Institute for Strategic Studies and Prognoses

Working paper series

Potential fiscal costs of the EU accession for Montenegro

Polish - Canadian Development Cooperation

Project supported by the Governments of Poland and Canada, through Polish-Canadian Development Cooperation Program, administered by the Education for Democracy Foundation

Working Paper:

Potential fiscal costs of the EU accession for Montenegro

Authors:

:

Malgorzata Markiewicz,
Center for Social and Economic Research (CASE)

Ivana Vojinović,
Institute for Strategic Studies and Prognoses (ISSP)

2006

Institute for Strategic Studies and Prognoses,
Podgorica

Library: Working papers

Editor of the libarary:
Prof. dr Veselin Vukotić

Editor of the issue:
dr Petar Ivanović

Techical layout:
Institute for Strategic Studies and Prognoses,
Podgorica

Cover design:
Nebojša Klačar

Printed by:
Institute for Strategic Studies and Prognoses,
Podgorica

Edition:
200 copies

Project supported by the Governments of Poland and Canada, through Polish-Canadian Development Cooperation Program, administered by the Education for Democracy Foundation

Abstract

The paper presents a fiscal estimate of Montenegro's perspective European Union (EU) membership. Although Montenegro's ultimate goal is EU membership, from this point in time it was hard to predict completely accurate financial consequences of the EU membership. Namely, it is likely that Montenegro will join the EU in the period falling out of the New financial perspective 2007-2013, meaning that there is no knowledge about financial rules that would be applied in its case. Consequently, estimations made in this paper are based on the financial rules applied for the EU-10 and Romania and Bulgaria. The basic speculative hypothesis of calculation is that Montenegro will join EU in 2007 and estimations covered period 2007-2009 in order to estimate its net budgetary position. The paper shows that Montenegro's fiscal position is expected to deteriorate by 1.8% of GDP on average in 2007-2009, if no expenditure restructuring of the fiscal framework is carried out. The expected deterioration of the public finances related to EU accession would be due to co-financing requirements, national contributions to the EU budget, and possible full pre-financing of the EU direct payments to Montenegrin farmers in the first year of accession. However, the above expenditures will be partly offset by the budgetary compensation allocated out of the EU budget, savings from agricultural subsidies and shifting of certain public expenditures to Cohesion Fund-supported projects.

***Key words**: EU membership, net budgetary position, EU budget, restructuring of public expenditures*

Table of contents

INTRODUCTION

The potential EU accession creates the chance to accelerate the process of the country modernization and provides all the privileges coming from the access to the common market. All the member states receive special funds allowing restructuring of their economies and stimulating faster catch-up with the most developed countries. However, besides privileges the accession brings also obligations and costs. Most of these costs have to be borne by the state budget, which in the short run may be reflected in deterioration of its balance. However, the member states are obliged to observe fiscal discipline within the frames described in the Treaty. Therefore, in order to keep the fiscal policy within the limits, these potential fiscal effects of the accession have to be identified in advance and if necessary, some adjustments have to be made.

In this paper we make an attempt to estimate the potential fiscal costs of the Montenegro accession to the EU. As Montenegro is not yet the potential accession country many assumptions have to be made. Additionally, the EU is permanently changing, so it is difficult to assume what will be the rules and financial package offered to Montenegro once it comes to the accession. As these calculations are based on many assumptions they are mainly indicative. The purpose was to present all the potential transmission channels of the EU accession to the budget and provide with some methodology of the calculations. Once more information is available this exercise can be repeated and more precise estimations will be provided.

Montenegro is in the process of negotiation of the Stabilization and Association Agreement, which is the first step towards the EU accession. In the first chapter we describe the SAA process in other Balkan countries and give some conclusions valid for Montenegro. We also comment on present enlargement capacity of the EU and its perception, which will strongly determine the accession of the new countries. The illustration of the current financial relations between Montenegro and the EU is provided in the chapter on pre-accession support. All these variables set up the general context of the EU accession for Montenegro in the end of 2006.

In chapter two all the potential factors of the EU accession influencing the budget are identified. The general categories are as follows: taxation, environmental investments, support for agriculture, state aid, public administration, co-financing and pre-financing, and membership fee. The last section concludes.

In order to provide some cross-country perspective the fiscal consequences are presented for the last wave of the EU enlargement (2004). For each category influencing fiscal position the general rules are presented and the current situation in Montenegro is analyzed in line with the availability of data. The membership fee is perceived to be the basic cost borne from the state budget. As the financing of the EU activities with the membership fees is complicated, the more detailed approach to this issue is developed. In the last section we conclude about potential range of fiscal costs for Montenegro.

I Current relations with the EU

A Stabilization and Association Process

The road towards the EU accession for Western Balkan countries was defined on Zagreb Summit in November 2000 as so called *Stabilization and Association Process (SAP)*. The summit underlined the connection between the progress in reforms and the prospects of possible accession to the EU. The SAP set the route to closer relationship with the EU based on incentives and obligations. One of the main components of SAP is Stabilization *and Association Agreement (SAA)* based on the gradual implementation of a free trade area and reforms designed to achieve the adoption of EU standards. SAA is an international Agreement between country and EU establishing legal framework for mutual collaboration and gradual approaching to the European standards. Before the country is offered such a contract there is a stage of careful preparation. Negotiations on SAA are a long process – it took over 3 years in case of Albania or over two years in case of Macedonia (Table 1). When signed it provides a formal mechanisms and agreed benchmarks for mutual cooperation. The SAA focus on respect for key democratic principles and the core elements of the EU single market. Effective implementation of the SAA is a prerequisite for any further assessment by the EU of the country's prospects of accession. The SAA has to be ratified and concluded by the Member States and the European Communities, meaning that it is not effective from the day it is signed. This process took around 3 years in case of Macedonia and Croatia.

Table 1: EU accession process in the Balkan countries

1.1 Country	1.2 Description
1.3 Albania	1.4 Negotiations on SAA started on January 2003. SAA was singed on 12 June 2006.
1.5 Bosnia and Herzegovina	1.6 A Feasibility study on opening SAA negotiations was adopted by Commission on November 2003. The SAA negotiations were officially opened in November 2005. SAA not signed yet.
1.7 Croatia	1.8 SAA signed on 29 October 2001 and entered into force on 1 February 2005. Application for accession to the EU presented on 20 February 2003. Accession negotiations opened in October 2005.
1.9 Macedonia	1.10 SAA was signed on 9 April 2001 after more than two years of negotiations and entered into force on 1 April 2004. Application for membership submitted on 22 March 2004 and in December 2005 the EU Council granted candidate status.
1.11 Serbia and Montenegro	1.12 The Commission started work on Feasibility Study on opening negotiations with Serbia and Montenegro during the autumn of 2003. SAA negotiations were officially opened on 10 October 2005. • For Serbia SAA negotiations are suspended due to not meeting commitments on cooperation with the ICRY. • In November 2006 Montenegro started negotiations with European Commission as an independent state

Source: EC documents

B Stabilization and Association Agreement with Montenegro

The SAA negotiations with Serbia and Montenegro started in October 2005. On 25 April 2006 the EU Council has positively approved Feasibility study for Montenegro adopted by the European Commission on 12 April. In the meantime Montenegro achieved independence in June 2006 after a referendum held on 21 May 2006. Following independence the EC established relations with Montenegro as sovereign and independent state. Then, Montenegro has begun negotiations on a separate SAA under new directives which were rapidly agreed with the Council. These negotiations were launched on 26 September 2006. It is assumed that these negotiations will build upon results achieved in the framework of negotiations with the former State Union (EC, 2006a). The EC identifies as a key challenge the upgrade of administrative capacity to implement the provisions of the agreement. Determination of the Montenegro government may accelerate the negotiation process on SAA and allow signing the agreement in the shorter perspective than it was in the case of Albania or Macedonia. The accumulated negotiating experience on behalf of Serbia and Montenegro may be applied in further negotiations. Based on other countries experience it will probably last 1-2 years and then about 3 years are needed for ratification of SAA. The country may submit the application for membership to the Council even when the process of SAA ratification has not concluded. The Commission assesses the applicant's ability to meet the conditions of membership and formulates the opinion for the Council on potential negotiations opening.

