I. Project Context

Country Context

Montenegro is a small, open economy relying primarily on tourism and foreign direct investments (FDIs) with GNI per capita of $7,240 (Atlas methodology) in 2014, the highest per capita income among the Western Balkan countries. It started accession negotiations with the EU in June 2012 with a view of potential EU accession by 2020.

After experiencing a double-dip recession due to the 2008 global financial and the 2012 Eurozone debt crisis, Montenegro’s economy expanded by 3.5 percent in 2013 but slowed down to 1.8 percent in 2014. Montenegro remains highly susceptible to external shocks owing to its high external current account deficit and external debt ratio (15 percent and 133 percent of GDP in 2014 respectively).

Significant fiscal consolidation has taken place since 2012. The fiscal balance was reduced from 5.9 percent of GDP in 2012 to 1.4 percent in 2014. Measures on the revenue side include increases in VAT and personal income tax rates. Expenditure restraints included a freeze in public sector wages, staff rationalization, pension indexation freeze, cuts in operations and maintenance and capital budget. However, reduction of the fiscal deficit was accompanied by the growth of
Montenegro’s public and publicly-guaranteed debt doubled from 2008 to 67.9 percent of GDP in 2014. In addition, the Government has substantial payment arrears, estimated at over 7 percent of GDP. The stock of tax arrears reached 10.6 percent of GDP by end-2013 driven by liquidity problems in the economy. A large part of the tax arrears are owed by insolvent or non-operating entities and are non-collectible but difficult to write off under current legislation. One-fifth of the tax arrears are owed by local government units that have signed a tax debt reprogramming agreement with the Ministry of Finance (MoF).

Improved revenue collection is a Government priority. Reforms focus on improving the overall business environment and increasing competitiveness and foreign direct investment. One manifestation of this initiative has been the establishment of the Committee to Fight the Grey Economy, chaired by the Minister of Finance and including multi-agency representation as well as representatives of Parliament. Some of the measures taken by the Committee have focused on legislative and administrative actions to increase the effectiveness of revenue collection. Growth in revenues has exceeded targets. However, longer-term sustainable improvements in the ability to collect taxes and social contributions require enhancement to tax administration systems, processes, and human resource skills that reflect the experience of similar organizations in the region.

**Sectoral and institutional Context**

Revenue collection has improved consistently since 2010 supported by tax policy changes and improvements in tax administration. Between 2010 and 2014, tax and social contribution revenues increased by 2.6 percentage points of GDP to 38.1 percent of GDP on the account of stronger revenue collection mainly of VAT and social security contributions, while PIT and CIT remained largely unchanged during this period. The recent buoyant revenue performance was a result of increases in the VAT and PIT rates, legislative amendments to facilitate the fight against the grey economy, and a number of improvements in revenue administration. Improvements related to tax administration include increased effectiveness of tax audit, expanded use of e-services, and increased voluntary compliance as evident by constantly growing number of registered taxpayers.

Montenegro has taken important steps in recent years to reform and modernize its tax administration. The legal framework on tax administration has been recently amended to clarify the role of tax and customs administration in revenue collection, simplify tax procedures, strengthen internal control of tax administration and the integrity of tax officials, and improve enforced tax collection. An important legal amendment was the repealing of a provision that was introduced in 2013 and envisaged transferring the tax audit function to a new government-wide Inspection Directorate. Enhancements were also initiated in the organizational structure of the tax administration, its strategic management, and management of IT resources.

Nevertheless, tax administration faces a number of organizational, human resource, and IT challenges that prevent it from achieving optimal performance. Significant investments are required to acquire a modern revenue management IT system and equip the staff with modern tools for improving tax registration, collection, audit, enforcement, and taxpayer services.

The Montenegro Tax Administration (MTA) is responsible for collection of substantial part of the tax revenues in the country and contributions to the Health and Pension Funds. The MTA is also responsible for administering the accounts of taxpayers and providing pertinent data to a variety of other public institutions including Customs Administration, the Health and Pension Funds,
Treasury, and the Central Bank. In addition to its tax responsibilities, MTA has been given responsibility for managing the system to register all businesses and to collect financial statements from all registrants. In January 2015, the responsibility for collection of excise duty was transferred to the Customs Agency.

The organizational structure of MTA is still evolving. On July 1, 2013, the MTA was subsumed under the authority of the MoF and the MTA lost its status as an autonomous entity. As a result, the MTA’s departments and staff responsible for financial management, legal services, and human resource management were merged into a single department within the MoF. While many of the tax administrations in OECD countries operate as semi-autonomous bodies, the degree of autonomy of the MTA seems low. This poses a challenge for institutional development particularly because decisions on managing human resources and training are taken outside the agency. At the same time, new departments were established in headquarters such as the Department for Plan and Analysis responsible for leading analytical work and preparing strategic and business operations plans. The MTA has an extensive regional structure with 8 regional offices and 13 branch offices located throughout the country while more than 50 percent of the revenues are collected by the Podgorica tax office where nearly 30 percent of MTA staff are employed.

A Large Taxpayers Office (LTO) was established in 2012 to enhance the audit of large taxpayers. The LTO is responsible only for tax audits and does not provide any taxpayer services. There are currently 110 large taxpayers, which contributed EUR267 million (excluding excise collection) of tax revenue or close to 30 percent of total net revenue in 2014 while LTOs in modern tax administration collect close to 50 percent of the revenues.

