed value. Given that the costs of filing and appeal are pretty high, the TA usually estimates slightly lower value, so that the assessed values are targeted to be between 90% and 100% of the real market value. Thus, the possible risk of an appeal, and entailing costs, are decreased.

One of the attributes of real estate is its relatively lower sales volume in the relevant period (e.g. in a one year period), which creates a problem for assessment of the value of given real estate, or the value of the capital transaction. Many real estate sales are not encompassed by the transaction records, so there is no available information for estimation of their value, or the value of transactions. This problem is less conspicuous in Belgrade and other larger cities (with lively trade in real estate), and far more obvious in smaller towns in Serbia.

Evasion of real estate sales tax (absolute rights transfer tax) is very rare, given the strong incentives to taxpayers to fulfill their tax obligation (registration of the sales contract and entry into cadastral registry). Still, there are cases when the transaction is not registered in full, but "covered" by a fictitious loan contract. Some estimates reckon with 10% of non-taxed transactions at the most. And even these are not evaded taxes, but rather postponed, for future taxation.

Inheritance and Gift Taxes

Inheritance and gift taxation is applied in cases of second order of succession based on the progressive tax rate of 3% on a tax base of 200,000 dinars, and 5% on a tax base over 200,000 dinars. In case of the third and subsequent order of succession, both inheritance and gift tax are based on the proportional rate of 5%. This provision is unreasonably complicated, non-transparent and creates additional incentive for taxpayers to decrease declared amount of the tax base. Low threshold of the tax rate change probably leads to a relatively modest reallocation of inheritances and gifts.

According to the data for year 2002, total revenues from collection of this type of tax amounted to 219,571 thousand dinars or approximately 0.1% of the total revenues from collected taxes – from the perspective of total fiscal revenues this tax is not very significant.

Property Tax

Property tax is collected from all property owners, or the owners of, broadly defined, property ownership rights. There are almost 2,500,000 registered taxpayers of the property tax, meaning that a large share of Serbia's population belongs to the category of taxpayers liable to pay this type of tax. There is no other direct tax with a higher num-

ber of identified taxpayers. This fact, along with facts related to the acquisition of property rights over socially or state owned housing at very favorable prices, resulted in a significant socio-political component in making decisions concerning this type of tax, especially in defining the tax rate and the method of tax base determination.

Property tax is levied based on the progressive tax rate: 0.40% on the tax base up to 6,000,000 dinars, 0.80% on the tax base over 6,000,000 dinars, 1.50% on the tax base over 15,000,000 dinars and 2% on the tax base over 30,000,000 dinars. This provision is inadequate: it is unnecessarily complicated, non-transparent and creates additional incentive to the taxpayers for decreasing declared amount of their tax base. Significant differences in tax rates create incentives to the owners to gift their real estate to successors of the first order, in order to disperse their ownership and reduce the tax burden, which causes diminishing of the potential fiscal effect of the progressive tax rate.

According to the data for the year 2002, total revenues from collection of this type of tax amounted to 3,291,172 thousand dinars or approximately 1.2% of the total amount of the collected taxes (0.7% of this amount comes from revenues from legal entities, and 0.5% are revenues from natural persons), which is lower than the revenues coming from collection of the real estate sales tax (transfer of absolute rights). This is, by all means, anomalous phenomenon resulting from: (a) relatively low property tax rate; (b) low property tax base, estimated far below the market value, and (c) relatively widespread evasion of this type of tax.

The tax base of the property tax consists of the market value of the given real estate on December 31st of the year preceding the year for which property tax is levied and collected. Generally, market value of the real estate is determined by applying the basic (floor space and average market price per square meter of the comparable real estate in the territory of the same municipality) and adjusting elements (location of the real estate, quality of the real estate as well as other elements affecting the market value of real estate). The method of defining basic and adjusting criteria allows for significant discrepancy between the estimated, assessed tax base, or estimated market value of the real estate and the real market value, or value realized on the free market. The first factor influencing this discrepancy is completely inadequate use of the statistical data in the assessment of the real market value of the given real estate. The problem lies in the fact that average market price per floor space square meter, as a basic indicator for calculating the real market value, is derived from the average declared sales prices of the newly built apartments on the territory of that municipality. However, this declared sales price has very little in common with the real market value of the particular real estate. Thus calculated average market price of the real estate is systematically underestimated, or downward biased. The main cause for this underestimation is that, in a number of cases, the market price is calculated as a sum of declared costs of building (excluding the costs of primary and secondary preparation and devel-

opment of the urban land), which is far below the full real market price. This leads to the severe underestimation of the value of the real estate (up to 50%). Possible upward bias, as a consequence of using a non-representative sample for data collection, cannot possibly compensate for the explained systemic downward bias, resulting from the calculation with an underestimated value of the indicator of average market price per square meter of the floor space, which inevitably leads to an underestimated tax base.

Although Regulations allow the possibility of using the value established in the process of tax base determination for the real estate sales tax, as a base for assessment of the average market price, or the price per square meter of the floor space, it is permissible only when there is no relevant data collected by the statistical bureau. Therefore, superior information, such as estimate of the tax base for real estate sales tax (transfer of absolute rights), is subordinated to the inherently inferior information of the statistical bureau.

Estimated average market price per square meter of the floor space, and of the real estate itself, is then adjusted for the location of the real estate, by multiplying price per square meter with the coefficient which cannot exceed one. This procedure is methodologically flawed and inevitably leads to further downward bias. Further on, adjustment is made for the quality of the real estate, with a coefficient which is lower or, in best case, equals one (only in case of the top quality, luxury homes), which is also methodologically erroneous and also leads to further downward bias, or further underestimation of the value of the tax base. Finally, that value is annually reduced for the value of depreciation which is calculated based on the annual depreciation rate of 1.5% (up to 70% of the initial value), which also unjustifiably decreases the tax base. Calculation of the depreciation is, in principle, methodologically acceptable; however in this case, the rate is unreasonably high (total depreciation/replacement of the real estate value is planned within 67 years). All of the above leads to severe underestimation of the tax base in case of all taxpayers (all natural and legal persons) who do not keep accounts.