By signing the Stabilization and Association Agreement, Montenegro will institutionalise its relationship with the EU. In the preamble of the signed Agreement, status of the potential candidate for Montenegro will be confirmed, probably without setting in advance any date of accession to the EU. According to the members of the Montenegrin team Agreement will be signed at the beginning of the 2007.

C Enlargement capacity of the EU

Montenegro can increase its efforts to negotiate, sign and fulfil the SAA. However, the accession will be determined by the political climate within the EU. The propensity to enlarge has limited along with the positions of the biggest member states such as Germany and France. On the Conference organized by Bertelsmann Foundation in September 2006 in Berlin, the German Chancellor Angela Merkel stated that does not see any further EU enlargement prospects after the accession of Bulgaria and Romania. This statement is even more important considering the German presidency in the EU Council in the first half of 2007.

Then, France has changed its constitution to ensure that French voters will have a say on future enlargements in a referendum. Moreover, Austria has noticed that it will hold a referendum on Turkish membership, when the time comes (BBC, 2006). On the occasion of recommendation for the accession of Bulgaria and Romania the EC President Jose Barroso made a statement the further enlargement should be preceded by institutional changes to improve the decision-making of an enlarged EU. In his opinion the EU has to decide first on the future of Constitutional Treaty and then to think about further enlargement. The same conclusion is provided in the last EC report on enlargement strategy (EC, 2006b): *A new institutional settlement should have been reached by the time the next new member is likely to be ready to join the Union*. The argument is following: *the Nice Treaty does not provide for adaptations to the composition and functioning of the other institutions for a Union of more than 27 Member States*.

Given the lack of enthusiasm for enlargement among old Member States, institutional obstacles and France constitution changes, accession of Montenegro will be more difficult than previous phases of enlargement.

D Pre-accession funds

1. CARDS

In 2001-2006 Montenegro was recipient of the CARDS financial assistance via European Agency for Reconstruction. CARDS program is an instrument aimed at providing technical-financial assistance in the processes of stabilization and association in the Western Balkan countries[1]. The following table summarizes breakdown of CARDS financial inflows in Montenegro by years.

Table 2. Overview of the CARDS assistance in period 2001-2005 (millions euros)

	2001	2002	2003	2004	2005	Total
REFORM OF PUBLIC ADMINISTRATION AND INSTITUTIONAL DEVELOPMENT						
1. Reform of public administration	1.2	2.0	3.0	7.0	6.5	19.7
2. Local self-government	4.5			2.0		6.5
ECONOMIC RECONSTRUCTION, REGENERATION AND REFORM						
1. Energy		2.6	2.0		1.5	6.1
2. Transport and infrastructure	9.0	2.2		2.5	4.0	17.7
3. Environmental protection		1.7	4.0		3.0	8.7
4. Economic development-rural economy			1.5		1.8	3.3
5. Economic development		3.0		2.0	4.0	9.0
SOCIAL DEVELOPMENT AND CIVIL SOCIETY						
1. Education	1.0			2.0		3.0
2. Civil society and media			1.0			1.0
3. Other			0.5	1.0	1.0	2.5
Internally displaced persons	0.6				0.7	1.3
Customs and taxation		1.0	1.0	1.0		3.0
High education		0.5	0.5	0.5		1.5
Total	**16.3**	**13.0**	**13.5**	**18.0**	**22.5**	**83.3**

Source: EAR

Financial assistance provided by the EU in the recent period had positive result. The most important projects done via EU assistance are the following: reform of the public administration (ongoing), assistance to the state bodies in the purchase of the modern information technologies, infrastructure (roads, bridges), reform of the energy sector, environmental protection, training programs for employees within the judicial system, customs, police etc.

Multi-annual indicative program for the period 2005-2006 adopted at the end of 2004 envisages that Montenegro will get support in the amount of €43.5 million.

[1] It was established by EC Regulation no.2666/2000

Table 2. Overview of plan of CARDS financial assistance to Montenegro in 2006 (million €)

AREAS	2006
1. Democratic Stabilization	**3**
1.1. Minorities rights and return of refugees	2
1.2. Civil society	1
2. Good Governance and Institution Building	**5**
2.1 Public Administration Reform	3.5
2.2. Integrated management of the border	1.5
3. Economic and Social Development	**9.5**
3.1 Investment Climate – Enterprise Development	2.5
3.2 Trade	2.5
3.3 Environment	3
3.4 Employment - Labour Market	1.5
4. GTAF (General Technical Assistance Facility) and Programme Reserve	**1.0**
TOTAL	**18.5**

Source: EAR, www.europa.eu

2. IPA

New Financial Perspective for period 2007-2013 envisages new pre-accession instrument – IPA (Instrument for Pre-accession) that will replace the current ones (PHARE, ISPA, SAPARD) and CARDS. Montenegro, falling within the category of the potential candidate, may use funds from IPA only for the following two areas: *institutional building* and *provision of assistance in transition and regional and over-see cooperation*. Total amount available under IPA is at the level of €11.47 mlrd. The following table shows IPA financial assistance over the period 2007-2009 to non-member countries, according to the multi-annual indicative financial framework (MIFF) for IPA[2].

Table 3. Pre-Accession assistance 2007-2009 under Multi-annual Institutional Financial Framework

Pre-acc. Assistance envelopes, (€ mill)	2007	2008	2009	2007-2009
Croatia	138.5	146.0	151.2	435.7
Former Yugoslav Rep. of Macedonia	58.5	70.2	81.8	210.5
Turkey	497.2	538.7	566.4	1602.3
Albania	61.0	70.7	81.2	212.9
Bosnia and Herzegovina	62.1	74.8	89.1	226
Montenegro	31.4	32.6	33.3	97.3
Serbia	186.7	190.9	194.8	572.4
Kosovo	63.3	64.7	66.1	194.1
TOTAL	1098.7	1188.6	1263.9	3551.2

Source: http://europa.eu/enlargement

Comparing to the financial pre-accession assistance Montenegro was receiving in recently, IPA will bring more funds. However, in order to be fully utilized, Montenegro needs to have high level of absorption capacity (macroeconomic, financial and administrative/institutional[3]).

[2] The multi-annual indicative financial framework (MIFF) for the Instrument of Pre-Accession Assistance (IPA) is designed to provide information on the Commission's intentions in terms of indicative financial allocations by IPA beneficiary and component. It takes the form of a financial table covering a 3 year period, which is elaborated on the basis of allocation criteria including the beneficiaries' needs, absorption capacity, management capacity and respect of the conditions, namely the Copenhagen criteria. The MIFF therefore acts as the link between the political framework within the enlargement package and the budgetary process.

