

ENHANCING THE
EFFECTIVENESS OF BiH
ADMINISTRATION:
CHALLENGES IN PUBLIC
FINANCE

Study on Potential Revenue Sources for
the Institutions of **Bosnia and Herzegovina**



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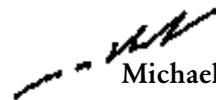
BD	Brčko District
BiH	Bosnia & Herzegovina (State)
CAFAO	Customs And Fiscal Assistance Office
FBiH	Federation of Bosnia & Herzegovina
IAG-T	International Advisory Group - Taxation
IFI	International Financial Institutions
NGO	Non Governmental Organisations
OHR	Office of the High Representative
PIC	Peace Implementation Council
PRSP	Poverty Reduction Strategy Paper
RS	Republika Srpska
SBS	State Border Service

Foreword

Reform of the indirect taxation system in Bosnia and Herzegovina represents a historic step for Bosnia and Herzegovina on its journey towards Europe and in its quest to give its citizens the prosperity they deserve. Few reforms in this country will be of such manifold importance; with this Bosnia and Herzegovina proves it is ready to embrace European standards.

Customs reform and the introduction of a countrywide, EU-compatible Value Added Tax will bring about significant improvements in the efficiency and effectiveness of the Bosnia and Herzegovina's institutions. The introduction of VAT and the strengthening of the indirect tax administration will reduce the opportunities for fraud and in this way generate savings of public funds and an increase in revenues.

The Study on Potential Revenue Sources for the Institutions of Bosnia and Herzegovina has provided vital input to the formulation of policy on indirect taxation in BiH. This Study represents research and analysis of the very highest order. On behalf of the Delegation of the European Commission to BiH I am privileged to be able to introduce this work.



Michael B. HUMPHREYS

Ambassador
Head of EC Delegation to
Bosnia and Herzegovina

Executive Summary

This study addresses the issues of securing sustainable financial revenue sources for the State Institutions of Bosnia and Herzegovina. Under the complex institutional framework resulting from Dayton the own resources of the State Institutions have been so far administrative fees and transfers from the Entities. The limitation and the constraints on the autonomy of the State these resources impose create a major problem. On the one hand, the international community, which has taken on important responsibilities that would elsewhere be regarded as competences of the State, is gradually withdrawing from BiH, and on the other hand, there are increasing international and domestic commitments of BiH - like the participation in the EU Stabilisation and Association process, the poverty reduction strategy agreed with the international community - which require raising responsibilities at State level as well as the capacity and the institution to meet them.

The solution cannot simply be found in an imaginative attempt to identify additional resources compliant with the present constitutional arrangements. It must also take into account the imperative necessity to increase fiscal efficiency and to contribute to the macro-economic sustainability of the country.

For this reason the study conducts (Chapter 2) an analysis of the overall architecture of the public finance in BiH. With the exception of the regulation of Customs taxes done under a State law, the Entities (and the Brčko District) regulate, administer and allocate all revenues. Harmonisation and hard budget constraints have been more or less imposed by the International Financial Institutions and do not result from strategic planning at national level. The tax revenue rely mostly on imports and consumption, expenditures are dominated by military expenses and transfers to households, and by foreign supported reconstruction.

When assessed from the point view of its scale/sustainability, integrity/effectiveness and efficiency the fiscal system of BiH suffers many weaknesses.

Regarding its scale two characteristics are immediately apparent: (i°) it is extremely difficult to assess because a consolidated general government account does not exist and there is no authority in charge of its compilation, less of monitoring it for ensuring the consistency of the fiscal and monetary policies; (ii°) everything indicates that it is excessively large, with total expenditures around 65% of GDP, and that current deficits are not sustainable.

The integrity of the fiscal system is weakened by very large fraud and fiscal losses. The lack of accountability and professionalism of the tax administrations, although improvements have been observed in the recent periods, remain a major concern. The capacity of the fiscal system to redress vertical and horizontal inequalities is very limited if not inexistent. In both Entities direct taxes, with little progressivity when they are not regressive, are a small fraction of revenue. The allocation of revenue on the derivation principle creates a situation, especially in the FBiH, where sub-entities are charged with most of the services to the citizens (education, health, provision of services of utilities, etc.) without the necessary resources.

