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Free Trade Zone in Southeast Europe? The Harmonization of Tax and Customs Legislation

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Free Trade Zone in Southeast Europe? The Harmonization of Tax and Customs Legislation

Executive Summary

On 27 June 2001 seven countries in Southeast Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania and FR Yugoslavia signed in Brussels a Memorandum of Understanding on the establishment of a Free Trade Zone in the region by the end of 2002 on the basis of bilateral trade agreements. In addition, the Memorandum expresses the intention of the signatory countries to harmonize their legislation with that of the European Union including the harmonization of tax and customs legislation.

The liberalization of trade in the region is a parallel process to that of the liberalization of trade between the seven countries and the European Union. The present research focuses on two very important factors for stabilization in the region: trade liberalization and harmonization of tax and customs legislation as a prerequisite for fiscal stability.

In the first part of the research the current economic situation in the seven SEE countries is analyzed and conclusions on the likely economic and non-economic implications of the Free Trade Zone on the basis of up-to-date theoretical and empirical studies are drawn. One of the main findings of this study is that the economic implications of the parallel process of liberalization of trade with the European Union will be much more beneficial than the ones resulting from the process of bilateral liberalization of trade between the seven SEE countries. The expected implications of the establishment of the Free Trade Zone on the economies of the countries with regard to FDI, growth and industrialization are ambiguous. While, the *non-economic* effects directly related to the Free Trade Zone would be of crucial importance. It can be argued that the Free Trade Zone will significantly increase the security in the region. Positive developments in the processes of social integration of minorities, elimination of corruption and improvement in infrastructure can also be anticipated. The anticipated costs in terms of foregone customs revenues are not substantial and will not undermine the fragile macroeconomic stability.

In the second part of the research the level of harmonization of tax and customs legislation in the countries in Southeast Europe as per the requirements of the European Union is outlined. Based on the results of the analysis of five of the seven SEE countries – namely: Bulgaria, Romania, Macedonia, Albania and Croatia, a considerable rate of harmonization of the tax and customs legislation with the European Union requirements has been achieved. For these countries no considerable problems with regard to the participation in the Free Trade Zone from this point of view can be anticipated. However, the prospects for membership of Bosnia and Herzegovina and Yugoslavia in the Free Trade Zone should be reviewed carefully after a substantial reform in their tax and customs legislation in compliance with the EU rules has been implemented. These legislative reforms should be accompanied by substantial institutional reforms, which will assist the long-term fiscal stability in the region.

Part One

Free Trade Zone in Southeast Europe?

Part One: Introduction

The countries in Southeast Europe are rather small and relatively *isolated* from an economic point of view. At the same time stabilization in general in Southeast Europe is possible only if a more advanced level of economic development and trade integration is achieved. Thus the *isolation* of the countries can be considered one of the main barriers towards stabilization. The establishment of a Free Trade Zone in the region by way of a network of bilateral trade agreements was the general approach accepted by the seven countries in the region in a Memorandum of Understanding signed in June 2001.

The economic developments will be analysed in this part of the research on the basis of key economic indicators. The various theoretical and practical implications of regional integration agreements of similar type as the one in Southeast Europe will be discussed. Focus will be given to different theoretical models and empirical studies, which serve as a basis for analysis of the relation between the Free Trade Zone on one hand and FDI, growth and industrial development on the other hand.

What is the practical impact of the size and level of economic development of the countries in the Free Trade Zone on the economic outcomes of trade integration in the region? What is the relation between the network of bilateral trade agreements and direct and indirect taxation? What are the dynamics of trade liberalization processes in Southeast Europe? How can free trade influence security? Can we expect that the grounds for ethnic conflicts, corruption and bureaucracy will be reduced? These are only part of the questions that this part of the research tries to approach.

In addition, a concise summary of the advantages and disadvantages for the seven SEE countries are given in outline. The major stakeholders, the relevant costs and the role of the Stability Pact are discussed as well. The present part of the research provides for some important observations on the process of the trade liberalization: why a network of bilateral treaties was chosen instead of a customs union, how Bulgaria and Romania became involved in the process and Slovenia was excluded; the effect of September 11 events on the processes taking place in the region. A number of recommendations on the future processes of regional trade integration are provided.

The present part of the research draws distinct conclusions, which add value to the current debate and provide new arguments in favour of the establishment of a Free Trade Zone in Southeast Europe.

Key economic indicators

The following represents a summary of the key economic indicators relevant to the analysis of the current performance of the countries in the region. The analysis of such data is particularly important with regard to the prospects for the establishment of a Free Trade Zone in Southeast Europe.

Selected SEE country indicators

The basic economic indicators for the SEE countries for 1999, are given below:

Table 1: Selected SEE country indicators

Indicator	ALB	B&H*	BUL	CRO	MAC	ROM	YUG**
Area in sq. km	28,748	51,209	110,994	56,538	25,713	238,391	91,296
Population, 1000 pers.	3,373	3,750***	8,191	4,554	2,018	22,458	8,372
GDP at ER, USD mln	3,789	4,418	12,403	20,176	3,432	34,027	16,450
GDP/capita (USD at ER)	1,123	1,178	1,510	4,485	1,699	1,515	1,965
GDP, real growth, in %	8	8	2.4	-0.3	2.7	-3.2	-23.2
Unemployment rate in %	18.4	39/38	16	19.1	32.4	11.5	25.5
Average monthly wage (USD)	112	210/148	112	640	170	128	118
Trade balance, % GDP	-17.5	-32	-12.1	-17.3	-17.6	-5.6	-10.9
FDI, stock, USD mln	425	n.a.	2,294	3,707	203	5,503	1,040

Source: WIIW South Eastern Europe/ WIIW Balkan Observatory

* In case two figures are given, the first one refers to the Federation, the second to Republika Srpska.

** Excluding Kosovo and Metohia.

***Excluding refugees overseas.

The analysis of the data presented in Table 1 shows, that the population in the countries is relatively poor. Only Croatia has a GDP/capita ratio, which substantially differs, from the other countries. If we compare the GDP/capita ratio of the USA for 1999, which is USD 31,920 with the one of the SEE-7 countries, we will realize that the difference is shocking. A simple calculation shows that even if there is no growth in the US GDP or such growth is compensated by an increase in population, it will take for Bulgaria approximately more than 30 years at an ambitious average annual GDP growth of 10%, to cope with the US "standards". The GDP growth rates for Albania and Bosnia and Herzegovina look impressive but if the low starting level of GDP is considered, they are still unsatisfactory. The unemployment rates are high and any further deterioration of the economic status of the population can lead to increasing social tensions. The average monthly salaries are comparatively low and consumption is limited. In addition, the trade balances of all the countries in the region are negative, which leads in practice to constant dependency on foreign financing which in its turn increases the foreign debt of the countries. The accumulated foreign direct investment flows mainly related to privatization deals are absolutely insufficient to turn around the current negative economic trends and to break the vicious circle.

Structure of the SEE Economies

Table 2: Structure of the SEE Economies for 1999 (preliminary estimates) as % of GDP

Sector	ALB	B&H	BUL	CRO	MAC	ROM	YUG
Agriculture	52.6	15.8	15.1	8.6	11.6	15.5	n.a.
Industry	26.0	27.8	23.4	32.0	32.6	31.0	n.a.
including manufacturing	12.2	n.a.	14.5	20.5	n.a.	22.2	n.a.
Services	21.4	56.4	61.5	59.4	55.8	53.5	n.a.

Source: The World Bank

The analysis of the structure of the economies in the region shows that agriculture is still an important sector in the region. In the case of Albania it is even the most important sector of the economy (see Lemel, 2000). In all other countries, it appears that the economies of the SEE countries are more or less “service oriented”. The analysis of the changes in the structure of the GDP for Albania, Bulgaria and Romania shows a sharp decline in the industry share of the GDP in the transition period (see Berov, 1999; Chavdarova, 1999).

Trade Openness

According to the World Bank and IMF experts the Trade Openness Indicators for 1998, 1999 and 2000 of the countries in the region are the following:

Table 3: Trade Openness

Country	X + M/ GDP *		
	1998	1999	2000
Albania	41.3	55.2	59.3
Bosnia and Herzegovina	98.4	78.2	77.1
Bulgaria	97.7	99.6	122.1
Croatia	88.8	89.2	95.8
Macedonia	99.8	98.0	114.4
Romania	56.1	62.6	73.7
FR Yugoslavia	66.4	56.0	81.2
SEE	72.5	74.8	86.9

Source: “Building Peace in South East Europe: Macroeconomic Policies and Structural Reforms since the Kosovo Conflict”, a joint IMF - World Bank paper, 2001.

Note: * Exports plus imports (including services) scaled by GDP

Trade has different impact on the economies of the seven SEE countries. As it can be seen from Table 3 trade plays an important role for Bulgaria and Macedonia. Its impact on the economies of Bosnia and Herzegovina, Romania, Croatia and Yugoslavia is substantial and only partially important for Albania. The data above shows that the importance of trade in the region as a whole is constantly growing – i.e. from 72.5 in 1998, to 74.8 and reaching 86.9 in the year 2000. It should, however, be noted that the above ratios do not reflect the unreported trade flows due to smuggling and inefficiencies in statistical reports.

Commodity Composition of SEE exports to the European Union

The following tables reflect the commodity composition of SEE-7 exports to the EU in percentages.

Table 4: Commodity Composition of SEE exports to the EU in 1998

Commodity	ALB	B&H	BUL	CRO	MAC	ROM	YUG
Agriculture	9.9	2.1	10.8	3.2	9.4	2.9	13.5
Textile	35.2	33.7	26.5	27.9	39.3	38.3	17.5
Footwear	29.6	16.3	4.7	8.5	3.7	11.0	4.0
Iron and Steel	5.6	3.7	14.4	0.7	23.5	7.9	19.2
Wood	3.5	16.4	2.5	9.1	1.5	2.5	4.2
Total of the above	83.8	72.2	59	49.3	77.4	62.7	58.4
Other	16.2	27.8	41	50.7	22.6	37.3	41.6

Source: "The Road to Stability and Prosperity in Southeastern Europe: a regional strategy paper", the World Bank, 2000.

The agriculture, textile, footwear, iron and steel and wood undoubtedly form the basic part of the SEE – 7 exports to the Member States of the European Union. If we rank the above five industry sector exports, the classification for the SEE countries as a whole will look in the following way:

1. Textile - representing 32.2% of all SEE exports.
2. Iron and Steel - representing 9.8% of all SEE exports.
3. Footwear - representing 8.8% of all SEE exports.
4. Agriculture - representing 6% of all SEE exports.
5. Wood - representing 4% of all SEE exports.

The above five groups amount to 61.8% of the value of the SEE export to the European Union and the trade of these commodities plays an important role in the foreign trade of these countries.

SEE Foreign Trade Indicators

The main indicators of the Southeast European exports and imports as a percentage of total imports for 1999 are given below:

Table 5: SEE Foreign Trade Indicators for 1999

Of	ALB		B&H		BUL		CRO		MAC		ROM		YUG	
To/from	X	M	X	M	X	M	X	M	X	M	X	M	X	M
ALB			n.a.	n.a.	0.9	0.0	0.2	0.0	1.2	0.2	0.1	0.0	n.a.	n.a.
B&H	n.a.	n.a.			0.3	0.0	12.8	1.5	0.1	0.1	0.2	0.1	20.3	5.7
BUL	0.0	3.9	0.0	0.4			0.1	0.1	2.6	5.6	1.2	0.4	1.2	4.6
CRO	0.1	0.8	15.0	21.1	0.2	0.0			4.4	3.3	0.2	0.1	0.5	0.6
MAC	1.8	1.6	0.1	0.0	3.0	0.6	1.5	0.7			0.1	0.0	11.8	3.7
ROM	0.0	0.6	1.1	0.5	1.3	1.2	0.1	0.2	0.3	0.4			n.a.	n.a.
YUG	0.2	0.1	26.7	10.8	2.9	0.4	0.0	0.0	11.8	11.1	1.1	0.3		
EU	89.9	77.6	42.3	37.6	53.3	50.9	49.4	56.7	50.9	50.7	66.0	62.7	34.3	38.3
SEE	2.1	7.0	42.9	32.8	8.6	2.2	14.7	2.5	20.4	20.7	2.9	0.9	33.8	14.6
Total Bln USD	0.2	0.9	0.7	2.8	3.7	5.0	4.2	7.7	1.1	2.1	8.3	9.5	1.5	3.3

Source: WIIW South Eastern Europe/ WIIW Balkan Observatory and author's calculations

All exports: f.o.b.

All imports: c.i.f., except Romania (f.o.b.)

Shares for Bosnia and Herzegovina recalculated including estimations of trade with Yugoslavia.

As it can be seen from the data in Table 5 above the trade relations between most of the countries in Southeast Europe are relatively underdeveloped. In fact, for various reasons some of the countries do not maintain any trade relations among themselves at all. The level of trade turnover between most of the countries is insignificant. From the countries in the region only the following trade partners have substantial trade relations:

- Yugoslavia and Bosnia and Herzegovina;
- Croatia and Bosnia and Herzegovina;
- Macedonia and Yugoslavia.

For all the countries in Southeast Europe the EU is the most important trade partner (for CEE see Kaminski, 2000). However for 1999, the export from the EU to the SEE-7 countries is less than 1% of all exports performed by the Member States while the import from the SEE-7 is approximately 0.5% of all imports.

Directions of SEE Trade in 2000

The import/export shares of direction of trade in the year 2000 show similar results. According to a joint report of the IMF and the World Bank, the preferences in the trade destinations look in the following way:

Table 6: SEE Direction of Trade, Export & Import Shares for 2000

Of	European Union		Intra-regional Trade		Rest of the World	
To/from	X	M	X	M	X	M
ALB	91	76	1	6	8	18
B&H	65	44	13	21	22	35
BUL	52	45	13	4	36	51
CRO	55	56	13	2	32	42
MAC	49	48	30	19	21	33
ROM	64	57	4	1	32	42
YUG	68	57	9	18	23	25
SEE	59	54	10	6	31	40

Source: Adapted from "Building Peace in South East Europe: Macroeconomic Policies and Structural Reforms since the Kosovo Conflict", a joint IMF - World Bank paper, 2001.

Based on the above data it can be concluded that the import share from the rest of the world is still substantial. On the other hand intra-regional trade is definitely not a major destination for export or import (see also East West Institute, 2000). The reasons for this situation are complex. In some cases such reasons are existing trade and non-trade barriers, in other - historical and political arguments, can explain the lack of interest. Another important factor is of course the unusually high level of business risk in the region that consists of poor financial and judicial system, currency risk, lack of export insurance facilities, etc.