There is a substantial amount of arbitrariness in assessing the tax base, or determination of the market value of real estate. For example, determination of the value of the coefficient, which reflects the quality of the real estate (adjusting element in the determination of the market value), is calculated based on frequently inaccurate and faulty descriptions of the building, which results in an incorrect value of the coefficient.

For taxpayers that keep accounts, the tax base is calculated based on the value of the real estate as entered in accounts (balance sheet). Although this procedure is methodologically correct in principle, the declared value is often well below the market value of the real estate, which significantly reduces tax base for property tax.

Tax exemptions from property tax are, in principle, well specified. Exemptions also include the *de minimis* provision, which exempts

owners whose tax base value is not higher then 250,000 dinars. Taking into account downward bias in determination of the tax base, the effective exemption limit is actually much higher. Although there is no explicit possibility for tax exemption of the poor, the *de minimis* provision, along with the tax credit, can be interpreted as a mechanism of the sort. Accordingly, it seems that there is no need for introduction of the special safety mechanism (circuit barker) for the poor in the area of property tax collection. That kind of protection should probably be developed on the existing foundations.

Nonetheless, tax exemptions are also applied for certain property, based on the intended use or the type of ownership (state authorities, diplomatic missions and consular offices, roads, historical monuments, public utility buildings etc.). Some of these exemptions are unconvincing: 1) real estate "used for educational, cultural, scientific, social welfare, health related, humanitarian or sports related purposes"-this provision was justified in socialist times, when all of the mentioned activities were organized and supported by the state, including state owned real estate; however, this justification vanishes when all these activities start functioning with private capital on a commercial basis, transfer of the socially owned real estate into private ownership included. Hence, there is no reason for distinguishing these from other commercial activities, and the real estate related to these from real estate related to other commercial businesses; 2) "agricultural buildings"– this exemption favors one economic activity (agriculture), without any economic rationale, since many other economic activities are in a worse position than agriculture.

Judging by the way that tax credits are specified in Law (40% for taxpayers who live in their own apartments and 10% for every member of the household, but cumulatively not more than 70%), they are, most probably, introduced as a form of welfare protection for the poor. However, this measure includes redundant protection for rich households too, since every three-member household, regardless of its total income, pays only 30% of the amount of the property tax. On the other hand, a single member household, for example, a poor retired person, pays up to 60% of the property tax amount. Furthermore, since tax credits are granted exclusively to households, this implicitly introduces a differentiated effective tax rate, so that legal entities pay property tax based on the effectively higher tax rate than the rate levied for natural persons, i.e. households. All in all, a fundamental examination of the current policy of tax credits is called for, since it has not accomplished the goal of welfare protection for the poor, but rather, has succeeded in significantly reducing fiscal revenues.

The possibility of property tax evasion in the case of real estate is significant and stems from the system of voluntary filing of tax declarations (returns) and two other phenomena. One is related to the fact that a large number of buildings are not registered – cadastral books are not regularly updated. The other phenomenon in Serbia is the practice of building without a permit, resulting in a large number of

illegal and unregistered buildings. Since these buildings are not formally registered, their owners are not recorded as taxpayers for property tax purposes. Finally, regular taxpayers do not have a strong incentive to fulfill their obligations, unlike in the case of real estate sales tax (transfer of absolute rights).

The general assessment of the legal provisions regarding property tax is not a favorable one. On the whole, this tax is badly designed. The tax base is assessed based on poorly defined procedure, which entails a number of methodological errors. This leads to an intentionally depreciated tax base, probably out of social policy considerations, although without explicit protection for the poor. That policy leads to a dual tax base: one, which is almost equal to the market value of the real estate, used in case of the real estate sales tax (absolute rights transfer) and the other, systemically underestimated, used in case of property tax. The progressive tax rate is unnecessarily complicated and does not contribute to a significant increase in fiscal revenues. Tax evasion is relatively widespread. All of the above results in relatively low fiscal revenue from collection of the property tax.

Other fiscal instruments

Besides the above listed tax instruments, the compensation for use of urban land is one of the instruments for collecting fiscal (public) revenues in case of local communities. Specific criteria, as well as measures for determination of this compensation are established by the local communities. In principle, this compensation is paid per square meter of floor space, and per unit amount of this compensation varies depending on the location and the value of the urban land use. The manner of defining variation of the unit amount of the compensation shows that the basic idea behind this provision was that total amount of the compensation should be proportional to the value of the real estate.Revenues collected based on the compensation for use the urban land are directly allocated to the local budget and are used for financing services considered as to the local public good.

Allocation of fiscal revenues

All the revenues collected from the property tax are transferred to the local authorities. This shows that, notwithstanding the existing provisions in the Law, property taxes are *de facto* considered a local tax. This is well justified, since these taxes are considered to be typical local taxes. According to the best international practices, in most cases these taxes are local taxes, or original revenues of the local community.

Tax Administration

Property taxes, according to the current regulation, are defined and implemented by the central authorities, i.e. authorities of the Republic.

All parameters regarding scope and application of this tax are defined in the laws and regulations prescribed at the level of the Republic. Implementation of these regulations, particularly levying and collection of taxes, is within the authority of the central (Republic) Tax Administration, which delegates its powers to its local (municipal) units.

THE CONCEPT OF THE TAX REFORM

Absolute Rights Transfer Tax (Real Estate Sales Tax)

Legal provisions regarding real estate sales (absolute rights transfer) tax are, in principle, well thought out. Regarding the tax policy, possibilities of future decrease of the tax rate should be examined, while taking care of the expected decline in fiscal revenues. This means that it is necessary to make a projection of fiscal revenues, especially taking into account the possibility of raising fiscal revenues by way of property tax reform. General guideline for alteration, or decrease of the tax rate on transfer of absolute rights, should ensure collecting higher total amount of fiscal revenues from property tax than the amount of fiscal revenues from transfer of absolute rights.