The efficiency of the fiscal system in influencing the behaviour of the economic operators and an adequate allocation of resources is far from satisfactory with numerous cases of double taxation and distortions which maintain the fragmentation of the national economic space.

While there is no doubt that a strengthening of the State institutions, and therefore secure financial resources, are needed, it is important to conduct this effort with a view of improving

the overall fiscal system so that it can address these issues. This does not mean that the State should do everything and Chapter 2 concludes by identifying the essential functions the State should be able to fulfil in BiH, and for which it should have the financial and technical capabilities.

They are: 1° The responsibility of the macro-economic stability, i.e. the capacity to establish and monitor the global macro-economic framework of the country and to ensure consistency between fiscal and monetary policies. Besides being a responsibility of every State it will be essential in the EU Stabilisation and Association process. 2° The organisation and regulation of a single economic space. It is a constitutional obligation and a requirement of the EU stabilisation and association process. 3° The coordination of the poverty reduction strategy which BiH is undertaking with the assistance of the international community is a responsibility falling under the overarching principles of the Preamble of the Constitutions of BiH.

In line with this analysis, Chapter 3 investigates the various indirect taxes, because there are the main sources of fiscal revenues, the regulatory functions of the State in the network industries, and the existing system of administrative fees. The objective is to identify reforms that would both improve the global fiscal system and generate resources for the essential functions of the State. The main lessons from this analysis are as follows.

Custom duties: the customs law, a State law, provides for a four rates tariffs and in general the trade policy is one of liberalisation with the conclusions of regional trade agreements, negotiations to join WTO, and participation in the Stabilisation and Association process. The implementation is done at Entities level with revenues allocated to the Entity of the point of clearance. Fraud and fiscal losses are important (of the order of 375 million KM/year i.e. 40% of actual revenue according to CAFAO); they can be explained in part by the long and difficult external border, but result largely from the lack of accountability and efficiency of the administrations and the competitive under

valuation of imports by the Entities (and Brčko) in order to attract clearance on their territory.

Excise duties are regulated and administered by the Entities, revenue remain with their respective central governments. The revenue is collected at producer/import point and in case of inter-Entity trade a tax credit is granted to the seller of the Entity of production on showing evidence of tax payment by the buyer of the other Entity. The system is incompletely harmonised and every harmonisation or modification requires a political agreement between all Entities. The main drawback, however, is that the current arrangement for inter-Entity trade does not eliminate double taxation since it applies only to a limited number of traders. Moreover, excises on imports, collected by the custom administrations, suffer the same problems as custom taxes.

Sales tax is the most important indirect tax. It is regulated and administrated by the Entities, and quasi harmonised (with the exception of the Brčko district). The rate is 20%, a very high value for this type of tax; in countries with properly working retail sales taxes those are not higher than 10%. By similarity with the international principle that tax revenue should accrue to the country under which jurisdiction the consumption of the goods takes place, the tax collection has been recently moved to the retail point. This generated massive fraud and fiscal losses (estimated to 500 million KM/year i.e. around 40% of collected revenue). The sales tax revenue remain with the Entity of the retail point, and in FBiH are totally assigned to the cantons and municipalities on basis of the derivation principle with the disadvantages already evoked. In addition to these drawbacks consumption taxes in the form of sales tax are not allowed in the EU at state or sub-state level. For these reasons, it has been decided to replace the sales tax by a VAT in BiH. The issue is therefore also analysed in this chapter.

The advantages of VAT are its absence of distortive effects and its lesser vulnerability to tax evasion. Its introduction requires decisions on the number of rates and their magnitude. In

a federal state two additional questions need to be resolved: will it be an Entity or state tax, how will the revenue be assigned to state, entities and sub-entities? There is a case for a centralised case because different rates induce cross border shopping and distortions, and because the "destination principle" would imply zero rating of inter-Entity exports and massive risks of fraud. It is worth noting that all European federal states have central VATs. The chapter analyses alternative systems applicable in BiH and shows the advantage of a central tax with an allocation mechanism based on a sharing formula or on the regional distribution of final sales.

