Commonalities and differences of tax systems in West Balkan countries Comparative analysis

Teuta Balliu, PhD Cand.

Lecturer, Faculty of Economy in University of Elbasan "A.Xhuvani".

Email teuta.balliu@uniel.edu.al

Aida GaçeLlozana, PhD Cand.

Lecturer in the Faculty of Economy in University of Elbasan "A.Xhuvani".

Email aidagacehe@gmail.com

Abstract

Countries of former Yugoslavia and Albania are considered as countries with many common problems as well as changes, which in this context are regarded as insignificant. On their way towards development, these countries are characterized by common problem, among which the most sensitive have been and still remain, unemployment, increasingly compressed public administration, unjustified optimism when planning the budget, mismanagement of public finances and poor fiscal discipline which mostly depends on being or not an election year. In these countries we notice the lack of harmony between economic and fiscal policies and the real needs of the economy. This is seen as other major common ofWest Balkan countries. This similiarity of problems narrows the possibility of competition associated to the foreign investment absorbing capacity. But, which is the moacroeconomic picture in the countries of West Balkan? What are their tax systems? How much are the foreign direct investments? Does the tax system serve as a promoter for these invvestments? This paper represents a comparative analysis of the fiscal systems in the countries of this region. The subject of this paper is the protection with arguments of the economic and fiscal policy which are built for the economic development of a country. This because we are given that there are two types of experiences related to tax system, one of which handles taxes as instruments for revenue collection and the other as a promoter factor for economic development.

Keywords: Fiscal policy, Tax system, economic growth, foreign investments

Introduction

Every state regards the analysis of fiscal policy with much interest, due to the fact that the capital cost does not just include the money cost, given in the form of interest rate for the loan, but also the fiscal cost, shown in the form of a fiscal burden that the investor should pay. A high fiscal burden, which increases the direct cost of the investment, might lead to the investor's discouragement and eventually, the debt searchingfor financing a project. Often in the public debates, financial authorities claim that their levels are in fact amongthe lowest in the region in order to legitimate their decisions to increase tax levels. In this paper, we will focus on the comparative analysis of the tax burden. We have made a comparative overview of tax levels in some countries of the region[1]. In terms of an investment project's implementation, these countries might also be competitive candidate states with our country, Albania. An investor, who aims to serve in the Balkan market, would consider the implementation of a potential project in one of the countries which are analyzed. In the investors' analysis, the value of cost factors, mainly those of taxing system, would be one of the main indicators in taking the investment decision (De Mooij, R.A and S. Ederveen, 2005). As a consequence, the differences in the fiscal evaluation of investments become instruments of regional competition. Western Balkan countries had a considerable economic growth before the crisis, but the growth was based on a high domestic consumption, related to the fast increase of the loan, and it was accompanied by the extension of the current account deficit and increase in the private

[1] The analyzed countries are Albania, Montenegro, Serbia, Croatia, Macedonia and Bosnia Herzegovina

sector loan. This economic growth was stopped when the global financial crisis was transmitted in the region through trade and financial channels, resulting in the decrease of external demand regarding regional exports, loan crisis, remittances declining and the decrease of direct foreign investments. The crisis caused a general decrease of economic activity, the expansion of budget deficits and the growth of public loan and the foreign one. In 2009, the GDP dropped in Bosnia Herzegovina, Montenegro and Serbia, whereas in Albania and Kosovo, the growth was slow compared to the period before the crisis. The consolidation of economic recovery which started in 2010 led to a moderate growth in every part of the region. While some improvements were noticed in the first half of 2011, the economic activity dropped in the second half and the first half of 2012.

Short-term economic perspectives for the Western Balkan still remain weak, and vulnerability has increased as a result of Eurozone crisis. The weaknesses in the financial sector are part of special concerns, taking into account the fact that the majority of banking system is part of foreign ownership and that most countries rely on funding from abroad, though this is not part of this paper and we are not going to deal with this. The appropriate background for the business is one of the main pre-conditions for the economic recovery and the growth of Western Balkan. Many elements of a healthy business environment- such as efficient and predictable governmental institutions, sustainable fiscal policy, an educated labor force, a well physical infrastructure and access in financing- all have a direct relation with the economic growth. The recent economic crisis has highlighted the fact that a background which supports economic competiveness is of great importance to better support of national economies to absorb shocks and provide a sustainable economic development. International institutions statistics show that Western Balkan countries have remained behind the countries of the group that includes 10 countries of EU, in a range of background indicators of business, investment and competiveness, as well as the institutional reform.