Assessment of the tax base in case of this tax is satisfactory; therefore no radical new solutions are needed. However, it is necessary to increase the resources of the Tax Administration (especially local branches of Tax Administrations) in order to facilitate execution of their tasks. Also provision should be made for facilitation of information transfer from the most developed municipalities, which record highest sales volume of real estate (thus being the most experienced in estimating value of the real estate) to the less developed municipalities.

Fiscal decentralization ***should not*** result in abandoning a single, centrally determined, tax rate of real property sales tax (transfer of absolute rights), nor should it lead to abolition of the unique procedure for assessing the tax base.

Taxpayers' incentives to fulfill their tax obligations are sufficiently strong in this case, so there is no need for substantial additional incentives. Residual tax evasion could be dealt with through measures, or development of institutions beyond the realm of the tax policy (mortgage credits, pledge etc.), which could create additional incentives for registration, or certification of the transfer of absolute rights.

Inheritance and Gift Tax

As far as inheritance and gift tax is concerned, introduction of the proportional tax rate is necessary and it should be uniformly applied in all cases liable to this kind of taxation, regardless of the actual inheritance or succession order. Furthermore, there are good reasons for bringing this tax rate to the level of the real estate sales tax, in order to

eliminate incentives for making fictitious inheritances and gifts. By the same token, changes in inheritance and gift tax rate should mirror changes in the tax rate on transfer of absolute rights.

Inheritance and gift taxes have a small fiscal effect, and significant increase in revenues from this tax should not be expected.

Property Tax

Property tax should not have an allocative effect – the only effect it should generate is fiscal effect. Allocative effects should be managed within the sphere of the urban land management reform (based on its privatization), establishment of the market for this resource (urban land) and the reform of the system of urban planning.

The property tax rate should be proportional and identical for all types of real estate, which implies that the current progressive tax rate should be abandoned. The issue of whether this rate should be determined by the central (republican) or local authorities belongs to the debate on fiscal decentralization – in other words, both solutions are legitimate.

If local authorities determine the rate of the property tax, central (republican) authorities should define quantitative range for determination of this rate. In principle, the central authorities may formulate this range in two ways: a) by specifying lowest and highest value of the tax rate; b) by specifying only the highest rate. The suitability of either of these provisions should be determined with regard to the policy of fiscal decentralization.

The most significant problems of the property tax lie in the difficulty of determining the tax base, or assessing the value of the real estate, subject to this tax. If these problems cannot be resolved in satisfactory manner, it is necessary to consider the possibility of replacing property tax with some other local tax, or appropriate fiscal mechanism which would compensate for lost fiscal revenues from this type of tax. The only tax of the sort is a community poll tax, which is collected from every inhabitant (or every inhabitant over 18), of the local community (lump-sum tax). Through implementation of this kind of tax, the problem of defining tax base for property tax, or the problem of real estate evaluation would be resolved. Furthermore, community poll tax is allocative neutral (economically efficient), implementation friendly (administrative costs are low) and the possibility of evasion is relatively small. However, this tax radically violates the principle of vertical justice (equity), which is discrediting enough to preclude its recommendation for implementation. Furthermore, the political costs of implementation of this kind of tax are prohibitively high, as illustrated by the fate of this tax in Great Britain at the end of 1980s. That is why this tax cannot be presented as a realistic alternative to the property tax.

In principle, the tax base of the property tax should be: a) *ad valorem*; b) based on the total value of the real estate, c) based on the capital value of the real estate. The *ad valorem* principle, which defines the

value of the real estate as a tax base, is the only possible solution which would not violate the principle of horizontal and vertical justice (equity). Also, there is a trend (especially in the transition economies and developing countries, since this was accomplished a long time ago in the developed countries) of recognizing this principle in specifying the tax base for real estate taxation.

The tax base should be based on the total value of the real estate, i.e. it is not advisable to differentiate between urban land and buildings on it (improvements). The current situation in Serbia is that, even if some general reason against the implementation of this principle existed (and it does not), it would not be feasible to implement differentiated taxes, in view of the still existing monopoly of state ownership on urban land. In other words, urban land would be excluded from taxation and only buildings could be taxed, which violates the *ad valorem* principle. As long as urban land in Serbia is not privatized (and the privatization process requires a new Constitution and appropriate new law on urban land), there is no possibility of implementing differentiated taxes on urban land, on the one hand, and constructed buildings (improvements), on the other. Even if the legal and operational prerequisites for implementation of differentiated taxes are met, the tax base would still be based on the total value of the real estate. The reasons for this lie in the easier assessment of the total value of the real estate, and the fact that contemporary best practices show that more and more countries are switching to this method of tax base assessment, and recognize the principle of allocative neutrality of the property tax. Isolating the urban land as a separate tax base is usually justified as a means of creating an opportunity for allocative intervention on the urban land market through a particular (differentiated) tax policy. By adopting the principle of allocative neutrality of property tax, this argument is rebutted.

The tax base should be based on the capital value of the real estate, i.e. the value of the real estate recorded on the date the capital transaction (transfer of absolute rights) takes place. Adopting this principle means discarding the alternative principle of rental value of the real estate, i.e. presenting the value of the real estate based the total annual rent obtained, or the one that could be obtained, by renting that real estate. Implementation of the rental value principle leads to problems related to the determination of the tax base, mainly regarding acquiring accurate information about the amount of market rent (it is easier to obtain information about the market value of capital transaction), as well as inevitable arbitrariness in evaluation of the tax base. Besides, this principle is being abandoned in contemporary tax laws, even in the former British colonies that have a very long tradition of its application.