Human resource capacity has been constrained by organizational changes and lack of clear strategy. The transfer of the human resource management function to the MoF has restricted the ability of the MTA to independently manage its staff. Furthermore, the MTA does not have a clearly outlined human resources strategy to ensure that it is adequately staffed with relevant skills. There are vacancies for auditors, IT, technical/legal and analytical skills which are critical for the effectiveness of the agency. Similarly, some of the regional offices and the tax audit function of the LTO are understaffed. A significant number of staff currently classified as providing taxpayer services, often perform other functions or are tasked with manual operations such as data entry resulting from shortcomings of the current IT system. Several key functions of a modern tax administration such as business analytics, sophisticated risk models and a risk-based approach to enforcement, and public internal control, are either not developed or in nascent stages of development. The skill mix is further constrained by an ageing demographic of staff with two-thirds being older than 50 years of age.

Human resource capacity has also been constrained by the lack of a clear training strategy. Training is provided on a regular basis but much of it is on-the-job training where a senior staff member imparts their knowledge of how things are to be done to new staff. A very limited number of formal training programs are offered to new and ongoing staff. This is especially critical for newly appointed tax auditors and staff in taxpayer services. The development of a long-term training strategy, beyond the current annual training plan, would help align staff skills with current and future business needs.

Fragmented and outdated IT systems result in many tasks being undertaken manually by staff and taxpayers. There are four IT systems currently in operation. Data is distributed across separate
databases with no interconnections. Consequently, data retrieval and production of consolidated reports and statistics is cumbersome and inaccurate due to inconsistencies in data across the various IT systems. Core procedures such as revenue management, tax audit, legal affairs, taxpayer assistance and enforcement collection are also not integrated. Fragmented IT systems also limit the ability of the MTA to systematically perform cross-checks with third-party data. Although the authorities use third party data sources, such as the Customs Administration, the Anti-Money Laundering Administration, the Real Estate Cadaster, and the Securities Commission; this information is collected manually on a case-by-case basis. Taxpayer registration is mostly a manual process. Although corporate taxpayers can register online, they are required to physically submit the required documentation at the MTA premises for revision. Individual taxpayers are required to manually complete and submit a registration form with the required documentation. Individual taxpayer data is entered into the system only after it has been verified and accepted, after which each taxpayer is assigned a unique taxpayer identification number (TIN). This process may take up to two days.

The MTA has recently developed an IT modernization plan and corporate governance framework to adequately prioritize and align IT needs over the short (2014-2015) and medium-term (2014-2019). Several actions in the strategy have already been implemented. For example, electronic-filing for corporate income tax, excise, and VAT was introduced on March 27, 2014. This reduced compliance costs for taxpayers as well as time and costs for the MTA due to electronic data inputs. Increasing the frequency and coverage of returns filed electronically will likely help increase voluntary compliance and lead to efficiency gains. In 2012, for example, only 8.7 percent of the total tax returns were filed electronically, but there was a much higher rate among large taxpayers, where e-filing reached 41 percent of tax returns.

The audit process suffers from several procedural weaknesses. Audits tend to be prescriptive: the tax issue and period to be audited is specified and procedures are fairly rigid. In light of evidence of non-compliance or tax evasion, auditors do not have the authority to widen the audit to other taxes without first obtaining a revised audit order. If a tax period has been previously audited, legal provisions prohibit reassessment of this period for any reason. While this policy is designed to protect taxpayers, it prevents auditors who uncover evidence of significant tax evasion during a single issue audit from expanding the scope of the audit to a comprehensive audit. Consequently, current procedures lead to an over reliance on comprehensive audits including in cases where these may not be warranted resulting in an inefficient use of audit staff.

The total tax arrears outstanding as of December 31, 2013 were 354 million Euros, which amounted to 41 percent of the total tax revenue collected in 2013. The MTA now publishes a list of the largest 100 tax debtors (with the amounts) on a quarterly basis. This has helped MTA make some progress recently, recovering 72 million Euros of tax arrears in 2012. However, approximately 90 percent of tax arrears are older than one year, and many of them were incurred more than ten years ago. Although a significant portion of these arrears will never be collected, there is currently no legal provision to write them off. In addition, part of the stock can be attributed to the high number of delinquent taxpayers, averaging one-fifth of the total number of registered taxpayers during the last three years.

II. Proposed Development Objectives
The development objective of the project is to improve effectiveness of operational functions and reduce the compliance burden on taxpayers. The higher level goal is to increase overall revenues.
The long-term vision is a tax administration that operates with a higher capacity to streamline risk-based business processes that contribute to the efficient collection of taxes and social contributions that are owed from all sources of economic activity. Increased compliance will generate a more robust revenue stream to provide essential services to citizens. Improvements in capacity will also support the country’s goal for EU accession and economic integration with EU member states.

III. Project Description

Component Name
Improving Operational Efficiency

Comments (optional)
The component will help enhance the strategic focus of management, increase attention to integrity, strengthen staff management and training, improve the analytical capacity required to support strategic management within MTA, improve the legal framework and the appeals function and to institute a modern revenue administration on par with best practice in the EU.

This component consists of three subcomponents: (1) institutional development; (2) change management; and, (3) project management.

Component Name
Increasing Effectiveness of Operational Functions

Comments (optional)
The activities within this component support new streamlined business processes and increased operational effectiveness of MTA. The data cleansing and rationalization of the existing IT systems, will increase compliance and responsiveness to MTA’s and taxpayers information needs. This component consists of two subcomponents: (1) modernizing MTA’s operational functions and (2) IT infrastructure.

Component Name
Reducing Compliance Burden to Taxpayers

Comments (optional)
This component will finance activities to modernize taxpayer services to increase understanding of revenue laws, procedures, and rights and obligations of taxpayers and thus reduce the compliance burden to taxpayers; establish a modern contact center to provide advanced services to taxpayers; and strengthen external and internal communications.

IV. Financing (in USD Million)

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V. Implementation
VI. Safeguard Policies (including public consultation)

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Comments (optional)

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