USAID ASSISTANCE IN FISCAL REFORM

INTRODUCTION OF VALUE-ADDED TAX IN SERBIA

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SERBIA

USAID ASSISTANCE WITH INTRODUCING A VALUE-ADDED TAX

I. PROJECT DATA

Level of Funding:

US$ 9,585,767

Project / Period of Assistance:

Serbia Tax Policy and Administrative Reform Project / 2002 – 2006

Types of Assistance:

1. Technical Assistance - in conjunction with other donors
2. Equipment and Materials - including hardware and software
3. Training - including formal and 'on-the-job' training and international study tours

Areas of Assistance:

1. Tax Law and Fiscal Policy Development
2. Tax Administration Business Processes
3. Automation
4. Capacity Building

Main Counterparts:

1. Serbian Tax Administration
2. Ministry of Finance

II. THE PROJECT: - BACKGROUND, PRINCIPAL RESULTS AND IMPACT

From late 2002 to mid 2006, USAID provided more than US$9.5 million in assistance to Serbia to further fiscal reform by enabling the Ministry of Finance (MOF) and the Serbian Tax Administration (STA) to formulate and implement a sound tax system. The scope of activities was fairly diverse as the Serbian Tax Administration (STA) was a relatively new organization in need of extensive technical assistance. The existing contract was modified in 2004 following a request from the MOF to USAID for additional support and assistance to ensure the successful introduction and implementation of the Serbian value-added tax (VAT).

The technical ability of the STA staff to administer a VAT was minimal - the VAT was a new tax and the existing knowledge base had been derived solely from reading material.

Technical assistance was vital in all aspects of VAT implementation: law and regulations drafting, organizational structure, training and preparation of material for educating taxpayers. Although the German donor agency (GTZ) was already providing a degree of technical assistance, there was more than sufficient work for all donors. The USAID project concentrated largely on tax administration, while GTZ continued with VAT training. The other main donors were the French Ministry of Finance and the European Agency for Reconstruction (EAR). The French advisors focused on the wider aspects of training and HR, while EAR provided material assistance with the IT infrastructure.

Assisting the STA and MOF with implementation of the VAT was a major task. USAID also provided assistance to complete the establishment of a Communications and Taxpayer Education department in the STA. Introduction of the VAT without media campaigns and taxpayer education would have been extremely difficult.

A. Background and Economic Context of the VAT Project

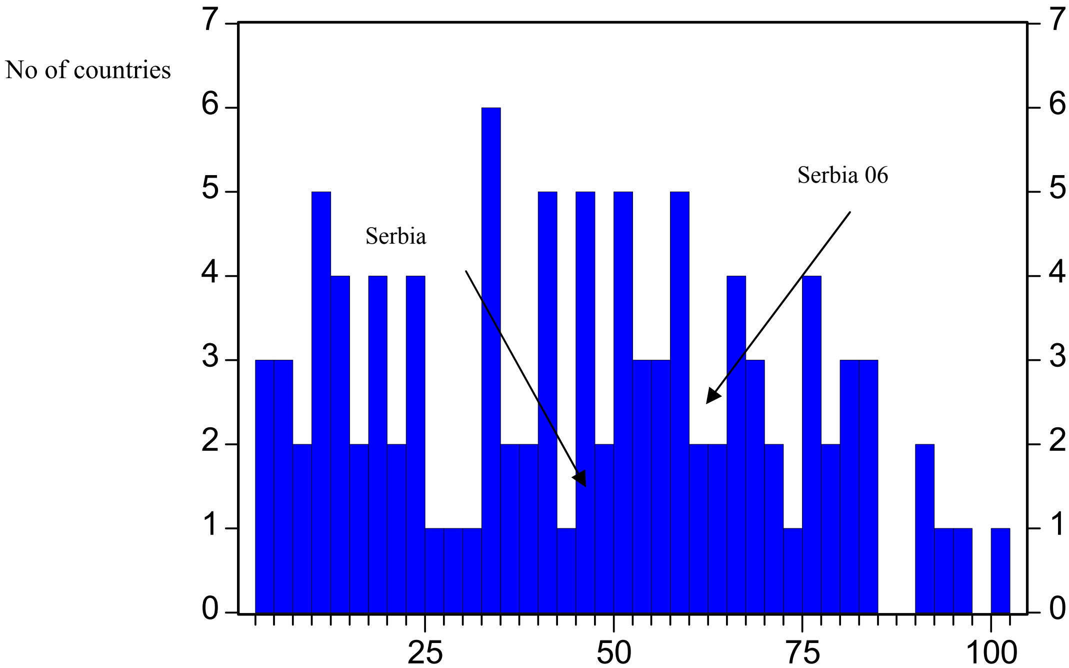
A major goal of the wider USAID Tax Reform Project activity was to create a tax system that treats all taxpayers fairly by means of a simple and transparent system with low rates and few exemptions. In 2003 the MOF announced its intention to introduce a VAT as a major step in the direction of achieving the above goal, in addition to being a prerequisite for achieving Serbia's longer-term goal of EU membership.