SEE Free Trade Barriers

According to a report issued jointly by the World Bank and the International Monetary Fund in October 2001, the main barriers to trade can be summarized in the following way:

Table 7: Description of Trade Barriers

Country	Tariffs Simple average (min, max)	Additional Tariff based barriers	Non-tariff barriers
Albania	7.8 (0, 15)	Differential excise taxes	Import licenses and permits are applied
Bosnia & Herzegovina	6.8 (0, 15)	1% Customs entry fee	Export restrictions on unprocessed leather
Bulgaria	12.4 (0, 74)	Some seasonal tariffs	Some minor state trading
Croatia	7.1 (0, 90)	226 tariff lines are subjects to compound duties	None
Macedonia (1998)	15.2 (0, 60)	1% import processing fee (to be eliminated in 2002)	Import bands and quotas removed in 1996
Romania	19.5 (0, 248)	Tariff quotas on limited number of goods	No significant NTB
FRY (2000)	9.4 (0, 30)	1% Customs inspection duty. A seasonal tariff of up to 20% for a number of agricultural goods. Montenegro and Kosovo apply their own external tariff schedules.	Import licenses are required for about 200 tariff lines

Source: 'Building Peace in South East Europe: Macroeconomic Policies and Structural Reforms since the Kosovo Conflict', a joint IMF - World Bank paper, 2001.

All of the countries have refrained from imposing export taxes on goods leaving the country. The only exception applies to Bosnia and Herzegovina, which imposes export taxes on raw and cut timber.

At the same time according to this survey, there are no import surcharges in Albania, Bulgaria, Croatia, Romania and Yugoslavia. Bosnia and Herzegovina applies various imports surcharges on specific groups of agricultural products, while Macedonia levies a 0.1% import fee for export promotion.

Based on the Memorandum of Understanding (see Appendix 1) such export duties or import surcharges shall be abolished in negotiating the new bilateral free trade agreements.

Regional Integration Agreements: A Theoretical Approach

Mr. Masood Ahmed, a Director of the International Economics Department of the World Bank, quite successfully expressed in the foreword of series of World Bank policy research working papers (i.e. 1750, 1782 of 1997) the complexities of regional integration:

“As regional trading arrangements (RTAs) have spread, enlarged and deepened over the last decade, they have posed challenges to economists on both intellectual and policy levels. On the former, do RTAs stimulate growth and investment, facilitate technology transfer, shift comparative advantage towards high value-added activities, provide credibility to reform programs, or induce political stability and cooperation? Or do they, on the other hand, divert trade in inefficient directions and undermine the multilateral trading system?”

The answer is probably “all of these things, in different proportions according to the particular circumstances of each RTA.” This then poses the policy challenge of how best to manage RTAs in order to get the best balance of benefits and costs. For example, should technical standards be harmonized and, if so, how; do direct or indirect taxes need to be equalized; how should RTAs manage their international trade policies in an outward-looking fashion?”

For the purposes of the current research, a summary of the research findings both theoretical and empirical of various scholars will be given in outline (see also Schiff and Winters, 1998a). This summary in its turn will be the starting point for the analysis on the prospects of the establishment of the Free Trade Zone in Southeast Europe and its likely implications on the economies of seven countries and on society's perceptions in the region.

In general, the specialized literature identifies three main types of trade integration:

1. “North – North” integration between developed countries (Canada joining CUSFTA);
2. “North – South” integration between developed and developing countries (Mexico joining NAFTA);
3. “South – South” integration between developing countries (MERCOSUR).

This division is quite important as the economic implications of the various regional integration agreements may vary substantially depending on the type of economic integration perceived. In my further analysis I will focus mainly on the ‘North – South’ and ‘South – South’ models as obviously Southeast Europe consists of developing countries.

The basic difference between free trade areas and customs unions is the ability of the countries partners in a free trade area to negotiate on a case-by-case basis their external tariffs. On the other hand, part of the Customs Union is the agreement on Common External Tariff (for more comprehensive discussion see also El-Agraa, 1994; Molle, 1994; Jovanovic, 1997, Krugman and Obstfeld, 2000).

Regional Integration and Foreign Direct Investment

Undoubtedly there is some correlation between the levels of foreign direct investment (FDI) and the degree of trade integration. However, depending on the economic status of the countries (North or South) involved in the trade integration processes, the impact of trade integration on the inflows or outflows of FDI may differentiate a lot. A number of additional factors such as political, trade protection or administrative developments, geographical location and infrastructure are relevant to FDI allocation as well. At the same time, additional determinants of such processes are the character of the already existing FDI and the time dimension (Blomstrom and Kokko, 1997).

Static and Dynamic Effects

The most immediate result of a trade integration process is the elimination or reduction of tariff barriers between the countries part of the Regional Integration Agreements (see also Bhagwati, 1998). In its turn, the reduced tariff barriers may lead to a decrease in intra-regional FDI, as a substitute for the increased trade between the countries. Thus, since there is a common market, there is no point of further investments in the region made by local companies – i.e. the comparative benefits of moving or spreading production to the other target country are less since the customs duties were reduced.

At the same time, the outside FDI is likely to be increased and focussed on the country having the most attractive locational advantages. This type of concentration is justified by the economies of scale, achieved on a regional basis by the Multinational Companies (MNC). The type of such concentrations will depend to a great extent of the type of structures used for outside investments and already existing in the region – i.e. horizontal or vertical; import-substituting or export-oriented.

As short-term effects of trade integration can be pointed out the effects of trade creation, trade diversion, and trade expansion (see Molle, 1994). Additional changes may be expected in the utilization of various intangible assets (trade marks, know-how, etc.) usually addressed as technological spillovers, the elimination of the replication of research and development (R&D) in different countries and least but not last the implementation of neutral legislation towards foreign and domestic investors.

One of the most important dynamic effects is the ‘reallocation of production resources to more closely reflect of regional comparative advantages’ (Blomstrom and Kokko, 1997). This could be illustrated in the following example. Countries ‘A’ and ‘B’ form a RIA, and a single MNC controls enterprises in both countries, which are operating below production limits. Thus, if tariff and non-tariff barriers are reduced, it is likely that the MNC will finally decide to close one of the factories in one of the countries and will shift the production to the other. The benefiting country in this case will be the one having the better locational advantages as a combination between macroeconomic and political stability, transparent legislation and procedures, infrastructure and higher level of public services. This ‘investment package’ will usually include varies tax benefits, clear intellectual property rights enforcement rules, high quality and low cost of the labour force.

Such allocation of investment centres may have different directions in the case of various industries. Thus, the 'investment package' of country 'A' in the cement industry for example may be better than the one of country 'B', and the production of the MNC in the region will be concentrated in country 'A'. However, country 'B' may possess more comparative advantages in the textile sector than country 'A', and the textile production will be shifted in the opposite direction.

Thus, although outside FDI is likely to increase, the precise effects for each country within the RIA cannot be easily identified. Various empirical studies were focused on different types of regional integration. I will try briefly to summarize some of the most important findings of Blomstrom and Kokko in their paper 'Regional Integration and Foreign Direct Investment' "produced in 1997 within the World Bank, with regard to 'North – South' and 'South – South' type of integrations.

North – South Integration and FDI

According to the paper, the example of Mexico joining NAFTA is quite positive. The empirical evidence shows that Mexico benefited largely in terms of FDI by joining NAFTA. This could be explained partly by the liberalization of the institutional framework of the country and the strong locational advantages of Mexico compared to the conditions in the Northern partners – USA and Canada. As such locational advantages can be pointed out the increasingly market oriented policies, geographical proximity and cheap labour. In practice, much of the newly attracted FDI in Mexico is due to substantial investments originating outside the NAFTA countries namely: the USA and Canada (see Echeverri-Carroll, 1995; Coffey, Dodds, Lazcano. Riley, 1999).

South – South Integration and FDI

MERCOSUR is a typical example of South – South integration between the countries of Argentina, Brazil, Paraguay and Uruguay. The initial empirical studies on the impact of the establishment of MERCOSUR on FDI suggest that macroeconomic stability is a more important determinant of FDI than is regional trade integration itself. As a result the outward FDI has increased substantially. However, it can be noticed that FDI flows are not distributed equally among the MERCOSUR countries. As far as Brazil and Argentina possess more locational advantages than Uruguay and Paraguay, the bulk of FDI is likely to be focussed there in the short and medium term.

The recent events in Argentina and the economic crisis support the notion that macroeconomic stability is not just a simple natural phenomenon but also a dynamic process, which is not irreversible. Thus, the economic crisis in Argentina that is part of MERCOSUR will unfavourably affect the level of FDI of the other countries in the group.

Regional Integration and Growth

Recent studies have explored whether the trade openness of the economies, their market size and the relevant economic development of countries that are close geographically have any positive impact on growth in the home country.

In 1998, Athanasios Vamvakidis published a report on the correlation between regional integration and economic growth. Based on the analysis and the empirical evidence gathered, the author concludes that “countries with open, large, and more developed neighbouring economies grow faster than those with closed, smaller, and less developed neighbouring economies”. The study concludes that based on the empirical models, the small countries participating in North – South integration will face faster growth. However, the tests performed with regard to the correlation between growth and regional integration under 4 distinct RIAs shows negative results. Thus, in the case of the following RIAs there is no empirical evidence that during the 1970s and 1980s regional trade integration has led to higher growth:

- Association of South East Asian Nations (ASEAN);
- Andean Common Market (ANCON);
- Central American Common Market (CACM);
- Union Douaniere et Economique de l’Afrique Centrale (UDEAC).

The author explains these results with the fact that the members were “small, highly protected and similar in their economic endowments”. On the other hand, the results of the same test for the European Union are positive for the same period and these results confirm that actually EU regional integration had positive impact on growth.

Regional Integration and Industrial Development

One of the basic challenges of regional trade integration is whether by entering into a RIA a developing country may increase its industrialization. The implications will depend greatly on the structure of the partner economies and level of economic development. For example, in the case of South – South integration it can be concluded that “the effective market enlargement caused by reducing intra-South barriers drives industrialization” (Puga and Venables, 1998). Thus, industrialization or the ability to attract industrialization will to a greatest extent depend on the market size of the integrated economies. In the case where the structures of the economies are complementary, the effect of trade integration is positive – trade creation. If the structures of Southern economies are similar, trade diversion will occur to within the most sensitive industry sectors and it will be to the benefit of the country having more locational advantages.

On the other hand, North – South integration is likely to be more beneficial for the developing countries participating in such type of RIA. Based on a theoretical model Puga and Venables conclude that this type of trade integration will lead to larger spread of

industry in the South economy due to improved access to large Northern market and low cost of northern intermediates. However, this effect is partially compensated by the increased competition faced by the Southern industry. At the same time, such type of integration may cause a decline in the real income of the North.

In fact according to both authors: "Losses in the North are greatest in the case of South – South liberalization". In fact, where the North reduces barriers to import from developing economies, "multilateral liberalization causes larger losses for the North than hub-and spoke arrangements". This to some extent explains the bilateral approach undertaken by the European Union with regard to trade liberalization. The trade policy of the European Union towards Central and Eastern Europe countries has turned the Member States into a hub of a network of bilateral agreements.

Using a purely theoretical model Venables in 1999, argues that South – South integration will lead to divergence of real income, as the low-income country being the loser. On the other hand, if North – South integration occurs, the Southern members are likely to converge with Northern high-income counterpart.

Regional Integration and Harmonization of Taxes

Income taxation

How does regional trade integration affect corporate tax rates in the partner countries? This is one of the questions that have to be addressed prior to entering in a RIA. In summary, the removal of barriers to movement of goods and services across borders will lead to changes in the allocation of resources (de Bonis, 1997a). Thus, partner countries will face the necessity of establishment of a certain level of income tax uniformity. Such uniformity could be achieved through tax harmonization or through competition. However, in the case of competition, the income tax rates are likely to fall below their optimum limits, which will lead in its turn to losses in budget revenues.

Harmonization of income taxes is far from being accomplished even in the European Union. The harmonization of income taxes does not simply mean harmonization of tax rates. In order, to achieve considerable level of harmonization, the countries should implement similar if not the same basis for corporate taxation. For various reasons: historical, political, social and economical, this is almost impossible in the near future. On the other hand, competition among the states will lead to constant downsizing of the rates and/or introduction of tax incentives. What can be the solution in such case? One useful suggestion is that some sort of "coordination could be useful" (de Bonis, 1997a) in order to limit the undesirable effects of revenue losses in the partner countries.

Another, important issue in this respect is the elimination of double taxation of income by way of Double Tax Treaties (DTT). The differences in the treatment of certain types of income such as dividends, interest and royalties can partly be eliminated between each pair of partner countries in the form of a DTT. Thus, the network of the existing DTT should be considered, prior to entering in the RIA. It can be presumed that DTTs usually encourage cross border trade and investment, and it is advisable that the countries in the RIA enter into DTTs with each other as well.

The correlation between RIA and personal income taxation is not of such importance. This can be partly explained by the fact that additional contributions (social, health,

unemployment, etc) affect the amount of take-in-home money of the employees. Substantial distortions in the allocation of labour resources among the countries in the region can only be expected if there is a considerable difference in the living standards and real wages of the countries in the region (see also in Bhagwati and Hudec, 1996). Additional restrictions on the movement of people (visas, work permits, etc) can also prevent such reallocation.

Indirect taxation

A certain degree of harmonization of indirect taxes is important for the success of each RIA (see also de Bonis, 1997b). One of the main concerns is relevant to the level of cross-border shopping. Once, the tariff barriers are removed, the residents of the bordering territories are more likely to shop across the borders. If there are considerable differences in the rates of the indirect taxes applied by countries in the RIA, the residents of the ‘higher’ rate country are more likely to shop in the ‘lower’ rate country. Such problems are still acute in the European Union. The difference is even sharper in the case of exemption from indirect taxes of specific groups of goods. However, harmonization of tax rates only is not the perfect solution. Harmonization of the overall legislation and basis for taxation together with the tax rates may prove far more efficient (Ranchev, 2001b)

This *reallocation of consumption* will lead to losses in budget revenues of the ‘higher’ income country. As far as the mechanisms for compensation of such ‘foregone’ budget revenues is practically impossible, harmonization is the only possible solution for avoiding most of the undesirable effects.

Summary

Based on the analysis presented above, we can summarize the following conclusions with regard to the implications of regional integration agreements:

1. RIA between developing countries is likely to have a positive effect on FDI for the region as a whole, as opposed to the benefits in terms of FDI inflows enjoyed by a developing country integrating with a developed one.
2. RIA between developing countries is not likely to have a positive effect on growth, as opposed to the benefits in terms of growth rates enjoyed by a developing country integrating with a developed one.
3. RIA between developing countries will lead to changes in the level of industrialization, which will depend on the size of the common market thus formed. If the structure of the economies is similar, trade diversion will occur to the benefit of the country having the best locational advantages. If the structure is complementary, a positive effect will occur – trade creation. Trade integration with a developed country is more beneficial for a developing country in terms of its industrialization.
4. Corporate income tax competition between members of a RIA should be avoided, as it will lead to substantial losses of budget revenues. As direct tax harmonization is practically impossible, countries may coordinate appropriate corporate tax levels and conclude DTTs.
5. Harmonization in the field of indirect taxes will lead to limitation of budget revenue losses within the countries forming a RIA.