Adopting the first and the third principle, results in discarding the existing dual system which recognizes different tax bases in case of real estate sales tax (absolute rights transfer tax) and property tax. Introduction of the uniform tax base in case of real estate results in increased

transparency and efficacy in property taxation. Furthermore, this unification would open possibilities for significant raise in fiscal revenues which could compensate for the existing systemic underestimation of the tax base in case of real estate tax.

Defining basic principles of the desirable tax base for real estate taxation, opens the question of the method of assessing the value of real estate, the tax base, specifically the procedure of specifying the particular amount which should be taken as market capital value of the taxable real estate. Principally speaking, there is a possibility of introducing self-evaluation, or taxpayer's obligation to assess the value of his own property, subject to a property tax, and file a tax declaration (return) with assessed tax base. Self-evaluation of the tax base, as one of the alternative options, is based on the possibility of introducing new, effective and powerful incentive to the taxpayers to realistically estimate the value of their property. In case of self-evaluation of the tax base, every taxpayer has an incentive to declare lower value, i.e. underestimate the value, in order to reduce his tax burden. Without a new, effective and powerful incentive for the taxpayers to realistically present the value of their property, self-evaluation as an alternative option is not advisable, since it would inevitably lead to a significant fall in the value of the tax base, and through that to a fall of fiscal revenues. Consideration of the suggested proposals for formulating these incentives (Allais' suggestion), concluded that they are not applicable, because they are not effective, and can even result in the creation of a perverse incentive structure. Therefore, it can be concluded that there is no feasible proposal for that kind of incentive at this moment, which means that the basic precondition for implementation of the self-evaluation system is not met.

Even if this incentive against systemic underestimation of the tax base in case of self-evaluation could be formulated, the problem of imperfect information, or lack of knowledge on the part of the taxpayers, still persists. In other words, even if an effective incentive exists (and there is none), values of the self-evaluated tax base could be very far from the market value of that property. This creates the need for monitoring that assessment by the Tax Administration, which is eliminating the basic advantage of the case for self-evaluation – low administrative burden. This is finally clarifying that self-evaluation of the tax base is not a realistic option.

Therefore, the only realistic solution is that the Tax Administration should be the authority to assess the tax base for property tax purposes, and assesses the market value of the property of taxpayers. This raises two essential questions: one is the issue of content and procedure of assessment, and the other is the issue of incentives to the officers of the Tax Administration (particularly their local branches) to implement the given procedure in an effective and impartial manner, in short, to do their job properly.

From the perspective of the content and the procedure of real estate assessment, the only acceptable provision is the one already implemented

in a number of countries. That provision is based on utilizing: already established estimates of values of the real estate (previously used as a tax base in case of absolute rights transfer tax, i.e. real estate sales tax), existing values of the assessed tax base for property tax and all material characteristics of the real estate (location, quality, amenities etc.). Based on mentioned input data, the model of the computer based mass assessment of real estate values for property tax base determination (*Computer Assisted Mass Appraisal – CAMA*), calculates the value of every individual property, regardless of the fact whether it was ever sold or not. For purposes of this report it is not necessary to go in details of CAMA model functioning, but it is useful to clarify its basic concept. The model uses different specific inputs for every individual property: the price of the property (if ever traded or sold), tax base used for determining absolute rights transfer tax (static base), as well as location and other characteristics of the individual property, including all the elements for determining the quality of the building. Based on the listed data, a set of regression equations is estimated, taking into account all available factors influencing variation of discrepancy between the static and dynamic base (tax base in the cases of real estate sales tax and property tax), in order to assess influence of these factors on the observed variation. Upon estimating values of the regression equations parameters, the next step is formulating forecast i.e. projections of the discrepancy between the static and dynamic base (which is considered to be an indicator of the market value of the real estate, or its value per square meter). That is the procedure for calculating a new value of the property tax base, through equalizing the static and dynamic tax base (market price).

Two important elements of the CAMA model should be pointed out. Firstly, calculating the value of every individual property in the certain area does not require data about all sales transactions (although data from different years can be used), rather it can be sampled on the level of the municipality or the local community. According to the initial estimates, successful functioning of the model in case of Belgrade, for example, requires data for roughly 600 sales of the real estate. This feature shows that this model could be used for a swift efficient estimation of the value of real estate (the new tax base). Also, there is a possibility of developing a single model for Serbia as a whole, for real estate within Serbian territory, in case of which belonging to a particular local community would be just one of the attributes, defined as an input, for every individual piece of real estate. This feature demonstrates that the model of real estate evaluation (assessment) could be efficiently organized on the level of the central republican Tax Administration. The role of the local (municipal) branches of the tax administrations would then be to send updated information about the estimated value of the real estate, used as a tax base for absolute rights transfer tax (real estate sales tax).

Implementation of the proposed CAMA model reduces the number of required incentives to the officials of the Tax Administration, just to incentives for assessment of the tax base in case of the real estate sales

tax. These incentives would facilitate, first of all, control over the whole procedure, with a special, already mentioned, requirement to avoid appeal to the second instance authority. In addition, internal auditing measures of the assessment process should also be developed. The central Tax Administration is a second instance authority in this case, and legal remedy against its decisions involves filing an administrative procedure.

Implementation of the CAMA model would not, in its own right, significantly raise administrative burden to the Tax Administration. Some estimations show that a single CAMA model, if implemented on the level of Serbia as a whole, would employ up to three persons. Since the results of this model depend on the quality of information about the value of traded real estate, it is necessary to establish unique procedures for processing information on enacted decisions about taxes on transfer of absolute rights, in order to keep CAMA model updated through new and timely input data. Also, there is a need for a constant flow of information and know-how, especially between the municipalities with a significant real estate sales volume and municipalities with less lively real estate market, in order to overcome the problems in local communities lacking experience and know-how in evaluating real estate.

As far as the legal formulation of the procedures for assessing the tax base is concerned, appropriate laws and regulations should stipulate precise and accurate definition of the principles and form of the procedure itself (sequence of steps), information used in the process of evaluation, without further specification of the content of evaluation (complicated formulas, point based grading etc.). As far as the classical evaluation is concerned, specification of the stipulated principles and procedures should be left to the experienced and skilled officers of the Tax Administration. In case of implementation of the computer evaluation, its content is predetermined by specific statistical procedures that shouldn't be tempered with.