Although the work of drafting the VAT Law started in 2003, a parliamentary election delayed this work early and the introduction date was postponed from January 2004 to mid-2004 and again to January 2005. Ultimately, the VAT went into effect on January 1, 2005, with a general rate of 18% on most goods and services, and a reduced rate of 8% on selected items. An accepted 'comfortable' period for introducing a VAT is normally between 18 months and 2 years, so even the final date of January 1, 2005 represented a significant challenge.

Despite the accelerated schedule for introducing the VAT, its implementation is considered rather successful. First, it more than made up the revenues foregone by eliminating the Sales Tax; and second, its general performance by international comparison was acceptable in the first year, and much better in the second year.

As the following histograph shows, VAT performance as measured by the VAT Gross Compliance Ratio (or VAT "C-efficiency" ratio) in 2005, the first year of implementation, was at 47—about average for VAT performance around the world—but then it rose sharply in 2006, to 62.

Figure 1: VAT C-efficiency rates around the world



Note 1: Data from www.fiscalreform.net benchmarking toolkit.

B. Outcomes and Impacts in the Project's VAT Assistance

The USAID project initially provided the MOF and STA with assistance that resulted in changes to the VAT Law and a recommendation for an integrated VAT project plan and specific simplification measures. USAID subsequently provided the requested additional resources necessary to support the government with the successful introduction of their VAT on January 1, 2005. The most significant outcomes and impacts are highlighted below.

1. Well prepared VAT legislation and Regulations

Much of the primary legislation had already been drafted with GTZ assistance, using Macedonia's VAT Law as a model. However, the GTZ-recommended model had been modified to retain some of the features of the Sales Tax—which would have made the new VAT hard to administer. The USAID project provided additional expert advice to make the Law more EU compliant and easier to administer.

USAID project assistance focused on vetting and making marginal improvements to the draft VAT Law for Parliament. The most significant improvements to the VAT Law that resulted from USAID project technical assistance include:

- raising the annual VAT registration threshold to limit the number of low contributing taxpayers and allow the tax administration to focus on the more revenue productive taxpayers;
- introducing quarterly rather than monthly filing for smaller taxpayers, i.e., for taxpayers with annual total revenues less than about $333,000; and
- removing some of the restrictions on claiming VAT credit on capital goods, consistent with VAT best practices and competitive trade policies.

These provisions reduced administrative burdens on the STA and compliance costs for businesses.

Table 1 below illustrates the reason for implementing a VAT with a reasonable registration threshold. As can be observed, taxpayers with annual turnover below 2,000,000 dinars (about $33,000) do not, as a group, contribute to revenue generation. The initial MOF proposal to put the registration threshold at 1,000,000 dinars (about $16,500) in annual turnover would have resulted in a larger number of taxpayers and increased administration for no revenue gain. Experience shows that an increase in the annual registration threshold normally results in increased VAT revenues since tax administration resources can be better targeted to revenue productive taxpayers.