[3] *Macro-economic absorption capacity* is being defined and measured in relation to GDP. *Financial absorption capacity* can be defined as the ability of the country to co-finance EU supported programs and projects, to plan

II Fiscal consequences of the EU accession

A Fiscal consequences based on 2004 enlargement

The EU enlargement has not only economic but also political effects strengthening democratic institutions and rule of law in the new Member States (MS). Economic consequences are related to the joining the common market and they have to result in decreasing transaction costs of trade, industrial cooperation and new business opportunities. These effects are reinforced by the inflow of structural funds, new wave of FDIs, better infrastructure and environmental standards. With the previous wave of EU accession in May 2004 it was quite clear for negotiating parties that although the net inflows of the EU funds for the countries will be positive the fiscal consequences may be ambiguous. Although new MS get huge amount of transfers, not all of them are recorded in the government accounts. Some funds go directly to private beneficiaries (e.g. farmers, enterprises, NGOs).

From the very beginning these countries were obliged to pay *membership fee* (state budget expenditure). This membership fee was paid in monthly instalments at the beginning of each month. Additional fiscal burden was posed by participation in the various institutions connected with the EU: the European Central Bank, European Investment Bank, European Development Fund and Coal and Steel Research Fund among others.

New Member States received EU budget funds in the framework of structural and cohesion fund, the Common Agricultural Policy. Majority of these transfers has a conditional character, meaning they require national *co-financing*. Such project related transfers include: structural and cohesion funds, funds for rural development and pre-accession assistance. The remaining, non-project related transfers (i.e. direct payments to farmers, export subsidies and intervention purchases) did not require co-financing, although most had to be *pre-financed* by the national budget (affecting thus fiscal position in a given year), similarly to the project related transfers. The need to pay membership fee, pre-finance and co-finance budget expenditures could pose financial problems to the budget due to a time lag between the membership fee paid up-front to the EU budget and incoming transfers (ex-post reimbursement of incurred expenses). In order to mitigate these difficulties the compensation instruments were introduced. To ensure that even on a cash flow basis the new MS remain in a net beneficiary position all of the new MS received additional cash flow lump sum payments and some of them received temporary budgetary compensation (namely Cyprus, Malta, Czech Republic and Slovenia). Hence, the new Member States received so-called Schengen facility to implement Schengen agreement.

However, despite these compensation instruments the ex-ante calculation indicated that some countries may experience deterioration of their budgets due to EU accession. For the sample of eight new MS (without Malta and Cyprus) joining the EU in 2004 the positive net fiscal effects of accession were expected in five countries. For Czech Republic, Hungary and Slovenia fiscal effects were negative despite relatively high budgetary compensations in the Czech Republic and Slovenia (Table 4).

---

and guarantee these national contributions in multi-annual budgets, and to collect these contributions from several partners interested in a program or project. *Administrative absorption* can be defined as the ability and skill of central and local authorities to prepare suitable plans, programs and projects in due time, to decide on programs and projects, to arrange the co-ordination among principal partners, to cope with the administrative and reporting requirements, and to finance and supervise implementation properly, avoiding irregularities as far as possible.

Table 4. Net fiscal effects of EU transfers in 2004-2006 (% of GDP), annual average (ex-ante projections)

	CZ	EE	HU	PL	SL	LT	LV	SK
Net fiscal effects of EU transfer flows (1+2+3+4+5+6)	-0.13	1.02	-0.06	0.45	-0.04	1.58	1.75	0.33
Membership contribution (1)	-1.12	-1.05	-1.06	-1.12	-1.04	-1.06	-1.04	-1.14
Budgetary compensation (2)	0.33	0.1	0.1	0.25	0.31	0.1	0.1	0.1
Structural Funds transfers (3)	0.33	0.79	0.44	0.67	0.16	0.87	1.06	0.65
Cohesion Fund transfers (4)	0.08	0.28	0.10	0.15	0.05	0.26	0.41	0.14
'Internal actions' and additional expenditures (5)	0.11	0.47	0.18	0.2	0.24	0.78	0.48	0.27
Rural development under the CAP (6)	0.15	0.42	0.17	0.3	0.23	0.63	0.74	0.3

Source: EFN Spring Report

For fiscal consequences of the EU accession some effects distributed over time have to be considered. Some fiscal costs could be covered before the accession (i.e. implementation of the *acquis communautaire*, others could be delayed with negotiated transitional periods applied. This possibility refers mainly to taxation and adoption of environmental standards. All of these issues are discussed below in detail.

The fiscal cost of compliance with the *acquis* is especially heavy in the areas of environmental protection (in particular rehabilitation of polluted industrial areas, water and air treatment and waste management) and transport infrastructure (road construction, and upgrading of railroads). It is estimated that the additional budget expenditures for infrastructure and environment protection may require up to 1.5% of GDP annually (Antczak et. al., 2006). The net fiscal effect of accession related expenditures is stronger than the net fiscal effect of EU transfers presented in Table 4 and negative for all NMS. It ranges from -1.3% GDP in Poland and Slovenia to -2% of GDP in Baltic countries and -2.6% of GDP in the Czech Republic (Table 5).

Table 5. Total net fiscal effects of accession in NMS-8, 2004-2006 (% of GDP), annual average

	CZ	EE	HU	PL	SL	LT	LV	SK	EU8
Net fiscal effects of EU transfer flows (1)	-0.1	1.0	-0.1	0.5	-0.0	1.6	1.8	0.3	0.6
Accession related expenditure (2)	-2.5	-1.7	-1.5	-1.3	-1.3	-2.0	-2.0	-2.3	-1.9
Infrastructure expenditures	-1.5	-1.5	-1.5	-1.5	-1.0	-1.5	-1.5	-1.5	-1.4
Reform of public administration	-1.5	-1.5	-1.0	-1.5	-1.0	-1.5	-1.5	-1.5	-1.4
Phasing out of production subsidies	1.0	0.3	1.5	2.0	1.0	0.3	0.3	1.0	0.9
Realignment of custom duties	-0.5	0.3	-0.5	-0.5	-0.5	0.3	0.3	-0.3	-0,2
Tax harmonisation	0.0	0.7	0.0	0.3	0.3	0.5	0.5	0.0	0.3
Total net fiscal effects of accession (1+2)	-2.6	-0.7	-1.6	-0.8	-1.3	-0.4	-0.3	-2.0	-1.2

Source: EFN Spring Report

B Taxation

Taxation issues in the EU are regulated to the limited extent and all the acceding countries of 2004 enlargement negotiated some transition periods in application of common rules. Thus, first we describe taxation principles indicating these areas where adjustment is necessary and then we present what exceptions were applied for selected countries. Finally, we provide estimations for Montenegro.

In general, the necessity of tax coordination can be distributed over time and increase revenues to the budget in the medium term. In case of 2004 enlargement the average additional budget revenues reached 0.7% of GDP in Estonia and from zero to 0.5% of GDP in other countries (Table 5) mainly from the broadening of the VAT base, higher excise duties and eco-taxes. The size of this effect depends on the tax law harmonization before the accession. However, there are also negative effects of accession in respect to VAT collection observed in the first year of membership due to one-off liquidity shortfall in collecting VAT from EU imports. According to the IMF this effect ranged from 0.3% of GDP in Slovenia to 0.5% of GDP in Estonia (Antczak, 2006).

1. Taxation principles in the EU

Tax policy remains the competence of the individual countries as long as it is consistent with the single market and free movement of capital. The Treaty Establishing the EC assumes that tax harmonization may refer only to indirect taxation, which is necessary when neutrality of consumption taxes is concerned. For this reason the Community adopted VAT and set general rules including the minimum rates (standard rate not lower than 15%, reduced - not lower than 5%).