Another important issue is reviewing/adjusting the level of the tax base as the time passes. The value of real estate changes over time, so it is necessary to provide for the change of the tax base accordingly. The most important changes cover: a) the retail price index; b) depreciation rate of buildings; c) dynamics (economic outlook) of the real estate market. Implemented CAMA model enables continual evaluation of real estate in the territory of the Republic, with low administrative burden, i.e. it is not very demanding on human resources. Regular and timely input of real estate value assessment data, for purposes of absolute rights transfer tax (real estate sales tax), is an indispensable prerequisite for continuing evaluation – which induces a slight raise in the administrative burden. Also, the difference between the new and the old value of the real estate can be defined in the model, and the model automatically adjusts the value of the tax base. Since the CAMA model always encompasses virtually all factors influencing the value of

the real estate, the new value assessment can be lower or higher than the old (existing) estimate.

Implementation of the CAMA model should lead to establishing the tax base for property tax for all taxpayers, including those that keep accounts. This could also serve as a method for overcoming the problem of systemic underestimation of the bookkeeping value of the real estate in the balance sheets of legal entities. The CAMA model could be tested first exclusively in the case of taxpayers who do not keep accounts and after review of the first experiences, application could be expended to taxpayers which do keep accounts, practically causing transformation of their tax base. Further study of the CAMA model in case of Serbia, as well as its adjustment will show if there is a need for a differentiated approach towards these taxpayers, i.e. the need for a phased approach in introduction of the new system of determining tax base for the property tax.

The list of tax exemptions for property tax purposes (diplomatic offices, religious buildings, etc.) should not include items for which further tax exemptions are not justified, these are: 1) real estate used for education, cultural, scientific, social welfare, health or sports related pruposes, if privatly organized and 2) agricultural buildings. Proposed removal of tax favoritism is justifiable, bearing the principle of allocative neutrality and equity of the taxpayers in mind.

In addition, it is necessary to define the threshold value of real estate (tax base) below which no property taxes shall be applicable, as it is currently envisaged in the law. Sufficiently high specification of this threshold (based on empirical testing or simulation) shall serve as a protection of the poorest. Since it can be expected that market values of real estate (new tax bases based on market values) could vary significantly, this threshold should be specified on the local (municipal) level, i.e. separately for every particular local community. The threshold can be generally defined as a certain share in (or percentage of) the average value of the real estate (the tax base) on the territory of a given local community. Implementation of thus defined general criterion for specification of this tax threshold facilitates centrally organized and executed tax exemption for appropriate taxpayers. The effects of different thresholds on the number of the exempted taxpayers (and some of their characteristics) and on fiscal revenues will be shown by the simulations of effects of different tax base values thresholds when tax bases (assessment results) are available.

Defining the lowest value of the real estate as a mechanism for protection of the poor will create an incentive to the households which are cash poor and rich in fixed assets (property), to reallocate their property from stock to flow. However, flows should also be taken into consideration, by way of defining the lowest level of taxpayer's income below which no property taxes should be levied. Nevertheless, tax exemption should come into force only if both criteria are met, i.e. if the value of property, as well as the amount of income of a given taxpayer, are both below specified thresholds.

Tax credits, as currently defined in the law, should be replaced by the unified tax credit in the appropriate percentage of the value of total tax liability for all taxpayers' housing. In that way, determination of the tax credit would depend exclusively on the effectively differentiated tax rate between living and business related real estate. Decisions about the applicability and proportion (the percentage) of tax credits should be made by the tax authorities at the particular level (central or local) which will, after implemented fiscal decentralization, be authorized for deciding on the amount of property tax rates.

As far as curtailing evasion of real estate taxes is concerned, the basic prerequisite is improving the real estate data base, i.e. acquiring accurate information about each item of real estate (land and buildings), their owners or users. Providing this information will also enable effective application of the penal provisions of the existing Property Tax Law. It is also necessary to examine the modest achievements of these penal provisions, and maybe even propose their amendment.

Other fiscal instruments

Apart from mentioned tax instruments, on the local level there is also a compensation for the use of the urban land. All revenues based on this instrument represent revenues of the local community. Judging by the way of calculation, by the intended use of collected revenues (financing local public resources), this compensation is a typical local tax, and a typical property (real estate) tax.

Therefore, it is necessary to integrate compensation for use of the urban land into the property tax. This may be achieved through abolition of this compensation in the current form, and its integration into the property tax through the appropriate raising of the property tax rate in order to, at least in the short run, reimburse the loss of fiscal revenues due to the said abolition. There are several advantages to integration of the compensation for the use of the urban land into the property tax. Firstly, this means realization of the idea of compensation as a substitute, or a form of local tax – since now, there is an institutional facilitation for its development into property tax, calculated based on the *ad valorem* tax base. Secondly, total costs of collecting fiscal revenues are decreased, since all the costs related to calculation and collection of the compensation vanish. Thirdly, this facilitates establishment of full control by the Tax Administration and competent local authorities over the flow of fiscal revenues and expenditures and assists implementation of the principle of budget unity in case of local public finances.

Since the compensation for use of the urban land is paid monthly, perhaps annual property tax could be divided into six equal monthly installments, in order to evenly distribute the annual tax burden. The advantages and disadvantages of this system should be compared to the existing system of quarterly collection of the property tax.

In course of the specified inclusion, the status of the compensation for servicing urban land **should not** be altered, since it is not public revenue. The pending privatization of urban land, as well as reform of the system for its utilization, will inevitably transform the nature of this compensation, but it will never develop into the public revenue of the local community.