The analysis of the network industries/utilities shows two common characteristics: (i°) an imperative need for better coordination and regulation at state level, (ii°) under performance of the operations of these enterprises which do not generate their potential revenues. The issues are currently addressed under the pressure of the international institutions with three lines of actions: the preparation for privatisation, the constitution of public corporation under Annex 9 of Dayton in order to improve operational cooperation, and the creation of new State institutions to regulate the sectors. These moves go in the right directions and should be continued. The prospects for State revenue are, however, limited since privatisation and better operations will benefit the owners, the Entities, and the users. Regulation is at best a cost recovery activity.

Similarly, administrative fees and special taxes do not appear as a potentially important source of State revenues. There are already many such fees and taxes at all levels of Government and increasing the number would be counterproductive and unjustified.

Chapter 4 summarises the conclusions from the previous chapters and formulates recommendations together with the legal basis to support them.

The general recommendation is to complement transfers from the Entities with own tax revenues. Within the legal constraints two scenarios can be considered:

1° The bottom line scenario compatible with the narrowest interpretation of the Constitution would consist in the creation of a State administration for customs with all revenue in a single State account. A fraction of the revenue should be assigned to the State and the rest allocated between Entities on the basis of a formula or of the regional distribution of final sales. This solution would provide a straight answer to the question of the terms of reference and would contribute to an improvement of the fiscal architecture in BiH. However, the gradual integration of BiH into the world economy and the move towards EU will induce a structural change in the source of revenues and a move away from taxes based on international trade towards domestic taxes. For this reason, a more ambitious reform to redesign radically all indirect taxes is recommended.

2° The reform would consist in unifying at State level the regulation and administration of all indirect taxes (customs, excises and VAT replacing the sales tax). A fraction of the proceeds of a State VAT tax should be earmarked for the financing of the State Institutions, the remaining being allocated on the basis of a sharing formula or the regional distribution of final sales. While not yet perfect, this would contribute significantly to the improvement of the various aspects of the fiscal system: its sustainability (rationalisation of tax policies, coordination and predictability of tax revenues); its integrity (better accountability and in the medium term less inflexible allocation mechanisms); its efficiency (unification of the single economic space, reduction of the grey economy with the introduction of the VAT).

The study ends with the crucial demonstration that this ambitious scenario does not require a change in the Constitution but is compatible with a reading of the Constitution which has been elaborated by the Constitutional Court of BiH.

1. Introduction

In the complex institutional architecture resulting from the Dayton Agreement the State institutions of Bosnia and Herzegovina (BiH) have extremely limited fiscal competences, in particular, they are at present do not collect taxes but only administrative fees and the essential of their resources comes from transfers from the Entities. However, new State level institutions and functions are created which are needed to respond to the demands of the international community and the insertion of BiH in the European and in the world economy (State Border Service, preparation of the Elections, unified veterinary services, etc.). The State faces therefore a genuine budgetary constraint and at the same time there is a justified pressure from the financial international institutions to reduce expenditures at all levels of government.

The purpose of this short study commissioned by the European Commission is to explore and analyse the possibilities of securing potential revenue sources for the Institutions of Bosnia and Herzegovina (BiH) taking into account the legal constraints and the imperative requirement to increase fiscal efficiency.

The study was conducted by two persons, a public finance macro-economist and a legal expert in constitutional law. It involved three short missions in BiH over the period July-October 2002. The findings and conclusions are based on the analysis of existing reports and materials and contacts with Government officials, representatives and experts of Bosnian institutions, and relevant parties from the international community and NGOs.

This report is organised as follows. Because the question of the resources of the State institutions cannot be separated from that of the design and operations of the whole fiscal system of the country, Chapter 2 provides an overall description of the institutional background and the organisation of public finance and fiscal policy in BiH and in the Entities. It shows that current trends are not sustainable. A limited number of key essential functions must be fulfilled by the State, requiring stable financial resources. These must be provided under the constraint of improving the overall efficiency of the consolidated fiscal system of the country and may therefore imply some reallocation of functions and responsibilities between the different layers of government. With these objectives and constraints in view, Chapter 3 explores a number of avenues and for each of them reviews the existing system, the main problems and issues resulting from its operation, and investigates the various options to improve it together with their economic, technical and legal implications. The areas analysed are taxes on goods and services - since they are overall the main source of revenue of the Entities - the possible revenue generated by the regulatory functions of the State in the major network industries, the administrative fees - currently the exclusive own source of finance for the State institutions. Chapter 4 draws the main conclusions from this analysis and derives the recommendations of the experts who have conducted the study. The legal feasibility of these recommendations is the object of a special section in this last chapter.