Hence, a common system of excise duties applies for manufactured tobacco, alcoholic beverages and mineral oils with common minimum rates applied since 1992 (Table 6). These minimum excise rates are regularly updated and are usually expressed in an amount per unit of product, although sometimes a percentage of the value is used instead.

Table 6. Minimum excise tax rates on harmonized products in the EU (as of December 2006)

Product	Rules on minimum rates
Tobacco products	• an overall minimum excise duty of 57% of the retail price for cigarettes of the price category most in demand; • for a minimum amount of excise duty of 64 Euro (as of 1 July 2006) per 1000 cigarettes of the price category most in demand • for fine-cut smoking tobacco intended for the rolling of cigarettes, 36% of the retail selling price inclusive of all taxes or 32 Euro per kilogram; • for cigars and cigarillos, 5% of the retail selling price inclusive of all taxes or 11 Euro per 100 items or per kilogram; • for other smoking tobaccos 20% of the retail selling price inclusive of all taxes, or 20 Euro per kilogram
Alcoholic products	• For alcohol (spirits), 550€ per hectolitre of pure alcohol • For intermediate products, 45€ per hectolitre of product. • For wine and sparkling wine, zero rate. • For beer, 0.748 € per hectolitre per degree Plato, or 1.87€ per hectolitre per degree alcohol, of finished product.
Mineral oils	• Petrol: 421 Euro per 1000 litres (leaded petrol) or 359 Euro per 1000 litres (unleaded petrol) • Gas oil: 302 Euro per 1000 litres (propellant), 21 Euro per 1000 litres (industrial/commercial use), 21 Euro per 1000 litres (heating – business and non business use) • Kerosene: 302 Euro per 1000 litres (propellant), 21 Euro per 1000 litres (industrial/commercial use), 0 Euro per 1000 litres (heating – business and non business use) • Heavy fuel oil: 15 Euro per 1000 kg (heating business and non business use) • LPG: 125 Euro per 1000 kg (propellant), 41 Euro per 1000 kg (industrial/commercial use), 0 Euro per 1000 kg (heating – business and non business use) • Natural gas: 2,6 Euro per GJ (propellant), 0,3 Euro per GJ

	(industrial/commercial use), 0,15 Euro per GJ (heating business use) and 0,3 Euro per GJ (heating non-business use) • Coal and coke: 0,15 Euro per GJ (heating business use) and 0,3 Euro per GJ (heating non-business use) • Electricity: 0.5 Euro per MWh (business use) and 1 Euro per MWh (non-business use)

Source: European Commission

Member States can levy other taxes on these products (i.e. road taxes) provided they do not constitute either a turnover tax or a barrier to trade.

The EU established generalized arrangement for the taxation of energy products and electricity extending the system of minimum rates applied for mineral oils to coal, natural gas and electricity. The aim is to reduce distortions of competition between mineral oils and other energy products. Then, in the interests of protecting the environment, the authorities of the MS have the right to grant tax advantages to businesses that take specific measures to reduce emissions.

With progress in globalisation allowing for capital flights, the companies and individuals take advantage of lower taxes, which leads to tax competition between member states. Some coordination in direct taxation could be beneficial; however, the EC Treaty requires unanimity for any change in the field of taxation. Attempts to harmonize direct taxation failed so far, therefore some smaller steps have been taken to facilitate cross-border cooperation between companies. Three corporate tax directives have been adopted:

- *The Mergers Directive* which removes tax disadvantages of cross border corporate restructuring operations;
- *The Parent/Subsidiary Directive* abolishes double taxation of profits distributed in the form of dividends by a subsidiary in one MS to a parent company in another;
- *The Interest and Royalties Directive* which abolishes withholding taxation of interest and royalty payments between associated companies of different MS.

The European Economic and Social Committee defined the term of *fiscal competition* as general policy of the given country providing good investment climate. These actions are opposite to so-called harmful competition, when the system of exemptions and privileges is applied to attract investments. The relatively lower tax could be treated as equivalent of subsidies and this is regulated by public aid policy. Social securities comprise the largest compulsory levy, but there are no plans to harmonize legislation in this area.

Income from interest on savings is one of the most mobile tax bases. The EU government may lose revenues if their residents do not declare interest accrued abroad. Since 1 July 2005 the EU governments have been exchanging information on non-residents savings. Austria, Belgium, and Luxemburg are for the time being applying a withholding tax instead and transfer a large part of these revenues to the investors' home country. Lastly, the Directive does not preclude MS from levying other types of withholding tax than that referred to above in accordance with their national laws or double-taxation conventions. Taxation of dividends paid to companies is largely governed by the Parent/Subsidiary directive. As for taxation of dividends paid to individual portfolio investors the Commission has concluded that higher taxes cannot be levied on inbound dividends than on domestic dividends or on dividends paid to non-residents than on those paid to residents. This rule is not based on any specific directive but on European Court of Justice' decision which ruled that a measure providing for different tax treatment of domestic and inbound dividends was clearly incompatible with the

EC Treaty. It is possible to provide for methods of tax relief that are compatible with the EC Treaty while maintaining possibilities to tax dividends in a relatively straightforward way.

Montenegro applying for EU membership is required to take over the whole body of EU law (acquis) and to refrain in the run up to membership from introducing any measures which conflict with that law. Adopting the EU law the country must take care that any new tax measure is compatible with EC rules. This is one of the priorities for the 'partnership' arrangements. On the road to the EU accession Montenegro will have to adjust its tax regulation, however, the speed of this adjustment is in the competence of the authorities. Then, some transitional period may be negotiated as it was the case during the last round of EU enlargement. We will shed some light on these exemptions.

2. The pace of tax system adjustments

All the new EU member states negotiated transition periods for applying the EU tax rules. The common exemptions refer to increase in excise tax for cigarettes and for limit of turnover exempted from VAT. Each country negotiated them individually thus the granted exemption differs in time (Table 7).

Following EU accession, the new MS have adopted significant changes to their withholding tax regimes in order to comply with EU directives. Most of the new MS countries have complied immediately with these directives, although some of them have negotiated a transition period. The least controversial is the merger directive for which no transition period was applied. For two other different transition periods apply.

Adjustments to EU directives were used by some countries to introduce changes in the corporate tax law. In some cases taxation of dividends was increased in order to apply the same rate as for taxation of profits (Poland, Lithuania, Slovenia), while in others withholding taxes on dividends were cancelled altogether (e.g. the Czech Republic).

Table 7. Transitional periods applied for adjustment in tax systems to acquis granted to new EU MS

COUNTRY	EXEMPTION
	Possibility to keep VAT tax exemption for international passenger transport
Cyprus	Zero VAT rate on foodstuffs, pharmaceuticals, and construction land – end 2007 Preferential VAT rate on restaurant services – end 2007 Excise tax exemption for fuels used in cement production, for fuels used in local personal transport, – 30 April 2005 Application of simplified procedures for VAT (accounting of cash and transactions between related companies) – 30 April 2005 Possibility to exempt from VAT turnover lower than 15.600 Euro
Czech R.	Excise tax on cigarettes – end 2007 Preferential VAT rate for thermal energy and construction services – end 2007 Lower excise tax for ethyl alcohol produced by small distilleries Possibility to exempt from VAT turnover lower than 35.000 Euro
Estonia	Excise tax on cigarettes – end 2009 5% VAT rate for heating - 30 June 2007 CIT exemption of undistributed profits - end 2008 Possibility to exempt from VAT turnover lower than 16.000 Euro
Hungary	Excise tax on cigarettes -end 2008 Preferential VAT rate on coal sale and other fuels used for heating of apartments and heating services - end 2007 Preferential VAT rate on restaurant services - end 2007 Lower VAT rate on delivery of natural gas and electric power– 30 April 2005 Lower excise tax for ethyl alcohol produced by small distilleries