Fiscal effects

The proposed reform of the property tax will inevitably lead to the increase of the fiscal revenues based on these taxes. Rapid increase in revenues based on property taxes is expected for two reasons: (1) significant raise of the tax base, through acceptance of the real market value of the real estate as a tax base; and (2) including compensation for use of urban land into the property tax. It is estimated that the effects of these two factors on the increase of the fiscal revenues based on the property tax, will be more than enough to offset possible decline in fiscal revenues stemming from the possible reduction in the tax rate in the case of real estate sales tax (transfer of absolute rights).

More specific estimates of the fiscal effects of the tax reform will be possible only after information about the range (band) for future tax rate policies of local authorities becomes available. Therefore, more elements on fiscal effects will be offered upon obtaining more specific data, i.e. even preliminary results of the CAMA assessment procedure for Serbia.

Continuous comparison of the fiscal effects of different tax policies (tax rate, tax credits, etc.) and more accurate results of this testing, would be made possible only upon full development and continuous maintenance of the CAMA model. This will allow *ex ante* testing of the fiscal effects of considered tax policies for every local authority managing a local community.

Allocation of fiscal revenues

The total amount of the collected revenues from property tax shall constitute original revenue of local communities, and other forms of local government (city and municipal). In the of city authorities the method of allocation of these revenues to the constituent municipalities should be pre-defined. This provision in allocation of fiscal revenues paves the way for transfer of responsibilities in the formulation of the tax policy to the local authorities. Since these revenues from property taxes would become original revenues of the local communities, they will have a strong incentive to formulate efficient local taxes, and cooperate with the central Tax Administration concerning all aspects of efficient collection of taxes.

Tax decentralization

All the important parameters of property taxes, as well as their implementation, should be clearly defined in the laws and regulations by central (republic) authorities. These parameters include: tax rates on transfer of absolute rights (real estate sales tax), inheritance and gift tax rates, method of calculation and collection of taxes, method of the tax base determination etc.

Local authorities should be free to determine the effective property tax rate, i.e. local authorities should specify a proportional property tax rate which is to be applied in their territory, as well as a percentage of the general tax credit applicable to all households in their territory. These provisions should certainly be consistent with provisions prescribed for the whole territory of the Republic, as defined by the central authorities. Guidelines should define highest and lowest tax rate, as well as maximum amount (percentage) of the tax credit that local authorities can approve. The permitted range should be large enough to provide for possibility of choice between different effective tax burdens that local authorities may impose on their citizens, since they are, through the elections mechanism, accountable to their citizens. Besides, since significant variations of the tax base between municipalities are expected, a wide range of permissible tax rates will create opportunity for more justified allocation of the tax burden between citizens.

In this situation, local authorities face conflicting incentives – one encourages increases and the other decline of the tax rate, and/or tax burden. However, local authorities would obviously prefer a situation with the lowest possible tax burden and highest possible grants from the central government for financing local budget. Accordingly, the system of sharing formula for local communities could be adjusted to enable those local communities investing more effort in real estate tax collection (greater tax burden), to receive greater amounts from central authorities. This will be an incentive for higher local tax burden and for effective tax collection.

Local authorities should be given the power, at least, in the beginning of implementation of the new property tax, over annual re-adjustment of their tax rate. Later, only after a few years of implementation, this provision should be reassessed and possibly limited, by legally determining a fixed period (e.g. two or three years) in which the same tax rate must be maintained. Rationale is that in the first period, local authorities should be given opportunity to alter tax rates every year, and through the method of trial and error, find an optimal tax rate and optimal local tax burden.

Implementation of the tax regulation in the area of the property tax, actually levying and collecting these taxes, should continue to be within the jurisdiction of the local branches of Republic Tax Administration, with a significant improvement in communication between local authorities and local branches of the Tax Administration. In view of

the fact that there is a different level of capabilities between the existing local branches of the Republic Tax Administration, it is essential to facilitate the transfer of knowledge between these branches of the Tax Administration.

Schedule of the reform implementation

The key element of the proposed tax reform is development of the CAMA model for Serbia as a whole. Consequently, this should be made an absolute priority. It is still unclear how long it will take to finish "feeding" the model, i.e. to collect new data and sort already acquired material available to the Tax Administration. First examinations of the Tax Administration lead to the conclusion that the bulk of data is already available. Therefore, "feeding" the model could take three to four months at the longest.

After completion of collection and sorting of data, or the "feeding" phase of the model, three to four weeks of working on the CAMA model would be required for determining the value of real estate in Serbia. Therefore, the first results would be available after three to four months from the setting up of the model. In other words, if preparatory operations were to start on September 1st, the results of the model could be expected at the beginning of 2004.

The results of the model, i.e. value of real estate of all the taxpayers, would serve as a base for more reliable simulations of all the parameters which, taking the tax base as given, define the tax burden and tax revenues. Based on these simulations, further guidelines could be given for defining the following parameters: (1) the lowest property tax rate; (2) the highest property tax rate; (3) the highest amount (percentage) of the tax credit; (4) the amount of the threshold value of taxable property. If the full results of the CAMA model for Serbia were available by the beginning of year 2004, the above explained simulations, or testing of the different (alternative) tax policies could be completed during the first quarter of 2004, and the results of the simulations of those policies would be available by March 31st, 2004.

Specific tax policy provisions in the area of property taxes should be defined during the second quarter of 2004. Drafts of the actual textual proposal of all the relevant laws and regulations should be completed by the end of the second quarter, more precisely by June 30th, 2004.

All drafted laws and regulations should pass parliamentary procedure and come into force during the third quarter of the 2004, more precisely, by September 30th, 2004. This will create an opportunity for local authorities to prepare and enact all the necessary regulations which would facilitate implementation of the new property tax, during the last quarter of 2004.

New property tax regulations will then be applicable from the January 1st, 2005.

ANNEX

Necessary data for the CAMA model

All the listed data should be specified for the unit of immovable property.