Regional Integration in Southeast Europe: A Practical Approach

Main Features of the Memorandum of Understanding

On 27 June 2001 in Brussels the seven SEE countries signed a Memorandum of Understanding on Trade Liberalization and Facilitation. According to a press release of the Stability Pact the document is setting out of the importance of the open trade regimes recognizing the primacy of multilateral trading systems and creating a framework for regional trade co-operation at the same time.

The agreed actions support the EU integration of the SEE 7 countries. Albania, Bosnia-Herzegovina, Bulgaria, Croatia, the Republic of Macedonia, Romania, and the Federal Republic of Yugoslavia have reached agreement on the following:

- Free trade between the signatory countries to be realized by completing the network of free trade agreements between them by the end of 2002;
- The agreements, both existing and those to be negotiated, will provide for free trade in at least 90 % of the parties' mutual trade by value and of HS tariff lines; tariff reductions are to be front-loaded with 6 year transition periods;
- The special status of those Signatory Countries that are candidates for accession to the EU is recognized.
- A standstill clause for non-tariff measures is included.

It is agreed that the free trade agreements will contain:

- An appropriate common set of preferential rules of origin;
- WTO-consistent provisions for the application of antidumping, countervailing and safeguard measures;
- Transparent and non-discriminatory measures concerning public procurement, state aid and state monopolies;
- A clause for the future liberalization of services.

The Memorandum of Understanding expresses the Signatory countries' intention to **harmonize their legislation with that of the EU**, specifically as concerns:

- Customs procedures and methodologies for the collection of trade statistics;
- Company law, company accounts and taxes, banking law and competition law.

The Memorandum of Understanding concludes by:

- Requesting the Stability Pact Working Group on Trade Liberalization and Facilitation to review progress and propose measures to fulfill the provisions of the Memorandum;
- Urging WTO members to support and facilitate early accession to the WTO of the three countries still non-members;
- Calling on the international community to provide technical and financial assistance to allow the signatory countries to meet the undertakings of the Memorandum;
- Ministers in charge of trade of the signatory countries are to meet regularly too to promote the process of implementation.

Undoubtedly the document represents a breakthrough of the process trade liberalization in the region and the likely effects for each of the 7 SEE countries will have to be examined according to the information available at present.

The existing FTAs among the seven SEE countries

The following table provides information on the existing (concluded) Free Trade Agreements among the SEE – 7 countries that have signed the Memorandum of Understanding.

Table 8: Existing SEE-7 FTA network

	ALB	B&H	BUL	CRO	MAC	ROM	YUG	Total
ALB		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0
B&H	n.a.		n.a.	YES	n.a.	n.a.	n.a.	1
BUL	n.a.	n.a.		YES.	YES	CEFTA	n.a.	3
CRO	n.a.	YES	YES		YES	n.a.	n.a.	3
MAC	n.a.	n.a.	YES	YES		n.a.	YES	3
ROM	n.a.	n.a.	CEFTA	n.a.	n.a.		n.a.	1
YUG	n.a.	n.a.	n.a.	n.a.	YES	n.a.		1

Source: Stability Pact and Investment Guide/ Seeurope.Net

Based on the above information and pursuant to the provisions of the MoU by the end of 2002, Albania has to conclude 6 new FTAs, while Bosnia and Herzegovina, Romania and Yugoslavia should finalize 5 new FTAs each. Bulgaria, Croatia and Macedonia will have to negotiate 3 new FTAs each. So in order to fulfil the requirements of the MoU 15 new FTAs should be concluded and probably 5 of the already existing ones will be revised substantially.

The enormous number of new FTAs requests an outstanding administrative effort on behalf of the governments of the SEE – 7 countries. **It seems impossible from a very practical prospective to negotiate successfully 15 new treaties within such a short deadline. One possible solution is the agreement on a Model of a FTA, created within the Trade Initiative of the Stability Pact, with the assistance of WTO, World Bank and EU experts.** Furthermore, the existing 5 treaties (excluding CEFTA obligations of Romania and Bulgaria) should be carefully re-examined and aligned with the provisions of the MoU. In addition, the prospective integration of the SEE - 7 countries in the European Union urges for a harmonized approach with regard to any future trade integration arrangements.

International trade relations of the seven SEE countries

The seven SEE countries and the European Union

Further to the **Regional Approach** adopted by the EU General Affairs Council in 1997, on 26 May 1999, the European Commission proposed the creation of a **Stabilization and Association Process (SAP)** for Albania, Bosnia and Herzegovina, Croatia, Macedonia and Yugoslavia. In general, the SAP is intended to provide substantial incentives to the SEE – 5 countries in case certain political and economic conditions are met.

One of the most significant incentives of the SAP, created even prior to the finalization of the Stabilization and Association Agreements with all SEE – 5 countries was asymmetrical trade liberalization. This further market opening from EU perspective is expected to contribute to the process of political and economic stabilization in the region and at the same time not causing any negative effects to the Member States. On the basis of a Council Regulation 2007/2000 amended by Council Regulation 2563/2000 the existing autonomous trade preferences were improved and now provide for 95% autonomous trade liberalization for the exports of the SEE – 5 countries to the European Union. These provisions were accordingly transported in the Stabilization and Association Agreements concluded by the EU and Macedonia in April 2001 and the one with Croatia in October 2001.

A major condition for the provision of these incentives is the need for effective economic reforms and regional cooperation in particular through the establishment of FTAs in conformity with GATT and relevant WTO provisions. However, in the event of non-compliance in this respect, the European Council may take appropriate measures by a qualified majority vote, on the basis of a Commission proposal (art. 2 of Council Regulation 2007/2000).

The existing ‘Europe Agreements’ between the EU and Bulgaria and Romania provide for the creation of a free trade area and envisage a mutual gradual liberalization of trade restrictions. The agreements secure free trade in manufactures (excluding steel) with a variety of transition periods. All restrictions limiting the access of industrial products should disappear by the year 2002. In addition, some specific preferential arrangements exist with regard to agricultural products.

Other international trade relations

The analysis of the international trade relations of the seven SEE countries will not be complete if account is not taken of the existing FTAs concluded with other countries or blocks. The data with regard to such trade relations considering the seven SEE countries can be summarized in the following way:

- Bulgaria and Romania are CEFTA members;
- Bulgaria, Croatia, Macedonia and Romania have FTAs with EFTA;
- Macedonia has a FTA with Russia;
- Bulgaria is has a FTA with Turkey;
- Croatia and Macedonia have FTAs with Slovenia;

Four of the seven SEE countries are members of the World Trade Organization, while Bosnia and Herzegovina, Macedonia and Yugoslavia have the status of observers and are WTO applicant countries.

The FTA between Bulgaria and Macedonia: short term effects

As of 1 January 2000, a free trade agreement between Bulgaria and Macedonia was enforced. The agreement, which is in compliance with the provisions of GATT and WTO, provides for the liberalization of trade between the countries with a maximum 5-year transition period. Special provisions with regard to agricultural and fishery goods exist as mutual concessions are exchanged. A summary of the trade statistics as provided by the Bulgarian National Statistical Institute for 1999 (prior to the FTA) and for 2000 (after the FTA) is presented below.

Table 9: Changes in Bulgarian Trade with Macedonia for 1999 and 2000 in thousand USD¹

	1999		2000		Changes
	Amount	Share	Amount	Share	2000/1999
Indicator	'000 USD	%	'000 USD.	%	%
Export	105386	2.63	110378	2.29	4.7
Import	25203	0.46	25847	0.40	2.6

Source: "Iznos i Vnos", issue No.4 /2000, Bulgarian National Statistical Institute

The data in Table 6 shows that no considerable changes have taken effect in the dynamics of the trade relations between Bulgaria and Macedonia as a result of the establishment of the FTA at the beginning of 2000. However, it should be noted that the low levels of trade volume does not provide for sufficient evidence which could lead to some specific conclusion with regard to the impact of trade liberalization. Generally, there is a slight increase in the export from Bulgaria to Macedonia at 4.7% as opposed to the 1999 levels. At the same time the import from Macedonia has also increased at 2.6% in 2000 considering the 1999 levels.

The major groups of commodities traded currently between both countries are:

- Food and live stock;
- Mineral oils, lubricants and similar products;
- Chemical products;
- Finished goods;
- Metals.

Notwithstanding the positive trade balance of the trade of Bulgaria with Macedonia for the reviewed periods of 1999 and 2000, we can not conclude that the free trade agreement has lead to a dramatic increase in the value of the goods traded – i.e. trade creation. Some of the possible reasons for the lack of significant changes in trade levels are outlined below.

¹The export is FOB, the import is CIF. Share means the share of the import from Macedonia as opposed to the whole import and the export to Macedonia as to the whole export.

The prospects of the Free Trade Zone in Southeast Europe

In this section of the report, the possible economic implications of the network of bilateral FTAs among the seven SEE countries (Free Trade Zone) on FDI, growth, industrialization and taxation will be addressed. The following analysis is based to a greatest extent on the conclusions of various theoretical and empirical studies relevant to similar type of trade integration discussed in the previous section. It should be noted that some of the implications are contradictory or overlapping based on the fact that two parallel processes of trade integration are taking place in the region: on one hand it is the free trade between the SEE - 7 countries and the European Union and on the other hand it is the establishment of the Free Trade Zone among the countries in the region themselves. Furthermore, the various implications of regional trade integration are intra-related – i.e. as the case of FDI and taxation.

The Free Trade Zone and FDI

One of the most likely results of the establishment of the Free Trade Zone will be the decrease in intra-regional FDI as a substitute for increased regional trade. However, this negative effect will be of minor importance, since intra-regional FDI is not substantial by the moment.

On the other hand, it can be anticipated that outside FDI will be increased. The countries having the best locational advantages will attract the most of FDI inflows. Arguably enough, these countries will be Romania, Bulgaria and Croatia (see Table 1). Depending on the pace of economic and political reforms, Yugoslavia may join the above group at a later stage. Recent empirical studies suggest that in the case of South-South integration as the Free Trade Zone in Southeast Europe, macroeconomic stability will be a more important factor than regional integration itself, thus Bulgaria and Croatia will gain one additional advantage. As it seems that the political and economic situation in the region will continue to be volatile, the top positions of FDI favourites within the group may change but leading countries in attracting FDI will remain the same in the short and medium term.

Albania, Bosnia & Herzegovina and Macedonia are not likely to benefit a lot from any positive FDI inflows to the region at least in the short term as result of the establishment of the Free Trade Zone. Furthermore, trade diversion may occur once again to the benefit of the leading group.

The above ambiguous effects on FDI take into account the establishment of the Free Trade Zone as a single factor. However, all the countries in the region have engaged in liberalization of trade with the European Union – their largest trade partner. This type of integration (North-South) leads in general to positive FDI inflows in the Southern economies. In this way, these slightly negative implications on FDI for Albania, Bosnia & Herzegovina and Macedonia due to the establishment of the Free Trade Zone may be partially or fully compensated. However, the presence of macroeconomic stability will be once again an important factor.

The Free Trade Zone and Growth

Recent empirical studies on the correlation between growth and regional integration of the same type as the Free Trade Zone in Southeast Europe show that no such direct correlation can be found based on empirical evidence.

Once again, the process of increasing trade liberalization between the SEE – 7 countries and the European Union as a separate process should lead to more positive effects in terms of economic growth as compared to the establishment of the Free Trade Zone by itself.

The Free Trade Zone and Industrialization

The countries in the region are more or less “service” oriented, Albania being the only exception with prevailing agricultural sector. The transition period has proved to be detrimental to the industrial development of most of the countries in the region. In order, to estimate properly the effect of the Free Trade Zone on industrial development two factors shall be carefully considered:

- Market size; and
- Structure of the economies.

The market size of the new regional block will exceed 55 million people; due to a greatest extent to the population of Romania, Yugoslavia and Bulgaria. In this way, this increased market size is very likely to lead to a positive trend in industrialization.

On the other hand the structures according industry sectors development are rather similar (see data on commodity composition of export in Table 4). In most of the countries, based on the commodity composition of SEE exports to the European Union we can conclude that textile, iron and steel, footwear, agriculture and wood are among the most developed export-oriented sectors in the region. This fact will inevitably bring the problem of trade diversion. As discussed above, the countries having the best locational advantages, in comparison with the other countries in the SEE – 7 group, will benefit most from the allocation of industry. Furthermore, divergence of real income is very likely to occur, as the low-income countries being the losers.

Will the positive effect of trade liberalization with European Union override the effects of potential trade diversion and lead to greater industrialization? It seems that only empirical evidence on the concentration of industrialization in the following years will bring more clarity to this problem.

The Free Trade Zone and Taxation

Comparative Analysis of the Tax Systems in the Region

In the countries in Southeast Europe, as well as on world scale, there is a common tendency of the decrease of the corporate tax rates. In 2001 Bulgaria, Albania and Croatia reduced substantially their corporate tax rates in response to the lower rates of the corporate tax burden in the region as for Bulgaria they reached 23.5% - 28%, for Albania 25% and for Croatia 20%. The corporate tax and VAT rates, the number of double tax treaties (DTT) and the availability of tax holidays have a direct impact to the analysis of the tax systems in the region (Table 10).

Table 10: SEE-7 Tax Systems in 2000

	Corporate Rate	VAT	DTT	Tax Holidays
ALB	30	20	14	n.a.
B&H	30	n.a.	n.a.	Yes
BUL	28/32,5	20	46	n.a.
CRO	35	20	27	Yes
MAC	15	19/5	17	Yes
ROM	25	19	66	Yes
YUG	25	n.a.	20	Yes

Source: Investment Guide/ Seeurope.Net and Central European Tax News, Deloitte&Touche, 2001.

As it can be seen from the table, the levels of the corporate tax rates for the year 2000 are comparatively low. This tendency can be explained partly with the growing globalization of the business and implementation of new technologies, the increased exposures, relevant to the investments in the countries of Southeast Europe. As far as the business and the capital are becoming more mobile and the political and economic risk is substantial, the countries in the region are facing a significant pressure to provide competitive corporate tax rates (Ranchev, 2001a).

For these purposes, a comparative analysis of the tax basis and the available tax preferences should be carried out. Except for Bulgaria and Albania, in almost all the countries in the region, specific tax preferences are available from which local and foreign investors can take advantage.