2. Fiscal governance and related problems

2.1 Institutional background

The Constitution of Bosnia and Herzegovina (BiH) results from the Dayton agreement and has created a quasi-federal State comprising two Entities, the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS). The area of Brčko, which remained contested after the Dayton agreement, was settled through international arbitration, and the Brčko District (BD) was established in March 2000, with powers largely similar to that of an Entity. The Federation itself is multi-ethnic and is divided into 10 cantons (see maps).



Table 1 provides general indicators for BiH and the Entities.

Table 1 - Bosnia and Herzegovina general indicators (year 2000)³

	BiH	FBiH	RS	BD
Population estimates (in thousand) in 1991	4,377	2,784	1,593	n.a.
Population estimates (in thousand) in 2001	3,365	2,298	1,066	(85)
Area (square km)	52,280	26,411	25,376	493
Nominal GDP in KM (2000)	9,260	6,699	2,562	n.a.
GDP par head in KM (2000)	2,752	2,915	2,403	n.a.

Sources: UNDP, *Bosnia & Herzegovina, Human Development Report, 2002*
 IMF, *Bosnia & Herzegovina, Statistical Appendix, March 2002.*
 Foundation Global Contact: *Guidebook for Citizens to Brčko District*
Bosnia and Herzegovina, January 2002

Under this constitutional construction BiH is a sovereign state with a decentralised political and administrative structure. The State of BiH is the central authority but has only limited and specific powers whereas the two Entities and the Brčko District are politically, administratively and fiscally autonomous.

The State competences include the monetary policy, currently managed through a currency board, foreign policy, trade and customs, regulatory competence on international and inter-Entity criminal laws, telecommunications, transport system and traffic control, immigration, refugees and asylum policies. The Entities, which have their own respective constitutions, exert all functions not expressly assigned to the State by the Constitution of BiH.

The two Entities are asymmetrical in their institutional organisation. The FBiH is composed of 10 cantons subdivided into 84 municipalities, whereas the intermediary canton layer does not exist in the RS which comprises 63 municipalities. In the Federation, the cantons have a significant fiscal authority. This administrative structure is best visualised in Table 2:

Table 2 - Bosnia and Herzegovina: Administrative Structure

Tiers of Government	State	Entities		Brčko District	Total
	BiH	FBiH	RS	BD	
Central	1				1
Entity		1	1		2
Canton		10			10
Municipality		84	63	1	148
Autonomous District				1	1
Total	1	95	64	2	162

Source: World Bank, *Bosnia and Herzegovina, From Aid Dependency to Fiscal Reliance, 2002.*

³ The latest official population data are those from the 1991. The 2001 data are estimates which take into account the high death rate and the movements of refugees due to the war.

2.2 Organisation of public finance

The organisation of the fiscal system reflects this complex architecture.

2.2.1 Revenue and expenditures of the State of BiH

The revenues and expenditures of the State are very limited.

The **revenue** consists of three main categories: own resources, transfers from the Entities, extraordinary revenues.

The own resources are administrative fees and revenue from own activities. The list of administrative fees and the fees themselves have been initially set by a Decision of July 1999 of the OHR imposing the Law on Administrative Fees. The Law has been amended by a Decision of the OHR of December 2000 authorising the Ministries to establish additional administrative fees and to adapt upwards or downwards the existing ones. Under the current practice these administrative fees constitute the main "own resource" to finance the State institutions of BiH. The own resources have been gradually complemented by revenues arising from state institutions activities such as the Institute of Standards, the Institute for Accreditation, the Communication Regulatory Agency and the Department of Civil Aviation. Such revenues are intended to recover partially or totally the operating costs of these institutions, agencies and departments.