1) Information about the taxpayer (information regarding natural person or legal entity available to the Tax Administration);
2) Location of the given immovable property, measured by the degrees, minutes and seconds of the geographical latitude and longitude;
3) Distance from the center of the settlement;
4) Zone where the building is located (if territory is divided into zones);
5) Municipality where the immovable property is located;
6) Floor space of the real estate;
7) Area of the land belonging to the real estate;
8) Use of the real estate (land and improvements);
9) The year in which the property was built;
10) The year of reconstruction (if any);
11) Floor number (only for apartments);
12) Sales value of the real estate (capital transaction);
13) Date of transaction completion, or date of filing a declaration of the tax base;
14) Existing tax base for property taxation (for the latest available year);
15) Year for the Existing tax base for property taxation
16) All data defined as elements for determination of the quality of the building according to the Regulation on Method for Calculating Property Tax Base for Real Estate (RS OG, No. 26/2001).

If there is any additional available information about the particular property, it should be included in the model.

VIII Tax Debts

CURRENT LEGAL FRAMEWORK

Treatment of tax debts and relating Tax Administration (TA) procedures are governed by the Law on Tax Procedure and TA (herein further: the Law):

A taxpayer becomes a tax debtor if not meeting tax obligation within the term determined in the material tax laws (Article 65). Forced collection begins with issuance of the corresponding decision, or upon expiry of a ten-day period after delivery date of the notification that due obligations have not been met (Articles 71 and 77). If establishing, in the course of forced collection, that a taxpayer's property is not adequate for payment of the debt and such taxpayer is a legal entity, the TA shall initiate bankruptcy procedure (Article 112).

The Law has also regulated the issue of the time limitation concerning the right of a TA to determine and collect the tax and related tax duties (Article 114). Accordingly, the TA cannot exercise the right to determine the tax and related tax duties after the term of three years, and the right to collect due payments cannot be exercised after the term of five years. However, these time limitations do not apply in case of the contribution for pension and disability insurance. The reasons for exempting this contribution from the time-limitation regime applied to other taxes is obvious: namely, the insured cannot obtain the right on pension insurance unless the contribution is paid in each and every year in the course of his length of service. The time limitation of five years for collection of the tax is appropriate since, if in the period of five years it fails to take any action towards the collection, it is the Administration, and not the insured, who should be held responsible for the fact that the time limitation has expired.

However, it is not clear why is the time limitation for determination of obligations is only three years, which means that it is shorter than general time limitation while it should actually be longer. A possible explanation may be that even the legislator in Serbia does not regard tax avoidance as illegal conduct, although in the developed democracies tax evasion, as well as tax avoidance, are considered serious criminal acts and legal punishment sometimes equals that for the most serious criminal offences belonging to the area of "common" criminality (major robberies, manslaughter and similar).

It is also possible that, having in mind the transition processes which the Serbian economy is undergoing, the legislator instituted a three-year limitation for determination of tax obligations in an attempt to convince prospective investors that the TA will not, after the privatization process of a company is over, come to "have another look" at the company's tax history. Article 115 of the Law is yet another proof that this might be a possible explanation for deciding on such a short time limitation for the right to determine obligations. Namely, this Article empowers the Government to, upon proposal of the Minister for Finance and Economy, issue the decision on writing off the taxes and related tax duties to the taxpayers being sold in the privatization process or undergoing the restructuring process.

Although the specific nature of the transition process, and, essentially "one-time" character of the privatization process (although not of the restructuring process), may offer some justification for granting the Government such power, it is nevertheless the precedent that the obligations lay down by law may be modified by the decision of the Government. Also, apart from the general statement that a taxpayer is undergoing the privatization process or restructuring process, the law provides no details about the requirements or the limits that must be met to be able to issue a decision on writing off the debt.

Independently from this in-principle objection that derives from the principle of division of competences between the legislative and executive authorities, the issue of usefulness of such a precedent must be raised. Or, in other words, the question is whether this possibility of treating tax obligations in such a flexible manner is really helping the companies to get privatized or restructured. The answer may be sought in the results of the reprograms approved before the Law came to effect.

For the total of 198 taxpayer, which in 2001 or 2002 were approved a reprogram of tax obligations, the status of tax debt as per the day of 31 December 2000 was 10.6 billion dinars. Within the reprogram, they were written off almost entire amount of interest (2.7 out of 3.5 billion dinars), as well as granted a grace period of 3 to 12 months and scheduled payment in 12 to 36 installments. As per the day of 31 December 2002, the total tax debt of these taxpayers amounted to 12.8 billion dinars, i.e. it increased by more 1/5. More than half of these payers (112) do not implement the reprogram at all or do it only partially, and in ten payers a bankruptcy procedure was initiated. Hence, in 132 out of 198 cases, or in 2/3 taxpayers precisely, the reprogram of obligations which included writing off the interest, i.e. the legal obligation, did not attain desired goal.

One of the ways in which, maybe a more effective, effort was made to solve the issue of tax debts while supporting the privatization process at the same time, is conversion of the public companies' tax debt into the state property. This nationalization of a kind, however, can be meaningful only if a company that has undergone the transfer of ownership is eventually sold, since only then can the state compensate, at least for

a part of tax debts, out of the income from privatization. However, this procedure is absolutely pointless when a company is without a likely buyer. In such a case, the lifetime of a company would be prolonged for a certain period of time, but there would also be more opportunity for such company to incur more debts, and not only tax-related to that.

TA AND DEBTS

In 2003, the Law on Tax Procedure and TA (the Law) was enforced. That is also the year in which the TA was established pursuant to this Law and the year in which two complex processes began: first is the process of the TA transformation, and the second is the process of consistent implementation of material tax laws in conformity with the adopted integral Process Tax Law.

Transformation of the TA and full establishment of all functions foreseen in the Law involves major and essential changes in all fields of its work. This transformation began in the circumstances imposed by the old TA when the prevailing method for determination of obligations was issuing decisions, IT capacity for automatic monitoring of how regularly the payments were made was not in place, and there was no in-office control. The administration almost entirely relied on the on-site control while the selection of taxpayers which were subjected to control was random, and quite often politically influenced. The control was conducted by the organizational part of the administration which almost had no operative linkage with other functional parts of the administration while the territorial organization was almost confederation-like decentralized.