The Harmonization in the Region

The harmonization of the tax and customs legislation is of specific importance for the establishment of the Free Trade Zone. Undoubtedly the creation of clear rules, in line with the European requirements in this field is of substantial importance for securing long-term fiscal stability in the region. On the other hand, there is a significant risk for the countries in the Free Trade Zone if a compatible tax and customs legislation is not present. With the removal of the trade barriers, the differences between the tax legislation will become apparent - especially with regard to the VAT and the excise duties. In this way, if there are significant discrepancies in the applicable VAT and excise duty rates, upon the establishment of the Free Trade Zone, we could witness an unexpected growth of the cross-border trade, which under equal conditions will lead to a decrease of the budget revenues in the countries, which apply higher rates of indirect taxes. At the same time the differences in the corporate rates might have a substantial impact on the decision of the potential investors to prefer a specific country for investment among all other countries in the region (Ranchev, 1999).

Therefore, an analysis carried in advance with regard to the level of harmonization of the internal tax and customs legislation of each of the countries in the region in Southeast Europe with the European requirements is of primary importance for the effect of the establishment of the Zone. For a detailed analysis of the harmonization process in the region, please refer to the second part of the research.

Harmonization and FDI in the Region

The problems, related to the re-distribution of the investment flows, from the so-called tax competition perspective, are a painful topic from a long time even for the countries within the European Union. According to a report, presented to the EU Member States at the meeting in Helsinki in December 1999, 66 deviations within the tax systems of the Member States were discovered, which could be qualified as *harmful* or unfair tax competition under the Code of Conduct. Based on a recently published communication of the European Commission, the EU candidate countries should obey the provisions of the Code of Conduct and should abolish in the near future the existing *harmful* tax preferences, as well as to refrain themselves from the introduction of any new legislation in this respect.

In practice the amount of potential foreign investments from an international perspective and particularly in the region is a rather scarce resource (see Table 1), for the attraction and taxation of which a fierce struggle between the governments of the countries in Southeast Europe is in place (Ranchev, 2000). Some of the most remarkable examples of tax preferences in the region is the lack of withholding taxation and possibility of a decrease of up to 100% of the corporate tax due in Macedonia. In a similar way Croatia reduces or exempts from taxation with profit tax the investments exceeding certain limits and number of new employees in certain industries - i.e. high tech industries. As of 2001 in Romania in addition to all other tax preferences, specific tax holidays for small and medium sized enterprises exist, which include exemption from customs duties upon the import and reduction of the corporate tax by 20% relevant to an increase of the new employees by 10%. In the Bosnia and Herzegovina Federation the newly established companies are exempt from taxes in the first year and substantial reductions are provided in the following two, while in the Republic Srpska there is full exemption from profit tax for the foreign investors for the first 5 years. Further to the above analysis, it is of primary importance that **the countries in**

the region coordinate properly their tax policies. Engagement in **tax competition** and downsizing of tax rates and/or tax incentives will lead to **substantial budget losses.**

Summary

It seems that the establishment of the Free Trade Zone in Southeast Europe as an isolated event is not likely to have a substantial positive effect on the economic development of the region. Recent strategic theoretical and empirical studies show that the short-term economic implications are ambiguous. It seems that the economic effects of fiscal stabilization through tax and customs harmonization can play more significant role in the economic stabilization in the region than regional trade integration alone. The background for tax and customs harmonization and the level of harmonization with the European Union requirements will be discussed in much more details in the second part of the research.

However, it should be noted that the outcome of the establishment if the Free Trade Zone should not be measured by economic indicators only. There are a number of non-economic implications that are important as well and could not be verified by amounts in foreign currency, shares, ratios and percentages. Most of these implications will be discussed in the following section of this part of the research.

Non-economic arguments in favour of the Free Trade Zone

Regional integration agreements do not have only economic implications. Specific non-economic arguments may be far more influential than *sound* economic arguments. In this section a number of important non-economic effects of the Free Trade Zone will be discussed in more details. In fact, issues like security, corruption, ethnic conflict resolution, institution building, promotion of infrastructure projects, environment, health and intellectual property rights may play a far more significant role in creating peace and stability and thus future economic prosperity, than factors that can be measured statistically.

How can free trade influence security?

A classical example of a trade block formed for security reasons rather than on the prospects of some economic benefits is the predecessor of the European Union, the European Coal and Steel Community of 1951. Politicians, at that time saw a good case in reducing the tensions between France and Germany by establishing that Community, which greatly decreased the chances of a new war. The same arguments favoured the creation of the European Economic Community in 1957. It can be argued that similar objectives are present in easing the conflicts between Argentina and Brazil in the case of MERCOSUR of 1991 and between Indonesia and Malaysia in the formation of ASEAN (Schiff and Winters, 1998b).

Schiff and Winters (1998b), argue that RIAs are an important tool in international diplomacy in three distinct ways:

1. Some RIAs help to stabilize neighbouring countries and thus reduce the probability of migrant flows or bloodshed spilling across international borders.
2. RIAs respond to outside threats by cementing relations between the integrating partners.
3. RIAs between previously antagonistic states can potentially reduce tensions.

In most of the cases observed in modern history, free trade provides for increased security (see also in Bianchini and Uvalich, 1997). The free trade between partner countries usually leads to increased trust and mutual understanding. On the other hand free trade accelerates the trade flows between various business entities (exporters and importers), which aim at achieving a common goal – profit. In this way, people on both sides of a border once having a business stimulus to talk and in fact negotiate with each other, are less likely to justify a military attack or simply envy each other, as they are no longer strangers.

The “Made in ...” Example

How many Bulgarians have recently seen a product bearing the sign: ‘Made in Albania’? If we go to the statistics (see Table 5), there is a zero figure for the Albanian export to Bulgaria; it is obvious that the number of such Bulgarians is insignificant. Thus, there is no way in which the average Bulgarian can witness anything about Albania aside the ambiguous news on the TV. A product of good quality and modest price can actually create more confidence in the neighbouring consumer than any other public relation tools.

Reducing the trade costs of Bulgarian import from Albania may increase the demand for Albanian products in Bulgaria. Such trade exchange may lead to increased contacts between the consumers of different cultures and religions. The Free Trade Zone has one more benefit: trade between the countries will be based on free market conditions and not on the political preferences of one ruling party or another.

Bureaucracy and corruption – how can we fight them?

The Free Trade Zone can lead indirectly to a decrease in the bureaucracy and corruption in the seven SEE countries. It can be argued that one of the main sources for corruption is the presence of restrictive measures imposed by a state. Some of the most apparent examples are: customs duties referred to as tariff barriers on one hand and on the other permits, licenses, quotas which can be qualified as non-tariff barriers. If we presume that in general upon the import of goods the customs authorities of the recipient country will collect:

- Customs duties;
- Customs entry fee (see Table 6)
- Indirect taxes (usually VAT).

It should be noted that usually the import VAT charged and collected by the customs authorities is deducted as input VAT credit by the importer. So it can be considered rather a temporary financing by the importer to the budget. Thus the import VAT is not a cost itself. The costs that could not be reimbursed by the business in an import transaction are the customs duties and any entry fees. As such they become a part of the value of the goods to be sold and usually reduce the profit margin. In this way if a business wants to reduce such *administrative* costs and to increase the profit margin, such business is more likely to engage in bribing a corrupt customs officer. The value of customs duties and fees can sometimes be substantial (see Table 7). If the importer should pay customs duties and fees, at a rate of 30% for example, the incentive for engaging in an import transaction can be diminished substantially if present at all. By smuggling the goods the business avoids payment of customs duties and fees and the state in fact loses part of its budget revenues.

If we reduce or eliminate these additional costs – customs duties and fees, the business is less likely to undertake the risk of getting caught. Thus a cost-benefit analysis would show that the risk of legal prosecution could be much higher than the level of the anticipated *benefit*.

It would be very simplistic to say that the reduction or elimination of customs duties and fees will be the magic solution for the corruption problem. However, it can be argued that the free trade in at least 90% of mutual SEE trade (see Memorandum of Understanding) will substantially decrease the grounds for customs corruption. On the other hand the stand still clause for non-tariff measures which should be included in each bilateral free trade agreement will lead to a decrease in bureaucracy and will eliminate the grounds for corruption relevant to such non-tariff barriers.

The struggle against bureaucracy and corruption should not stop with the elimination of some of the basic reasons for its existence. The implementation of harmonized statistical information systems can further accelerate the processes.

Social and economic integration of minorities

Considerable part of the roots of all conflicts on the Balkans can be found in the substantial presence of various minority groups in the population of the SEE countries. The following information gives an idea of the variety of minorities in the seven SEE countries:

Table 11: Major Ethnic Groups in SEE-7 Countries

Country	Population (millions)	Major Ethnic Groups
ALB	3.5	Albanians (95%), Greeks (2%), Other (3%)
B&H	4.3	Muslims (43%), Serbs (32%), Croats (18%), Other (7%)
BUL	8.2	Bulgarians (85%), Turks (9%), Roma (3%), Other (3%)
CRO	4.8	Croats (78%), Serbs (12%), Other (10%)
MAC	2.0	Macedonians (50%), Albanians (32%), Other (18%)
ROM	22.7	Romanians (89%), Hungarians (7%), Roma (2%), Other (2%)
YUG	11.1	Serbs (63%), Albanians (14%), Montenegrins (6%), Hungarian (4%), Other (13%)

Source: Data from "Balkan Countries", Chavdarova, 1999. For Bulgaria - data from the World Bank.

It can not be expected that the establishment of the Free Trade Zone will lead to a *miraculous* settlement of all disputes among the mainstream population and minorities in the region. Free trade in the region is not a substitute for properly addressing of human rights, cultural or educational problems. The problems related to the social and economic integration of minorities have long and rather complex historical background and development (see Ivanov, 1996; Schierup, 1999; Tanter and Psarouthakis, 1999).

However, it seems that especially in the case of cross-border minorities the elimination of trade barriers may lead to a greater participation of such minorities in the acceleration of cross-border trade. Increased and legal cross-border trade in its turn may lead to a decrease in illegal activities as a major source of income for some of these groups and finally to a greater integration in the *official economy* of each country. Part of these cross-border minorities may engage in the promotion of such trade either as employed by trade companies or by establishing their own companies, which may result in their greater social and economic integration with the mainstream population.

Other implications

Institution building

Good governance and stable institutions are of substantial importance for economic stability and prosperity for the region. It seems that weak governance together with the volatile

political environment in Southeast Europe are one of the reasons for the lack of institutional memory. At the same time institutional memory is crucial for successful institution building. The extensive technical assistance provided by foreign agencies and funds is almost obsolete if institutional memory is not preserved.

How can the Free Trade Zone affect positively the institutional building processes in the region? According to a joint report of the IMF and the World Bank issued in October 2001, the political economy in the SEE countries is *maturing*. The free elections and recent political developments in most of the countries suggest that political risks will decrease over time. However, the situations in Kosovo, Yugoslavia, Bosnia and Herzegovina and Macedonia are still a reason for major concerns.

Stable political environment will inevitably assist in a positive way the institution building processes at least by preserving some sort of institutional memory. The negotiation of these 16 new bilateral free trade agreements will substantially increase the international negotiation skills of the seven SEE governments. These new skills will further assist in the opening of the economies of these countries to the rest of the world based on the experience acquired in negotiation of the Free Trade Zone.

Infrastructure

The infrastructure is one of the most important prerequisites of growth in international trade. On the other hand the elimination of trade barriers provides in its turn for greater incentives to invest in infrastructure projects of regional importance. As export and import transactions grow in number and value in the region, infrastructure sector will become more and more attractive to private foreign and local investors. This fact will reduce in the long run the need for substantial public investments financed primarily by international financial organizations and will make it possible for the seven SEE governments to concentrate their efforts and limited resources on sectors where state assistance has no substitute.

Thus, the Free Trade Zone may stimulate new investments in the transport sector including maintenance and building of new roads and railways. Truck transport, shipping, civil aviation and logistic services will take off as a result of increased trade flows.

Substantial changes in investment opportunities in the telecommunications and energy sectors on a regional basis may be provoked as a result of the functioning of the Free Trade Zone. It will be too optimistic to argue that positive changes in infrastructure will depend only on the liberalization of trade. However, the elimination of trade barriers for sure will be a catalyst of any positive developments in the regional infrastructure.

Environment and Health Issues

According to the Memorandum of Understanding the seven SEE countries will ensure that trade legislation and regulations relating to plant, animal and human health, safety and environment are compatible with the provisions of WTO, EU and other relevant international bodies.

The establishment of the Free Trade Zone will further assist the cooperation between the governments in moving towards the implementation of standards, technical regulations, conformity assessment, testing, metrology and accreditation systems in align with European and international requirements.

The progress in these sensitive areas will decrease non-tariff barriers to trade and will facilitate the development of consumer confidence towards other countries products available in the domestic market.

Intellectual Property Rights

Undoubtedly, abuse of intellectual property rights is a significant problem in the region. Based on the Memorandum of Understanding the seven SEE countries should further harmonize their legislation in the field of intellectual property protection with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights and other related international agreements. In view of the above the countries are required to develop and implement appropriate measures for enforcement that will combat piracy and counterfeiting effectively.

Summary

Based on the above analysis it can be argued that the establishment of the Free Trade Zone in Southeast Europe may have significant non-economic implications, which are positive for the long-term development of the region as a whole. It seems that the main argument in favour of the Free Trade Zone will be the increased security through cooperation.

While the economic implications of the Zone itself may prove ambiguous especially when compared with the effects of trade liberalization with the European Union, it can be anticipated that the Zone will decrease the level of bureaucracy and corruption and will help to some extent the social integration of minorities. At the same time trade liberalization in the region will have a positive impact on institution building, environment and health and intellectual property rights.

It is unrealistic to claim that free trade is the only remedy for the security problems in the region. However, the economic grounds for beneficial trade contacts between the people in the SEE countries provide a powerful argument for the establishment of the Free Trade Zone in Southeast Europe. Peace, stability and economic prosperity are interrelated. If the basis for peace and stability in terms of increased security are present, economic prosperity is more likely to come soon, and to lead the countries out of the vicious circle.

Seven Advantages & Seven Disadvantages

The economies of the countries in the region are relatively small and isolated. Undoubtedly the establishment of a Free Trade Zone with a common market of 55 million customers will help this isolation to be overcome. New opportunities for realization of the weak competitive production in the region will be created which will assist partially in the economic stabilization on the Balkans.

