I. Introduction and Context

Country Context

1. Montenegro is an upper middle income economy with a GNI per capita of $7,220 in 2012. Montenegro started accession negotiations with the European Union (EU) in June 2012 and strives to accede to the EU by 2020.

2. 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 of GDP in 2013. The nascent recovery, however, has not yet had much impact on the labor market, with the unemployment rate remaining stagnant at 20 percent. Montenegro is highly susceptible to external shocks owing to trade and capital market integration with the EU and large external imbalances (the current account deficit and external debt to GDP ratios at 15 and 114 percent, respectively).

3. Although the government has implemented a strong fiscal adjustment since 2010, the realization of contingent liabilities has largely offset these gains. A freeze in public sector wages,
staff rationalization, pension indexation freeze, expenditure restraints in operations and maintenance as well as in the capital budget, supported by tax rate rises (including the VAT and the personal income tax) and strengthened tax collection efforts have all helped the government to reduce the fiscal deficit to below 3 percent of GDP in 2013. This outcome was achieved despite the calls of guarantees issued to the metal industry, amounting to over 3 percent of GDP in 2013 alone.

4. Montenegro’s public and publicly-guaranteed debt doubled from 2008 to 64 percent of GDP in 2013. Guarantees stood at 8 percent of GDP in 2013. In addition, the Government has substantial payment arrears, estimated at 4.8 percent of GDP. The stock of tax arrears reached 9.9 percent of GDP by end-2013 driven by increased liquidity problems in the economy. A large part of these arrears are several years old and essentially 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). The electricity company, a state-owned enterprise, has emerged as the second largest tax debtor.

Sectoral and Institutional Context

1. Montenegro has taken important steps in recent years to reform and modernize its tax administration. Many of these reforms are still ongoing, in particular the development of the Montenegro Tax Administration (MTA)’s first strategic plan, which will identify reform priorities, monitor progress, and be important for the Government’s ongoing negotiations with the EU. MTA is aware of its reform needs but also acknowledges that it needs both financial and technical support in realizing reform. MTA management sees the development of a strategic plan as an important first step in prioritizing and organizing the components of reform that will be required.

2. On July 1, 2013, the MTA was subsumed under the authority of the MoF and the authority lost its status as an autonomous entity. As a result, the MTA’s Department for Financial Accounting (which managed the budgeting and finance activities) and its Department for General, Legal, and Technical Issues (which managed human resources) were closed and centralized into a single department within the MoF. This poses a challenge for institutional development particularly because training and modernization of skills are seen as priority to help MTA staff deal with the increasing diversity of business transactions in the Montenegrin economy. It also means that decisions regarding institutional development and reforms are under the direct control of a political authority, the Minister of Finance.

3. MTA has undergone important internal organizational changes in recent years. The Department of Plan and Analysis was established to lead the analytical work and prepare strategic and business operations plans. A Large Taxpayers Office (LTO) was established in 2012 to enhance the audit of large taxpayers. There are currently 110 large taxpayers, which contributed 310.2 million Euros of tax revenue or 37% of total net revenue in 2012. However, the LTO is only responsible for tax audits and does not provide any taxpayer services. This is not consistent with the trend in most modern tax administrations which assign LTOs full responsibilities, including tax arrears management, taxpayer assistance, legal affairs, and tax audits.

4. An amendment to the Decree on State Administration Organization and Manner of Work stipulates that the newly created Inspection Directorate shall carry out inspection supervision in public revenue collection (among other areas) beginning January 1, 2014. A broad consensus exists within the international community that the tax administration should have ownership over the entire tax administration cycle, ranging from taxpayer registry and revenue collection to tax appeals.
Fragmentation of this process would result in inefficiencies and reduce the effectiveness of compliance controls. The Bank is not aware of any country in Europe or elsewhere that does not have the tax audit function within the tax administration. Fortunately implementation of the legislation has been postponed until January 2015 but the legislation has not been amended or revoked.

5. MTA has fragmented and outdated IT systems which force staff and taxpayers to undertake many tasks manually. There are four IT systems currently in operation and data is distributed across separate databases. Consequently, data retrieval and production of consolidated reports and statistics is cumbersome. At the same time, the core procedures, such as revenue management, tax audit, legal affairs, taxpayers assistance and enforcement collection, are not integrated. Also, due to the limited integration of the IT systems, the MTA does not systematically perform cross-checks of data contained in tax returns with third-party information. Although the authorities do use data from third party 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. Furthermore, taxpayer registration is mostly administered manually. Although corporate taxpayers can register online, they must still physically submit the required documentation at the MTA premises for revision. Individual taxpayers must manually complete a registration form and submit it to the MTA with the required documentation. After a verification process, the application is either accepted or rejected, and only then are accepted applications inputted into the information system. Each taxpayer is assigned a unique taxpayer identification number (TIN). If the full documentation is provided, the registration process usually takes one to two days, but the MTA does not measure this processing time.