Changes in the fiscal policy and their influence in the economic growth of a country. Literature review

If we refer to the literature for determining the trends of the economic thought, we emphasize that there are two trends of economic thought regarding the influence of fiscal policy in the economic growth of a nation, known as Keynes trend and neoclassic theories (Szostak, 2009). According to the **Keynes** theory of aggregate demand, the reduction of governmental cost or the tax increase, reduce that aggregate demand and indirectly to the incomes, transmitting a negative influence into the production (Keynes, 1936). In the full model of this theory, which is shown in the standard analysis of the IS-LM curve, the multiplier of negative effects is partly counterbalanced from the *crowding* effects due to lower interest rates and monetary devaluations. **Neoclassic** models emphasize other transmission mechanisms, through which reductions in the government budget deficit influence the economy, whose positive effects might surpass the negative effects of Keynes multiplier in the aggregate demand. In a country that suffers from severe imbalances of budget deficit, the measures against its reduction are seen as necessary to replace the governmental insolvency. The deficit reduction would influence in the decrease of risk price in the interests norms. This would increase the value of wealth market in the private sector and consequently would increase the aggregate demand. On the other hand, the government'sdeficit reduction would serve the private sector and consumers as a signal for reduction, in the future, of tax burden and increase in their incomes. The current studies prove that the tax levels have a considerable influence in the establishment of right balances between savings and investments, as a result in the economic growth (Solow, 1956). Taxing decreases not only the purchasing power of the tax obligator[1] but also causes effects of economic, financial, social, and moral type (Nicodeme, 2007). Among the main effects, we can mention the tax transfer, tax transformation, the objection for its pay, evasion, the influence in the accumulation and allocation of incomes, international exchanges, economy etc (Mankin, N.G &Biedeman, D.K 2003). The majority of developed countries use the tax policy as a mean to get a faster development from the point of view. To achieve this, they promote the development in those branches of economy which encourage or bring a faster economic development (Prammer, 2011). These branches were offered tax facilities which are related to the reduction of tax obligation in order to re-invest their profits, which is supposed to bring economic development.

[1] The tax obligator is a physical or judicial person, who based on law, is obliged to pay the tax and complete the tax obligation. Not every person is classified as this. This classification includes those who have an asset or have incomes from their work or capital.

Economic growth for the Western Balkan

This study of Western Balkan includes Albania, Bosnia Herzegovina, Macedonia, Montenegro and Serbia. The region has a population of less than 20 million inhabitants and a relatively low level of development. After the political stabilization and renovation of transition process in the end of 1990s and early 2000s, the region made a considerable economic progress.Western Balkan economies had relatively high rates of annual economic growth in the pre-crises period (2001-2008), an average of 5.7 % in GDP. However, the economic growth in the region before the crisis was based in a high internal consumption, related to the growth of loan and a high increase in real wages.Its model of growth was largely based on a cheap international capital and loans to be indexed to international currencies and liberalization of foreign trade and financial markets. The global financial crisis which began in the second half of 2007, initially as a crisis in the US housing market, spread beyond the financial sector and severely touched the global economy. Until September 2008, the Western Balkan countries did not feel the influence of the financial crisis because they had a low percentage of bad loans. However, the capital markets of countries in this region were shocked when in the autumn of 2008 foreign investors' institutionsbegan withdrawing funds. The end of that year saw also the attraction of foreign currency savings (Bank, 2014). Referring to the table 3.1, it is clearly discerned that the overall situation along 2013 of the region has been positive. The growth of gross domestic product for 2014 is projected to be positive excluding the economies of Serbia and Croatia.

The commonalities and changes of tax systems in Western Balkan

The following analysis does not pretend to illuminate the effects of fiscal policy on investment and economic growth, but if the considerations of placing an investment project in one of the countries of the region, included in the analysis, will be affected to a certain amount by fiscal policy as theory and literature in the field of finance emphasizes, the comparative analysis is very important and can serve as a response to neutralizing and / or competitive policies.(De Mooij, R.A. and Ederveen,2005). When we take into consideration Western Balkan countries we must consider that we are dealing with small economies and not major markets. Western Balkan countries have signed and have become part of many tax agreements between them and institutions of international rules, the applicability of which, almost from all countries surveyed in this analysis, leaves much to be desired.Although the governments of these countries have agreed to implement several principles, procedures or tax rates, their full implementation seems far away. So, which are the taxes and the tax rates that individuals and businesses face in these countries?Let's see one by one starting with the group of direct taxes passing to the indirect group later.

