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

Part One

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Part One

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

Executive summary

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 behavior 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 level of harmonization of the legislation on direct, indirect taxes and customs duties throughout the European Union 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 most of the countries in Southeast Europe (SEE). 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, a strategic approach shall be taken to lead the countries on the road of fiscal stability and future econimic prosperity. A number of strategic plans state that Albania, Bosnia and Herzegovina, Croatia, Macedonia and Yugoslavia (Serbia and Montenegro) should join the European Union as well even at a later stage. Thus mainly for the purposes of the second part of the research, the tax and customs legislation of these countries from this aspect is analyzed as well.

Based on the results of the analysis in 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 EU requirements was achieved. For these countries no considerable problems relevant to the participation in the Free Trade Zone from this point of view can be anticipated. However, the prospects of a membership of Bosnia and Herzegovina and Yugoslavia in the Free Trade Zone should be reviewed carefully after a substantial reform in the tax and customs legislation in compliance with the EU rules is implemented.

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.

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. The legal basis for tax harmonization is found in Articles 100 and 101 of the Rome Treaty, that 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.

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.

Parent-Subsidiary 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.

Merger 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.

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.

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. 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 stnadard 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.

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.)

The procedures for the harmonization of Excise Duties as well as the some of the most important requirements of the European Commission in respect of each duty are set out in specific directives, together with the proposed rates.

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.

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. The SAA with Macedonia was signed in April 2001. Such SAA is to be negotiated for Croatia as well. 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 2003 or 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 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 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 which 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, those 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. The reports analyse the undergoing processes in Bulgaria and Romania with respect to fulfilment of the criteria for membership as outlined above dated 8 November 2000.

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 implementation. The Commission estimated highly the development and operation of an integrated information system (Asycuda) and 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, lack of adequate training and standardised ethics rules.

Taxation

The Commission noted with regard to taxation that the VAT system is considerably harmonized with the EU legislation. As of January 2000, new provisions concerning special schemes for travel agents and investment gold 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 recommendations with regard to direct taxation were specifically addressed.

In the report the Commission has recognized the efforts of Bulgarian government in modernizing the tax administration. The establishment of the State Receivables Agency, United Revenue Collection Agency and the Tax Policy Directorate within the Ministry of Finance were identified as positive steps. However, some of the negative aspects of the reform are the high staff turnover and increased level of tax arrears.

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. With regard to the administrative capacity Romania plans to have a computerized integrated tariff by the end of 2002. Romania has issued in March 2000, a Code of Conduct implementing measures to combat fraud and corruption. The progress in the areas of transit, computerization and application of simplified procedures has been estimated highly. However, recommendations

have been made with respect to the improvement of the system of customs laboratories and training of customs administration.

Taxation

According to the report, Romania has achieved a substantial allignment the national tax legislation with the *Acquis* including the legislation relevant to VAT. Recently, a single 19% rate was introduced replacing both the standard rate of 22% and the reduced rate of 11%. Substantial delays in refunding of VAT are still a serious issue.

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. However, important differences were found to exist, in particular the exemption of excise duties of certain mineral oils used for household consumption and the application of very low levels.

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, by the Commission estimated its effectiveness as considerably low.

New Developments

In April 2001, a Stabilization and Association Agreement (SAA) was signed between the European Union Member States and Macedonia. The SAA is a specific associative agreement within a wider pre-accession strategy, which aims to prepare the candidate countries for accession. As a preferential agreement, it is expected to contribute to the economic and political stability of the country as well as to assist the relevant changes in legislation. Under the SAA, the association of Macedonia in the EU should be completed within 10 years, as an evaluation of the process is to be made within 4 years.

A similar SAA is to be signed with Croatia in the near future, which will give a clear sign to 4 out of 7 SEE countries for the possibility of EU membership.

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.

The idea for a Free Trade Zone in Southeast Europe is unrealistic in the absence of **common rules in the tax and customs legislation**. 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 Excises legislation;
- Harmonization in customs duties legislation;
- Harmonization in the field of direct taxation and tax 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, 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 complete 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.

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 the 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:

Country	Structure	Calculation Basis	Total
Albania	10	2	**12**
B & H	0	0	**0**
Bulgaria	14	10	**24**
Croatia	10	8	**18**
Macedonia	14	8	**22**
Romania	14	9	**23**
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 the be made in Albania and Croatia with regard to the excise duty treatment of certain goods and the basis for the calculation 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 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:

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 the be made in Bosnia and Herzegovina, Macedonia and Croatia with regard to the customs duty provisions, while in Albania, Bulgaria and Romania the process of customs duties approximation is almost finalized. 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 Tax Reform

The estimation of the rate of direct tax harmonization and tax 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 tax reform.