The main part of the revenues of the State is made of the transfers from the Entities. They are meant to cover the service of the external debt and, together with the administrative fees, the operational costs of the State institutions. The Dayton agreement specifies that the Entities will contribute to these transfers in the proportion 2/3 for FBiH and 1/3 for RS, but the total amount results from a negotiation between the State and the Entities and involves an iterative process each year to elaborate the budgets of the three institutions - the State and the two Entities.

Finally the State benefits from extraordinary revenues such as those coming from the succession of the Former Republic of Yugoslavia, reparations of war damages, and specific international transfers to finance the organisation of the elections.

The **expenditure** side of the State account comprises the operating costs of the BiH legislative, judiciary and executive and the new services and agencies which are created as the need arises, such as the State Border Service, the Communication Regulatory Agency and others. The other major items are the service of the external debt, covered by the matching transfers from the Entities, and special programmes such as the Election Commission.

It is immediately apparent from this description that the State functions are minimal and in particular they do not involve any redistributive or developmental responsibilities.

Given the rigidity of the revenue mechanisms the development of new State institutions and functions can only take place if it is financed by the international community, at least in the initial periods.

The account of the BiH State institutions is presented in Annex 1 Table 1. The table highlights the small magnitude of the State account, with total revenues and expenditures lower than 5% of the GDP of BiH. Chart 1, using data from this table, shows the importance of the Entities transfers (shaded areas: around 85% of total revenue) and the limited expenditures responsibilities outside the service of the debt. The latter represents about 65% of total expenditures and is financed by matching transfers from entities.

Chart 1
Structure of State of BiH revenues and expenditures (average 1998-2001)

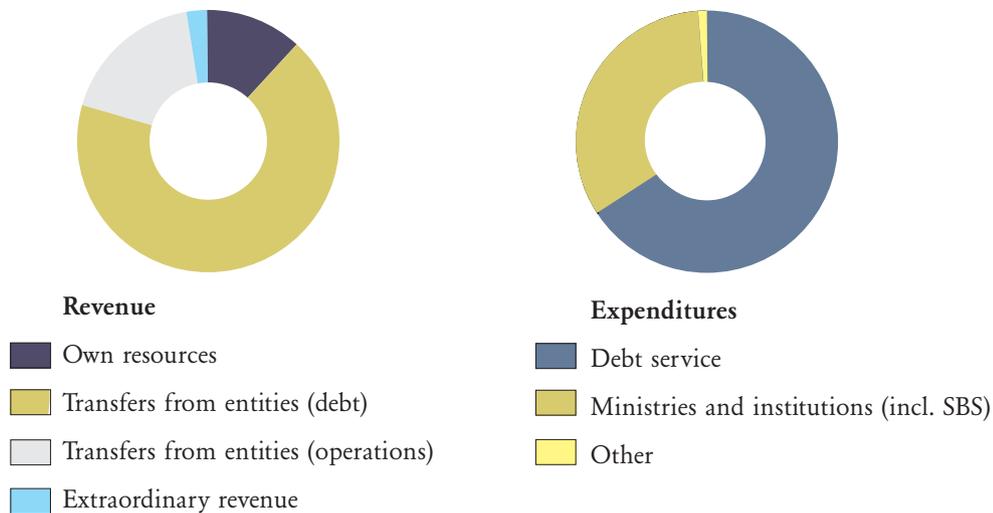


Table 1 of Annex 1 also shows the dependency on budgetary transfers and grants from the international community to finance special programmes (elections) or to establish new State institutions such as the State Border Service.

2.2.2 Revenue and expenditures of the Entities and sub-entities

The revenues and expenditures of the Entities and the BD correspond more to that of sovereign states. The fiscal organisation and governance differ substantially between the FBiH where fiscal governance is widely shared between the federation and the cantons and municipalities, and the RS where public finance is much more centralised with only limited power in the municipalities and no cantons.

On the revenue side it is important to make a clear distinction between the regulatory function, the administration and collection of taxes, and the allocation of tax revenues.

At present all taxes, apart from customs, are regulated by the Entities or sub-entities, which pass the laws on the taxes and define the basis, the exemptions and the tax rates. The State legislates only customs. Entities legislate most direct and indirect taxes. In the FBiH the sub-entities, cantons and municipalities regulate some property taxes, administrative and court taxes, and various fines, rents, utility user charges. In the RS all taxes are regulated by the central government of the RS with the exception of some administrative taxes, court taxes and user fees.