If we try to summarize the disadvantages (risks) and the advantages for the economies in the region relevant to the Free Trade Zone, such a comparison will look in the following way:

Table 12: Advantages and Disadvantages

Advantages	Disadvantages
1.The region will become more secure	1.The process requires additional financing
2.Reduction of the trade costs	2.Losses in terms of foregone customs revenues
3.Reduction of corruption and bureaucracy	3.Will the customs control be more effective?
4.Trade will increase	4.The structure of the economies is identical
5.The developed industries will gain	5.The less developed industries will lose
6.New markets	6.The consumption in the region is low
7.Foreign investments can increase	7.Tax competition and trade diversion may occur

As it can be seen, each comparative advantage of the Free Trade Zone can become a comparative disadvantage. Thus each argument has at least one counterargument. *How should a decision on the establishment of the Free Trade Zone be taken if this is the case? Why did the seven SEE countries sign the Memorandum of Understanding at all?*

The analysis of timing of the above effects is crucial to the decision making process. Globalisation processes do not provide for an alternative for trade liberalization. Sooner or later the seven SEE governments will be forced to eliminate trade barriers among themselves. While the decrease in the customs revenues will be overcome in the short-term (see more details in the following section), security is definitely a long-term objective for the region. In this way, the relatively low costs (mainly foregone customs revenues) can be considered an investment in the common security of the region, which will lead to a certain degree of stability and finally to prosperity.

Analysis of Risks

Major Stakeholders

Who are the major stakeholders and what are their interests with respect to the establishment of the Free Trade Zone? The following major stakeholders can be identified quite easily:

- The European Union;
- International financial organizations like the World Bank and the IMF;
- The seven SEE governments;
- The business community in the region and abroad.

The European Union and the international financial organizations were the most active stakeholders in the Free Trade Zone discussion. This can be explained by the fact that their financial support and in the case of the European Union political involvement is substantial. Security and economic stabilization are of major importance for this group of stakeholders.

The seven SEE governments were initially somewhat reluctant to embrace the Free Trade Zone project. One of the main reasons is the fact that the political horizon (political mandate) has proven to be rather short in this part of the world for various reasons. However, the seven governments signed with no objections the Memorandum of Understanding and the risks of no compliance with its agenda can currently be considered low.

The local business community has not yet realized the impact of the Free Trade Zone on their future operations. The effects of the Free Trade Zone will however become apparent quite soon and we can anticipate the active participation of the local and world business community in the discussion.

The Stability Pact

Another important figure in the process of the establishment of the Free Trade Zone is the Stability Pact. However, the Stability Pact by the moment is perceived as just a forum where the European Union and other countries like the USA, the international organizations and the governments meet to discuss issues of common interest. The Stability Pact has initiated the discussion for the Free Trade Zone, but the arguments were provided mainly by the European Union through the Stabilization and Association Process.

The future role of the Stability Pact should not be underestimated. This rather unique organization may become very active in the *free trade* negotiation process. The negotiation of 15 new bilateral free trade agreements is a rather complex task. One possible solution is the creation of a Model Free Trade Agreement that can be used by the seven SEE governments in the negotiation process. This Model Agreement can be created under Working Table II of the Stability Pact. The initial consent on such a Model Agreement can save a lot of precious time and will assist the governments in meeting the ambitious deadline of completion of the agreements – i.e. by the end of 2002.

The costs

How much the Free Trade Zone would cost to the budgets of the seven SEE countries? This is one of the most important questions remaining and one of the basic arguments of the opponents of the Zone. According to a recent report of the World Bank and IMF the implication of SEE budget revenues from the liberalization of trade in the region is the following:

Table 13: Southeast Europe: International Taxes (all data in percent of GDP)

Country	1999	2000	Direct revenue loss from SEE trade liberalization*
Albania	7.2	8.7	0.5
Bosnia and Herzegovina**	5.9	6.3	1.3
Bulgaria	1.1	0.9	0.0
Croatia	3.1	2.5	0.1
Macedonia	4.0	3.3	0.6
Romania	1.5	1.1	0.0
FR Yugoslavia***	2.3	2.4	0.4

Source: 'Building Peace in South East Europe: Macroeconomic Policies and Structural Reforms since the Kosovo Conflict', a joint IMF - World Bank paper, 2001.

* Estimated share of international taxes paid on imports from SEE countries;

** Includes revenues received by entities;

*** Federal government only.

If the impact in USD terms is to be calculated on the basis of the GDP for 2000, the results will be the following:

Table 14: Direct revenue losses from the Free Trade Zone

Country	GDP 2000 (USD Mln)	Revenue loss (% GDP)	Revenue loss (USD Mln)
Albania	3,722*	0.5	19
B&H	3,200*	1.3	42
Bulgaria	11,987	0.0	Minimum
Croatia	19,031	0.1	19
Macedonia	3,818*	0.6	23
Romania	36,719	0.0	Minimum
FR Yugoslavia	17,273	0.4	69
Total loss			172

Source: Author's calculations based on data adjusted from 'Building Peace in South East Europe: Macroeconomic Policies and Structural Reforms since the Kosovo Conflict', a joint IMF - World Bank paper of 2001, the World Bank and WIIW South Eastern Europe.

* Investment Guide/ Seeurope. Net

Based on the above analysis it is obvious that Bulgaria and Romania will lose almost nothing due to the fact that their trade regimes are considerably liberalized and SEE import share is rather low. The anticipated losses of Albania, Croatia and Macedonia could not be

considered significant as well. However, the implications for Bosnia and Herzegovina and Yugoslavia may have some impact on the structure of their budgets for the year 2003.

Funding

The estimated loss of USD 172 million per annum allocated mainly in five of the seven SEE countries can be compensated in each of the following ways:

- Using internal resources by increasing fiscal discipline either through tax reforms or decrease of public spending; or
- Using external resources through non-refundable grants or new loans from the European Union or the international financial organizations; or
- A combination of the above options.

Although the direct revenue loss is estimated as an annual figure after the first year of operation of the Free Trade Zone, the negative implications will slowly fade away due to increased regional trade and taxes collected on the increased turnover and profits of the local business entities. It is very likely that these costs will not trigger the short and fragile macroeconomic stability in the region evident from the year 2000 growth rates.

It should be noted that the indirect costs related to the implementation of the project might prove substantial. Based on the statements presented by the international organizations on the occasion of the signing of the Memorandum of Understanding it seems that the European Union, the USA and the World Bank will cover a considerable part of these costs (mainly technical assistance).

Only the European Union has provided to the region for the year 2000 through PHARE and OBNOVA approximately Euro 520 million. The anticipated package for the period 2001-2006 provided through CARDS is estimated at Euro 4.65 billion. These funds show a clear determination that the European Union is interested in the stabilization of the region, and that the Member States shall adequately support the ambitious goals of the Memorandum of Understanding.

The way ahead: Observations, Suggestions and Conclusions

Some Observations

As some of the issues, which affected the final decision of the practical form of the Free Trade Zone, were not addressed, it is necessary to make some short observations. The following observations are based to a considerable extent on the common sense and logic of the political and economic processes rather than on some formal political documents or other evidence. Thus, they should be considered just an example of how the political processes have evolved to the point the decision was taken.

A Customs Union versus a Network of Bilateral Treaties

A Customs Union between the European Union and the seven SEE countries could have more economic advantages for the Southeast countries than the present situation of a network of bilateral FTAs on one hand, and the trade preferences given through the Stabilization and Association Process and the Europe Agreements of Romania and Bulgaria on the other hand. One of the reasons behind this specific decision of the European Union could be found in the ‘hub-and-spoke’ approach, which reduces the economic exposures for the Member States (Puga and Venables, 1998). The differences in the specific stage of economic development between the Southeast European countries themselves and the Member States represent another strong argument in favour of bilateral negotiations.

Another possible reason is the complexity of the negotiation of a Customs Union. In addition to the free trade negotiation would be the agreement on a common external tariff. If the Customs Union approach had been accepted, the starting date of the Free Trade Zone in Southeast Europe could be substantially delayed. Furthermore, the present approach allows for a more flexibility of the relations of the European Union with each candidate country in the accession process.

Third but not last is the problem with the undergoing processes of disintegration in Southeast Europe. Although, changes in the borders among the states are not foreseeable in the near future, the present status of Kosovo and the volatile environment in Bosnia and Herzegovina, Macedonia and Montenegro have partially lead to the decision on the current ‘patchy’ approach. The establishment of a Customs Union would mean a guarantee made by the European Union that the processes of economic and political stabilization are irreversible - a guarantee, which the Member States are unwilling at the present moment to provide to the outside world.

Bulgaria and Romania in the Game

The initial scenarios of the establishment of the Free Trade Zone did not envisage the participation of Bulgaria and Romania in the initiative. It seemed the both countries and especially Bulgaria were somewhat reluctant to embrace the idea for a free trade in the Balkans. However, the elimination of Bulgaria and Romania would lead to a considerably smaller market of 24 million, which could not lead to substantial changes in the foreign investors perceptions of the region. The population of the SEE-7 countries on the other hand is about 55 million, which opens much more opportunities for potential investors.

Another reason, for *packing* of Romania and Bulgaria together with the other SEE-5 countries is the need for a *positive* example. Thus, both countries could play the role of the ‘carrot’ in the ‘carrot and stick’ approach implemented by the European Union for the countries in the region. On the other hand such packing from a very practical point of view means that both countries will not finalize their EU membership negotiations with the *first wave* countries.

The Status of Slovenia

The absence of *successful* Slovenia from the Free Trade Zone initiative is one of the interesting aspects of the decision-making process. Actually Slovenia is the only former Yugoslav republic left out of the Free Trade Zone process. Officially Slovenia welcomes the intentions of the SEE-7 countries to liberalize regional trade, but remains an observer of the process. This fact supports the notion that a considerably faster *track* is envisaged for Slovenia on the road of EU accession.

The September 11 Impact

Undoubtedly, the September 11 events will have a negative impact on the economic development of the region. As recession in the USA will affect the European Union, it is inevitable that the demand for import from SEE countries will decrease. According to preliminary estimations published in Business Week of October 22, 2001 the GDP growth of Europe for 2001 will drop from 1.8 to 1.6. The negative implication for 2002 will be even more serious from the estimation of GDP growth of 2.5 prior to the events, down to 1.5 after September 11, 2001.

It is still subject to discussion whether the effect of these events will have a substantial impact on these less globally integrated and relatively small SEE economies. Increased regional trade may turn out a possible alternative for the decreased demand of the Member States for goods produced in the region. However, liberalization of trade in the region will become a reality in 2003, while the expected downturn of the world economy will have its peak in 2002.

Suggestions

Suggestion One

The first step in trade liberalization has already been taken. The countries in the region have shown their consent on future liberalization of trade in the region in the Memorandum of Understanding. However, the next steps appear to be even more complex than the agreement of seven Balkan states on a common agenda.

The year 2002 will be crucial for the successful finalization of the process. 15 new bilateral treaties have to be negotiated, signed and ratified by the national assemblies and finally become effective as of 1 January 2003. In addition, the existing 5 treaties (excluding CEFTA agreement between Bulgaria and Romania) have to be re-negotiated and brought in line with the Memorandum of Understanding. This might turn a major challenge of the process, unless a unified approach is undertaken. **A unified approach in this case means a Model Agreement implemented in all bilateral free trade agreements.** In practice it is the only solution if the ambitious deadline is to be met at all.

Suggestion Two

The harmonization of legislation with the European Union requirements will take much more time than the initial steps in the liberalization of trade. **The harmonization of legislation should be accompanied by a genuine reform in the public administration,** because implementation of the legislation is a much more complex task than the transportation of legislation itself.

Suggestion Three

The best practices in the region and the world as a whole have to be studied very carefully in the process of forming of the specific national policies in the region. But how could such precious experience be shared among the seven countries?

As discussed above the Stability Pact may have an important role in this process. The importance of the Stability Pact as a place where ideas meet reality should be substantially increased. By the moment the Stability Pact is mainly perceived as a mediator in the financial negotiations between several donors and the SEE governments. This role helps a little in the process of long-term stabilization of the region. **The Stability Pact has to become a real forum for discussion of the best practices between the governments in Southeast Europe supported by the European Union, the USA and the countries and organizations.**

Conclusions

The process of liberalization of trade with the European Union is process, which is more influential in economic terms than the establishment of the Free Trade Zone of the Balkans taken as a separate process. The anticipated short-term economic effects of the Free Trade Zone on FDI inflows, growth and industrialization tend to be rather ambiguous.

However, in terms of security the Free Trade Zone has its important regional role. It can be argued that the establishment of the Zone will additionally help the stabilization and eventually the long-term future prosperity of the region.

The estimated costs in terms of foregone customs revenue seem minimal in view of these ambitious goals. On the other hand these immediate budget losses will probably not undermine the fragile macroeconomic stability apparent in recent years. In fact the international community has *poured* much more funds in the regional budgets than the expected losses from trade liberalization. Fortunately, it seems that the international community will continue to provide substantial financial resources in the region to stimulate political and economic reforms.

The Free Trade Zone represents the necessary and currently missing step that should be taken after the liberalization of the trade with the European Union. The growing trade with the Member States and associated economic growth would achieve only partial success if the countries in the region remain *complete strangers*. Reducing the grounds for corruption, ethnic tensions and poverty are some of the *side* effects of the establishment of the Free Trade Zone, which do not immediately increase the GDP growth rates, but will contribute substantially to its stable growth in the medium and long run.

Part Two

Survey on the level of harmonization of the relevant tax and customs legislation in the countries in Southeast Europe

Part Two: Introduction

In its 1999 Report on the Progress Towards Accession by the Candidate Countries, the European Union Commission states:

“As we approach the new millennium the European Union is preparing for the biggest expansion in its history. Early in the next century it will be possible to re-unite Europe on terms very different from the divisions and strife of the twentieth century. On the basis of shared ideals and agreed common rules of political, economic and social behaviour the current Member States and candidate countries will be able to chose to join together in a wider Union. The countries of Central and Eastern Europe, Malta, Cyprus and Turkey have already shown their determination and their capacity for change, their economies are increasingly integrated with that of the Union and huge efforts are being made by Parliaments, governments, the public and private sectors to prepare for EU membership.”

The objective of the present part of the research is to analyze the European Union legislation with regard to direct, indirect taxes and customs duties and the current level of harmonization of the tax and customs legislation in Southeast Europe.

To achieve this objective, a general overview of the structure of the legislation of the European Union was made in summary of the most important directives issued by the European Commission. The research outlines the level of harmonization of tax and customs legislation as per the requirements of the European Union in the countries in Southeast Europe. From the countries in the region only Bulgaria and Romania have declared their firm intentions for joining the European Union and have initiated the accession process. However, in view of the consequences of the Kosovo crisis and the processes in Macedonia, a strategic approach shall be taken to lead the countries on the road of fiscal stability and future economic prosperity. It is already a widely shared idea that Albania, Bosnia and Herzegovina, Croatia, Macedonia and Yugoslavia (Serbia and Montenegro) should join the European Union as well even at a later stage. In 2001, Macedonia and Croatia has signed Stabilization and Association Agreements with the European Union.

The tax and customs legislation of these countries is a significant factor for the long-term fiscal stability in the region and at the same time is an important aspect of the future establishment of the Free Trade Zone in Southeast Europe.