6. 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 became available on March 27, 2014, which will reduce the compliance costs for taxpayers and save tax administration significant time and costs for manually inputting data. Increasing the frequency and coverage of returns filed electronically would 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 92 percent of tax returns.

7. The audit process suffers from several procedural weaknesses. Audits tend to be prescriptive: the tax and period to be audited is specified and procedures are rigid. If an auditor finds evidence of non-compliance, they do not have the authority to widen the audit without first obtaining a revised audit order. If a tax period has been previously audited, legal provisions prohibit this period to be reopened for any reason. Although this policy is designed to protect taxpayers, it does not permit auditors who uncover evidence of significant tax evasion during a single issue audit to expand 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. This is an inefficient use of resources.

8. The total tax arrears outstanding as of December 31, 2012 were 360 million Euros, which amounted to 46 percent of the total tax revenue collected in 2012. 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 were older than one year, and many of them were accrued more than ten years ago, either during the economic transition from the Yugoslav economic system to a more market based system or during the conflicts of the 1990s when many companies went bankrupt. 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.

9. Several reform initiatives funded by the European Commission (EC) are ongoing or planned for the next financing period. The European Commission and several EU members (on a bilateral relationship) provide technical assistance to help prepare Montenegro for future EU membership. This includes advisory services to align tax legislation with the acquis and support for the introduction of the VAT Information Exchange System (the system that ensures electronic exchange of information related to VAT registration of companies within the EU).

Relationship to CAS

1. The proposed project is closely aligned with the Country Partnership Strategy (CPS) for Montenegro 2011-14. The CPS seeks both to help the country recover from the 2009 recession and advance longer term goals, focusing on (i) strengthening institutions and competitiveness in line with EU accession requirements; and (ii) improving environmental management. The proposed tax administration modernization project is expected to contribute to the first pillar of CPS by improving effectiveness and efficiency of MTA, supporting a better environment for doing business in Montenegro, and by reducing both the burden of compliance with tax legislation and unfair competition from grey economy. These improvements will also support Montenegro’s EU accession efforts.

2. The project will increase the effectiveness of tax collection, support the redistribution of the tax burden from the general population to higher income groups and corporate tax payers, lower compliance costs for all taxpayers and increase the efficiency of tax administration. Increased revenue collection will generate the resources needed to increase pro-poor and growth enhancing expenditure programs. Lower compliance costs will increase competitiveness and thereby facilitate private investment and economic activity.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

The development objectives are to improve the efficiency of collecting tax and social contribution revenues, to increase compliance, and to reduce the burden on taxpayers to comply.

The long-term vision is a tax administration that operates with streamlined 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 and the modernized tax administration will improve the business environment by reducing the burden on compliance on taxpayers, increase the country’s competitiveness, and attract foreign investment. Currently, Montenegro ranks 86th in the ease of paying taxes in the 2014 Doing Business rankings, down one ranking from last year. Modernization will also support the country’s goal for EU accession and economic integration with EU member states.
Key Results (From PCN)

Improved operational efficiency
• Tax revenue per tax employee
• MTA staff satisfaction with the new skills and ability to apply them, measured through staff survey, disaggregated by gender

Increased compliance
• Tax gap for VAT, Corporate Income Tax (CIT)
• Net adjustment per tax auditor*.

Reduced compliance costs
• Percentage of taxpayers filing electronically;
• Taxpayers’ satisfaction with quality* of service and integrity* of MTA staff, measured through surveys, disaggregated by gender for individual taxpayers;

Indicators marked * correspond are proposed core sector indicators for tax administration

III. Preliminary Description

Concept Description
1. The proposed project seeks to improve MTA’s institutional arrangements and management systems to take full advantage of a highly automated, low-discretion, risk-based system. The project entails an investment of US$20 million over a period of five years in the organizational restructuring and the development, management, and infrastructure changes necessary for optimal deployment of an integrated tax management information system. The project includes financial and technical support for: revenue collection methodologies and procedures; information technology and other technological infrastructure; training and technical assistance to underpin MTA’s management decisions on organization structure and capacity of the tax audit; and operational systems refinements necessary to ensure that the economy reaps the full benefits of the investment. The new IT System (ITS) financed under the project would provide for electronic interaction with taxpayers as well as link to other systems that share data with MTA, including Treasury, Customs, Pension Fund, and Health Fund. Total projected cost of the project is based on similar projects in the ECA region. Measurement of intermediate outcomes and outputs will be integrated into the project in order to provide relevant and timely feedback as to the progress of the project.