	Possibility to exempt from VAT turnover lower than 35.000 Euro
Latvia	Excise tax on cigarettes – end 2009 VAT exemption for heating services for individuals – end 2004 Simplified VAT collection procedures related to wood transactions – 30 April 2005 VAT exemption of services provided by authors, artists and performers Possibility to exempt from VAT turnover lower than 17.200 Euro
Lithuania	Excise tax on cigarettes – end 2009 Possibility to exempt from VAT turnover lower than 29.000 Euro
Malta	Zero VAT rate on foodstuffs and pharmaceuticals – 1 January 2010 Possibility to exempt from VAT turnover lower than 14.600 Euro or 37.000 Euro
Poland	Excise tax on cigarettes – end 2008 Lower excise for ecological fuels – 30 April 2005 Zero VAT rate on books and special periodicals – end 2007 Preferential VAT rate for restaurant services – end 2007 Preferential VAT rate for sale of new apartments, construction and reconstruction services – end 2007 Preferential VAT rate on foodstuffs – 30 April 2008 Possibility to exempt from VAT turnover lower than 10.000 Euro
Slovakia	Excise tax on cigarettes – end 2008 Preferential VAT rate for thermal energy and construction services – end 2007 Lower VAT rate on natural gas delivery and electric energy – 30 April 2005 Lower excise tax for ethyl alcohol produced by small distilleries Possibility to exempt from VAT turnover lower than 35.000 Euro
Slovenia	Excise tax on cigarettes – end 2007 Preferential VAT rate on restaurant and construction services – end 2007 Possibility to exempt from VAT turnover lower than 25.000 Euro

Source: UKIE

3. Tax changes necessary for Montenegro and their fiscal effect

Current tax rates in Montenegro are among the lowest in Europe, providing thus an attractive fiscal environment both for domestic and foreign capital. In the area of indirect taxation it is mainly aligned with those of EU (table 8).

Table 8. Taxation in Montenegro

Tax category	Tax rate
VAT	Standard: 17% Reduced: 7%
Excises	detailed breakdown by product categories shown in the table 9
Customs	average rate: 6%*
Personal Income Tax	15%
Corporate Income Tax	9%

*except for countries with which Montenegro has signed Free Trade Agreements
Source: Ministry of Finance of Montenegro

One of the accession effects is connected with removal of custom duties on imports from EU countries. The size of this effect depends on country tariff rates prior to accession.

The key regulation in the EU on consumption taxation is the Sixth Directive. The provisions of the Sixth Directive are contained in the Montenegrin taxation law for VAT in terms of legal standards shaped according to the European model. As concerns types of taxpayer, base and rates, the Montenegrin VAT Act is to a very high degree harmonized with the Sixth Directive. Dealing with the tax rate, the Sixth Directive prescribes three levels: the standard rate, which may not be lower than 15%, one or two reduced rates for goods specially stated in Annex H of the Directive, which may not be lower than 5%, and the zero rate. Although unweighted average VAT rate for EU-15 of 19.47% was greater than standard rate in Montenegro, VAT rates in Montenegro are within the above mentioned EU thresholds, meaning that in this field no rates changes will be necessary.

Table 9. Excise taxes in Montenegro

Excise product		Excises			
Alcoholic beverages	beer[4]	€1.9			
	still wine	€0			
	sparkling wine	€35			
	other fermented beverages	€40			
	intermediate alcoholic beverages	€70			
	ethyl alcohol	€550			
Tobacco products	cigarettes (domestic and imported)	(€1.00 €/kg, which is 0.02 €/pack) and a proportional excise amounting to 26% of the retail price (including excise and VAT).			
	cigars and cigarillos	€10.00 per kg			
	fine cut smoking tobacco (for rolling of cigarettes)	€20.00 per kg			
	other smoking tobacco	€15.00 per kg			
Energy products	Petrol and other light oils	€0.120/kg of air craft fuel	€0.120/kg of fuels for ramjets of petrol type	€0.364/lit of motor unleaded petrol	€0.364/lit of other motor petrol
	Kerosene	€0.120/kg of petroleum (kerosene) for motors	€0.120/kg of fuel for ramjets of petroleum type	€0.120/kg of other kerosene	€0.069/kg of fuels for ramjets of petroleum type
	Gas oils	€0.270/lit of diesel fuel	€0.120/lit of diesel fuel used as heating fuel	€0.270/lit of fuels for ships and other fuel	€0.120/lit of other oils
	Heating oils	€0.023/kg of low-sulphur oil for metallurgy	€0.023/kg of other heating oils		
	Crude oil gases and other gas carbon-hydrogen	€0.069/kg of mixture of propane and butane	€0.069/kg of other crude oil gases		

Source: Excise Law

Montenegro has established a system of excise taxation that by its concept is equivalent to the European. With respect to the taxation of alcoholic beverages, it is fully harmonized with EU rates. On the other hand taxation of tobacco and energy product is still non-aligned with the EU[5]. Montenegrin excises on tobacco products are harmonized with the EU with respect to

[4] Excise duty amounts to € 1.90 per volume of alcoholic strength per hectolitre of beer and it is applied on each category of beer whose strength of alcohol exceeds 0.5% vol.

[5] Besides the existence of the rates lower than the EU minimum, the categorization of products (alcohol and mineral oils) is not fully harmonized as well.

types of products that are taxed. However, the amount of excise on cigarettes expressed as a percentage of the retail price for the standard group of cigarettes comes to 26%, so less than the prescribed minimum excise according to the '57% rule'. The taxation procedure is harmonized with EU procedures. Until delivery, the products are kept in bonded warehouses and after the payment of excise are marked with the control stamps, and are then delivered to the market. Exported products (with the existence of a formal export procedure) are not excise taxed because this will be calculated and charged in the importing country. The problem of illegal sales, contraband in tobacco products and tax evasion that is a concern to EU countries exists in Montenegro too, leading to the loss of a large part of budgetary revenue. In order to gradually adjust the excise amount on tobacco with the lowest amount in the EU, the Government is authorized to increase, by law, the determined excise duty up to 20% annually. That means that it will take about four years before reach the full EU level of excises on tobacco.

In the area of the taxation of mineral oils there is the least degree of harmonization, and this cannot be expected to be settled in the very near future. Hence, it is realistic to assume that Montenegro will follow the same path as EU-10 (especially in terms of granted transition periods). Thus, Montenegro should expect higher revenues from excises in future as a result of upward harmonization with EU. Additionally, Montenegro will be obliged to obey rules prescribed within Energy Products Directive[6]. The basic intention of this Directive was that the taxation of all energy products (including the taxation of electricity) should lead to the implementation of the EU ecological policy, which emphasized the need to stabilize the emission of gases (CO2, methane). For the moment, Montenegro is lacking that kind of policies, meaning that in future its adoption will lead to the generation of new revenues in the national budget.

C Environmental investments

Acceding the EU Montenegro will have to adopt the environmental standards in line with the *acquis*. In order to implement these standards huge investments have to be made. The considerable expenditure burden (especially in the water and waste management sector) will be laid on general government finances. For now, estimations of potential costs for Montenegro are not available.

D Support for agriculture

The launching of EU support for agriculture should reduce or eliminate some existing agriculture subsidies. The overall fiscal effect is determined by the share of the agricultural sector in each country. Only the part of CAP, namely the transfers related to rural development programs are channelled through the public finances. Direct payments for farmers are only pre-financed from the budget.

