Chapter 4.

Tax policy in South East Europe

This chapter assesses tax policy in six South East European economies. It begins with a brief overview of the general features of the tax system including tax revenues and the balance of the tax mix. It also discusses tax policy assessment tools such as models to forecast future tax revenues, micro-simulation models and tax expenditure reporting. It then focuses on three key sub-dimensions. The first, tax policy, explores whether tax policy fosters an environment conducive to inclusive economic growth and how its design affects revenues raised, investment and competitiveness. The second sub-dimension, tax administration, assesses the efficiency of the tax administration. The third, international tax and tax co-operation, explores the extent to which the six SEE economies co-operate on tax matters with other economies and whether their international tax rules are aligned with international best practice. The chapter includes suggestions for enhancing the policies in each of these sub-dimensions, which in turn would foster the competitiveness of these economies.

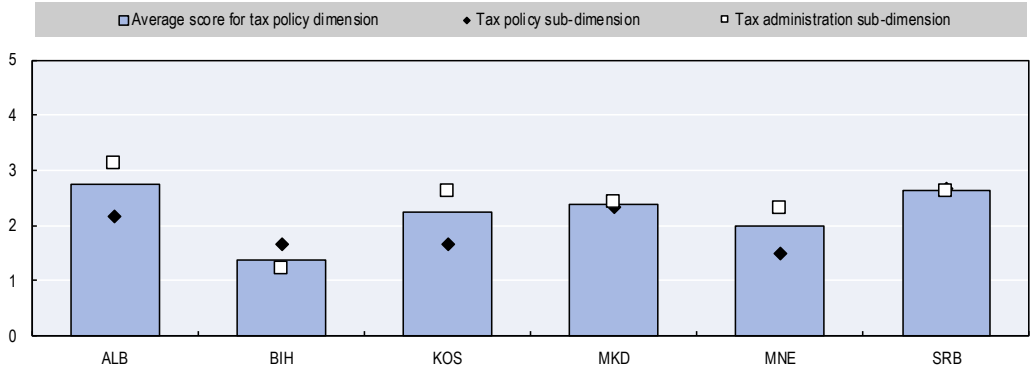
Main findings

Tax revenues have risen steadily throughout South East Europe (SEE) over the last decade, although they remain low in most of the six SEE economies assessed in this report: Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Kosovo,* Montenegro, and Serbia. Some of the economies face challenges in raising sufficient tax revenues to balance their budgets and to invest in infrastructure, education and a well-developed social welfare system.

These six SEE economies impose relatively low corporate and personal income tax rates and offer generous corporate tax incentives. The tax mix is tilted towards indirect taxes and social security contributions (SSCs) which are levied at relatively high rates. The low tax burden on capital income aims to create a tax climate which is conducive to economic growth by stimulating domestic and foreign investment. However, high SSCs place a significant tax burden on labour income, reducing incentives to work and making it expensive for employers to hire workers, especially low-income and low-skilled ones. The high labour-income tax burden may help explain the economies' relatively large informal sectors. The limited role of personal income tax (PIT) reduces the ability of the tax system to redistribute income from richer to poorer households.

Figure 4.1 presents average scores for selected aspects of the tax policy frameworks and tax administration in SEE economies. The economies still need to strengthen their tax policy assessment tools and their tax administration. However, filing and payment procedures have become less complex, which has improved tax compliance. The international tax and co-operation sub-dimension was not scored in this assessment and is therefore not included in Figure 4.1. However, the assessment found that international tax rules in the SEE economies are not aligned with international best practices. The economies would benefit from enhanced regional and international co-operation to address tax avoidance and tax evasion and to better protect the domestic tax base.

Figure 4.1. **Tax policy: Dimension and sub-dimension average scores**



Note: The average takes into account the scores given to some of the tax policy framework and tax administration sub-dimension indicators. See the methodology chapter for information on the *Competitiveness Outlook* assessment and scoring process.

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* This designation is without prejudice to positions on status, and is in line with United Nations Security Council Resolution 1244/99 and the Advisory Opinion of the International Court of Justice on Kosovo's declaration of independence.

Comparison with the 2016 assessment

In general, the six SEE economies have improved their overall tax performance since the 2016 assessment. This is particularly the case for the tax administration sub-dimension. Overall, however, the scores remain relatively low, suggesting there are still opportunities to strengthen their tax systems.

Nevertheless, it should be taken into account that some areas that were scored in the previous edition of the report are only used for descriptive analysis in this edition. These include the general features of the corporate income tax (CIT) system, investment incentives, some features of the value-added tax (VAT) system and the international taxation framework. Therefore, the scores presented in this edition are not fully comparable with those in the previous edition of the report. In addition, changes in indicator scores do not always reflect actual policy or administrative improvements or deterioration over time: they may reflect increased understanding of the weaknesses in their tax system, which may translate into a lower score for some indicators. These factors help explain why the scores for some indicators are lower than those in the 2016 *SEE Competitiveness Outlook*.

Achievements

Tax revenues as a share of gross domestic product (GDP) have been increasing, although in most of the six SEE economies they remain below the OECD average.

The six economies have made significant efforts to strengthen their tax administration. Scores for key indicators in the tax administration sub-dimension have improved, particularly the areas of function and organisation, compliance assessment and risk management, and taxpayer services.

The implementation of a VAT registration threshold means that VAT administration can concentrate resources on larger businesses. VAT registration thresholds lower compliance costs for small businesses and ensure a more effective use of administrative resources and audit capacity.

The six SEE economies are working together to strengthen the functioning of their tax administrations. Tax administrations across the region are sharing experiences and exchanging information on best tax practices.

Remaining challenges and key recommendations

- **Evaluate the design of corporate tax incentives.** Corporate tax incentives are generous across the six SEE economies. As the economies already have low CIT rates – intended to create an attractive investment climate – there is little need for profit-based tax incentives to stimulate investment, such as tax holidays or targeted preferential rates. Profit-based tax incentives lower revenues from CIT without necessarily increasing investment significantly, and they also create negative spillover effects and tax avoidance opportunities. Existing profit-based tax incentives should either be turned into expenditure-based ones, such as accelerated or enhanced tax depreciation or investment tax credits, or be phased out altogether.
- **Analyse the combined impact of PITs and SSCs on labour market outcomes**. Despite relatively low PIT rates across the region, the economies levy high SSCs in order to finance their benefit systems. This results in a high tax burden on

labour income, which may have particularly strong negative impacts on low-skilled and low-income workers who might be priced out of the formal labour market. The economies should evaluate whether they could lower SSCs by increasing PITs and making it more progressive, introducing an earned income tax credit, and/or reducing SSCs for low-income earners.

- **Consider reducing the gap between taxes on labour and capital income.** This gap provides a strong incentive for entrepreneurs to incorporate their business and to earn capital instead of labour income. These challenges seem to have received little tax policy attention in the SEE economies.
- **Broaden the VAT base**. VAT in all the SEE economies is levied on a narrow tax base as a result of the widespread use of reduced rates and exemptions.
- **Develop tax policy tools to assess tax systems and their economic impacts**. Better tax revenue data, tools that assess the effective tax burdens on labour and capital, the implementation of micro-simulation models, and more systematic tax expenditure reporting are a priority for all six economies.
- **Continue to strengthen tax administrations to improve tax collection and compliance**. Further efforts in guaranteeing independence and transparency of the tax administration and strengthening taxpayer services should be a priority.
- **Bring informal workers and businesses into the tax base**. Strengthening the design of CIT and PIT must be an integral part of a strategy to encourage informal businesses to operate in the formal economy. Strengthening the tax administration will result in a broader tax base overall.
- **Bring international taxation rules in line with international best practice**. The six SEE economies have transfer pricing and thin capitalisation rules in place but they are not aligned with international best practice.
- **Evaluate the use of a worldwide tax system and implement measures to protect the domestic tax base**. The SEE economies might want to weigh the advantages and disadvantages of moving from a worldwide to a territorial tax system.
- **Strengthen co-ordination and co-operation among the economies in the region**. By working together, the six SEE economies would benefit from more effective tax enforcement and lower overall tax avoidance and evasion. Enhanced tax policy dialogue on CIT incentives, for instance, could help to create a more attractive investment climate across the region.

Context

Taxes provide governments with the revenue they need to finance public expenditure. A well-designed tax system contributes to an economic and social environment which is conducive to investment, innovation, work, risk-taking and entrepreneurship and ensures that individuals have the opportunity to develop and use their skills.

Tax systems should be designed to encourage inclusive economic growth. This implies sharing the benefits of increased prosperity and productivity among everyone, translating into an increase in well-being across society. Growth-enhancing tax reforms might come at the cost of meeting some equity goals. Inclusive economic growth

therefore means managing trade-offs between equity and efficiency and taking the distributional implications of tax policies and benefits into account (Brys et al., 2016). Tax and benefit policies that contribute to lowering poverty in the SEE economies will be conducive to economic growth within each economy and across the region.

A well-functioning tax system requires a strong tax administration, and results in low compliance costs and increased tax certainty for taxpayers, and low enforcement and administration costs for governments. Well-functioning tax administrations involve modern management and operational structures and good taxpayer services.

Tax systems should include well-designed international tax rules aligned with international best practice to facilitate domestic and international trade and investment. A well-designed tax system benefits from co-ordination and co-operation on international tax matters both within the SEE region and more widely.

This chapter examines the extent to which governments have established competitive tax systems. The tax dimension is linked to several other policy areas examined in this report, especially:

- **Chapter 1. Investment policy and promotion** and foreign direct investment are facilitated by a sound tax environment.
- **Chapter 5. Competition policy** is strengthened by transparent tax policies that help prevent tax evasion and avoidance, which would provide an unfair advantage for some firms over competitors.
- **Chapter 8. Employment** is affected by tax policies, which influence the choices made by participants in the labour market. For example, labour taxation determines the difference between the total labour costs faced by employers and the after-tax wage received by employees, thus affecting labour demand and supply decisions.
- **Chapter 9. Science, technology and innovation** is facilitated by predictable tax rates and credible policy commitments. Tax credits can be used to encourage business research and development spending, while environmentally related taxes encourage firms to innovate.
- **Chapter 13. Environmental policy** can be supported by tax-related incentives to help reduce environmental footprints.

Tax policy assessment framework

The tax dimension in the *2018 Competitiveness Outlook* examines the extent to which governments have established competitive tax systems. Without seeking to be exhaustive, it considers three broad sub-dimensions which are critical to healthy fiscal environments that favour economic growth and well-being across the population:

1. Tax policy: does tax policy foster an environment conducive to inclusive economic growth? How does the design of tax policy affect the revenues raised? How does it affect investment and competitiveness?
2. Tax administration: what are the functions of the tax administration? How effectively are they able to ensure tax compliance?
3. International tax and tax co-operation: do the six SEE economies co-operate on tax matters with other economies, particularly in the SEE region? Are their international tax rules aligned with international best practice?