Corporate tax

Taxation on the companies' profit is one of the most important in the taxing category. The comparative analysis over the companies' profit is of special value as it enables the identification of incentive policies that several states offer in order to encourage the reinvestment of a large amount of capital or a faster development of economic activity in the companies in general. We have made the following analysis for each country in this paper.

Bosnia and Hercegovina

Resident companies[1] are subject to tax on worldwide income, while non resident companiesare taxed on income derived from the relevant jurisdiction only. The taxable base is determand by increasing the accounting profits or losses for nonreductible expenses and reducing the accounting profits or losses for allowable items. In Bosnia and Herzegovina the dividents are not taxable until distibuted to shareholders. Capital gain is generally taxed as profits, at a rate of 10%. Dividends paid from this state to a non-resident are subject to a 5% withholding tax. For the incentives we can say that Bosnia and Herzegovinaoffers a full corporate income tax exemption for companies whose exports exceed 30% of total income and companies investing not less than BAM 20 million over five consecutive years in production, provided the investment during the first year is at least BAM 4 million. A company is exempt from corporate income in one year if that

[1]A company is resident if it is registred as a legal entity there.

year its workforce is comprised more than 50% of persons with disabilities or special needs hired for a period longer than one year. All costs relating to Research and Development are recognized as expenditure.

Macedonia

Resident companies, as in Bosnia and Hercegovina, are subject to tax on their worldwide income. Legal entities which derived profit from a business activity are subject to profit tax, which is 10%. Accumulated undistributed profits are not subject of profit tax until they are distributed. Dividends paid to non-residents are subject to a 10% withholding tax, unless the rate is reduced under a tax treaty. Regarding the incentivies we can mention that a 10-year tax holiday is available for companies operating in a free economic zone.

Albania

In Albania a company is resident if its legal place or effective management is in it. Resident taxpayers are taxed on their worldwide income and non-residents are taxed only on Alnanian-source income. Dividend income is considered taxable income, unless the participation exemption or a treaty applies. Capital gain is considered taxable income too. Starting from 1 January 2014 for company wich turnover is over 8 million ALL the standart rate of tax is 15%. If the total turnover of a company is between 2 million ALL and 8 million ALL the corporate income tax is 7.5%. The companies with a turnover less than 2 million ALL are subject to the simplified income tax on small business at a fix annual amount of 25000 ALL. Dividends paid to non-resident pay 10% withholding tax, unless the rate is reduced under a tax treaty. Relief from corporate income tax may be granted for projects such as investment related to public sector and infrastructure projects, tourism and oil industry.

Serbia

Corporate taxation related to residence[1] is the same as in Bosnia and Hercegovina, and Macedonia.Taxable income includes both business income and capital gain. The rate is 15%, and the capital gain is subject of a 15% tax for residents and 20% for non-residents. Dividends paid from a Serbian-resident company to another Serbian company are exempt from corporate income tax. Dividents paid by a Serbian resident company holding at least 10% of the shares in a non-resident distributing company for one year are eligible for a credit for foreign tax paid on dividends. The tax treaties are mentioned different times during this analyse, and Serbia as the other countries does not respect all of them. So, even the rate of withholding tax is reduced under a tax treaty in Serbia the dividends paid to a non-resident are subject to a 20% tax. Payments made by a resident in preferential tax jurisdictions are subject to a 25% withholding tax. Regarding the incentives we can mention that a 10-year corporate income tax exemption is available for large investors that invest over 1 billion RSD in fixed assets and hire an additional 100 emplyees over the period of investment.

Croatia

In Croatia the residents[2]are taxed on their worldwide income and non-resident are taxed only on Croatia-sourse income as in Albania and Montenegro.The rate of corporate tax is 20%. The capital gain is included in taxable income and is taxed with the same rate 20%. Dividends are subject to tax in Croatia, except for dividends paid to a resident entity. Dividends paid to a non-resident entity are subject to a 12% withholding tax unless the rate is reduced or exempt under a tax treaty or the individual qualify for an exemption under Europian parent-subsidiary directive. Deductions are available for research & development (scientific and developmental) expenditure i.e the taxpayer can decrease its taxable base by 100% up to 150% of qualifying expenditure. Investment incentives can reduce the corporate tax rate, depending on the amount invested and the number of employees connected to the investment.