2. The proposed project is informed by the results of the Integrated Assessment Model for Tax Administration (IAMTAX) diagnostic conducted in late 2013. The key gaps identified in the IAMTAX analysis have been addressed in the project design. These include the fragmented and out of date IT system, the need for an improved system of risk based enforcement, the need to improve the capacity of the large taxpayer office, the need for a human resource management strategy and improved training and more comprehensive taxpayer services. During project preparation, the Bank is providing assistance to help MTA develop a strategic plan to guide reforms. The project will incorporate activities to address key strategic objectives in the final plan and seek to align results indicators with those in the final plan. Based on initial drafts of the strategic plan, the proposed project is in alignment with the overall objectives of MTA. The proposed project has five components.
3. Component 1. Improving Operational Efficiency. This component will support the institutional changes envisioned under the project and will have three subcomponents: (i) institutional development, (ii) change management, and (iii) project management. The institutional development subcomponent will support the development of a modern organization and management structure, instill a strategic orientation to optimize the HQ and regional structure of MTA to increase MTA’s effectiveness, and strengthen analytical, human resource management and training capacity. Furthermore, this subcomponent will support an improved legal framework and appeals process. The change management subcomponent will ensure that all changes in MTA will be carried out using established change management approaches that seek to build commitment of all staff in the change process. It will also finance international change management consultants, change management training, and the development of an internal communications strategy. A specific element of change management will be to ensure that the change management pays attention to the different needs and impacts upon female and male staff. The project management subcomponent will support project management and strengthen MTA’s capacity to ensure timely and quality project implementation in accordance with World Bank guidelines.

4. Component 2: Increasing Compliance. This component will: (i) support the recasting of operational functions (tax audit, enforcement, anti-fraud, business fiscal intelligence) within the MTA headquarters and regional offices to adopt modern tax administration practices, which will assist in increasing taxpayer compliance behavior; (ii) acquire an integrated tax system from a commercial tax software vendor, which will then be customized to reflect the tax and social legislation of Montenegro; (iii) acquire the required hardware to operationalize the ITS and its integrated risk management, document management and data warehouse functions; (iv) provide appropriate training to the users of the ITS; and (v) establish a backup disaster recovery centre. The new ITS would provide support for all business functions, including user management, registration, returns processing, accounting, payment processing, enforcement, objections and appeals, audit, risk assessment, reporting, work flow, data warehouse and business intelligence tools, a document management system, and a taxpayer portal.

5. Component 3: Reducing Compliance Burden to Taxpayers. This component will finance activities to modernize taxpayer services and communication; create mechanisms for transparency and accountability, such as a consultative panel and community surveys to ensure effective community input; modernize the call center to provide advanced services to taxpayers; promote community understanding of revenue laws, procedures, and rights and obligations of taxpayers; promote taxpayer efficiency through simplification and provision of electronic services; and strengthen external and internal communication.

IV. Safeguard Policies that might apply

<table>
<thead>
<tr>
<th>Safeguard Policies Triggered by the Project</th>
<th>Yes</th>
<th>No</th>
<th>TBD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental Assessment OP/BP 4.01</td>
<td>✗</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Natural Habitats OP/BP 4.04</td>
<td>✗</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forests OP/BP 4.36</td>
<td>✗</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pest Management OP 4.09</td>
<td>✗</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Physical Cultural Resources OP/BP 4.11</td>
<td>✗</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indigenous Peoples OP/BP 4.10</td>
<td>✗</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
V. Financing (in USD Million)

<table>
<thead>
<tr>
<th>Financing Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrower</td>
<td>0.00</td>
</tr>
<tr>
<td>International Bank for Reconstruction and Development</td>
<td>20.00</td>
</tr>
<tr>
<td>Total</td>
<td>20.00</td>
</tr>
</tbody>
</table>

VI. Contact point

World Bank
Contact: David Michael Nummy
Title: Senior Public Sector Specialist
Tel: 473-4966
Email: dnummy@worldbank.org

Borrower/Client/Recipient
Name: Ministry of Finance
Contact: Radoje Zugic
Title: Minister of Finance
Tel:
Email:

Implementing Agencies
Name: Montenegro Tax Administration
Contact: Mr. Milan Lakicevic
Title: Director
Tel:
Email:

VII. For more information contact:
The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500