Figure 4.2 shows how the sub-dimensions and their constituent indicators make up the tax dimension assessment framework. Each sub-dimension is assessed through quantitative and/or qualitative information. Qualitative information was collected by the OECD through comprehensive questionnaires that were completed by public officials and independent consultants. Quantitative indicators are based on national or international statistics. Some of the areas discussed in the tax policy and tax administration sub-dimensions have been scored in ascending order on a scale of 0 to 5 summarised in Annex 4.A1.[1] For more details on the methodology underpinning this assessment please refer to the methodology chapter.

Figure 4.2. **Tax policy assessment framework**

Tax dimension

Outcome indicators
- Total tax revenue
- Tax to GDP ratio
- Tax mix: revenues from individual taxes as a percentage of GDP or total tax revenues

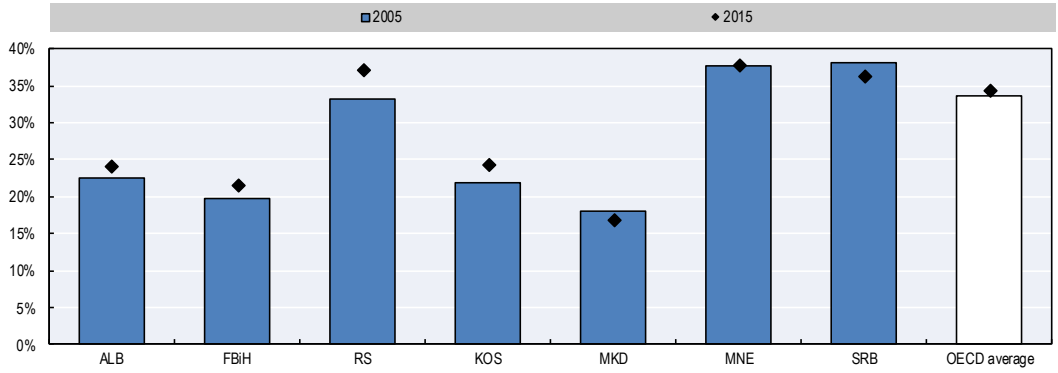
Sub-dimension 1 Tax policy	**Sub-dimension 2** Tax administration	**Sub-dimension 3** International tax and tax co-operation
Qualitative indicators 15. Tax revenue statistics 16. Modelling and forecasting 17. Tax expenditure reporting **Other descriptive information** – General features of the corporate income tax (CIT) system – Corporate tax incentives – Social security contributions (SSCs) and tax burden on labour income – Key design features of VAT	**Qualitative indicators** 18. Functions and organisation 19. Compliance assessment and risk management 20. Independence and transparency 21. Tax filing and payment procedures 22. Taxpayer services	**Other descriptive information** – International taxation framework – International tax features of the CIT system – Regional tax co-operation
Quantitative information Statutory corporate income tax rates	Not applicable in this assessment	Not applicable in this assessment

Tax revenues and the tax mix in SEE economies

Tax revenues increased as a share of GDP between 2005 and 2015 in most of the SEE economies (Figure 4.3). The revenues raised vary widely across economies, however. Revenues are particularly low in the Former Yugoslav Republic of Macedonia (16.7% of GDP) and the Federation of Bosnia and Herzegovina[2] (21.5% of GDP). On the other hand, in Serbia (36.2% of GDP), the Republika Srpska (37.1% of GDP) and Montenegro (37.6% of GDP) they are above the OECD average (34.3% of GDP).

Public debt is relatively high but budget deficits are relatively low in most SEE economies (see Table 4.1).

Figure 4.3. **Tax revenues as a percentage of GDP in SEE economies (2005 and 2015)**



Note: FBiH – the Federation of Bosnia and Herzegovina; RS – the Republika Srpska. For both entities in Bosnia and Herzegovina the data are for 2010 and 2015; for Kosovo and Montenegro, the data are for 2006 and 2015.

Source: Government statistical offices and ministries in the region provided economy-specific data as part of the *Competitiveness Outlook* assessment conducted in 2016-17.

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Table 4.1. **Debt level (in 2015) and budget deficit (in 2016) in the SEE economies**

% of GDP

SEE economy	Debt level	Budget deficit
ALB	72.7%	2.2%
BiH	44.2%	0.8%
KOS	< 20%	2.7%
MKD	47.8%	2.6%
MNE	65.7%	3.5%
SRB	74.7%	1.4%

Note: Data on debt levels for Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, and Serbia were provided by the respective SEE governments. Budget deficit data for Albania, Bosnia and Herzegovina, and Montenegro came from EIU (2016); the budget deficit data for the Former Yugoslav Republic of Macedonia were provided by its government; the budget deficit data for Kosovo were obtained from Oxford Economics (2016).

Source: EIU (2017), *World Economic Indicator Database,* www.eiu.com/home.aspx; Oxford Economics (2016), "Kosovo"; SEE governments.

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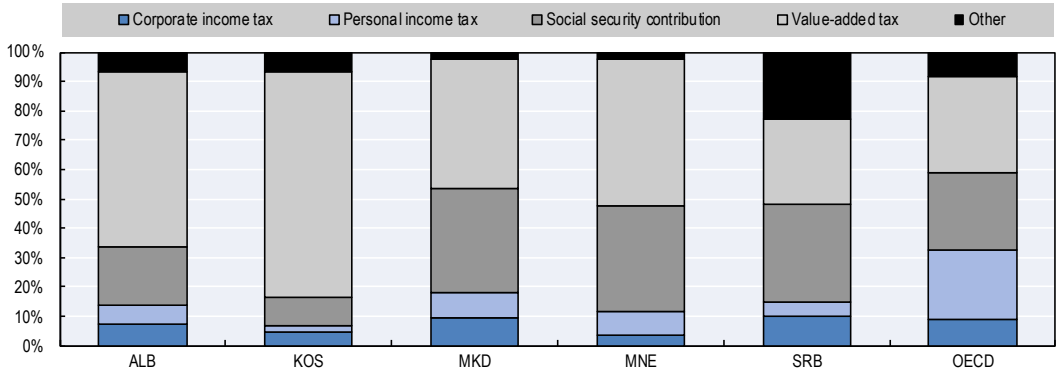
The tax mix for all of the economies differs significantly from the average tax mix in OECD countries (Figure 4.4). In the SEE economies, the tax mix is tilted towards SSCs and VAT, while PIT only raises a small amount of revenue. In 2015, only Albania and Kosovo collected less revenue from SSCs as a percentage of total tax revenues (20.2% and 9.5% respectively) than the OECD average (26.2% in 2014). The other economies raised over 30% of total tax revenues from SSCs. All the economies except Serbia raised more revenues from taxes on goods and services as a percentage of total tax revenues in 2015 than the 2014 OECD average of 32.6%. All the assessed economies raise very little revenue from PIT in comparison to the OECD average of 24%. In the SEE

economies this share ranges from 2% in Kosovo of total tax revenues to 8.8% in the Former Yugoslav Republic of Macedonia (Figure 4.4).

Figure 4.4. **Tax revenues as a share of total tax revenues (2015)**



Note: CIT – corporate income tax; PIT – personal income tax; SSC – social security contribution; VAT – value-added tax. The revenues included in the "other" category are not necessarily consistent across SEE economies; OECD average is for 2014. Information for Bosnia and Herzegovina is not available.

Source: OECD (2016a) *Revenue Statistics* (database), http://dx.doi.org/10.1787/ctpa-rev-data-en. Government statistical offices and ministries in the region provided economy-specific data as part of the *Competitiveness Outlook* assessment conducted in 2016-17.

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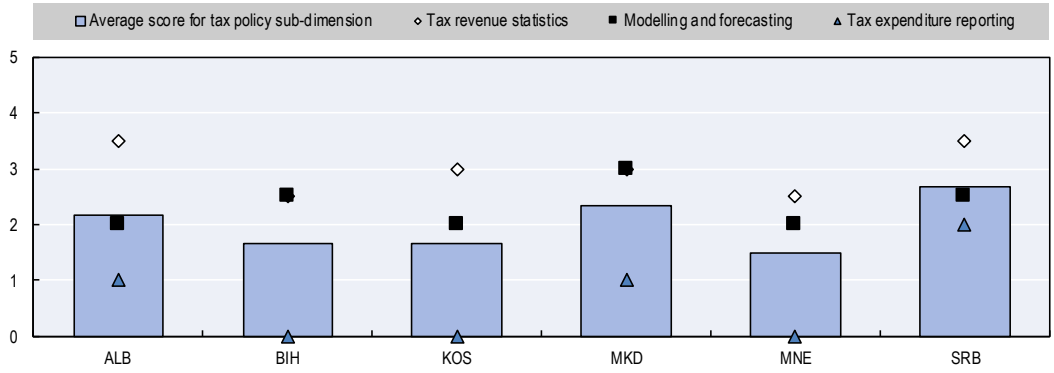
The six SEE economies would benefit from shifting some of their tax mix away from SSCs towards other taxes. High SSCs distort labour markets and provide incentives for workers to remain in the informal sector. In addition, because SSCs are levied at the same rate for all income levels, they do not contribute to making the tax system progressive. Overall, raising more revenues from PIT while lowering SSCs could help make tax systems both more efficient and more progressive.

Tax policy

Tax policy aims at creating a competitive tax environment which encourages investment, work, risk-taking and entrepreneurship while raising sufficient tax revenues to finance public expenditure and ensuring that the tax burden is shared fairly across the population. The tax policy sub-dimension analyses the tax policy frameworks in the six SEE economies. This sub-dimension includes three qualitative indicators to assess the tax policy tools applied in SEE economies: 1) tax revenue statistics; 2) modelling and forecasting; and 3) tax expenditure reporting (Figure 4.5). This section also reviews general features of the CIT systems, including the CIT rates and revenues levied by governments and the corporate tax incentives introduced to stimulate investment. It also looks at other types of taxes, examining the levels of SSCs and the overall tax burden on labour income, the taxation of dividends and interests at the individual level, and key design features of the VAT system. The average score for this sub-dimension for the region was 2.

Figure 4.5. **Tax policy: Sub-dimension average score and indicator scores**



Note: See the methodology chapter for information on the *Competitiveness Outlook* assessment and scoring process.