The CAP probably will change its form after 2013 as a result of the on-going reforms. On the Brussels summit in October 2002 the agreement was made on slight reform of the CAP. It was decided that till 2013 the amounts for market interventions and direct payments will be frozen. Then, in June 2003 the next agreement was made on 10% cuts in subsidies for all agriculture entities but small ones in all 15 EU countries. As a result of all these measures the share of expenditures on CAP in the EU budget till 2013 will decrease almost by ¼. It is

[6] Directive no. COM/97/30 adopted by the European Parliament in 1999 (A4-0171/1999)

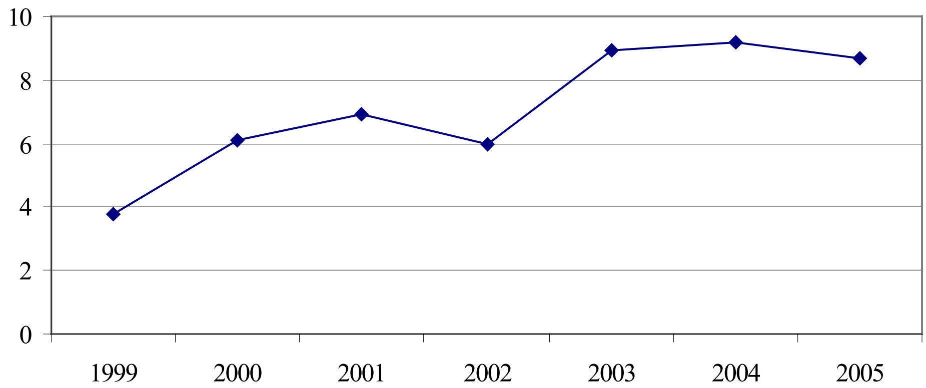
planned that in 2008-2009 the Community will review the general financing rules including support for agriculture.

In case of 2004 enlargement the new MS were included in the CAP but on special conditions. Apart from funds granted from the EU budget, the local governments got the right to top-up payments to framers from two sources: reallocation of rural development funds and domestic budget. From the EU budget the farmers receive 25%, 30% and 35% of the EU15 payments in 2004-2006, and only in 2013 will reach 100% of EU15 level. These amounts may be complemented by the MS governments up to 55%, 60% and 65% for the same period. Besides, up to 40% of top-ups in this three-year period may be financed by rural development allocations. For Bulgaria and Romania the EC will follow the same rules as for the 10 new MS. These countries will begin to receive 25% of the direct payments level applicable to the EU15 in 2007 and this amount will be increasing annually.

1. Support for agriculture in Montenegro

Since 1999 Montenegro received about €17 million for agriculture. This kind of support is provided to Montenegrin farmers from the national budget. Until 2002, the main part of the so-called *agro-budget* was spent on direct payments (premiums for milk, regress in plant production and cattle breeding), while in recent years number of more general programs have been developed.

Graph 1. Agricultural support paid from national budget in period 1999-2005



Source: Ministry of Agriculture, Forestry and Water Management

Overall support to farmers for Montenegro according to the OECD methodology (the share of market measures and budget support in overall revenues of farmers) amounts to more than 25%. Based on this Montenegro falls in the group of countries with medium/high support to agriculture. However, more than 95% of that support stems from the higher level of prices in comparison with the world prices. However, Montenegrin support to agriculture is at the level of €12 per citizen which is low in comparison with EU-25 (€130 per citizen). Additionally, support in new member states upon accession ranged from €20 (Poland) to more than €80 (Slovenia). Finally, Montenegro does not have nor administrative capacities neither developed mechanisms to deal with some of the EU schemes. Based on these, we assume that the Montenegro government will decide to subsidize agriculture topping up the EU funds. However, the administrative capacity has to be built in order to join the EU system of agriculture transfers. This may be costly.

E State aid

Starting with the Lisbon agenda in 2000 which launched the process of reducing the general level of state aid and shifting the emphasis from supporting individual companies or sectors towards tackling horizontal objectives of Community interest, the Council has adopted a series of conclusions on State aid. In 2001, at the Stockholm European Council, member states committed themselves *to demonstrate a downward trend in State aid in relation to GDP by 2003, taking into account the need to redirect aid toward horizontal objectives of common interest, including cohesion objectives.* The latest European Council held on 22-23 March 2005 reiterated its call to Member States *to continue working towards a reduction in the general level of State aid, while making allowance for any market failures*. While a slight decline in the level of aid in relation to GDP can be observed in the majority of Member States, the underlying trend since the launch of the Lisbon agenda is more stable than downward[7]. Bearing in mind these requirements Montenegro is trying to tackle this issue and to bring the level of state aid in relation to EU standards.

1. State aid in Montenegro

In Montenegro monitoring team for tracking and control of state aid was created for the first time in 2005 with the purpose to prepare a report on the *On inventory of state aid in the Republic of Montenegro*. Report comprised of the state aid data for 2003 and 2004 provided from the state budget. The following table summarizes it according to the types (horizontal, sectoral, regional and state aid at the level of local government and customs and tax exemptions).

Table 10. Inventory of state aid in Montenegro

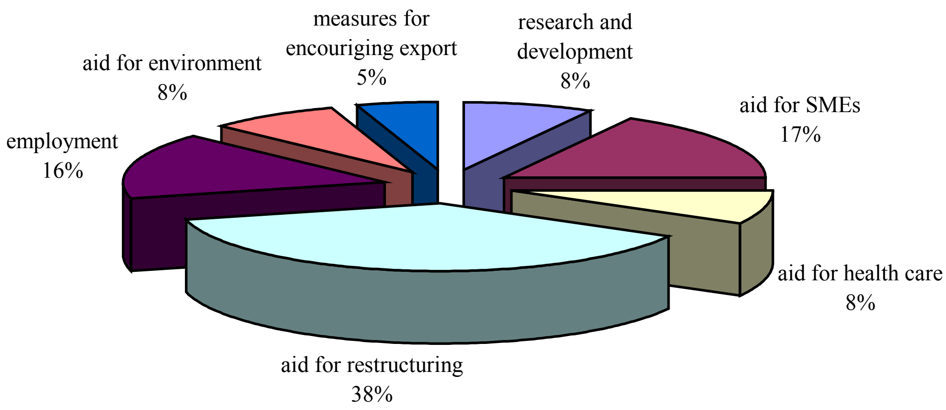
INVENTORY OF STATE AID IN MONTENEGRO				
million €				
Aid type	2003		2004	
	amount	% of total aid	amount	% of total aid
Horizontal state aid	9.22	18.7	7.14	17.6
Sectoral aid	19.70	40.0	16.05	39.6
Regional and state aid at the level of local government	9.61	19.5	1.18	2.9
Customs and tax exemptions	10.75	21.8	16.15	39.9
TOTAL	49.27	100	40.53	100
PARTICIPATION IN GDP	3.4		2.6	

Source: Report On inventory of state aid in the Republic of Montenegro, Republic of Montenegro Ministry of Finance, Monitoring team for tracking and control of state aid, July 2005

<u>Horizontal state aid:</u> According to methodology provided by the European Union, horizontal state aid is intended to all economic subjects participating in the market. Its effects are less selective than sectoral state aid. The following graph shows structure of the horizontal state aid in Montenegro in 2004.