[1]A legal entity is considered resident if it is incoeporated in Serbia or managed or controlled from Serbia.
[2]An entity is resident in Croatia if it is incorporated and regestered there or if it is controlled and managed there. An entity may also became resident by carrying out business activities in Croatia that meet the criteria for a permanent establishment.

Montenegro

The residents are taxes in the same way as in Albania and Croatia. Even here the capital gain is treated as profits and both of them are taxed with a tax rate of 9%. The withholding tax is again 9%, and it is levied on dividends paid to a non-resident and on dividends paid to a resident. Regarding the incentives we sholdsaz that an eight-year tax holidaz is granted to companies engaged in production activities in an underdeveloped areas.

Based on the above data we conclude that Albania mostly promotes small businesses. Bosnia and Herzegovina with its tax on companies' incomes clearly seems to promote imports and exports. On the other hand Croatia through its tax system encourages investments and employment, while Macedonia stimulates investments in free trade zones. Montenegro and Serbia through the exceptions and tax incentives that they apply, they promote investments in less developed sectors.

Personal income tax

Personal income tax is part of direct taxes. Countries like Macedonia, Bosnia and Herzegovinaand Serbia aplly the flat tax as it is shown in the table 4.2(Business, 2013). In the literatures and empirical studies this kind of taxis considered like a tax which stimulates savings and investment. Albania (starting from 1 January 2014) together with Croatia and Montenegro apply progressive tax rate on personal income. The progressive rate of Croatia starts from 12% up to 40%. The most part of the countries, after the financial crises of 2008, apply the progressive tax as a way for collecting more revenues without takind in consideration the experience of the EU countries and the empirical studies which emphsises that the increased tax rates negatively impact the economic growth.

Value Added Taxes (VAT)

Indirect tax generally plays a crucial role in the budget revenues of West Balkan Countries (Crawford I, M. Keen and S. Smith, 2009). According to the project of Doing Business 2013 inderect taxes are around 14% of GDP and the VAT constitutes the greatest part with 10.8% of it. Which are the main charachteristict of VAT in Western Balkan? Do these countries apply tax facilities?

Macedonia applies VAT on the supply goods, the provision of services and on imports. In Croatia VAT is imposed on the sale of goods and on the provision of services and is this country which has the highest rate in the region. The rate of VAT in Albania is also one of the highest rate in Balkan.

What kind of exemption do these countries apply? Macedonia imposes 5% on food products, pharmaceuticals, production equipment, computers and public transportation. Exemptions include the supply of banking and financial services, insurance, health and education and 0% for exports. In Bosnia and Herzegovinacertain public services, health and medical services and financial services are extempt. Even in this country the VAT on exports is 0%. In Albania the VAT imposed for exports is 0% too. The supply of medicines is extempt from VAT. Serbia has the preferable rate of 10%, and certain items are extempt or zero-related. In Croatia the standart rate of VAT is 25% with reduced rates of 13% and 5%.In Montenegro is levied a reduced rate of 7% on certain goods and services. Exports are again zero-related and extemptions exist for financial services, the sale of land etc.

Foreign Direct Investments' concentration among Balkan States

The lack of harmony between the system, the integrity of the procedures and the real needs of the economy is a common 'evil' for Western Balkan. All the countries of the region suffer from relatively large sizes of informal economy. It is particularly expanded in Bosnia and Herzegovina (Europian, 2013). Above, we gave an overview of some part of the tax system, the one which is directly related to investments for each of the countries surveyed in this analysis. Let's see how much were the foreign direct investments (FDI) for each of the countries surveyed in this analysis. As seen from the data presented in Chart 5.1, Serbia is the state which has the highest level of foreign investments, which is then followed by Albania and Bosnia Herzegovina. If we refer again to the profit tax rate we will remind that Serbia, Macedonia and Bosnia and Herzegovina apply 10% of flat tax, while Albania passed on the progressive tax on 1st January 2014. The effects of this tax may be considered as opportunities for future studies.