Table 1: Distribution of taxpayers by turnover band in 2005

Annual turnover of VAT payer (dinar millions)	Number of VAT payers	Turnover of the group	Participation in turnover	Net VAT	Participation in VAT
0 – 2	43,516	30,898	0.7%	-304	-0.5%
2 – 5	26,394	87,477	2.0%	2,547	4.2%
5 – 10	18,929	134,598	3.0%	3,003	5.0%
10 – 20	13,270	186,907	4.2%	3,816	6.3%
20 – 50	10,183	317,651	7.2%	5,714	9.4%
50 – 100	4,202	294,640	6.7%	5,120	8.5%
100 – 500	4,150	853,900	19.3%	12,600	20.8%
500 – 1000	512	351,829	8.0%	5,665	9.4%
> 1000	468	2,161,530	48.9%	22,350	36.9%
TOTAL	121,624	4,419,430	100.0%	60,511	100.0%

Source: Serbian Tax Administration

2. New VAT Registration Procedures

USAID project staff assisted the STA to develop VAT registration procedures and forms. Business process requirements were prepared by the project team. The registration procedure was kept as simple and straightforward as possible and information demands at a minimum. A Taxpayer Identification Number (TIN) had already been established.

3. Simple Declaration and Refund Procedures

A major project success was in ensuring that the periodic VAT declaration was kept simple, with only 17 boxes for completion. STA staff, the Deputy Minister of Finance and other advisors strongly argued for many more boxes on the VAT return, but despite initial resistance counterparts eventually conceded that a simpler form would be best. It was also agreed that the STA would mail periodic tax returns to taxpayers who could then either mail them back or hand them in to their local tax office. This procedure allows the STA to follow up on any undelivered or return mail and helps to address the inherent 'Achilles heel' of any VAT: the refund mechanism. Because of the potential for fraudulent claims from non-existent companies, it is necessary to check to ensure that a real taxpayer and an actual business are located at the address provided in the registration form.

4. VAT Organization

The STA avoided substantial reform of its organization structure at the time of VAT introduction, despite advisors' recommendations. A key element was a very substantial reduction in the number of local tax offices, which at that time was considered politically too sensitive and was thus not accepted. However, the Deputy Minister of Finance did make the concession that the VAT would only be administered at 55 of the 170 tax offices, much more keeping in line with the idea of consolidating tax offices and reducing duplication of efforts. In addition, the need for a central operational unit to monitor the VAT refund system was accepted and implemented.

5. A Successful Media and Taxpayer Education Campaign

Wider project activity resulted in the successful establishment of a unit in the STA for media, communications and taxpayer education to work with the project team on planning and executing the VAT media and taxpayer education campaigns. Most of the materials, including public notices, pamphlets and leaflets had to be prepared by the project staff due to lack of technical capacity in the STA. All documents were reviewed prior to publication by the STA. It is not uncommon for staff in transitional and developing countries to have difficulty with public information, as they are simply not used to preparing such documents. More general information was developed for citizens to explain the impact on prices and the benefits from improved tax compliance. The media campaign was steered by the project and funding by USAID ensured extensive coverage in the media. The policy was, get the advertising for free if you can, and only pay when you need. The STA's outreach activity was tested by market research surveys, and the results were evaluated by the project in coordination with the STA. Careful monitoring helped the STA identify and target additional educational seminars for members of the farming community, who had not fully understood how the VAT would impact their sector.

6. VAT Refund Controlling Procedures

The USAID team led the development of policies and procedures for processing and controlling VAT refund claims, as understandably the STA had no prior experience of making regular tax refunds to taxpayers. Business was quite skeptical that the STA would actually pay refunds on VAT payments.

It is not unusual to find that most of the VAT is collected at import and that little value is added on the territory. As one official succinctly put it, customs collects the VAT and the taxman 'gives it away.' Nonetheless, today, about four times as much VAT is collected in Customs as is collected on domestic transactions in Serbia, which is more than twice the normal international experience.

The STA implemented the project-designed refund and return reviewing procedures to ascertain the credibility of refund claims. From the receipt of the first VAT refund claim, the majority of genuine claims have been paid in a timely manner. In many countries, VAT refunds are paid only with considerable delay, if at all, which harms business as well as discourages taxpayer compliance.