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Tax statistics reporting and revenue forecasting occur but analytical capacity could be strengthened

The six SEE economies would benefit from further improvements in their statistical reporting in general and their **tax revenue statistics** in particular. The average score across the six SEE economies for this indicator is 3, which suggests that the tax collection agency routinely collects and calculates simple statistics on corporate taxation, and analyses with sufficient detail which types of business and industries pay CIT. The methodologies they use to collect and present tax revenue data vary from economy to economy, making the data hard to compare across economies, however. The OECD has developed a methodology that enables international comparison of tax revenues on a consistent basis (OECD, 2016a). The OECD Revenue Statistics methodology includes a conceptual framework which defines the concept of a "tax" and provides guidance for the classification of different taxes. The SEE economies would therefore benefit from participating in the OECD Global Revenue Statistics project, which would provide them with comparable tax revenue data.

Forward-looking effective tax rates on investment and wages should be basic inputs into economic and tax policy analyses. Most of the SEE economies perform simple calculations and tax statistics, but do not have well-developed effective tax rate models. Strengthening their analytical capacity would allow policy makers to be better informed and would ensure greater public-sector transparency and accountability.

All six of the assessed SEE economies use aggregate **modelling and forecasting** tools, which are important for estimating future tax revenues. These models are also regularly assessed. The average score across the six SEE economies for this indicator is however 2.3 (Figure 4.5), indicating that while the ministries of finance maintain aggregate tax revenue forecasting models for each main tax, there is insufficient analysis of the information or a lack of micro-simulation models.

None of the economies make widespread use of micro-simulation models. These models simulate taxes, SSCs and any social benefits, in order to predict the effects of a potential tax reform and current tax policies. Albania, Kosovo and Montenegro do not implement any micro-simulation models. Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia and Serbia have started to use micro-simulation models to assess their tax policies and reforms, although not yet on a regular basis. As a first step,

micro-simulation models could be developed to assess the distributional impact of VAT in SEE economies, following work that has been carried out in OECD countries (OECD/KIPF, 2014).

The SEE economies do not calculate the revenue forgone arising from **tax expenditure**. Across the six economies, the average for this indicator is 0.7 (Figure 4.5), reflecting the fact that tax expenditure accounting and reporting are not conducted at all (Bosnia and Herzegovina, Kosovo, and Montenegro) or only sporadically (Albania and the Former Yugoslav Republic of Macedonia). Serbia, the economy with the highest score, undertakes disaggregated tax expenditure accounting routinely.

Although there may be good reasons to provide targeted tax relief, in general tax subsidies generate distortions between different types of taxpayers and activities. They also make the tax system harder to administer and comply with, and they tend to make tax systems less equitable, as better-off individuals often benefit more from tax expenditure than poorer households. Tax expenditure is equivalent to direct government spending, but is less transparent to the public at large. None of the six economies prepare an annual tax expenditure report. This should become a regular practice for SEE economies.

Corporate income tax revenues are relatively high

Statutory CIT rates in the six SEE economies are low compared to the OECD average (24.7% in 2016), ranging between 9% and 15%: Albania and Serbia apply a 15% rate; Bosnia and Herzegovina, Kosovo, and the Former Yugoslav Republic of Macedonia levy a 10% rate; and Montenegro's standard rate is 9%.

Despite the low rates, revenues are not particularly low in all of the SEE economies. In 2015, the Former Yugoslav Republic of Montenegro reported CIT revenues of 2.2% of GDP, and they were 1.9% of GDP in Albania and Serbia and 1.2% in Kosovo and Montenegro.[3] The average in OECD countries was 2.8% in 2015 (OECD, 2016a). The fact that CIT revenues are not necessarily very low despite low tax rates and generous CIT incentives (see below) may be explained by high levels of investment and/or a high degree of incorporation by businesses, among other causes. For example, lower rates may act as incentives for business incorporation, allowing entrepreneurs to earn lower-taxed capital instead of higher-taxed labour income. Thus the low CIT rates may mean lower revenues from PIT and SSCs. More in-depth tax policy analysis would help to clarify these different issues.

A large informal sector means the tax burden is borne by a relatively small number of taxpayers

The tax burden in the six SEE economies is borne by a small number of taxpayers. The region has a large informal sector, although no exact figures for its size seem to exist. This limits the amount of tax revenue that can be raised, creates distortions between the formal and informal economy, and reduces the ability of the tax system to help reduce inequality.

Governments have a variety of tools available to them to bring more taxpayers into the tax system, including simplified tax regimes for certain types of individuals or businesses. They can also target their audit capacities at those agents who are more likely to evade taxes and operate in the informal economy. Focusing on entire value and business chains and using import and export information from customs effectively could be an integral part of approaches to gradually increase compliance across the SEE economies.

The SEE economies offer a wide range of corporate tax incentives

The six SEE economies all have generous profit-based corporate tax incentives. In Bosnia and Herzegovina, both entities grant a 30% reduction in corporate tax liability for investment in fixed productive assets if the investment exceeds 50% of taxable income (for the Republika Srpska) or 50% of corporate tax liability (for the Federation of Bosnia and Herzegovina). In the Former Yugoslav Republic of Macedonia, companies located in technological industrial development zones are exempted from CIT on their profits for ten years (certain limits are in place). Montenegro grants an eight-year tax exemption of up to EUR 200 000 of total tax liability to newly created corporations in underdeveloped areas. In Serbia, the profits on investment in fixed assets exceeding RSD 1 billion (Serbian dinar, about EUR 8 million) are exempted from CIT for 10 years if they create a minimum of 100 additional jobs.

Some of the SEE economies have expenditure-based CIT incentives, which reduce the cost of investment. For instance, Kosovo grants a deduction of 10% of the cost of an investment in a new asset. The Former Yugoslav Republic of Macedonia allows for immediate expensing of the total cost of new business-related investments in fixed tangible assets.

In light of the economies' low standard CIT rates, the policy rationale is weak for profit-based CIT incentives, including rate reductions, exemptions and tax holidays. Tax incentives increase the after-tax return of investments that would have occurred anyway, thereby yielding "windfall gains" for capital owners and investors. Tax incentives also increase the costs for the tax administration, which has to monitor compliance with the incentives' eligibility criteria. They also create incentives for tax planning and evasion. For instance, taxpayers have an incentive to remain below the income thresholds which trigger higher taxation, potentially hindering the growth of those businesses. Tax incentives also create negative spillover effects and tax avoidance opportunities. Profit-based tax incentives should be avoided and the current tax incentives should be turned into expenditure-based tax incentives, such as accelerated or enhanced tax depreciation or investment tax credits, or phased out altogether. Instead of using CIT incentives, SEE economies may want to tackle the weaknesses in their investment climate directly, instead of compensating for them through their tax system. Such a strategy would integrate enhanced co-operation across the SEE region (see below)

The SEE economies make widespread use of presumptive and preferential tax regimes targeted at small and medium-sized enterprises (SMEs). In Albania, businesses with annual turnover below ALL 5 million (Albanian lek, about EUR 37 200) enjoy a 0% CIT rate, while for SMEs with turnover between ALL 5 and 8 million (EUR 37 200-59 400) the rate is 5%. In the Former Yugoslav Republic of Macedonia, a 0% CIT rate applies to entities with turnover below MKD 3 million (Macedonian dinar, about EUR 48 700) and there is a 1% tax on turnover for entities with gross incomes of MKD 3-6 million (EUR 48 700-97 400); entities in this category can choose to apply the preferential regime or be taxed under the general regime. Kosovo levies reduced CIT rates of between 3% and 9% – the rate varies with the type of economic activity – for SMEs with an annual turnover below EUR 50 000.

Such size-based thresholds are not necessarily an effective tool to support investment and may restrain growth. Size-based tax preferences give businesses incentives to remain below the threshold so as to continue benefiting from such targeted regimes, both in terms of reduced compliance costs and paying less tax (OECD, 2015a). They may encourage growing SMEs or larger companies to split into different companies to benefit from the

preferential tax treatment, or to deflate their revenues and inflate costs. Such regimes may also provide windfall gains to businesses that, for various reasons, may not be likely to invest and grow. Finally, when reduced rates are based on turnover, they tend to penalise low profit-margin businesses, which end up being taxed at a higher rate than businesses with a lower turnover but higher profits.

The marginal tax wedge on labour income is high despite relatively low personal income tax rates

In general, high SSCs encourage people to work in the informal sector, particularly where tax administrations are weak. High labour taxes in the formal sector may also push low-productivity workers into the informal sector or unemployment. SSCs increase the cost of employing workers and reduce workers' after-tax earnings. The greater the difference between total labour costs in the formal sector and after-tax disposable income for workers, the greater the incentive for employers and employees to avoid taxes by remaining or joining the informal economy. High levels of informality may in turn negatively affect productivity, growth and trust in government institutions (Box 4.1).

Box 4.1. **Main consequences of informality**

A large informal sector can have significant negative consequences for the economy. Workers employed in the informal sector have limited access to social protection, inadequate contracts, comparatively lower wages and are highly vulnerable when they lose their job or when they retire. High levels of informality may also reduce workers' access to training, exacerbating skills shortages. This ultimately generates greater inequalities. This is of particular concern in the SEE economies where inequality is already very high.

A large informal sector also affects productivity and growth. Production in the informal sector is often inefficient, either because firms stay too small to avoid being detected or because they use outdated production technologies. The relative cost advantages enjoyed by informal firms may allow them to stay in business even if they are not productive (Andrews et al., 2011). Firms operating in the informal sector also have more limited access to finance, which constrains investment, and to qualified labour.

A significant level of informal economic activity also has significant negative fiscal consequences. High levels of informality reduce the amount of tax revenue received by the government. Informal workers may also be receiving social benefits, adding to the unnecessary fiscal burden on the state. This is not so clear cut, however, as it can be argued that taxing the informal sector has limited revenue potential because informal workers and businesses tend to be poor and taxation would entail heavy collection costs.

Finally, high levels of informality can erode formal workers' trust in public institutions and reduce their willingness to pay taxes, which may lower revenues through other channels. Importantly, the larger the informal sector, the more incentives people have to remain in or enter the informal sector as there is less fear of being sanctioned and they may view the informal sector as being tolerated.