General Overview of the European Union Tax and Customs Legislation

In this section the basic elements and principles of the European Union legislation are summarized.

Structure of the European Union Legislation

In general, the legislation of the European Union (EU) consists of Primary Community Law and Secondary Community Law.

The Primary Community Law consists of the treaties concluded between the Member States (MS) such as the Rome Treaty establishing the European Economic Community in 1957 and the European Union Treaties.

The Secondary Community Law is based on the proposals of the European Commission that are enforced and become legally effective when the European Union Council considers and adopts them. The principal sources of EU legislation are:

- **Regulations:** these are generally applicable to all Member States and binding on their entirety. They pass directly into the Member States' legal systems, without the need for further administrative or legal implementation. Regulations are valid as soon as they are published.
- **Directives:** they are binding with regard the result to be achieved and are addressed to the governments of the Member States. The national authorities have the choice of form and method of implementation.

The European Commission is responsible for ensuring that the Member States implement the Directives in time and can take the Member States to the European Court of Justice for failure to do so, which it often does. The European Court of Justice can impose penalties on Member States from failure to implement a Directive properly on time.

Other legal instruments are **Decisions**, which are addressed individually and are binding in their entirety upon those to whom they are addressed, **Recommendations** and **Opinions**, which are not binding upon Member States. As legal instruments can be considered also the **Conventions**, which are agreements drawn up between the Member States and become effective only after ratification of the national parliaments.

The Primary and Secondary Community Law together with the decisions of the European Court of Justice as well as the established political practices form an independent legal system, known as the ACQUIS COMMUNAUTAIRE. The provisions of the Acquis are compulsory and are applied directly in the internal legislation of each Member State and have priority over the national legislation when it is not in compliance with the Acquis (see: Lier, 1993; Terra and Vattel, 1997; Williams, 1998).

European Union Legislation on Direct Taxes

Primary Community Law

The tax harmonization measures of the European Union are mainly focused on the promotion of cross-border cooperation between enterprises. The main aim is to remove the influences that the tax systems of the Member States may have on decisions with regard to allocation of a business activity (see also Tirard, 1994; Albretgese and Kogels, 1999). The legal basis for tax harmonization is found in Articles 100 and 101 of the Rome Treaty, which prescribes approximation of direct taxes, among others, which affect the functioning of the internal market. Based on these provisions, the Parent-Subsidiary Directive and the Merger Directive have been adopted (for discussion on tax treaties and EC Law see Gassner, 1997).

Some of the most important Directives related to the harmonization of direct taxes are given in outline below.

Exchange of Information Directive

On 19 December 1977 the EC Directive for Mutual Assistance in Direct Tax Matters (77/799/EEC) was adopted by the Member States to counteract tax evasion and tax avoidance. Originally it only applied to direct taxes, but it was amended to include indirect taxes (79/1070/EEC). The Directive allows the competent authorities of Member States to exchange information necessary to enable them to make a correct assessment to tax. The Directive envisages three categories of mutual assistance:

- Exchange on request, whereby a competent authority of one Member States requests the competent authority of another Member State for particular information;
- Automatic exchange of information; and
- Spontaneous exchange of information where information should be forwarded to another Member State without a request. This category would be used, for example, where a Member State suspects a loss of tax due to artificial transfer of profits within a group of companies.

However, it should be noted that Member States are not obliged to provide the information if its collection would be in contravention with domestic legislation. The provisions of the Directive are in compliance with article 26 of the OECD Model Tax Convention and its commentaries related to the exchange of information on direct taxes. The latest proposals for amendments of article 26 of the Model on which most of the concluded double taxation treaties are based envisage that the exchange of information should include indirect taxes as well.

Parent-Subsidiary Directive

Scope of the Directive

The EC Parent-Subsidiary Directive of 23 July 1990 (90/435/EEC) aims at reducing the differences between the taxation rules for nationally operating groups and EU-wide operating groups by reducing the tax arising on profit distributions between companies resident in different Member States.

As is the case with the merger Directive, the term Company shall apply to all incorporated companies whose legal form is similar to a public or private limited company. In order to qualify for the Directive companies must be subject to one of the corporate income taxes as enumerated in article 1b of the Directive. These companies should have no possibility for an option or for an exemption from tax. Also they must be resident in a member state for tax purposes, without, under the provisions of a double taxation treaty concluded with a third State, being considered a resident for tax purposes outside the EU.

A Company qualifies as a parent company for the purpose of the Directive if it meets the above conditions and has a minimum holding of 25% of the capital of a company of another Member State fulfilling the same conditions. A share Company qualifies as a subsidiary if it is a company the capital of which includes the holding referred to in the previous sentence. Member States have the option of replacing, by means of bilateral agreements, the criterion of holding of the share capital by that of holding of voting rights.

Merger Directive

Scope of the Directive

On 23 July 1990, the Council adopted a Directive on the common system of taxation applicable to mergers, divisions, transfers of assets and exchange of shares concerning companies of different Member States (90/434/EEC). According to the Directive, the Member States had to adapt their legislation to The Directive no later than 1 January 1992. At the moment, the Directive is only relevant for the exchange of shares and the transfer of assets.

The Directive applies to mergers, divisions, transfer of assets, and exchanges of shares involving companies from two or more Member States. These companies must meet the same requirements as the ones, which must be met by companies to which the Parent-Subsidiary Directive applies, with the exception of the 25% criterion. Therefore, for the purposes of the Directive the term Company shall apply to all incorporated companies whose legal status is similar to a public or private limited company. Also companies must be subject to one of the corporate income taxes as enumerated in Article 1b of the Directive without the possibility of an option or of being exempt from tax and they must be resident in a Member State for tax purposes. The Directive does not apply to mergers, divisions,

transfers of shares, and exchanges of shares, if and to the extent companies and/or permanent establishments outside the EU are involved.

Code of Conduct

On 1 December 1997, the European Council adopted a Resolution on a Code of Conduct for Business Taxation, which deals with the problems of tax competition among the Member States. Although the Resolution of the European Council has no binding implications in the near future, its provisions are very likely to put political pressure to the governments of those Member States that offer specific tax incentives for attracting foreign investment. In general, the Code covers business measures, which are existing and are likely to have an impact on the allocation of a certain business activity within the European Union. The Code includes specific provisions with regard to the allocation of activities within a group of companies as well.

The Code provides for a definition of harmful tax policy measures which potentially may result in a substantially lower tax burden and which apply within a certain Member State. The Code states that Member States are not allowed to introduce any new measures that may fall within the scope of the criteria and are strongly encouraged to review the existing legislation that provides for such incentives and to take corrective action.

The potentially harmful tax measures include the following characteristics:

- particular advantages are given only to non-residents of the Member State or a given only with respect of transactions carried out with non-residents; or
- advantages are “ring-fenced” from the domestic market, so they do not affect the national tax base; or
- advantages are available even without the existence of a real economic activity and substantial economic presence; or
- the basis for profit determination within a multinational group is not in compliance with internationally accepted principles - i.e. OECD;
- the measure lacks transparency, for example in case of statutory rules being relaxed at administrative level in a non-transparent way.

Based on the Resolution a Code of Conduct Group was established to assess the tax measures that may fall within the scope of the Code. In a paper the Group (called Primarolo Group) reported to the European Council on 29 November 1999. The Primarolo Group identified 66 harmful tax measures in existence within all the Member States except for Sweden. At its session on 28 February 2000 the Council decided to make this report accessible to the public without taking any position on its content.

European Union Legislation on Indirect Taxes

Primary Community Law

The legal basis for tax harmonization of indirect taxes is found in Articles 95, 96, 97 and 99 of the Rome Treaty. In fact, the Directives on turnover taxes (VAT) and excises duties are based on Article 99 of the Rome Treaty which provides for approximation of the tax legislation to an extent which is necessary to ensure the establishment and the proper functioning of the internal market.

VAT Directives

The harmonization process of the VAT-systems of the Member States started with the 6th Directive of 17 May 1977 (77/388/EEC), which provided for a harmonized tax basis for VAT purposes. The process continued with additional Directives such as the 8th Directive of 6 December 1979 (79/1072/EEC) concerning the recovery of VAT for non-resident entrepreneurs. Additional clarification was provided by the ‘Single Market’ Directive of 16 December 1992 (92/5/EEC) and 10 April 1995 (95/7/EEC) and the Seventh Directive of 14 February concerning a community wide scheme for sale of used goods.

The underlying principles of the VAT Directives are widely implemented in the national tax legislation of the Member States (see also Terra, 1998 and in Liber Amicorum Leif Muten, 1999). However, they still allow each Member State to exercise discretion in a number of areas if they consider that the relevant provisions of the VAT Directives may affect substantially the fiscal stability. For example, in relation to the question of the rate of VAT, the Directives prescribe that the minimum standard VAT rate within the European Union should not be less than 15% but in fact Member States are still free to set a higher standard VAT rate. In addition, the Directives provide the opportunity for either one or two reduced rates of at least 5%, which apply to specific consumer sensitive categories of goods and services only.

In the speech of the European Commissioner on Taxation Mr. Mario Monti at the VAT Conference on 4 November 1996, several remarks with regard to the current VAT system were made. According to Mr. Monti the differences in interpretation, resulting from a huge number of derogations and options granted to Member States mean that the current VAT system can hardly be characterised as a common system. The divergence in the application constitutes a significant burden to small and medium sized businesses because of the high compliance costs. The switch to an origin based system as requested by the Council in its decision of 1991 is envisaged as the only approach compatible with the Treaty which requires tax harmonization to the extent that is necessary for the establishment and functioning of the internal market. In a true single market, there should not exist a distinction between domestic and intra-community transactions as there is in the VAT system at the current time. In his speech Mr. Monti outlines that it would not be possible to take a full advantage of a single currency if the new VAT system is not in place at the same time. According to Mr. Monti the single currency will make the market much more transparent, and businesses and consumers will find it easier to compare prices, making the obstacles for a free trade even more evident.

Excise Duty Directives

In general, Excise Duties, in addition to VAT, are levied on goods which may affect the health status of the users (tobacco and alcoholic beverages) and on goods which have an impact on the environment (mineral oils). In some of the countries, Excise Duties are levied on certain luxury goods (cars, jewelry, etc.)

Customs Duty Aspects of Harmonization

Unlike the case of VAT, harmonization efforts have led to genuine unification in the field of import duties. Most of the relevant rules are laid down in regulations with direct binding force in all Member States. As a result, import duties are, in principle, levied in the same way throughout the EU. Incidentally, this common approach also applies to other taxes levied on imports such as agricultural levies and anti-dumping duties.

The EU has a uniform set of rules dealing with customs duties on importation into the EU, or the so-called 'EC Customs Code', which came into force on 1 January 1994. This Code provides for a common tariff for each and every importation into the EU. Customs duties are levied at the moment of importation into the EU. Theoretically, it would make no difference whether the goods are imported into EU through Greece, Germany or Netherlands. Once goods have been imported into the EU they can be transferred freely throughout the entire EU area.

Southeast Europe and Integration in the European union

Who will join the European Union?

Introduction

Bulgaria and Romania have already signed association agreements with the European Union and during the EU Summit in December 1999 they were formally invited to start negotiations for accession in the EU. The European Commission authorized negotiation for a Stabilization and Association Agreement (SAA) with Macedonia and Croatia. The SAA with Macedonia was signed in April 2001 while the one with Croatia was signed in October 2001. At the same time a feasibility study on a SAA for Albania has been finalized. All the other countries in the region are not yet in an association status with the EU but are expected to start negotiations for SAAs.

When will the new members join the EU?

Based on the experience of the most recent entrants into the EU (Austria, Finland and Sweden), full membership for the first new entrants is unlikely to be achieved much before 2004 for the ‘first wave’ countries from CEE. Unlike previous enlargements, it is also not certain that all of the new members will join at the same time. However it is even more difficult to predict the possible years of accession of the so-called ‘second wave’ countries like Bulgaria and Romania. According to the Commissioner Verheugen, the year 2006 is ‘realistic’ - i.e. for the accession of Bulgaria. At the same time it is impossible to define the terms for EU accession for all the other countries in the region. In this way amongst the SEE countries Bulgaria and Romania can be considered as EU accession favourites.

How will EU membership be achieved?

In order that to be accepted by the EU for membership the SEE countries will have to fulfil certain criteria. At the Copenhagen summit in 1993, the political and economic conditions for membership were defined. These requirements are:

- that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for the protection of minorities;
- the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the union;
- the ability to take on obligations of membership, including adherence to the aims of political, economic and monetary union.

Applicants will have to demonstrate that their economies are run on a sound, free-market basis, that they have established democratic governmental institutions and respect the basic human rights of their citizens, and that their legislation has been adapted, where necessary,

to accommodate the provisions of the EU legislation. The practice of enlargement involves the following stages:

- Pre-entry negotiations;
- Ratification by parliaments of the existing members;
- Obtaining the agreement of the electorate.

What customs and tax changes are necessary in the SEE region?

Despite the stated intention of the EU to harmonise both direct and indirect tax regimes throughout the union, to date there are few criteria relating to direct tax laws with which the members have to comply. Notwithstanding this, as full members of the EU, SEE countries would be expected to have established a system of VAT and excise duties, to have enacted where appropriate the Merger and Parent/Subsidiary Directives, and would be bound by the Arbitration Convention which seeks to eliminate double taxation within the EU. To date, whilst all possible members either already operate, or are pledged to introduce, EU compatible VAT systems, no one has yet amended their domestic legislation to take account of the two direct tax directives. New members would also be bound by any future rulings of the European Court of Justice dealing with non-discrimination with regard to tax issues.

Inevitably, if the EU moves further towards establishing a harmonized tax system, Member States including new members from the SEE region would be expected to amend their tax and customs regimes accordingly. However, it is unlikely that any major EU direct tax changes will take place before the first wave of new members enters the Union. As such in the short to medium term, the tax systems of the SEE countries are more likely to evolve due to developments within their own countries than due to directives of the EC.

A Customs and Taxation Pre-Accession Strategy (XXI/831/97-EN)

Introduction

The European Commission, Directorate General XXI, Customs and Indirect Taxation prepared the document, which was issued on 7 May 1997. The document sets out proposals to direct the ongoing work in the customs and taxation area towards assisting the CEE accession candidates to prepare them for future membership of the EU. It can be presumed that the provisions of this document will apply to the SEE countries as well. Customs and taxation have an important role to play in each of the requirements as defined above, which make the modern customs and tax services the cornerstone of the efforts of these countries towards EU level operations. Indeed, if customs and tax administrations are not adequately prepared, the application of EU and national law in the following vital areas cannot be guaranteed:

- Revenue collection;
- Control on illegal imports (weapons, drugs etc.);
- Control on standards;
- Agricultural controls;

- Industrial protection (tariffs, quotas etc.).