As anticipated, it was not long before the STA was presented with fraudulent VAT refund claims and the project provided additional expert advice on how to detect and manage these types of cases.

7. Improved Audit

The introduction of the VAT necessitated changes to compliance strategies and audit procedures. The increased risks from a VAT are best countered by audits at taxpayers' premises and placing less reliance on desk audits. Many countries devote up to 20% of their VAT audit resources to making issue-oriented VAT refund audits. These are not designed to be full audits but rather a check on the accuracy of a particular VAT refund claim. Recognizing and identifying VAT fraud was a concern that was addressed by the project in coordination with the EU Customs and Fiscal Assistance Office (CAFAO). Numerous presentations on the types of fraud were made to both audit and investigation staff. A number of cases of large-scale VAT fraud have already been discovered, and coordination between the audit and investigation staff is becoming increasingly effective. As a result, there have been a number of successful prosecutions for VAT evasion.

With USAID project assistance, the STA now allocates audit resources to better effect. The STA has now implemented risk groups and risk ranking, and the foundations of a risk-based audit system have been laid.

III. FACTORS OF SUCCESS

1. *Political Leadership and Ownership*. The Government of Serbia recognized that VAT implementation was not progressing in a satisfactory manner. The STA required additional resources and specific expertise in implementing a VAT. Neighboring Macedonia had successfully introduced a VAT and had recently

reformed its payment system. This was exactly what Serbia envisioned, and the project was able to provide Mr. Nikola Gruevski (an ex-Minister of Finance who is currently the Prime Minister of Macedonia) as an advisor to the then Serbian Minister of Finance. Consequently, government at the highest level was involved in the reform, and experiences of others within the region in introducing the VAT were shared with Serbian counterparts.

2. *Adaptability.* It is common in transitional and developing countries to have an absence of core systems, infrastructure and capacity. Many countries use the introduction of VAT as a 'Trojan Horse' to introduce more modern tax administration procedures, though that course was not taken in Serbia. The political imperative was a speedy introduction of an EU-type VAT but without any significant additional resources. In order to ensure VAT implementation, all systems had to be designed to meet the environment at that time while providing some improvement to procedures.

3. *Planning*. While the STA had developed a preliminary project plan, it lacked any integration of milestones and a logical sequence of events. Helping the STA get its plan in shape was an important first step, and provided a window of opportunity for project advisors to help with planning and implementation. Keeping to the sequence of events meant that it was possible to have delivery of computer systems after implementation of the VAT on January 1, 2005. For example, the VAT refund control system was only needed after the second or subsequent tax returns were filed. All first VAT refund claims were, as a matter of policy, subject to audit.

4. *Practical, focused approach to implementation.* By limiting implementation to only 55 tax offices, rather than to all 170 offices, the tax administration was better able to manage the implementation of this complex new tax. This willingness to take a practical approach, rather than following rigid organizational rules, was essential to the successful first-year implementation.

5. *Simplicity*. The preparation of simple VAT registration forms and a particularly simple and easy to complete periodic VAT return were key success factors. This allowed the STA to prepare simple solutions for managing data and implementing centralized mailing. The introduction of quarterly (as opposed to monthly) filing for smaller taxpayers was a key factor in reducing both administrative costs and compliance costs for taxpayers. It also allowed vital time to process and verify the initial VAT refund claims from monthly filers before the quarterly filers filed their first claims after March 2005.

6. *Public education.* USAID financing of the media campaigns and publications was a critical success factor since the government had not provided any funding. The use of the media and informational materials to help taxpayers understand what was expected of them was a new and welcomed experience. Market

research, also funded by USAID, confirmed that the media campaigns had been a success.

7. *USAID flexibility*. As noted, the USAID tax assistance project did not originally contemplate providing assistance in VAT design, development or implementation. When it became apparent that the VAT implementation might not go off successfully and that other donor assistance was not going to provide the needed resources and assistance, USAID stepped into the breach and provided this assistance. By bridging the gaps in donor assistance, USAID was able to support a successful VAT introduction that could very easily have faltered otherwise.