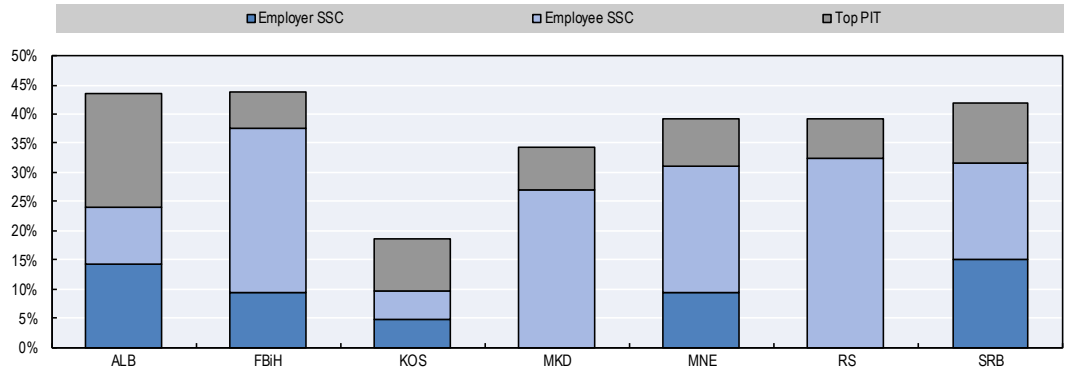
The six SEE economies levy high SSCs but have relatively low PIT rates. The top PIT rates across the region range between 9% in Montenegro and 23% in Albania. Despite these relatively low PIT rates, high SSCs add up to a high overall tax burden on labour income. Employees in the SEE economies face SSCs ranging from 5% to 33% of their monthly gross income. In Albania and Montenegro, employees cannot deduct SSCs from taxable personal income, further increasing the tax burden on labour income. Employers must also make contributions ranging between 0% and 17.9% of their employees' salaries, which they can deduct as a cost from their taxable corporate income.

In three of the six economies – Albania, the Former Yugoslav Republic of Macedonia and Serbia – the average tax wedge for those at the bottom of the income distribution is highly regressive – hitting the poorest hardest. These economies impose a minimum amount of SSCs on earnings: workers who earn less than a minimum threshold have to pay the same contributions as those who earn at the threshold. This minimum contribution means that the average contribution rate is higher for very low-income workers. The thresholds are ALL 22 000 per month in Albania (about EUR 163), MKD 16 438 per month in the Former Yugoslav Republic of Macedonia (about EUR 267), and RSD 22 215 per month in Serbia (about EUR 181). Although these minimum contribution thresholds are set at low levels, they could still distort the labour market by discouraging low-income workers, in particular those working part-time, from joining or remaining in the formal sector.

The marginal tax wedges on labour income are relatively high due to the combined effect of PITs and SSCs in the SEE economies. In simple terms, the marginal tax wedge indicates the burden for every 1 additional unit of currency earned by an employee. Following the OECD *Taxing Wages* methodology (OECD, 2017a), the marginal tax wedge is calculated as the additional taxes – PIT, and employee and employer SSCs – which have to be paid when total labour costs increase with each additional currency unit. The marginal tax wedge is 43.6% in Albania, 43.8% in the Federation of Bosnia and Herzegovina, 18.6% in Kosovo, 34.3% in the Former Yugoslav Republic of Macedonia, 39.3% in Montenegro and in the Republika Srpska, and 41.8% in Serbia. Figure 4.6 presents marginal tax wedges levied at the income level where the top PIT rate is first levied.

Figure 4.6. **Marginal tax wedges at the income level where the top personal income tax rate starts being levied**

% of total labour costs



Note: Figure shows the marginal effective tax on wages levied at the threshold income level for the top rate of personal income tax (PIT). This means that the results presented apply at different income levels in different economies. The marginal tax wedge is broken down into the share of PITs, employees' social security contributions (SSCs) and employers' SSCs that have to be paid as a percentage of total labour costs; employee's SSCs are calculated as the income level where the top PIT rate hits first, augmented by the employer SSCs that have to be paid by the employer at that income level. Employees' SSCs are deductible from the PIT base except in Albania and Montenegro. As a result, the relative tax shares differ from the statutory PIT and SSC rates that have to be paid.

Source: OECD analysis following the *OECD Taxing Wages* methodology (OECD, 2017a).

StatLink http://dx.doi.org/10.1787/888933703675

Reducing tax wedges for low-income workers could improve incentives for employers to hire and declare workers and for employees to operate in the formal economy. Lehmann and Muravyev (2012) found evidence, based on a panel of Latin American countries, that a larger tax wedge increases informality and suggest that lowering the tax wedge might be one of the most effective instruments for reducing informality. The SEE economies should evaluate the effect on work incentives and labour demand by employers of the labour income tax wedges at different income levels.

Reducing SSCs for low-income workers would come at a budgetary cost, which the SEE economies would need to compensate for. They could fund some social benefits through general taxation, in particular those benefits where there is no clear link between the level of contributions and the level of benefits, such as family allowances or health insurance. Funding can also be raised through other taxes, including corporate income, consumption or property taxes. Some OECD countries (e.g. France through the *Contribution Sociale Generalisée*) partly finance their social security systems through such taxes.

The SEE economies would benefit from an in-depth analysis of the tax burden on labour income in their economies. The OECD carries out such an analysis for its member countries in its annual *Taxing Wages* report (see for example OECD, 2017a); the economies would benefit from a similar analysis of effective tax rates. *Taxing Wages* provides details of all the taxes levied on wage earnings. It covers PITs, employees' SSCs, employers' SSCs and payroll taxes net of cash benefits received by in-work families. The report illustrates how these taxes and benefits are calculated in each member country and examines their impact on household after-tax incomes. The results of this publication enable quantitative cross-country comparisons of tax burdens, total labour costs and the overall tax and benefit position of single individuals and families at different levels of earnings.

Businesses have a modest tax-induced incentive to finance investment with debt rather than equity

Corporations face a modest tax-induced incentive to finance domestic investment with debt in the SEE region. Interest payments are deductible from the CIT base but the return on equity is not, which creates a tax-induced incentive to finance investment with debt rather than equity. As the debt-equity bias increases with a higher CIT rate, and standard CIT rates are low in SEE economies, the debt-equity bias in SEE economies remains low. In all economies except Montenegro, dividends paid by a resident corporation to a domestic corporation are exempt from CIT (at the recipient level). The six economies tax the interest paid to resident companies as ordinary business income in the hands of the recipient and subject to the corporation's CIT rate.

The debt-equity bias in most of the SEE economies persists when taxes on capital income at the individual level are taken into account. Dividends paid by a domestic company to resident individuals are subject to a final withholding tax in Albania, the Former Yugoslav Republic of Macedonia, Montenegro, and Serbia; i.e. no additional tax is levied on distributed dividends at the individual level for shareholders in these economies. In Bosnia and Herzegovina (both entities) and Kosovo dividends paid to resident individuals are exempt. Given the standard CIT rates and taxes on dividends in each economy, the combined statutory tax burden on dividends equals 10% in Bosnia and Herzegovina and Kosovo, 27.8% in Albania and Serbia, 19% in the Former Yugoslav Republic of Macedonia and 17.2% in Montenegro. Interest paid to resident individuals is subject to a final withholding tax in all economies. The final withholding tax rates are

15% in Albania and Serbia, 10% in Kosovo, and 5% in Montenegro. As a result, the tax burden on dividends is higher than on interest in all economies except Kosovo, where interest and dividends are subject to the same tax burden of 10%.

VAT rates are relatively high but levied on a narrow base

Raising additional revenues through VAT is less detrimental to economic growth than raising revenues through other taxes. The OECD's *Tax Policy Reform and Economic Growth* report, which assessed the impact of four major categories of taxes on long-run GDP per capita, ranked consumption taxes as the second least damaging to economic growth after recurrent taxes on immovable property and before other property taxes and personal and corporate income taxes (OECD, 2010). VAT is therefore generally considered a comparatively efficient way to raise revenues. In addition, a well-designed VAT system can provide incentives for businesses to enter the formal sector and can help to reduce informality (Box 4.2).

The six SEE economies levy relatively high VAT rates on a narrow VAT base. Apart from Serbia, which has a relatively broad VAT base, the SEE economies have a long list of VAT-exempted goods and services. Standard VAT rates in the SEE economies range from 17% in Bosnia and Herzegovina to 18% in Kosovo and the Former Yugoslav Republic of Macedonia, 19% in Montenegro, and 20% in Albania and Serbia. The average VAT rate in the OECD is 19.2%. The VAT base is narrow because a wide range of goods and services are taxed at a reduced VAT rate or exempt from VAT altogether. The reduced VAT rate is 10% in Albania and Serbia, 8% in Kosovo, 7% in Montenegro, and 5% in the Former Yugoslav Republic of Macedonia.

Box 4.2. **How VAT can help to reduce informality**

VAT could help collect revenues from the informal sector. As discussed above, informality is a significant challenge across the SEE economies. In addition to being able to tax a wide range of economic activities, VAT creates positive "chain" effects by encouraging informal economic agents to become formal. The simplest way to tax the informal sector is through indirect taxes, i.e. by taxing the goods and services that informal businesses buy (Joshi et al., 2014). VAT functions in part as a tax on the purchases by informal operators from formal businesses as informal businesses have to pay at least some VAT on their inputs but are not entitled to VAT refunds (Keen, 2007). This does not require any active participation in the tax system (e.g. filing tax returns) and thus does not involve compliance cost issues (Joshi et al., 2014). VAT thus creates positive incentives for informal firms with actual or prospective dealings with formal firms to enter the formal tax system in order to be able to claim tax credits and recover the VAT on their inputs.

Most OECD countries (except Chile, Mexico, Spain, Sweden and Turkey) apply a VAT registration or collection threshold below which small businesses are not required to charge and collect the tax (OECD, 2016b). Of these, 16 have a relatively high VAT threshold (roughly based on a turnover of over EUR 26 000), while 13 have a relatively low one (EUR 1 300-26 000). Whether to establish a threshold or not – and the specific level of the threshold – depends on many design factors, including the level of administration and compliance costs, the audit capacity of the tax administration, the impact on incentives for businesses to grow, and the level and impact on informality. All these considerations make it difficult to identify the optimal threshold, which may vary across economies.

All six SEE economies have opted to apply VAT registration thresholds, and they are set relatively high. The threshold is around EUR 16 000 in the Former Yugoslav Republic of Macedonia, EUR 18 000 in Montenegro, EUR 25 000 in Bosnia and Herzegovina, EUR 30 000 in Kosovo, EUR 37 000 in Albania and EUR 65 000 in Serbia. A relatively high threshold may give small businesses an advantage when in competition with larger companies, while a relatively low threshold may act as a disincentive to grow or as an incentive to split activities artificially to avoid VAT. The level of the threshold is often the result of a trade-off between minimising compliance and administration costs and the need to avoid jeopardising revenue or distorting competition (OECD, 2016b). The SEE economies have chosen to concentrate their VAT administration capacities on larger businesses by setting rather high thresholds. This approach has many merits. As they continue to strengthen their tax administration capacity, they may consider gradually lowering registration thresholds over time.

A major concern with VAT systems is that they are perceived as regressive, although the evidence for this is mixed (Brys et al., 2016). Some studies have concluded that VAT is a regressive tax after analysing how much VAT people in different income groups pay as a share of their current income. In contrast, studies that measured the VAT burden as a share of current expenditure across either income or expenditure distributions found that VAT systems were relatively proportional, or even slightly progressive. The difference in results between the two approaches is driven by savings behaviour. Saving rates tend to increase with income, which means that higher-income households will tend to have proportionately less of their income subject to VAT because they spend less of their total income (in the current period) than lower-income households (OECD/KIPF, 2014).