The fact that the centralized tax accounting system is not in place is possibly one of key problems faced by the Tax Administration, in operative terms. It is a logical consequence of earlier circumstances and former organization of the administration. In other words, at this moment the TA cannot get, at one place, the whole picture of the initial status, current balance, and payments the individual taxpayers made against all tax obligations. Some segments of this picture, although neither updated nor reliable, can be found in the territorial units, and, as regards the current balance against the sales tax, excise duty (not including those paid at the customs) and the taxes and contribution with current obligations and payments withheld – although they are there, the initial status is missing. In other words, the tax accounting system does not yield accurate data about the structure and level of debt for individual payers, nor about the structure and debt of the overall tax debt of the registered payers.

At the same time, the TA inherited a large number of taxpayers whose bank accounts were blocked, mostly by decisions issued in the course of on-site controls. Additional problem is presented by the fact that the decisions on payment issued during on-site controls were not entered into the tax accounting system. One of the reasons for this rests with a

never resolved conflict of competence between two parts of the same administration. An answer has not yet been found to the question of how to record a decision concerning the profit tax obligation when it is made during an on-site control when that same obligation is already entered into the accounting system based on the decision of the same administration, but its other organizational unit. The newly-formed TA need not come up with a solution for this specific issue since it is related to the organizational problems of the former administration. However, it must establish, without delay, a clear picture of all former and current obligations for each registered payer. It must also promptly start to use all the mechanisms the Law puts at its disposal for collection of taxes: from providing assistance and services to the taxpayers, to the forced collection of tax debt from the entire property of the taxpayer.

Although challenging, the forced collection is an exceptionally important step in establishing credibility of this institution. Selection of the debtors which shall be subjected to this procedure is a crucial moment in this step. Both the taxpayers and the general public must be well aware of the selection criteria and all the taxpayers must be treated in a consistent and uniform manner.

However, this is where the problem emerges. In the circumstances in which estimated overall tax debts amount to approx. 100 billion and practically all companies owe taxes, this will not be an easy step for the Tax Administration. Bearing in mind its obligation to instigate bankruptcy procedure if a taxpayer is insolvent and taking into account that the new bankruptcy law has not yet been adopted, the TA may be left to its own devises when it comes to resolving the problems that, due to inefficient economic system, have accumulated over the decades.

By introducing Value Added Tax in which a tax return is a systemic occurrence, in contrast to present situation when it occurs only due to some error made by either the taxpayer or the administration, a new problem shall emerge. In conformity with the Law, tax return may ensue only if a taxpayer is not a tax debtor against any type of tax. Bearing in mind our present situation, only a small number of taxpayers, particularly those who were not paying sales tax up till now – mainly the industrial producers – will have the opportunity to exercise their right on the VAT-based return since the majority of them are at the same time tax debtors. This problem may seriously set back implementation of VAT and additionally aggravate the problem of liquidity which regularly occurs in the initial stages of implementing this type of tax.

RECOMMENDATIONS

1. It is necessary that the Ministry of Finance set as its priority goal to establish a centralized tax accounting system as well as to identify, in order to facilitate attainment of this goal, specific additional resources and put them at the disposal of the Tax Administration. In the TA itself, a special team should be formed and assigned the exclusive task

of realizing this goal. Without an accurate, regularly updated, and centralized tax accounting system, the TA will not be able to competently perform a single task within its jurisdiction.

2. Consider the possibility of prescribing, in transitional and final provision of the Law on Value Added Tax, that in the year 2004 the right on return as provided by the Law on VAT will be obtainable only by those taxpayers which have settled all tax debts incurred in 2003. This practically means that all tax debts that were incurred by the payment coming due in 2002 shall not be taken into account when returning or approving tax credit in 2004.

3. It is necessary to compose a final list of those companies currently undergoing privatization or restructuring process which shall be allowed to convert their debt into the share of the state, or those currently subject to a special tax regime because undergoing privatization or restructuring process as a preliminary stage for privatization pursuant to Article 115 of the Law. Likewise, it is necessary to define a term in which the privatization process will be completed and then followed by bankruptcy or liquidation process. This term could be the same for all companies or set for each individual enterprise separately based on the actual situation. Also, it is necessary to clearly identify, at the same place, their tax duties for the duration of this specific tax period. A list of companies, term and obligations could be a subject matter of a separate law to be submitted to the National Assembly for adoption.

4. Amend the Law so as to rescind the right of the Government to write off tax debts and extend the time limitation for determination of tax obligation to ten years. In the context of the new control concept, a three-year time limitation for determination of tax obligations is too short. When all new functions are established, although the number of on-site controls would be smaller, they would be better prepared, both in professional and analytical terms. The same as in other countries with the developed tax administration, it may happen in such circumstances that a taxpayer is not once in five years subjected to on-site control. In the circumstances where other forms of monitoring regularity of payments and office control are well developed, on-site control may be considered unnecessary. However, on-site control is most reliable when it comes to determining how regularly the payments of tax obligations are made. It would particularly gain in importance when the concept of self-declaring the obligations becomes a dominant method for determining the level of obligation. Because of these reasons, the time limitation for determination of obligations is not adequate and should be extended.

5. Regardless of the problems that will be encountered even if we do not have to wait for due changes in legal framework, the TA must, for the sake of general prevention and particularly because of existing accumulated debts, instigate the procedures of forced collection without any further delay. The situation in which everybody owes and therefore no action is taken towards forced collection additionally encourages belated payment. The problem of the taxpayer selection

must be resolved in compliance with the Law and the Law clearly empowers the TA to instigate only such procedures which are cost-effective and not to instigate them at all in cases when the taxpayer does not own property from which the debt can be paid (Article 81 of the Law).