[7] Source: State Aid Scoreboard - spring 2005 - (presented by the Commission) Brussels, 20.04.2005 COM(2005) 147 final

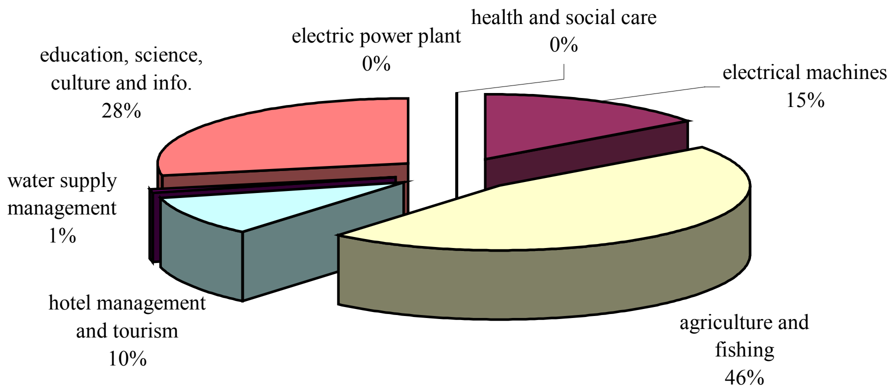
Graph 2. Structure of horizontal state aid in Montenegro in 2004



Source: Report On inventory of state aid in the Republic of Montenegro, Republic of Montenegro Ministry of Finance, Monitoring team for tracking and control of state aid, July 2005

Sectoral state aid is intended for individual economic entities within specific business activities, i.e. sector (industry, agriculture, and other). The following graph shows structure of the horizontal state aid in Montenegro in 2004.

Graph 2. Structure of sectoral state aid in Montenegro in 2004



Source: Report On inventory of state aid in the Republic of Montenegro, Republic of Montenegro Ministry of Finance, Monitoring team for tracking and control of state aid, July 2005

Regional and state aid at the level of local governments. Regional state aid is aimed at encouraging development of less developed areas in the form of subsidies of state budget to municipalities. State aid at the level of local governments comprises municipal subsidies to public utilities enterprises. The goal of regional state aid is to encourage the development of less developed areas. In Montenegro regional aid is awarded from the republican budget as the subsidies to municipalities. State aid at the level of local governments comprises municipal subsidies to public utilities enterprises. State aid at the level of local government was reduced from 8,612 mil. € in 2003 to 1,041 mil. € in 2004. At the end of 2004, regional state aid amounted to €0.14 million making the share of 0.08% in GDP.

Customs and tax exemptions. In 2004 exemptions from payment of customs and other import duties, non-payment of customs and reduction of customs rate in 2003 were prescribed in 184 and 185 of the Law on Customs[8] and Decree on Customs Tariff[9]. In 2004 average customs rate amounted to 6.11%, and the amount of exemptions was €16.15 million.

Write-off of tax as a form of termination of tax debt is prescribed in Article 7 of the Decree on collection of matured but unpaid taxes and contributions and other public revenues[10], and is related to the possibility of lump sum settlement of tax liability with a discount. Based on records of Tax Administration on concluded Agreements on lump sum payment (with discount) of matured but unpaid liabilities, the amount of written-off tax debt in respect of these contracts in 2003 was €0.52 million, while during 2004 no tax write-offs were recorded.

The greatest part of the state aid awarded from the Budget of Montenegro is related to sectoral aid, and smaller part to horizontal aid. In the coming period the structure of state aid should be changed in favor of horizontal aid as less selective and more efficient. Data on the state aid in Montenegro point out that its share in GDP declined in 2004 by about 0.8 percentage points. However, as compared with the EU average state aid in Montenegro is still at the high level. Over the period 2002-2004 the average state aid for the 10 new MS amounted to 1.35% of GDP and in the EU-25 the average was of 0.49% of the respective GDP. On the positive side, if Montenegrin Government makes as effort of reducing the share of the state aid by 0.5 percentage points each year, it is likely to expect that Montenegro reaches the level of about 0.6% of GDP in 2008. In this way it will approach to the EU-25 level. It could be concluded that these data are not worrisome in comparison with individual countries (for instance Romania upon the entrance in the EU has state aid at the level of about 1.8% of GDP), especially bearing in mind that there is the possibility to decrease state aid before entering EU.

F Public administration

This accession related costs originate from the obligation to fulfil the *acquis* as well as to distribute EU funds, which creates a need to strengthen the administrative capacity. The magnitude of this effect was estimated at the level of about 1% of GDP (Table 3).

G Co-financing and pre-financing

The amount of co-financing strongly depends on the project implementation and the funds absorption rate. The annual average estimated co-financing requirements in the NMS were assessed at the level of 0.4% of GDP (Hallet, Keereman, 2005) or from 0.4% of GDP in Czech Republic and Slovakia to 0.7% of GDP in Latvia and Lithuania (Jedrzejowicz and Poznanska, 2005). Actual amounts were lower due to low absorption rates after accession. It is not yet known what part of the potential transfers was absorbed in practice. Hence, as concerns direct CAP payments to farmers in the first year of accession they have to be fully pre-financed, as they are reimbursed from the EU budget in the subsequent year. In addition other payments for structural funds have to be pre-financed.

[8] Official Gazette of the RoM no. 7/02, 38/02, 72/02, and 21/03.
[9] Official Gazette of the RoM no.47/03
[10] Official Gazette of the RoM no.24/04

H Membership fee to the EU budget

Any EU MS is obliged to pay membership fee. All these payments comprise own resources used to finance the EU budget. The total amount of own resources cannot exceed 1.24% of the EU GNI[11]. Own resources can be divided into the following categories (EU, 2005):

- *traditional own resources (TOR)*, which include two categories: agricultural duties and sugar levies on the one hand and customs duties on the other hand;
- *the VAT-based own resource*;
- *the GNI-based own resource* ('the additional fourth resource'), which acts as a residual resource.

Finally, a specific correcting mechanism in favour of the UK ('British rebate') is also part of the own resources system.

<u>Traditional own resources</u>

Agricultural duties and customs duties are levied on imports of agricultural and non-agricultural products from third countries at rates based on the Common Customs Tariff. Sugar levies are paid by sugar producers to finance the export refunds for sugar. From 1 January 2001 MS have the right to retain 25% of these revenues to cover the collection costs.

<u>VAT based own resources</u>

The VAT-based own resources are levied on VAT bases, which are harmonized in accordance with Community rules. The same percentage is applied to the VAT base and in 2005 it was fixed at 0.5%. However, this rate must be decreased to account for the UK correction. The adjusted rate in 2005 amounted to 0.3179%. The upper limit of the VAT base to be taken into account of 50% of each MS GNI is introduced. The purpose is to avoid that less prosperous MS, where consumption account for a higher percentage of GNI to contribute out of proportion to their capacity. In 2005, the 50% capping was applied to 13 MS (Czech Republic, Estonia, Greece, Spain, Ireland, Cyprus, Lithuania, Luxembourg, Malta, Poland, Portugal, Slovenia and the United Kingdom).

<u>The own resource based on GNI</u>

The GNI-based own resource (so called 'fourth resource') was introduced in 1988 to balance the EU budget. This resource is paid by all countries in such proportions as they have in total EU GNI. The same percentage rate is levied on each MS's GNI, which is established in accordance with Community rules. The rate is fixed during the budgetary procedure. The amount of the GNI resource needed is determined as a difference between total expenditure and all other revenue. In 2005, the rate of the GNI-based resource amounted to 0.6518%.
The VAT-based and GNI-based own resources are approved in the country budget bill as expenditures.

[11] GNI – gross national income comprise the total value of goods and services produced within a country (i.e. its GDP) together with its income received from other countries (notably interest and dividends) less similar payments made to other countries.