Many countries have tried to address the perceived regressive nature of VAT by supporting the poor through exemptions or reduced rates. However, these are rarely well targeted (Box 4.3). The general recommendation for OECD countries is therefore to use direct cash transfers rather than reduced VAT rates to support low-income households if a well-functioning transfer system is in place (OECD/KIPF, 2014).

Many of the exemptions and reduced rates in the six SEE economies are not well targeted from an equity perspective (OECD, 2016b). They would benefit from broadening their VAT bases. VAT regimes across the SEE region provide for a long list of VAT-exempted goods and services; Serbia is the exception as it has a relatively broad VAT base. For example, all the economies exempt from VAT rents on residential property, education services and either healthcare services or the supply of medical products. In addition, Albania and Kosovo exempt newspapers, magazines and certain other types of printed materials. Albania also exempts certain services linked to sports, services provided by dental technicians, advertisements through electronic and written media, and some printing services. Kosovo also exempts public transport. Bosnia and Herzegovina and Montenegro exempt any activity that can be seen to be connected to the public interest. The Former Yugoslav Republic of Macedonia exempts the cross-border transport of people.

Box 4.3. **The distributional effects of reduced VAT rates**

Almost all OECD countries have one or more reduced VAT rates to support various policy objectives. A major reason for the introduction of a differentiated rate structure is to promote equity. Countries have generally considered it desirable to alleviate the tax burden on goods and services that form a larger share of expenditure of the poorest households (e.g. basic food, water). Countries also often decide to not tax medicine, health services and housing at high rates. Reduced VAT rates have also been used to stimulate the consumption of "merit" goods (e.g. cultural products and education) and other non-distributional objectives, such as promoting locally supplied labour-intensive activities (e.g. tourism) and correcting externalities (e.g. energy-saving appliances).

In general, VAT exemptions, zero-rates and reduced rates are not a well-targeted tool to support low-income households. Reduced rates that are implemented for the distinct purpose of supporting the poor (i.e. to address distributional goals) typically do have the desired progressive effect. For example, reduced rates for basic food in general provide greater support to the poor than the rich as a proportion of household income or expenditure. However, despite this progressive effect, these reduced VAT rates are an ineffective way to target support to poor households. At best, rich households receive roughly as much benefit – in absolute value – from a reduced rate as poor households and at worst they benefit vastly more. This is unsurprising as richer households can be expected to consume more, and often more expensive, products than poorer ones. Thus, while poorer households may benefit from reduced VAT rates on "necessities", the wealthier gain even more.

Well-functioning cash transfer programmes that cover the entire population are a more effective tool to compensate poor households for the VAT they have paid. It is more efficient and fairer to tax all goods and services at the standard VAT rate and compensate the poor directly through cash transfers (and/or reductions in PITs, etc.), especially if the standard VAT rate is not particularly high. It should be noted, however, that compensating all (and only the) losers of a reform through a transfer programme might in practice be very difficult to achieve.

The distributional arguments in favour of differential VAT rates may be more persuasive in countries which do not have the administrative capacity to provide more direct transfers to poorer households. In this situation, levying low or even zero rate VAT on the goods typically consumed by poorer households might be considered, at least in the short run.

Preferential VAT rates for social, cultural and other non-distributional goals benefit richer households considerably more. These tax provisions often provide so large a benefit to rich households that the reduced VAT rate actually has a regressive effect – benefiting the rich more both in aggregate terms and as a proportion of expenditure. For example, reduced rates on hotel accommodation and restaurant food benefit the rich vastly more than the poor, both in aggregate and proportional terms, in all OECD countries in which they are applied. Similar results, on a smaller scale, are found for reduced rates on books, and cinema, theatre and concert tickets.

Finally, VAT rates may not be the best policy instrument to correct negative externalities. Differential VAT rates may improve efficiency if it means that the private marginal costs of an activity are brought closer to the marginal costs for society. However, VAT is a blunt instrument for correcting environmental externalities, as it may be hard to target the actual source of pollution. For example, reduced rates on energy-saving appliances may boost demand and therefore stimulate the consumption of these goods. The reduced VAT rate may encourage consumers to shift from more to less energy-consuming items (replacing an old refrigerator with a new one, for instance). However, this may also lead to an increase in the purchase of energy-intensive products, e.g. replacing an old refrigerator with a new refrigerator and a freezer (Copenhagen Economics, 2007).

Source: OECD/KIPF (2014), *The Distributional Effects of Consumption Taxes in OECD Countries*, http://dx.doi.org/10.1787/9789264224520-en.

The way forward for tax policy

In order to raise more tax revenues, the six SEE economies could consider broadening their tax bases. This would allow them to balance their budgets, reduce debt levels and finance better public services and infrastructure to help drive continued economic growth. In doing so, the SEE economies should assess the efficiency and equity implications of their tax system. Overall, they should strengthen their tax systems in order to stimulate economic growth that is beneficial to taxpayers across the income distribution.

Maintaining low tax rates will require keeping tax systems simple and tax bases broad. The SEE economies could broaden the VAT base by **reducing VAT exemptions and taxing goods and services at the standard VAT rate**.

The CIT base could also be broadened. Given the very low CIT rates in the region, the rationale for implementing generous profit-based CIT incentives is weak. The SEE economies should therefore **evaluate their current tax incentives and avoid falling into the trap of a "race to the bottom" tax competition**. They should avoid profit-based tax incentives and turn the current incentives into expenditure-based tax incentives, such as accelerated or enhanced tax depreciation or investment tax credits, or phase them out altogether. Instead of relying on CIT incentives, the SEE economies may want to tackle the weaknesses in their investment climate directly, rather than compensating for them through their tax system.

Bringing more individuals and businesses into the formal economy should be a key priority for the SEE economies. A well-designed tax system can help to encourage businesses and households to operate in the formal economy. The SEE economies could introduce simplified tax regimes that apply to some types of individuals or businesses, or improve their design. They should also target their audit capacities at those agents who are more likely to evade taxes and operate in the informal economy. Focusing on entire value and business chains and effectively using the import and export information from customs could form an integral part of an effective approach to gradually increase compliance across SEE economies.

Despite low PIT rates, the SEE economies impose a high overall tax burden on labour income because of high SSCs. **Shifting the tax mix away from SSCs and towards other type of taxes may reduce market distortions** and provide incentives for workers to leave the informal sector. The SEE economies could also consider reducing the labour income tax wedge by introducing an earned income tax credit within the PIT and/or targeted SSC reductions for low-income workers. Albania, the Former Yugoslav Republic of Macedonia and Serbia should consider levying SSCs as a percentage of actual income rather than imposing minimum contributions below an earnings threshold. All six SEE economies could fund some social benefits through other taxes. They could also strengthen the role of PIT to make the tax system more progressive.

The SEE economies may want to strengthen their tax rules on fringe benefits in general and particularly the use of company assets for private purposes. Currently, manager-owners of closely-held corporations face a tax-induced incentive to consume out of their own business.

Corporations in all the SEE economies except Kosovo have a small tax-induced incentive to finance investment with debt rather than equity. **Economies may want to tax interest payments for individual tax residents at higher withholding rates** in order to tax interest and the return on equity more equally.

Finally, all six SEE economies would benefit from implementing micro-simulation models and systematic tax expenditure reporting. They should strengthen their tax policy assessment tools, including the development of corporate effective tax rate models and *Taxing Wages* models. These would allow the SEE economies to deepen their analysis of the combined impact of PITs and SSCs. The SEE economies could also improve their tax revenue data reporting, in particular by joining the Global OECD Revenue Statistics project which presents detailed, internationally comparable data on tax revenues across the world.

Tax administration

Sound tax policies and clearly drafted legislation are not enough to guarantee that tax systems are competitive. Governments must ensure the consistent and transparent implementation of tax policies and legislation through effective administration. Indeed, an efficient administration is critical to maximise tax compliance and revenue collection. From a business perspective, an efficient tax administration is also essential to limit the costs of complying with tax obligations. The tax administration sub-dimension assesses the efficiency of the tax administration in the six assessed SEE economies through five qualitative indicators: 1) functions and organisation; 2) compliance assessment and risk management; 3) independence and transparency; 4) tax filing and payment procedures; and 5) taxpayer services. Scoring the economies from 0 to 5 against these indicators can help to understand the degree to which the SEE economies are building effective tax administrations.

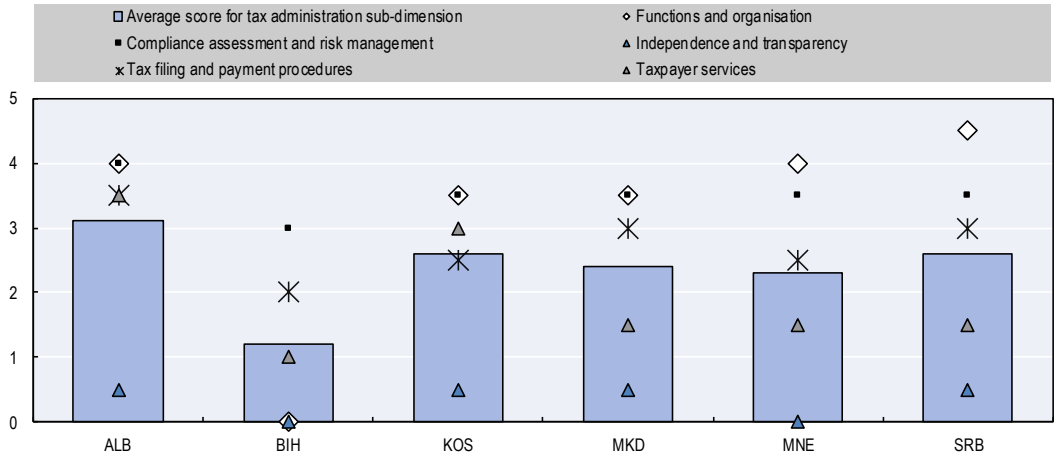
In general, all six economies have made significant efforts to strengthen their tax administration indicated by the fact that their average score is 2.4 for the sub-dimension overall (Figure 4.7). By strengthening their administration, the SEE economies aim to maintain low direct tax rates. They have made significant improvements in functions and organisation, compliance assessment and risk management, and taxpayer services. However, they may need to make more effort to secure the independence and transparency of their tax administrations as they continue to be autonomous or semi-autonomous bodies within their finance ministries and lack independent management boards. Such a reform might be difficult in certain economies as it goes against their constitutions (as for instance in Bosnia and Herzegovina).