The European Commission, in order to provide support for the partner country in establishing modern customs and taxation services, operating on the basis of EU-compatible legislation, defined the following three core objectives:

Core objective 1: to provide support to policy makers responsible for customs and taxation in creating an overall modernisation strategy for the administrations concerned;

Core objective 2: to provide support for policy makers responsible for customs and taxation in creating a legal framework in accordance with the provisions detailed in the EU's pre-accession strategy;

Core objective 3: to provide support to policy makers responsible for customs and taxation in creating services having the operational capacity to apply the Community "Acquis" in their respective areas of responsibility and thus ensuring:

- The application of commercial policy
- Revenue collection
- Social protection
- That the trade can function efficiently

A Pre-Accession Strategy for Customs

The strategy must contain, specific to each candidate country, actions consistent with the three core objectives cited earlier, and will be pursued in accordance with the following order of priority:

- Strategic reform plan;
- Creation of legislative framework;
- Creation of operational capacity.

Strategic reform plan

The main indicator is the production of a strategic customs reform plan, agreed with both the national Government and the Commission. This can be based on the World Customs Organisation strategy; plans used in other customs administrations etc.

Creation of legislative framework

The main indicators are:

- Production of modern EU compatible customs code;
- Production of a modern EU compatible customs application provisions;

- Production of any necessary further modern EU compatible customs related legislation;
- Production of books of instruction to officers;
- Availability of information to the public.

Creation of operational capacity

The main indicators are:

- Correct application of commercial policy;
- Increased revenue receipts;
- Increased social protection;
- Reduction in waiting times at borders;
- Creation of specialised services (investigation, training centres);
- Increased information flow to operators;
- Increased co-operation with operators;
- Creation and functioning of dispute resolving mechanisms.

A Pre-Accession Strategy for Taxation

The importance of taxation to the candidate countries in their preparations for accession cannot be overstated. In particular, as revenue accruing from customs duties decreases upon accession to the EU, it will be vital for the candidate country to have reliable alternative sources of revenue at their disposal, and an effective tax administration in place to ensure that this revenue is collected. In addition to the general background considerations outlined in the main document a new pre-accession strategy in the tax area must also take into account several specific issues:

- The current state of tax reform in the candidate country;
- The economic and social conditions prevailing in each country (e.g. low wages of tax officials, rapid development of private sector, the absence of organisations and status governing use of tax advisors).
- The candidate country legislation and administration is compatible with the requirements of the EU “Acquis” in the tax area and the CEEC White Paper (COM (95) 163 final) published in 1995.
- The tax administration of the candidate country has the capacity to effectively apply new tax regimes;

- That a clear and fair relationship is established between tax administration and economic operators in each candidate country (public information, public relations, inspection of services etc.).

The Future Tax Policy in the European Union and the Enlargement Process

On 23 May 2001, the European Commission issued a Communication that identifies the priorities in the tax policy in the European Union. The objectives of European Union taxation policy must accord with the goal set by the Lisbon European Council of making the European Union the most competitive and dynamic knowledge-based economy in the world by 2010.

According to the Communication the enlargement process should not be ignored when considering the objectives of European Union tax policy. However, the candidate countries' ability to take on the obligations of the *Acquis* leaves certain tax policy issues open for negotiation. In fact for the vast majority these issues relate to some of the fundamental cornerstones of the tax *Acquis*. Where such issues are considered to jeopardise the proper functioning of the Internal Market or may even lead to significant distortions, the Commission will recommend, in line with existing negotiation principles, that the Council **does not grant transitional periods for the candidate countries.**

It seems that European Union tax policy development is taking account of the prospect of enlargement. Thus, for instance, it was agreed at the European Council in Santa Maria Da Feira in June 2000, that candidate countries are expected to respect the principles of the Code of Conduct for business taxation; and all of the current candidates have in principle undertaken to do this.

Summaries of the European Commission Reports

In Agenda 2000 the Commission says it would report regularly at the European Council on progress made by each of the candidate countries. The following represents a summary of the European Commission reports on the progress towards accession of Bulgaria and Romania in taxation and customs union for the year 2000. The reports analyse the undergoing processes in Bulgaria and Romania with respect to fulfilment of the criteria for membership as outlined above dated 13 November 2001.

Bulgaria

Customs

According to the report, Bulgaria has made a considerable progress in implementing EU customs legislation. Bulgarian Customs Act and regulations are much in alignment with the *Acquis* but still efforts are to be made with regard to its proper implementation. The Commission estimated as positive the reform of the customs administration. However, the basic problems identified by the Commission are the corruption and the administrative capacity to apply the *Acquis*. The report states that Bulgarian customs administration still faces high staff turnover and lack of adequate training. Better coordination with other border-related services such as the police is still required.

Taxation

The Commission noted with regard to taxation that the VAT system is considerably harmonized with the EU legislation. As of April 2000, new provisions concerning the VAT refunds to foreign legal entities for services used on the territory of Bulgaria were introduced. No further progress was reported with regard to excise duties whose rates are much lower than the minimum rates applied in the European Union. No particular developments with regard to direct taxation were specifically reported. However the Commission outlined the importance of further compliance with the principles of the Code of Conduct.

In the report the Commission has recognized the efforts of Bulgarian government in modernizing the tax administration. The establishment of the United Revenue Agency should be further pursued.

Romania

Customs

By the time of issuance of the report, Romania has considerably harmonized its customs legislation with the EC Customs Code and its implementing provisions. The integrated computerized system (ASYCUDA) is operational and processes 98% of all customs declarations. However, recommendations have been made with respect to the improvement of the system of customs laboratories, fight against fraud and corruption within customs administration.

Taxation

According to the report, Romania has achieved a substantial alignment the national tax legislation with the *Acquis* including the legislation relevant to VAT. However some more changes in the VAT legislation are still to be enforced.

In the field of *excise duties*, the reform applied since January 1998 has brought the structure of the national legislation closer to the community legislation. Some of the major areas of conflict with the *Acquis* were eliminated and the rates of excise duties are gradually increased.

With regard to direct taxation, a substantial tax reduction of corporate tax to 5% exists for profits stemming from export transactions. This tax benefit contradicts the *Acquis* in the area and the compatibility can be questioned. In spite of the measures taken to modernize the tax administration, the Commission estimated the results of this process as limited.

The rate of harmonization of tax and customs legislation in SEE

Why is harmonization necessary?

As a result of the failure of the initial economic reforms in Southeast Europe, each of the countries faced at a different stage the necessity for a choice of an appropriate model for a fiscal policy, that could guarantee to a maximum extent long-term **fiscal stability** and a considerable level of **independence from foreign funds**. In the absence of any specific geopolitical alternatives, most of the countries in Southeast Europe chose the European models of tax and customs legislation, that have already proven their efficiency.

In parallel to the gradual process of harmonization of their internal legislation some of the countries - Bulgaria and Romania, were invited in December 1999 to start negotiations for accession in the Union. This fact, supported by relevant technical assistance, had additionally encouraged the rest of the countries in the region to undertake serious steps in the approximation of their national legislation. Albania, Croatia and Macedonia initiated substantial legislative reforms and as a first step introduced Value Added Tax, based on the provisions of the European legislation. At the same time, the customs legislation in some of the countries was set much in align with the European requirements (Ranchev, 2001a).

The idea for a Free Trade Zone in Southeast Europe is related to the implementation of **common rules in the tax and customs legislation**, given the ambitions of all SEE countries to join the European Union. As discussed in the first part of the research, immediately after the removal of the trade barriers, the differences in the tax legislation among the countries - especially in VAT and excise duties will become apparent. For example, in case of substantial differences in the applicable rates of VAT and excises for certain groups of commodities, a striking growth in the cross-border trade can be anticipated. This may lead to fiscal losses in revenue for the countries applying higher indirect tax rates.

Given the above, it is extremely important that an analysis of the requirements of the European Union in direct and indirect taxes is carried out together with a review of the level of harmonization of the internal legislation in the field of each country in Southeast Europe. The differences should be removed or limited in very short terms prior to the establishment of such a Zone.

Method of Analysis

In the analysis of the rate of harmonization of seven countries in the region (SEE-7) and namely Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia and Yugoslavia, the following results came out with regard to the following four criteria each of equal importance:

- Harmonization in the field of VAT legislation;
- Harmonization in the field of Excise Duties legislation;
- Harmonization in customs duties legislation;
- Harmonization in the field of direct taxation and administrative reform.

It should be noted that the rate of harmonization of indirect taxes – VAT and Excises and the field of customs duties is of primary importance for the establishment of a Free Trade Zone in Southeast Europe. As long as the direct tax harmonization is at its initial stage of implementation even within the European Union, for the purposes of this research only the availability of tax holidays was taken into account with regard to the provisions of the Code of Conduct. Basic sources of information were official statements of the Governments of Romania and Albania (IOTA, 1999), analysis of the tax and customs legislation of Bulgaria, Croatia and Macedonia, information of Deloitte&Touche, KPMG, Southeast Europe Economic Forum on the legislative developments in Bosnia & Herzegovina and Yugoslavia. The fulfillment of each criterion is evaluated on a scale from 0 to 25 points, as 0 is given for a lack of any harmonization, and 25 points mean maximum harmonization achieved. The maximum result for the rate of harmonization as a total of the points given for each criterion is 100 points.

VAT Harmonization

The estimation of the rate of VAT harmonization consists of the estimation of following two sub criteria:

- Compliance of the structure of the legislation with 6th Directive; and
- Analysis of the treatment of certain supplies.

The maximum result in evaluation of the first sub criterion is 15 points and the maximum for the second is 10 points. The results of the analysis can be summarized in the following table.

Table 16: VAT Harmonization

Country	Structure	Supplies	Total
Albania	12	8	20
B & H	0	0	0
Bulgaria	14	9	23
Croatia	12	8	20
Macedonia	14	9	23
Romania	14	9	23
Yugoslavia	0	0	0

Source: Author's analysis

It can be concluded that in the VAT legislation of Albania, Bulgaria, Croatia, Macedonia and Romania there is a considerable level of harmonization already achieved. The VAT rules in all these five countries are based on the provisions of the Sixth VAT Directive. Some more progress is to be made in Albania and Croatia with regard to the VAT treatment of certain supplies, while in Bulgaria, Romania and Macedonia the process of VAT approximation is almost finalized. On the other hand, in Bosnia and Herzegovina and in Yugoslavia no VAT system is introduced currently.

Excise Duties Harmonization

The estimation of the rate of Excise Duties harmonization consists of the estimation of following two sub criteria:

- Compliance of the structure of the legislation with EU Directives; and
- Analysis of the basis for calculation of the Excise Duties.

The maximum result of the evaluation of the first sub criterion is 15 points and the maximum for the second is 10 points. The results of the analysis can be summarized in the following table:

Table 17: Excise Duties Harmonization

Country	Structure	Calculation Basis	Total
Albania	10	2	12
B & H	0	0	0
Bulgaria	14	9	23
Croatia	10	8	18
Macedonia	14	8	22
Romania	14	8	22
Yugoslavia	5	0	5

Source: Author's analysis

It can be concluded that in Bulgaria, Macedonia and Romania there is a considerable level of harmonization of excise duties already achieved. The excise duty rules in these three countries are based on the provisions of the relevant EU Directives. Some more progress is to be made in Albania and Croatia with regard to the excise duty treatment of certain goods and the basis for the calculation of the excises, while in Bulgaria, Romania and Macedonia the process of excise duties approximation is almost finalized. Given the distant prospects of EU membership of the countries, the approximation of the levels of applicable tax rates was not analyzed. On the other hand, in Bosnia and Herzegovina no excise duty system is introduced currently. Yugoslavia has an operating excise duty system but it is still not in compliance with the relevant EU rules.

Customs Duties Harmonization

The estimation of the rate of Customs Duties harmonization consists of the estimation of the following two sub criteria:

- Compliance of the structure of the customs legislation; and
- Analysis of the harmonized coding system.

The maximum result of the evaluation of the first sub criterion is 15 points and the maximum for the second is 10 points. The results of the analysis can be summarized in the following table:

Table 18: Customs Duties Harmonization

Country	Structure	Harmonized System	Total
Albania	14	9	23
B & H	10	9	19
Bulgaria	14	10	24
Croatia	12	8	20
Macedonia	10	8	18
Romania	15	10	25
Yugoslavia	5	0	5

Source: Author's analysis

It can be concluded that in Albania, Bulgaria, and Romania there is a considerable level of harmonization of customs duties already achieved. The customs duties rules in these three countries are entirely based on the provisions of the EC Customs Code. Some more progress is to be made in Bosnia and Herzegovina, Macedonia and Croatia with regard to the customs duty provisions. Romania has even launched an integrated information system for reporting used by the customs administration. This considerable compliance with EU legislation is partly due to the technical assistance provided by the EU to the administrations in these countries aiming at fostering customs control and fighting corruption. On the other hand, Yugoslavia has an operating customs duty system but it is still not in compliance with the relevant EU rules.

Direct Taxes Harmonization and Reform

The estimation of the rate of direct tax harmonization and administrative reform consists of the estimation of following two sub criteria:

- Compliance of the provisions of the Code of Conduct; and
- Analysis of the stage of the administrative reform in tax and customs administrations.

The maximum result of the first sub criterion is 10 points and the maximum for the second is 15 points. The results of the analysis can be summarized in the following table:

Table 19: Direct Taxes Harmonization and Reform

Country	Direct taxes	Reform	Total
Albania	8	10	18
B & H	0	8	8
Bulgaria	9	14	23
Croatia	0	10	10
Macedonia	0	12	12
Romania	0	12	12
Yugoslavia	0	5	5

Source: Author's analysis

It can be concluded that in Albania and Bulgaria due to the absence of tax holidays there is a considerable level of harmonization with the provisions of the Code of Conduct already achieved. All the countries in the region have put a lot of efforts in the tax reform, as some more progress is to be made in Bosnia and Herzegovina and especially in Yugoslavia whose system is too complex.

Results of the Analysis

Part of the lower overall results achieved by Romania, Croatia and Macedonia are due to the tax preferences available in their tax systems, which are not in compliance with the Code of Conduct.

Table 20: Results of the Analysis

Country	VAT	Excise duties	Customs duties	Direct taxes and reform	Total
Albania	20	12	23	18	73
B & H	0	0	19	8	27
Bulgaria	23	23	24	23	93
Croatia	20	18	20	10	68
Macedonia	23	22	18	12	75
Romania	23	22	25	12	82
Yugoslavia	0	5	5	5	15

Source: Author's analysis

The Case of Slovenia

The tax system of Slovenia in the field of excise duties and VAT is considerably approximated with the relevant EU legislation. The customs duties regime is in compliance with the EC Customs Code. The harmonization of direct tax legislation will be finalized with the accession of Slovenia in the EU when the merger and the parent subsidiary directives will be implemented. The tax policy of Slovenia is committed to the same goals as in the EU countries and tax and customs reforms are progressing steadily. If the level of harmonization of tax and customs legislation should be evaluated by the end of year 2000, undoubtedly Slovenia could be ranked highly among the other SEE countries, subject to this analysis.