Other revenues

These group comprise other than own resources incomes of the general budget such as tax and other deductions from staff remunerations, bank interest, contributions from non-member countries to certain Community programs (e.g. in the research area), repayment of unused Community financial assistance, interest on late payments and the balance from the previous year.

The budgetary imbalances are corrected in favour of the United Kingdom. This correction mechanism was introduced in 1985 and was modified on several occasions. UK pays only 1/3 of the VAT-based fee and other countries pay missing 2/3 in accordance to their shares in GNI of the EU, but even these shares are decreased for some countries. The financing share of Germany, the Netherlands, Austria and Sweden is restricted to ¼ of its normal value. This cost is redistributed across the remaining 20 MS.

1. Calculation of the membership fee for Montenegro

Membership fee is one of the most important fiscal costs of accession. As for 2004 enlargement group the membership contribution was equal to about 1% of GDP (Table 4). Malta and Cyprus were obliged to pay higher membership contributions (1.5% of GNP). Due to relatively high amount of import the membership fee for Montenegro will be even higher than for these two island countries. The membership fee is calculated based on the assumption that Montenegro is established a regular EU member today. For calculations the methodology described above is applied. The estimation indicates the annual amount of 1.7% of GDP (Table 11).

2. Estimation of other fiscal costs of the EU accession

Agriculture

To estimate the potential flow of funds for agriculture we assume that Montenegro will negotiate the financial package comparable to that received by Slovenia in 2004 enlargement. Slovenia is selected as a benchmark because of very similar amount of arable land (1813.6 sq km for Slovenia and 1892.2 sq km for Montenegro), production pattern and landscape conditions. As direct payments for agriculture are more shifted from production-based to the area-based rule, we assume that arable land similarities are a good common characteristic. In our calculations we consider that the EU direct payments have to be pre-financed, and that the government will decide to top up the amounts within the limits. These all are the costs for the budget whereas the benefits are received mainly by farmers. All these costs for the general government budget are summarized in table 11 and amount around 0.2% of GDP annually.

Structural funds

To estimate the potential flows of funds available for Montenegro for structural policies we assume that the amount will be comparable to that of Latvia. Latvia has received the highest amount of such funds in terms of GDP so we assume this is the upper bound of what can be negotiated. We assume optimistically that Montenegro will be able to get similar support as Latvia did due to successful negotiations. Montenegro will be also the poorest EU country so we can expect that significant amount of transfers to catch-up will be available.
It is assumed that half of the available amount of structural funds is used by the public enterprises and all of the cohesion funds. Based on this we assume 25% of co-financing from the budget for structural funds and 15% co-financing for cohesion funds. All of these are the

budget costs. The total co-financing costs will increase from 0.15% to 0.3% of GDP due to growing absorption rate in the following years after the accession (Table 11).

III Conclusions

To estimate the fiscal costs of accession we sum up the membership fee with agriculture expenditures and co-financing of structural policies (Table 11) and end up with total EU connected outflows (costs for the budget) of around 2% of GDP. It is assumed that Montenegro will receive the funds for internal policies at the amount of average for 10 new MS joining the EU in 2004. As a result we receive the net budgetary outflows, which is the amount of EU accession related expenditures corrected for the amount of internal policies inflows. The EU accession can have negative consequences for the budget in the amount of about 1.8% of GDP annually. It leads to the following policy recommendations:

1. The EU accession will pose additional costs for the budget of around 1.8% of GDP so the budget deficit in the eve of accession has to be close to the balance in order to fulfil the fiscal criteria of the Stability and Growth Pact.
2. In 2004 enlargement the new MS received budgetary compensations to mitigate the fiscal problems caused by the accession. Montenegro can also apply for such funds. However, as can be see from table 4, the maximum amount of compensation was of 0.33% of GDP – much below the gap defined here.
3. Budgetary difficulties could be mitigated with the additional revenues due to tax harmonization and cancellation of some state aid.
4. There will be also indirect accession costs connected with adjustment of public administration capacity, accession related expenditures connected with necessary improvement in infrastructure and environmental standards and application of the acquis. However, these costs may be distributed over time (before and after the accession with possibility to apply for transitional periods).

Table 11. Calculation of the Montenegrin net budgetary position as a result of cross financial flows with the EU budget (as a % of GDP)

	2007	2008	2009
Agriculture	**0.26**	**0.19**	**0.20**
-market measures	0.08	0.14	0.13
-direct payments	0	0.10	0.11
-rural development	0.15	0.21	0.29
Structural policies	**0.15**	**0.25**	**0.30**
-structural funds	0.84	1.05	1.06
-Cohesion fund	0.05	0.38	0.62
Membership fee	**1.7**	**1.7**	**1.7**
Total EU outflows	**2.10**	**2.13**	**2.19**
Internal policies (inflows)	**0.34**	**0.34**	**0.34**
Net budgetary outflows	**1.8**	**1.8**	**1.8**

Source: Author's calculations

All these calculations are based on the assumption that Montenegro is acceding the EU today. As this is not possible to anticipate what will be the financial conditions applied for Montenegro accession thus we have to made many assumptions. Therefore, all these calculations are very assumptions sensitive. We do not claim about the size of effect but mostly about the direction. It seems clear that EU membership will pose new budget pressures so the fiscal policy should anticipate these additional expenditures and adjust before the accession takes place.

IV References

1. Antczak M., Markiewicz M., Siwinska J., 2006, Fiscal pressures on the road to EMU, Background paper to EFN report on 'convergence and integration of the new Member States to the Euro Area'

2. Andronova Vincelette, G., Vassileva, I., 2006.: “Untangling the maze of European Union funds to Bulgaria”, World Bank Policy Research Working Paper 3962

3. Antczak, M. 2003, “Do Acceding Countries Need Higher Fiscal Deficits?”, CASE, Varšava

4. Backe P., 2002: “Fiscal Effects of EU Membership for Central European and Baltic EU Accession Countries”, Oesterreichische Nationalbank,

5. European Commission: Indicative breakdown of expenditure within individual headings and sub-headings, after the trialogue of 4 April 2006. Working document of the Commission services, fiche no. 94 REV1, 2006, 2 p.

6. European Commission: Payment schedules by expenditure headings. Working document of the Commission services, Annex to fiche no. 2, 2004a, 9 p.

7. European Commission: Revised eligibility statistics. Working document of the Commission services, fiche no. 57 REV2, 2005b, 8 p. EU, 2005, Financial Report

8. European Commission, 2006a, Commission Staff Working Document, Montenegro 2006 Progress Report

9. European Commission, 2006b, Communication from the Commission to the European Parliament and the Council, Enlargement Strategy and Main Challenges 2006 – 2007 including annexed special report on the EU's capacity to integrate new members BBC, 2006, Q&A: EU enlargement, 26 September

10. Jedrzejowicz T., Poznanska D., “The Flip Side of Fiscal Concergence? EU and NATO accession-related pressure on public expenditure in CEE countries”, National Bank of Poland, August 2005.

11. Hallet M., Keereman F., 2005, “Budgetary transfers between the EU and the new Member States: manna from Brussels or a fiscal drag?” ECFIN Country Focus

12. Mrak M., Rant V., 2004: “Conceptual Challenges of the Enlarged EU and the New Financial Perspective”, The Journal for Money and Banking, volume 53, br. 5

Web sites:

www.europa.eu

www.vlada.cg.yu

www.isspm.org

Project supported by the Governments of Poland and Canada, through Polish-Canadian Development Cooperation Program, administered by the Education for Democracy Foundation

Institute for Strategic Studies and Prognoses