Organisational structures and functions of tax administrations are more comprehensive

Organisational structure is an important factor in the operational efficiency and effectiveness of the tax administration as well as the delivery of services to taxpayers. One of the key factors that strengthens the efficiency of the tax administration is the presence of a unified tax administration which covers all taxes and all of the core tax administration functions.

Compared to the findings of the 2016 *Competitiveness Outlook*, the organisation and overall governance of most tax administrations covered in this report have improved. In this assessment, all the economies except for Bosnia and Herzegovina scored 3.5 or above for the functions and organisation indicator (Figure 4.7). In 2016, all the economies scored 3 except for Serbia.

Figure 4.7. **Tax administration: Sub-dimension average score and indicator scores**



Note: See the methodology chapter for information on the *Competitiveness Outlook* assessment and scoring process.

StatLink http://dx.doi.org/10.1787/888933703694

Albania, the Former Yugoslav Republic of Macedonia, Kosovo, Montenegro and Serbia have unified bodies with links to the collection of SSCs. In all these economies, the administrations are organised around either a function or a taxpayer approach, or a combination of both, and regular training is provided to tax administration officials. In Albania and Serbia, the tax administration is assessed to ensure that its tax administration functions are unified; in Serbia, this assessment has led to adjustments.

Compliance assessment and risk management have improved across all the SEE economies

To be efficient in monitoring compliance and managing risks, tax administrations should have an ongoing process in place that allows them to consider where the greatest compliance risks lie within their economy. This process should also allow the administration to determine the appropriate treatment or management of these risks. This process should include consideration of potential changes to and improvement of systems, and possible legislative change as well as audit intervention.

Since it is impossible to check every single taxpayer, risk-based selection is a key element of effective and efficient compliance programmes. This allows administrations to make effective trade-off decisions and use their scarce resources to best effect. As such it is important that the results of audit programmes are regularly assessed and reported – this helps to not only make sure that operations are transparent to the wider public, but also to inform and help improve the tax administration's overall risk management model.

Risk auditing efforts should make use of third-party reporting systems. All advanced economies make extensive use of third-party information reporting, whereby institutions such as employers, banks, investment funds, and pension funds report taxable income earned by individuals (employees or clients) directly to the government (Kleven et al., 2011).

All six of the assessed economies received a score of 3 or above for this indicator, reflecting moderate improvements and a proper understanding of the need for strong compliance assessment and risk management (Figure 4.7). However, the six SEE economies do not have particularly strong third-party reporting systems in place.

Developing such systems, especially in combination with a withholding tax regime, is a proven way for tax administrations to improve both tax compliance and their risk analysis, risk treatment and, where necessary, targeting of tax audits (OECD, 2015b).

Tax administrations are increasingly transparent but still lack independence

Independence and transparency are important features of a well-developed tax administration, if the tax system is to be seen as a legitimate public authority with the necessary safeguards in place when collecting money from taxpayers. Independence is necessary to ensure that the tax system is not influenced by political actors who may seek to circumvent established tax laws or use taxation powers to discriminate against political rivals. By ensuring a transparent and independent tax administration, governments are making a credible commitment to taxpayers about the integrity of future tax procedures and signalling to the private sector that they will not abuse the power to tax.

Trust in the fairness of the tax administration (and also the wider tax system) is very important for maintaining and enhancing compliance and for the tax system's sustainability. It means enforcement must be visible and credible, taxpayers must be seen to be treated fairly and with respect, and adequate channels for queries and appeals must exist. Where trust in the fairness of tax administration breaks down or taxpayers feel detached from the social norms supporting the payment of tax, they may become disengaged, more prone to under-report or less concerned about errors. At worst, it may encourage some to take active steps to evade tax obligations. Corruption among tax collectors may deter individual taxpayers from paying taxes, or they may opt to pay a bribe or enter into the informal economy.

Tax administration offices across the six SEE economies still lack independence; however, they have taken important steps towards establishing transparency. In fact, the average score across the six economies is 0.3 for this indicator (Figure 4.7), reflecting that most of the economies lack a policy to ensure that the tax administration is independent. While none of the economies have policies in place to establish independent management boards, all the tax administrations have rules to deal with staff abusing tax collection powers. In Albania, staff abusing tax collecting powers are subject to the criminal code and the law on tax procedures, while in Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia and Serbia, employees of the tax administration are subject to disciplinary measures in cases of abuse of power. In Kosovo and Montenegro, staff have a code of ethics. All the economies have also introduced whistleblower protection rules (see Chapter 17) and Albania and the Former Yugoslav Republic of Macedonia have put in place monitoring procedures to ensure the transparency of the tax administration.

Tax filing and payment procedures have been streamlined

Complying with tax obligations requires businesses and individuals to have internal resources and/or access to external resources such as tax consultants and accountants. This can impose particularly burdensome costs on small and medium-sized business. Thus, streamlining and simplifying tax-compliance procedures helps to limit the burden imposed on businesses.

The six SEE economies reported that tax filing and payment procedures are reasonably quick and relatively simple. The average score for this indicator across the six SEE economies is 2.7 (Figure 4.7), reflecting that tax filing and payment procedures are relatively simple, tax return forms are kept straightforward, and that all of the economies have e-filing procedures available for most, if not all, taxes, which helps to simplify filing

procedures. All the economies make widespread use of e-filing. In Albania, e-filing is the only system available. E-payment is so far only available in the Former Yugoslav Republic of Macedonia and Kosovo. However, Kosovo does not have software for tax compliance available to taxpayers and Montenegro does not offer taxpayers easy background validation tests. The tax administrations in Serbia and the Former Yugoslav Republic of Macedonia, have no difficulty in verifying proper calculations and running background validation tests.

Most of the economies, except for Bosnia and Herzegovina and Serbia, report that they review their tax filing and payment procedures regularly to ensure that they are clear and transparent. However, these reviews are not performed by an independent body or carried out systematically. In Kosovo and Montenegro, these reviews have led to readjustments.

Taxpayer services vary across the SEE economies

Taxpayer services play a critical role in maximising voluntary compliance by providing taxpayers with the information and assistance they need to meet their tax obligations. Taxpayer services refer to the types of services that the tax administration offers to taxpayers. These typically include information and assistance, responding to in-person and telephone inquiries, handling appeals, and offering online filing and payment systems. Tax administrations should be using customer-centred techniques such as taxpayer segmentation (to differentiate between different groups of taxpayers) and opinion surveys, and guaranteeing that taxpayers are able to easily assess services.

Taxpayer services vary across the six SEE economies, ranging from 1 in Bosnia and Herzegovina, to 3.5 in Albania. The average across the six economies is 2 (Figure 4.7). All of the SEE economies except Albania implement customer segmentation models to better meet taxpayer needs. Both entities of Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Montenegro, and Serbia do not have easily accessible taxpayer ombudsmen. This is the only reason why these economies did not have a higher score for this indicator. Kosovo is the only economy not to conduct surveys of taxpayers' satisfaction with the services available, or to put any monitoring processes in place.

There is ample scope for all of the economies to use information technology (IT) tools more extensively to improve tax collection. Across OECD countries, higher spending on IT is associated with better performance-related indicators, such as e-filing, e-payment and lower tax collection costs (OECD, 2015b). Box 4.4 describes examples of innovative user design and engagement approaches in Singapore and Finland.

The way forward for tax administration

Strengthening the tax administrations of the six SEE economies would bring more taxpayers into the tax system and broaden their tax bases. This strengthening should support efforts to address tax evasion and ensure that timely and effective action is taken against those who deliberately set out to avoid or evade taxes. Strengthening the tax administration further would also be an efficient way to increase tax certainty, lower compliance and enforcement costs, increase tax revenues, and make the tax system more efficient and fair.

Box 4.4. **Good practice: User design and engagement in Singapore and Finland**

The Inland Revenue Authority of **Singapore** (IRAS) organised its first "Tax Hackathon" in September 2016. The aim was to co create taxpayer-centred experiences for SMEs, the self-employed and individuals. To ensure that the opportunity areas were practical and relevant to taxpayers' experiences, IRAS conducted several rounds of focus group discussions with both external and internal stakeholders. Around 70 participants collaborated with IRAS to brainstorm and build working prototypes relating to the opportunity areas. Over 3 days, the event developed 19 creative and innovative working prototypes such as record-keeping and expense-tracking mobile apps, personal tax dashboards, and "chatbots". The outcomes showcased the power of co-creation with the coming together of start-ups, developers, designers, tax and accounting professionals, industry experts, students and IRAS staff.

Tax **Finland** plans to support the development of its MyTax customer portal with a range of user-centred tools and services. To do this it will apply "compliance by design" and "customer experience management" as guiding principles. It will also bring together advanced analytic techniques, design thinking, user-centred design methods and user testing skills. To support this approach it is introducing these disciplines to other development areas. It has begun promoting awareness of service design and its benefits throughout the organisation (including idea and hypothesis testing through early and low-level prototyping and experimentation). It is also planning to establish professional capability in design thinking and user design to enhance the usability and accessibility of its products and services.

Source: OECD 2017), *Tax Administration 2017: Comparative Information on OECD and Other Advanced and Emerging Economies*, http://dx.doi.org/10.1787/tax_admin-2017-en.

All of the economies need to continue their efforts to invest in human and IT resources to enhance the efficiency of their tax administration and to improve tax collection. They also need to strengthen their ability to access and use third-party data for greater efficiency, increased levels of compliance and improved targeting of interventions. Box 4.5 describes how Canada uses integrated risk assessment to decide its audit approach to large businesses, and Box 4.6 presents some examples of best practice from other OECD countries.

Box 4.5. **Good practice: Integrated risk assessment in Canada**

The Canada Revenue Agency (CRA) has implemented an integrated risk assessment system which allows the agency to consider risks among large businesses both at the economic entity level and at the legal entity level. This system links information from CRA databases and various forms with tax returns. It then applies risk algorithms to the data to score risks for the entire large business population. Taxpayers considered by the automated system to be a high to medium risk are further analysed by experienced integrated large business audit teams to determine their overall risk profile. The risk profile determines the audit approach taken. Those taxpayers considered high risk will be subject to a full compliance audit. Taxpayers in the medium-risk category may be subject to a full compliance or limited scope audit. Taxpayers considered low risk may be subject to a compliance assurance review to validate the low-risk ranking. The approach allows the CRA to focus its audit resources on high-risk large businesses while reducing the compliance burden for businesses associated with low risk.

Source: OECD (2017b), *Tax Administration 2017: Comparative Information on OECD and Other Advanced and Emerging Economies*, http://dx.doi.org/10.1787/tax_admin-2017-en.