Conclusions

Ranking

As long as the tax and customs legislation in the SEE countries is still in the process of constant changes, the results of the comparative analysis are conditional and valid as at the end of the year 2000. Based on the results of the analysis with regard to the rate of harmonization, the countries in the region can be divided in the following three groups:

Table 21: Ranking

Group	Country	Total points	Rank
1.Harmonized	Bulgaria	93	1
	Romania	82	2
2.Advanced	Macedonia	75	3
	Albania	73	4
	Croatia	68	5
3.Beginners	B & H	27	6
	Yugoslavia	15	7

Source: Author's analysis

Based on the results of the above analysis the countries can be divided in three major groups according to the level of harmonization achieved in the field of tax and customs legislation. Thus, the first group of countries called 'harmonized' consists of Bulgaria and Romania. Macedonia, Albania and Croatia fall in the second group of countries with 'advanced' level of harmonization. Bosnia & Herzegovina and Yugoslavia, which are ranked in the third group, could be referred as 'beginners' in the harmonization process.

Observations

The Social Aspects of Harmonization

Harmonization of Direct Taxes

As noted above the harmonization of direct taxes is still an on-going process in the legislation of Southeast Europe countries. However, the social effects of the application of the Code of Conduct can be estimated as contradictory. As a general rule, tax incentives foster economic activity and attract foreign investment, which subsequently leads to a decrease of unemployment. However, in principle the tax incentives undermine the fiscal stability by reducing tax revenues that may lead to substantial cuts in the social expenses.

Harmonization of Indirect Taxes

The social effects of the harmonization of indirect taxes should not be overestimated. It should be noted that the society in Southeast Europe now faces greater problems in respect to the on-going structural reform of the economies, unemployment, poverty and lack of adequate health and social security system. Thus as the level of consumption is to a great extent restricted or growing very slowly, the undergoing changes in the tax legislation are of less impact on the society as a whole. In general, the excise duties will be increased but this in fact will cause very limited effect on the consumption. The immediate effect of harmonization of indirect taxes will lead to an increase in consumer prices of these products in the short run. In the long run the government the prices should be decreased as result of a growing competition between the producers of such goods within each country and the acquisition of new means of production by the companies that are already entitled to input VAT credit.

However, it should be noted that the introduction of more harmonized principles, will lead in general to increased revenue collection, less administrative control and greater tax compliance of the VAT and excise duty registered companies.

Harmonization in the field of Customs Duties

The introduction of new harmonized principles in the Customs Duty provisions will lead to a simplification in the administrative procedures. That simplification should presumably be followed by a decrease in the compliance costs of the companies involved in the import and export transactions, which could have a positive impact on the price levels as a whole and thus positive social effect on the entire society. However, it should be noted that the tax and customs systems in Southeast Europe are undergoing tremendous changes and thus the overall social effect of the introduction of the new harmonized principles is a subject that has to be evaluated in due course of time.

The harmonization and institutional reforms

The harmonization of the legislation in Southeast Europe should be directly related to substantial institutional reforms. No legislation could be effective if it is not implemented successfully. The support from the European Union and the international financial organizations will be decisive factor in this delicate process.

The Rate of Harmonization and the Free Trade Zone

It is obvious from the results that in five of the SEE – 7 countries there is a considerable rate of harmonization of the tax and customs legislation with the EU requirements. In Bulgaria and Romania, the harmonization process in tax and customs legislation has achieved considerable approximation. Some more changes are to be implemented in the tax and customs legislation of Macedonia, Albania and Croatia. For these countries we cannot anticipate considerable fiscal problems relevant to the participation in the Free Trade Zone.

At the same time, the prospective membership of Bosnia and Herzegovina and Yugoslavia in the Zone, urges for a substantial reform in the tax and customs legislation in compliance with the EU rules.

Final Remarks

The objective of the present research has been to identify at this rather initial stage some of the most significant implications of the future trade liberalization on the economies of the seven SEE countries and the societies in the region. The findings of this research show that although short-term economic effects are ambiguous for the region as a whole, the process of trade liberalization will bring more security, which in its turn will assist the economic reforms and will probably lead to a greater degree of harmony and stability in these countries in the long run.

However, it should be noted that free trade is not the remedy for all the problems in the region. Trade liberalization is by no means a substitute for the need to address the existing historical, political, ethnic and cultural problems and to seek solutions exceeding the limits of political mandates and the missions of international envoys. The unstable situation in Bosnia and Herzegovina, Macedonia and Kosovo represents a significant challenge to the processes of trade liberalization in the region.

Trade liberalization and fiscal stability through harmonization of tax and customs legislation should go hand in hand, in order to secure a long-term vision for the undergoing processes of transformation. The common goal of achieving European Union membership for the countries in the region makes the transformation processes rather unique. It can be argued that harmonization of tax and customs legislation in combination with regional trade liberalization is a phenomenon that can be observed currently only in Europe.

The purpose of this study is to make an empirical contribution to the current debate on the salience of trade liberalization and fiscal stability in this troubled region. The Memorandum of Understanding signed by the countries in the region in June 2001, sets out an ambitious agenda for the governments of the seven countries. The objectives of the Memorandum of Understanding go far beyond trade liberalization. In fact, the countries have agreed on a work plan that can be considered a significant step in the process of modernization of these states. The international community should stimulate by all means and support this important multilateral agreement, as agreements of that type as well as success stories are quite rare in Southeast Europe.

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General References

The following resources contain information of relevance to many of the topics covered in the present report.

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European Commission, DG External Relations: contains information of the processes of the EU relations on SAP with South East European countries available at: http://europa.eu.int/comm/dgs/external_relations/index_en.htm

European Commission, DG Taxation and Customs Union: contains information about the current activities taking place in the EU with regard to customs and taxation issues available at: http://europa.eu.int/comm/dgs/taxation_customs/index_en.htm

KPMG International Tax Facts Database (ITFDB): is a menu driven database, containing of current tax information on over 75 countries, maintained by KPMG available at: http://www.us.kpmg.com/microsite/Global_Tax/TaxFacts/index.html

Earnst&Young Passport Online: is a menu driven database, containing of current tax information, maintained by Earnst&Young available at: http://www.ey.com/global/gcr.nsf/EYPassport/EYPassport_Home

SEEurope Net: is a menu driven database, containing current tax and investment information on SEE countries available at: <http://www.seeurope.net/en/>

SEERECON: is a menu driven database, containing information on projects for SEE countries supported by the World Bank and the European Commission available at: <http://www.seerecon.org/>

Stability Pact Database: official web site of the Stability Pact for SEE available at: <http://www.stabilitypact.org>

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Appendix One: Memorandum of Understanding

Full text of the Memorandum of Understanding on Trade Liberalisation and Facilitation

Brussels, 27 June 2001

Ministers,

REPRESENTING the Republic of Albania, Bosnia and Herzegovina, the Republic of Bulgaria, the Republic of Croatia, the Federal Republic of Yugoslavia, the Republic of Macedonia and Romania (hereafter the Signatory Countries), on the occasion of their meeting on trade liberalisation and facilitation within the context of the Stability Pact for South Eastern Europe, held in Brussels on 27 June 2001;

HAVING REGARD to the pledge, made by signatories to the Stability Pact in Cologne on 10 June, 1999, to foster ‘economic co-operation in the region and between the region and the rest of Europe and the world, including free trade areas’;

RECALLING the Declaration of the Zagreb Summit on 24 November, 2000, in which Heads of State or Government of the Republic of Albania, Bosnia and Herzegovina, the Republic of Croatia, the Federal Republic of Yugoslavia, and the Republic of Macedonia undertook to establish regional co-operation conventions providing for a regional free trade area; and the SEECP Action Plan for regional economic co-operation, agreed at the Fourth Summit in Skopje on 22 and 23 February, 2001, in which Participating Countries (the Republic of Albania, Bosnia and Herzegovina, the Republic of Bulgaria, the Federal Republic of Yugoslavia, the Hellenic Republic, the Republic of Macedonia, Romania and the Republic of Turkey, reaffirmed that ‘further liberalisation of trade, undertaken also by the countries of the region will better serve their national economies’;

RECOGNISING the primacy of the multilateral trading system as compared with regional initiatives, in the fields of trade facilitation and liberalisation that are mentioned below; the importance of WTO membership and compliance with WTO rules as well as the importance of liberal trade regimes in order to foster economic development; and the relevance of the EU Stabilisation and Association process and the EU enlargement process in this context;

DETERMINED to liberalise and facilitate trade further among the Signatory Countries and to advance the accession to the WTO of Bosnia and Herzegovina, the Federal Republic of Yugoslavia, and the Republic of Macedonia;

CONVINCED that these measures will enhance the ability of the region to attract investments and further the prospects of its integration into the global economy;

HAVE today adopted this Memorandum of Understanding on Trade Liberalisation and Facilitation.

The Signatory Countries agree to:

1. Develop further the network of Free Trade Agreements on trade in goods between the Signatory Countries, in compliance with WTO rules and in accordance with the process and commitments relevant to each country's individual relationship with the EU. To this end, the Signatory Countries will:

1.1. Refrain, upon signature of this Memorandum, from taking any new trade restrictive or distorting measure, that would go beyond that which is necessary to address specific and sensitive situations in compliance with WTO rules, thereby establishing a base line for the negotiation and, if applicable, the revision of Free Trade Agreements.

1.2 Negotiate mutually beneficial Free Trade Agreements between themselves, with a view to signing the agreements, covering products originating in the parties, by the end of 2002, in accordance with the following principles:

1.2.1 Export duties or charges having equivalent effect shall be abolished upon entry into force of each agreement. Quantitative restrictions on imports or exports and measures having equivalent effect shall also be abolished.

1.2.2 Import duties or charges having equivalent effect shall be abolished on at least 90% of the parties' mutual trade by value and of HS tariff lines by the end of the transitional period.

1.2.3 Import duties or charges having an equivalent effect on a large majority of goods should be preferably abolished upon entry into force of each FTA; those on sensitive goods would be progressively reduced during a transitional period of not more than 6 years.

1.3 Review existing bilateral Free Trade Agreements already concluded between the Signatory Countries and ensure that they are compatible with the principles set out in paragraphs 1.2.1 to 1.2.3 by the end of 2002.

1.4 Ensure that all these Free Trade Agreements enhance integration of the Signatory Countries into EU structures. The Signatory Countries which are candidates for accession to the EU will conclude, as a first priority, free trade agreements with those Signatory Countries with which the EU has concluded SAAs, where such agreements do not yet exist; agreements with the other Signatory Countries will be negotiated in line with obligations undertaken in the framework of the accession negotiations and in conformity with this Memorandum. Candidates for accession to the EU will ensure that existing and new agreements mirror, to the extent possible, the current scope and level of liberalisation of EU arrangements.

2. Set in motion, upon signature of this Memorandum and within the context of the Stability Pact Working Group on Trade Liberalisation and Facilitation, the Procedure to Eliminate Quantitative Restrictions and Measures with Equivalent Effect on Trade, agreed by the Signatory Countries to identify, review and eliminate such measures, in particular those which are not compatible with WTO provisions.

3. Include in the Free Trade Agreements an appropriate common set of preferential rules of origin furthering the objectives of this Memorandum.

4. Ensure that provisions in the Free Trade Agreements regarding the application of antidumping, countervailing and safeguard measures, are consistent with WTO rules. Include provisions related to public procurement, state aid and state monopolies in the Free

Trade Agreements in order to ensure further liberalisation, transparency and non-discrimination in trade between the Signatory Countries.

5. Simplify customs procedures, especially at border crossings; harmonise legislation, documentation and procedures with those of the EU; engage in mutual assistance between customs administrations and other agencies concerned with the cross-border movement of goods, vehicles and persons; and harmonise methodologies for the collection of trade statistics. To this end, they shall continue to conclude appropriate agreements, in addition to existing arrangements, where possible on a regional basis.

6. Include in the Free Trade Agreements a clause foreseeing the future liberalisation of trade in services, in accordance with GATS Article V. The Signatory Countries request the Stability Pact Working Group on Trade Liberalisation and Facilitation to commission an assessment of the current situation in their countries concerning trade in services and of prospects for regional co-operation in this area.

The Signatory Countries intend to take additional steps to liberalise and facilitate trade. To this end, they will:

7. Ensure that trade legislation and regulations relating to plant, animal and human health, safety and environment are compatible with the provisions of WTO, EU and other relevant international bodies, bearing in mind the Signatory Countries' current and future obligations in their contractual relationships with the EU.

8. Co-operate in moving towards the implementation of standards, technical regulations, conformity assessment, testing, metrology and accreditation systems that are compatible with European and international principles. The Signatory Countries shall endeavour to participate in the work of relevant international organisations, exchange technical and methodological information in the field of quality control of production processes and take other measures aimed at improving quality. They will pursue mutual recognition and similar arrangements between themselves and partners, which are consistent with the provisions of the WTO and will promote co-operation among their standards and accreditation bodies.

9. Harmonise legislation on company law, company accounts and taxes and banking law with that of the EU. The Signatory Countries will also harmonise their competition law with that of the EU. They will further strengthen, where necessary, the enforcement capacity of relevant Authorities, including competition or similar bodies, and establish such Authorities where none exist.

10. Upgrade their legislation in the field of intellectual property protection in compliance with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights and other related international agreements. They will develop and implement appropriate enforcement measures in order to combat piracy and counterfeiting effectively.

Maintain an open trade regime toward the rest of the world, pursue further multilateral trade liberalisation within the WTO and conclude Free Trade and other trade agreements with neighbouring and other interested countries.

To ensure achievement of the undertakings outlined above, the Signatory Countries:

12. Request the Stability Pact Working Group on Trade Liberalisation and Facilitation to review progress in the above undertakings regularly and propose measures required to fulfil the provisions of this Memorandum. The Working Group should also be used by Signatory Countries to inform each other about developments in the bilateral free trade agreements and other trade-related measures.

13. Appeal to WTO members to support, assist and facilitate early accession to the WTO of Bosnia and Herzegovina, the Federal Republic of Yugoslavia, and the Republic of Macedonia.

14. Call upon the international community to provide technical and financial assistance to facilitate for the Signatory Countries to meet the above undertakings. They stress the importance of the realisation of trade facilitation and promotion projects that will benefit all Signatory Countries.

15. Agree to meet again within twelve months of the date of signature of this Memorandum and subsequently on a regular basis, to review progress, to adopt measures to implement this Memorandum and to develop further trade and investment.

SIGNED at Brussels, on 27th day of June in the year two thousand and one.

(Followed by signature)