Summary and recommendations

The growth outlook is positive for most of the Western Balkan countries but at low levels. Most of the tax revenues come from indirect taxes and more precisely from VAT which occupies the major role in tax revenues of GDP report.The three states which apply the lowest rate of VAT are Bosnia and Herzegovina, Macedonia and Montenegro, while Macedonia, Bosnia and Herzegovina and Montenegro apply the flat tax which is considered more transparent and easily implementable. Albania with its exceptions and references in the field of taxation mostly promotes small businesses, while Bosnia and Herzegovina with its tax on the company's income seems clearly that encourages imports and exports. On the other hand Croatia through its tax system encourages investments andemployment, while Macedonia stimulates more investments in free trade zone. Montenegro and Serbia through exceptions and tax incentives encourage investments in less developed sectors. Over the last three years, Serbia, Croatia, Albania and Montenegro were the countries which have absorbed most of the foreign investments. It is indisputable that all the countries of the region need higher economic growth, but the most important thing for them is the sustainable growth. Eventhough Macedonia, Montenegro and Albania seem to have the best trends of the economic growth; it still remains at very low levels. The European Commission's 2013 report, states that "*almost all the countriesof this region have signed and agreed to apply international procedures and decrees in the sphere of economic and fiscal policies, but they have only partially implemented them".* The consolidation and implementation of fiscal policies remains the duty of the governments of this region in order to achieve sustainable development. Switching from a tax system (the cases of changes in the flat and progressive tax) to another is not related to long-term objectives, but sort-term ones which have more revenues on the budget. The changes of fiscal policies cannot remain prey of electoral promises, but they must rely on proper empirical studies and the experiences of the countries with sustainable economic development.

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Table 3,1. Real DGP Growth (percent change)

	2012	2013	2014
Macedonia	-0,4	2,9	3,4
Montenegro	-2,5	3,5	2,3
Albania	1,1	0,4	2,1

Bosnia and Hercegovina	-1,2	2,1	0,7
Serbia	-1,5	2,5	-0,5
Croatia	-2,2	-0,9	-0,8

Source.IMF World Economic Outlook. October 2014

Table 4.1. Coprorate tax rate for resident company in West Balkan

Country	Macedonia	B&H	Albania	Serbia	Croatia	Montenegro
Corporate tax (residents)	10%	10%	15%	15%	20%	9%

Source: Doing Buissnes 2014

Table4.2 Income tax rates in West Balkan Countries.

	Macedonia	B&H	Albania	Serbia	Croatia	Montenegro
Income tax rate[1]	10%	10%	Income up to ALL 30000 is exempt, 30000-130000 is taxed at 13% for the amount above ALL 30000, and 130001 and above is taxed at ALL 13000 plus 23% of the amount above ALL 130000	10%	12% up to 40 % depending on gross income.	Progressive tax at rates of 9% and 15%. Gross salary of 720 EUR is taxed at 9%, above this 5% rate.
Capital gain[2]	10% levied on 70% of the value of the gain	Not subject to tax	10%	10 for business, 15% and 20% for royalities.	From 25% to 40% depending on the nature of transactions.	9%

Source: Doing Business 2013

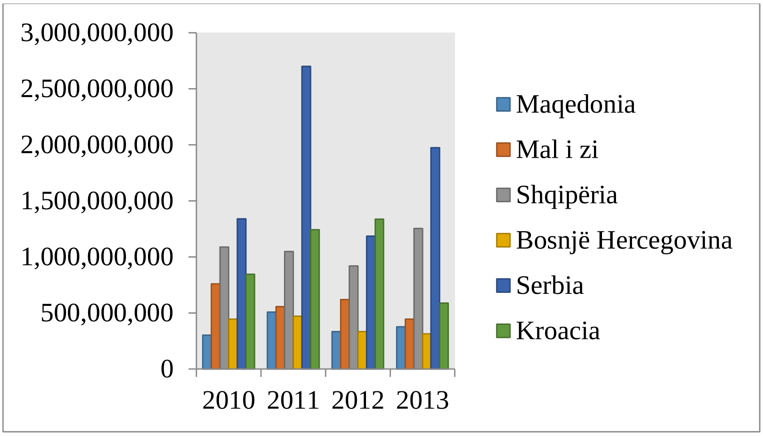
Table 4.3 VAT rate in West Balkans Countries

[1]In this case taxable income includes income from wages, salaries and other forms of employment compensation.
[2]Capital gain derives from the sale of immovable property, securities, equity participation in companies, income from copyright and royalties and interes derived from deposits.

VAT	Macedonia	B&H	Albania	Serbia	Croatia	Montenegro
Rate	18%	17%	20%	20%	25%	19%

Source: Fiscal low in respevtive country 2014.

Chart 5.1 Foreign Direct Investments Western Balkan countries



Source: World Bank