Tax administrations need to improve their relationships with taxpayers and seek to engage them in enhancing taxpayer services. This involves seeking taxpayers' assistance in making procedures as easy to comply with as possible, gathering better information on the causes of non-compliance and actively communicating information on tax requirements to businesses and households.

Box 4.6. **Use of third-party information reporting requirements and best practices**

In contrast to the high cost and low coverage achieved using traditional audit processes, comprehensive programmes for information reporting and matching can be an extremely effective tool to screen relatively large numbers of taxpayers' records. This helps to both detect non-compliance and encourage the correct reporting of tax liabilities. However, there are two pre-conditions if such arrangements are to be sufficiently efficient to make them attractive to revenue bodies: 1) electronic reporting by third parties of information reports; and 2) the use of a high-integrity taxpayer identifier to enable accurate matching of information reports with revenue body records.

Many countries require the mandatory reporting of payments of salaries and wages, and dividend and interest income (much of which is also subject to withholding taxes). However, use of mandatory third-party reporting varies substantially beyond these categories of payments. Other examples include:

- **Australia's reporting system for the building and construction industry:** an annual reporting regime introduced in July 2012 that requires details of payments made to sub-contractors in prescribed industries to be reported to the Australian Taxation Office on an annual basis.
- **Canada's contract payments reporting system:** annual reporting regime introduced in 1999 for payments in the building and construction sector and payments by government for services provided by business.
- **Ireland's system of third-party returns:** traders (including farmers), professionals and others carrying on a business (including non-profit bodies and government bodies) are required to automatically make third-party returns. Broadly, these include the following payment categories: 1) payments for services rendered in connection with the trade, profession, business, etc., whether paid on their own behalf or on behalf of someone else; 2) payments for services rendered in connection with the formation, acquisition, development or disposal of the trade or business; and 3) periodic or lump sum payments made for copyright. There is a prescribed list of exclusions to these requirements.
- **The United States' information reporting requirements:** the US tax code contains a very wide variety of transactions that must be reported to the Inland Revenue Service, generally in electronic format, for matching with tax records. In addition to wages and investment incomes, these transactions include agricultural payments, allocated tips, barter exchange income, brokers' transactions, capital gains distributions, non-employee compensation and fees, fishing boat crew member proceeds, fish purchases for cash, prescribed gambling winnings, real estate transactions, rents and sales of securities.

Source: OECD (2015b), *Tax Administration 2015: Comparative Information on OECD and Other Advanced and Emerging Economies*, http://dx.doi.org/10.1787/tax_admin-2015-en.

International tax and tax co-operation

International and regional co-operation over tax policy is vital for addressing tax evasion and avoidance and ensuring that profits are taxed in the economies where the profit-generating activities are performed and value is created. A strong international taxation framework allows economies to protect their domestic tax base from erosion due to tax avoidance and evasion. Regional co-operation over tax matters allows economies to learn from each other's best practices.

The international tax and tax co-operation sub-dimension considers whether the tax codes of the six SEE economies include key international tax rules. It also examines whether the economies participate in international taxation frameworks and co-operate with other economies, particularly in the SEE region. The information in this sub-dimension is not scored, but it was analysed using descriptive information.

Preventing tax treaty abuse

Tax treaties provide certainty in the taxation of cross-border transactions and eliminate double taxation. They allow governments to improve investment conditions with selected investor countries, in line with general economic and trade policy considerations. All of the SEE economies except Kosovo have a broad tax treaty network with at least 30 tax treaties in place; Kosovo has 10 treaties.

The costs and benefits of signing double tax treaties should be weighed carefully. Double tax treaties can bring a range of advantages to an economy and to those investing in them, but they need to be carefully designed. The negotiation and implementation of double tax treaties can be complex and can absorb valuable administrative resources. As double tax treaties typically reduce withholding tax rates, they could provide a windfall gain for existing foreign investment and could therefore result in a loss of tax revenues. Whether a capital-importing economy benefits from signing a double tax treaty will depend largely on whether it realises enough gains from increased foreign direct investment to offset any tax revenue losses (IMF, 2014). Entering into more tax treaties would allow the SEE economies to negotiate lower withholding tax rates levied by other countries on payments made to SEE economies. This could allow them to raise tax revenues from taxing foreign-source active and passive income and would provide them with the tools they need to obtain information on the financial activities of their tax residents and their offshore investments. The latter objective can also be achieved through the Convention on Mutual Administrative Assistance in Tax Matters, which only Albania has signed.

In terms of its fiscal impact, "treaty shopping" is likely to be the most significant form of treaty abuse. Treaty shopping occurs when an entity that is not a resident of one of two contracting states unfairly obtains treaty benefits through an intermediary in one of the contracting states. To address this concern, Action 6 of the OECD/G20 Base Erosion and Profit Shifting Project (BEPS) (Box 4.7) resulted in a commitment to ensure a minimum level of protection against treaty shopping. It requires any party to a treaty to include in the preamble to their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. The SEE economies should ensure that their current and new tax treaties include a minimum level of protection against treaty shopping.

The SEE economies' tax systems do not yet meet international best practice

BEPS arises when businesses can exploit gaps and mismatches between different tax systems. BEPS negatively affects an economy's tax revenues, the efficiency of tax systems and their ability to create a level playing field for all firms. While BEPS is a worldwide concern, it is of particular importance to developing and emerging economies whose tax legislation and administration may struggle with the complexities of modern business. Aligning with international standards ensures a coherent and efficient application of the tax system, eliminating tax uncertainty. Box 4.7 sets out some details of the recommendations from the OECD/G20 BEPS project.

Currently, none of the six SEE economies is a member of the Inclusive Framework. Joining it would support the economies in their efforts to align their international tax rules with international best practices. It would facilitate implementation, and being subjected to peer review processes would provide them with further guidance and support. Membership of the international framework, and tax systems which are aligned with international best practices, would also strengthen tax certainty for international investors.

Box 4.7. **The Inclusive Framework on base erosion and profit shifting**

In 2013, OECD and G20 countries, working together on an equal footing, adopted a 15-point Action Plan to address BEPS. Beyond securing revenues by realigning taxation with economic activities and value creation, the OECD/G20 BEPS Project aims to create a single set of consensus-based international tax rules to address BEPS, and hence to protect tax bases while offering increased certainty and predictability to taxpayers. In 2016, the OECD and G20 established an Inclusive Framework on BEPS to allow interested countries and jurisdictions to work with OECD and G20 members to develop standards on BEPS-related issues and reviewing and monitoring the implementation of the whole BEPS Package. In January 2018, 111 countries had become members of the Inclusive Framework on BEPS.

The OECD/G20 BEPS project has produced a 15-point action plan including minimum standards, common approaches, best practices and new guidance in the main policy areas.

- Four minimum standards have been agreed upon in the areas of fighting harmful tax practices (Action 5), preventing treaty abuse (Action 6), country-by-country reporting (Action 13) and improving dispute resolution (Action 14). All participating countries are expected to implement these minimum standards and implementation will be subject to peer review.
- A common approach, which will facilitate the convergence of national practices by interested countries, has been outlined to limit base erosion through interest expenses (Action 4) and to neutralise hybrid mismatches (Action 2). Best practices for countries which seek to strengthen their domestic legislation are provided in the building blocks for effective controlled foreign company rules (Action 3) and mandatory disclosure by taxpayers of aggressive or abusive transactions, arrangements or structures (Action 12).
- The permanent establishment (PE) definition in the OECD Model Tax Convention has been changed to restrict inappropriate avoidance of tax nexus through commissionaire arrangements or exploitation of specific exceptions (Action 7) (OECD, 2017c). Follow-up work is being undertaken which will also provide further guidance on the attribution of profits to PEs. In terms of transfer pricing, important clarifications have been made with regard to delineating the actual transaction, and the treatment of risk and intangibles. More guidance has been provided on several other issues to ensure that transfer pricing outcomes are aligned with value creation (Actions 8-10).

Box 4.7. **The Inclusive Framework on base erosion and profit shifting** (*continued*)

- The changes to the PE definition, the clarifications on transfer pricing, and the guidance on controlled foreign company rules are expected to substantially address the BEPS risks exacerbated by the digital economy. Several other options, including a new nexus in the form of a significant economic presence, were considered, but not recommended at this stage given the other recommendations; plus VAT will now be levied effectively in the market country facilitating VAT collection (Action 1).
- A multilateral instrument is implemented to facilitate the modification of bilateral tax treaties (Action 15). The modifications made to existing treaties will address the minimum standards against treaty abuse as well as the updated PE definition.

At the February 2016 G20 Finance Ministers meeting, the Inclusive Framework for the global implementation of the BEPS project was endorsed, with a reiteration of the commitment to the timely implementation of the BEPS project and to continue monitoring and addressing BEPS-related issues for a consistent global approach.

Monitoring the implementation and impact of the different BEPS measures is a key element of the work of the Inclusive Framework. Members of the Inclusive Framework are developing a monitoring process for the four BEPS minimum standards as well as putting in place the review mechanisms for other elements of the BEPS package. The third session of the Inclusive Framework took place on 21-22 June 2017.

In July 2017, 70 countries and jurisdictions also joined the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the Multilateral Instrument, or MLI); this is a major first step towards updating the more than 3 000 bilateral tax treaties that are in place globally. The MLI covers treaty-related minimum standards that were agreed as part of the BEPS package. These standards relate to the prevention of treaty abuse (Action 6) and the improvement of dispute resolution (Action 14). Furthermore, the MLI enables the parties to implement other tax treaty measures developed in the BEPS project, e.g. mandatory binding arbitration, or measures against artificial avoidance of permanent establishment status through commissionaire arrangements. Recognising the need to accommodate a variety of tax policies, the MLI is a flexible yet robust instrument that provides optionality while not diverging from the minimum standards.

Source: OECD (2017d), "Inclusive Framework on BEPS: Progress report July 2016-June 2017", www.oecd.org/tax/beps/inclusive-framework-on-BEPS-progress-report-july-2016-june-2017.pdf.

International exchanges of financial information for tax purposes could be strengthened

The six SEE economies need to strengthen their international exchange of information relationships. They are not following the international trend of increased tax transparency through the exchange of financial account information. The OECD Global Forum on Transparency and Exchange of Information for Tax Purposes is a multilateral framework open to both OECD and non-OECD countries, which has been carrying out work on transparency and exchange of information since 2000.[4] The Global Forum has developed two different international standards for the exchange of information for tax purposes: exchange of information upon request (EOIR) and automatic exchange of information (AEOI). Economies are evaluated for compliance with the EOIR standard through peer review. For the purpose of AEOI, a Common Reporting Standard has been developed that is incorporated into the domestic law of participating jurisdictions. Through both EOIR

and AEOI, economies reduce the extent to which individuals and companies are able to use offshore structures to avoid and evade taxes. The steady development of EOIR, as well as the introduction of AEOI, mark a step change in tax transparency, but there must be continued focus on the peer review process and on the development of the network of exchange of information agreements for these new systems to maximise their effectiveness.