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:

Country	Direct taxes	Tax 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 is not in compliance with the Code of Conduct.

Country	VAT	Excise duties	Customs duties	Direct taxes and tax reform	Total
Albania	20	12	23	18	**73**
B & H	0	0	19	8	**27**
Bulgaria	23	24	24	23	**94**
Croatia	20	18	20	10	**68**
Macedonia	23	22	18	12	**75**
Romania	23	23	25	12	**83**
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:

Group	Country	Total points	Rank
1.Harmonized	Bulgaria	94	1
	Romania	83	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.

Final Remarks

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 which 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 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 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 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, should take effect only after a substantial reform in the tax and customs legislation in compliance with the EU rules is carried out.

Free Trade Zone in Southeast Europe?

The present research report consists of two integral parts. The first part of the research focuses on the level of harmonization of tax and customs legislation of 7 countries in Southeast Europe as a tool for achieving fiscal stability in the region and one of the prerequisites for the establishment of a free trade zone on the Balkans. The second part of the research will be concentrated on the analysis of various economic, political, social and cultural issues relevant to the creation of a Free Trade Zone in Southeast Europe. The following represents an overview of the objectives and expected outcomes of the second part of the research.

The establishment of a free trade zone in Southeast Europe

The countries in the region are 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 economical development and integration is achieved. Thus the "isolation" of the countries can be considered one of the main barriers towards stabilization. A regional customs union of the countries in the region and relevant harmonization of VAT and Excise Duties can be the considered an appropriate scenario especially for the economies of the Balkan countries. In this way the requirements of the European Union in the field of taxation and customs reform can turn out to be a common starting point in the direction of economic integration of the region and future accession of the Balkan (SEE) countries in the European Union. On the other hand the week institutions and governance constraint economic development and adversely affect investor's perception of the region.

The data analysed in the first part of the research will serve as a base for the discussion of the possibilities of the establishment of a free trade zone in Southeast Europe. Focus will be given on the level of harmonization in the field of indirect taxes and customs duty regimes. The levels of corporate tax rates, available tax incentives will be given in outline and discussed as well.

The role of the Stability Pact in trade liberalization and facilitation

One of the main goals of the Stability pact is the creation of "vibrant" market economies in Southeast Europe based on sound macro policies. In order to fulfil this objective the markets must become open to foreign direct investment and the trade is to be based on effective and transparent customs and commercial/regulatory regimes. The research will identify the main scenarios open to the Stability Pact for achieving the ambitious objective of trade liberalization and facilitation.

Recent publications of leading scholars state that agreements between small, closed developing countries are unlikely to have a positive impact on growth. Another key finding is that only countries located to large developed economies can benefit from such location. The following issues will be analysed in more details in view of the objectives of the Stability Pact:

- Prospects for changes in tax and customs systems, infrastructure, institutions and social aspects of the reforms;

- The role of trade agreements, double tax treaties and transfer pricing in attracting foreign investment;

- The role of tax incentives and cross country tax competition in fostering economic cooperation in the region, between the countries in the region and the rest of Europe and the world;

- Bureaucracy and corruption - how can we fight them;

- Social and economic integration of minorities;

- The advantages and disadvantages of the free trade areas;

- The example of an operating free trade zone in the region - i.e. Bulgaria and Macedonia.

Analysis of the risks

The following risks for the failure or the delay of such a strategic project will be ascertained and discussed based on available statistical, economic and political data at the moment of the research:

- Analysis of the differences in the economies of the SEE countries that exist currently and discussion of the possibilities for economical integration as well as analysis of the option of implementing of a single currency (euro) in the region;

- Analysis of the political risks - are the countries in the region prepared for surrendering partly their national sovereignty in view of such a project;

- Analysis of the possibilities for funding and assistance from the European Union and/or through the Stability Pact that can be decisive for the project which will cover the initial loss of customs revenues;

- Discussion on whether the processes of integration of the economies of the countries on the Balkans should be achieved prior to the process of European Union integration or be considered a parallel process;

- Discussion on various strategies for achieving trade integration - customs union with the European Union, a network of double free trade agreements, possible integration of all of the countries in CEFTA and the establishment of a separate customs union;

- Discussion on the timing scale of possible implementation of different scenarios.

Conclusions and outcome

Conclusions on the possibilities for the fulfilment of such a project on a Southeast Europe scale should be made as a result of the research. Recommendations on the role of the Stability Pact will be presented and made available to the public by way of series of articles in support of the idea for establishment of a common Free Trade Zone in Southeast Europe.

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. Agreement has been reached by Albania, Bosnia-Herzegovina, Bulgaria, Croatia, the Republic of Macedonia, Romania, the Federal Republic of Yugoslavia 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.

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