Of the six economies, only Albania has signed the Convention on Mutual Administrative Assistance in Tax Matters and the Multilateral Competent Authority Agreement for AEOI (OECD/Council of Europe, 2011; OECD, 2017e). Albania and the Former Yugoslav Republic of Macedonia have been subject to peer review for EOIR, performed by the assessment team of the Global Forum, and both economies were found to be largely compliant.

Transfer pricing rules are mostly not in line with international guidelines

Transfer pricing rules prevent multinational enterprises from shifting profits into affiliated companies in lower-taxation territories. Most of the SEE economies, except for Serbia, have transfer pricing rules in place; however, there is scope to strengthen the rules and align them better with international best practices. Only Albania's transfer pricing rules are in line with the OECD Transfer Pricing Guidelines (OECD, 2017f). In both entities of Bosnia and Herzegovina, Kosovo, the Former Yugoslav Republic of Macedonia and Montenegro, the transfer pricing regimes do not impose any real obligations on taxpayers. The laws require taxpayers to compare transactions with associated entities to those taking place between independent parties, but no filing obligations are in place. The SEE economies would benefit from aligning with the OECD Transfer Pricing Guidelines which will require additional investment in the tax administration capacities.

The design of thin capitalisation rules in the SEE economies could be improved

Action 4 of the OECD/G20 BEPS Project established a common approach to the design of rules to prevent excessive interest deductibility. The BEPS project recommended implementing profit-based interest limitation rules (i.e. interest barriers) rather than those based on balance sheets; these should apply to both internal and third-party debt financing. The common approach is based on a fixed ratio rule which limits an entity's net deductions for interest, and payments economically equivalent to interest, to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA). Interest between 10% and 30% of EBITDA would remain deductible, while the excess interest could be carried forward indefinitely (OECD, 2015a). The common approach also includes a group ratio rule alongside the fixed ratio rule, which would allow an entity with net interest expense above a country's fixed ratio rule to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group; this group ratio also applies to both internal and third-party debt financing. Even though this approach is intended to reduce profit shifting rather than to correct the debt-equity bias, it does set a limit to the deductibility of interest and, therefore, indirectly reduces the corporate debt bias.

Although there is widespread use of thin capitalisation rules across the six SEE economies, they are not in line with the international best practice described above. Kosovo and Montenegro are the only economies without any thin capitalisation or interest limitation rules in place. In Albania, interest paid in excess of the interest rate officially publicised by the Central Bank and interest above a 4:1 debt-to-equity ratio is not deductible. However, Albania is planning to introduce a thin capitalisation rule in line

with the OECD/G20 BEPS Action 4: it will deny the deductibility of interest paid in excess of 30% of earnings before EBITDA. In Bosnia and Herzegovina, each entity applies a different thin capitalisation rule. The Federation of Bosnia and Herzegovina applies a 4:1 debt-to-equity ratio, which applies only to loans with related parties. In the Republika Srpska, interest in excess of 30% of earnings before interest and taxes is not allowed as a tax deduction. The Former Yugoslav Republic of Macedonia applies a 3:1 limitation rule to limit interest deductions paid over debt guaranteed or granted by a shareholder owning 25% or more of the capital of the entity; the ratio is calculated over the value of the participation the lender shareholder has in the entity. Serbia also applies a 4:1 debt-to-equity ratio but only for related entities, and a 10:1 debt-to-equity ratio for banks and leasing companies.

The SEE economies use a worldwide tax system for cross-border income

There are considerable international differences in the taxation of cross-border income. Worldwide taxation systems tax corporations on their worldwide income. In contrast, territorial systems tax only the income which has its source in the country. In practice, most countries apply a combination of both systems. In 2012, 28 of the 34 OECD countries had adopted a territorial tax system exempting most active earnings from tax if they were repatriated from subsidiaries incorporated in (some or all) host countries. OECD member countries commonly require 10% ownership of a foreign affiliate's shares to qualify for the territorial exemption. Most OECD countries with territorial tax systems exempt active income earned by foreign affiliates as well as gains on the sale of foreign affiliate shares. Some OECD countries with territorial tax systems limit their exemptions to affiliates resident in countries with which they have a tax treaty.

All of the SEE economies assessed here have adopted a pure worldwide tax system. Income earned abroad by resident corporations is brought into the CIT base in the SEE economies. Income earned abroad will have been taxed in the host country where the income has its source under that country's CIT and/or withholding tax rates when the payments are made to the SEE tax-resident corporation. The income is then taxed again in the SEE economy where the corporation is tax resident. In order to prevent double taxation, a tax credit is granted as a relief against double taxation across the SEE economies – except in Albania, where no unilateral relief is granted. As the CIT rates across the SEE region are low compared to the CIT rates in the rest of the world on average, any taxes paid at source are very likely to be higher than those payable in the SEE economies. As a result, the SEE economies are not very likely to raise much revenue from the taxation of foreign-source income.

Small open economies typically have territorial tax systems. The SEE economies are small open economies with a relatively low share of tax-resident businesses earning income abroad. The sort of full worldwide tax systems applied in all six economies have a high administrative cost without much likelihood of raising significant tax revenues.

The six SEE economies should consider introducing additional tax base protection measures. Across the six economies, the current CIT systems do not limit how much expense incurred to earn foreign-source income is deductible from the domestic CIT base. This may result in a significant tax revenue loss.

Regional tax co-operation has improved but more could be done

Some of the SEE economies have strengthened their tax collaboration with other economies in the region. Albania and Kosovo have worked together to strengthen the functioning of their VAT and to provide training to their staff. Montenegro has concluded

agreements on mutual co-operation with Bosnia and Herzegovina, Croatia, Serbia and Slovenia to exchange information and provide assistance in the detection of VAT fraud and avoidance. The Former Yugoslav Republic of Macedonia exchanges information with Albania, Bosnia and Herzegovina, Kosovo and Serbia.

The SEE economies would benefit from more regional tax co-ordination and tax co-operation. The intensification of co-operation efforts will help them to tackle tax avoidance and evasion in a coherent manner across the region. As the economies all face similar tax challenges, there are mutual benefits from intensifying information sharing and learning together.

The way forward for international tax and tax co-operation

The six SEE economies would benefit from joining the Inclusive Framework to work with OECD and G20 members to implement BEPS measures. Becoming members of the Inclusive Framework and implementing the BEPS minimum standards would support the economies in their efforts to align their international tax rules with international best practices. This in turn would allow them to strengthen tax certainty for international investors.

The SEE economies need to strengthen their international exchange of information relationships by joining the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and implementing the two different international standards for the exchange of information for tax purposes: EOIR and AEOI.

All of the economies need to strengthen their transfer pricing rules in line with the OECD Transfer Pricing Guidelines. They should also improve the design of their thin capitalisation or interest limitation rules in line with international best practice, i.e. implementing profit-based interest limitation rules rather than balance-sheet based ones and applying them to both internal and third-party debt financing. The economies could adopt a fixed ratio rule which limits an entity's net deductions for interest and payments that are economically equivalent to interest on a percentage of its EBITDA.

The SEE economies may want to consider protecting their domestic tax base by ensuring that costs incurred in earning foreign-source income are only deductible from the corresponding foreign-source corporate income which is taxable in SEE economies.

The SEE economies need to strengthen their tax policy and analytical capacity; this includes assessing the revenues raised from taxing foreign-source (both passive and active) business income.

The SEE economies should strengthen their tax co-operation with OECD member countries and with economies in the region. Systematic co-operation across the region should lead to more effective tax enforcement and lower overall tax avoidance and evasion.

Conclusions

The six SEE economies have been strengthening their tax administrations. They have improved their compliance assessment and risk management, reduced tax complexity, and made paying taxes easier. These efforts are an integral part of their efforts to maintain their low corporate and personal income tax rate regimes. Nevertheless, they should continue to modernise their tax administrations in order to bring more informal actors within the reach of the tax system.

The SEE economies continue to face significant challenges from a domestic and international tax policy perspective. Their tax bases are narrow, particularly for VAT and CIT. High levels of SSCs impose high tax burdens on labour income and limit the role of PIT in reducing inequality. Their international tax rules do not follow international best practice. All six SEE economies need to strengthen their tax policy assessment tools, including improving their tax revenue statistics, effective tax rate analysis and tax expenditure reporting. They may need to redesign their wide range of corporate tax incentives and take steps to prevent falling into the trap of "race to the bottom" tax competition. Instead, they should strengthen their tax co-operation both within the region and more globally.

Notes

1. A score of 0 denotes absence or minimal policy development while a 5 indicates alignment with what is considered best practices. Each level of scoring is updated for the individual indicator under consideration, but they all follow the same score scale: a score of 1 denotes a weak pilot framework, 2 means the framework has been adopted as is standard, 3 that is operational and effective, 4 that some monitoring and adjustment has been carried out, and 5 that monitoring and improvement practices are systematic.
2. There are four main administrative levels in Bosnia and Herzegovina: the State, the Federation of Bosnia and Herzegovina, the Republika Srpska and the Brčko District. The administrative levels of the State, the Federation of Bosnia and Herzegovina and the Republika Srpska are taken into account in the *Competitiveness Outlook 2018* assessment, when relevant. The Brčko District is not assessed separately..
3. These data were provided by SEE governments.
4. For more information see www.oecd.org/tax/transparency/about-the-global-forum.

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Annex 4.A1.
Tax policy: Indicator scores

Table 4.A1.1. **Tax policy: Indicator scores**

	ALB	BIH	KOS	MKD	MNE	SRB
Tax policy						
Tax revenue statistics	3.5	2.5	3.0	3.0	2.5	3.5
Modelling and forecasting	2.0	2.5	2.0	3.0	2.0	2.5
Tax expenditure reporting	1.0	0.0	0.0	1.0	0.0	2.0
Tax administration						
Functions and organisation	4.0	0.0	3.5	3.5	4.0	4.5
Compliance assessment and risk management	4.0	3.0	3.5	3.5	3.5	3.5
Independence and transparency	0.5	0.0	0.5	0.5	0.0	0.5
Tax filing and payment procedures	3.5	2.0	2.5	3.0	2.5	3.0
Taxpayer services	3.5	1.0	3.0	1.5	1.5	1.5

StatLink http://dx.doi.org/10.1787/888933703732

From:

Competitiveness in South East Europe

A Policy Outlook 2018

Access the complete publication at:

https://doi.org/10.1787/9789264298576-en

Please cite this chapter as:

OECD (2018), "Tax policy in South East Europe", in *Competitiveness in South East Europe: A Policy Outlook 2018*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264298576-9-en