Tax administration and collection rest with the Entities and the District of Brčko. Tax administrations are separate including customs. Thus, the customs legislation, tax basis and tariffs are set at State level but the implementation regulations are defined at Entity level. All other taxes are administrated and collected by the governments of the Entities with the exception of a few administrative taxes, fines and user fees collected on the basis of cantonal and municipal regulations.

Tax revenues are entirely allocated to the Entities and sub-entities, including customs revenues.

In the FBiH corporate income tax on the large corporations (banks, insurance, telecommunication, post and energy production), customs duties and excise taxes are assigned to the government of the Federation. All other taxes and social security contributions are assigned to the cantons. The cantons retain all revenues from the corporate income tax, except on the large enterprises which are assigned to the Federation. They share with their municipalities, on the basis of the cantonal Law on the Allocation of Public Revenue the revenues of the personal income tax and wage tax, of the sales tax, and of the property taxes.

In the RS all taxes are assigned to the central government with the exception of the personal income tax and the sales tax which are shared with the municipalities and the real estate and property transfer taxes which are totally assigned to the municipalities.

All revenues are collected by the Entities' respective central tax administrations. In both Entities they are allocated to the various levels of government to which they are statutorily assigned according to the "derivation principle", i.e. on the basis of the tax generated in that particular level of government. In other words it is the economic potential and resources endowments of the sub-entities which determine their tax receipts. In both Entities social security contributions are earmarked for the ethnic based extra-budgetary social funds.

Annex 2 provides an overall description of the various taxes and the regulation, administration and allocation rules in the Entities.

As evident from the description of the allocation mechanisms of tax revenues the distribution of functions and spending responsibilities across the different tiers of government differ widely between the FBiH and the RS. The expenditures side needs, therefore, to be commented separately for each Entity.

In FBiH responsibilities are shared with the cantons and there is a complex fragmentation of responsibilities. The three major groups of functions and expenditures at federation level are:

- The operation of its executive, legislative and judicial institutions at this level (see annex 4); the army represents a substantial part of these expenditures;
- Reconstruction and capital expenditures financed out of international grants and concessional loans from the international financial institutions;
- Transfers which can be split into three groups:
 - Transfers to the State of BiH as mentioned above;
 - Transfers to households and the social funds which are dominated by the transfers to war invalids, one of the most important expenditures item of the government of FBiH;
 - Transfers to cantons and municipalities; these transfers, which are a small share of expenditures, do not include the taxes collected for these tiers of government by the federation (sales tax for instance), which do not appear in the federation's budget. They are funds to assist the lower levels of government and are allocated in accordance with their respective economic situations and needs.

The cantonal budgets cover expenditures of the executive, legislative and judicial cantonal institutions, primary, secondary and higher education, health, social protection, culture and other functions determined by the cantonal authorities. Extra budgetary funds provide social security benefits in conformity with the legislation.

The central government account for the FBiH is presented in Annex 1, Table 2.

When reading it one should keep in mind that it does not include the revenues, such as the sales tax or the social security contributions, which are collected for other tiers of government or extra-budgetary funds. These factors explain that revenues and expenditures correspond each to 14%-17% only of the federation GDP. The main characteristics are the heavy reliance on taxes on goods and services, and among these, taxes on external trade. On the expenditure side the military expenditures were the most important item but are gradually declining. In the 2002 budget they still amount for 19% of total expenditures. Transfers to households, among which war invalids, are the other most important components but also decline gradually. Reconstruction and capital expenditures amount to about 5% of total expenditures or less than 1% of GDP of FBiH. The fastest growing component of expenditures is the debt service covering the succession debt and new loans from international institutions to finance reconstruction. Operations and maintenance expenditures other than wages (goods and services) are contracted.

The deficit of the central government of the FBiH budget has been financed exclusively by foreign concessional loans. The Cantons deficits cannot be financed by international nor domestic borrowing so that mis-adjustment of expenditures to revenues is generally first settled by accumulating arrears and then by downward adaptation of expenditures to the point that basic services are inappropriately provided to the populations.

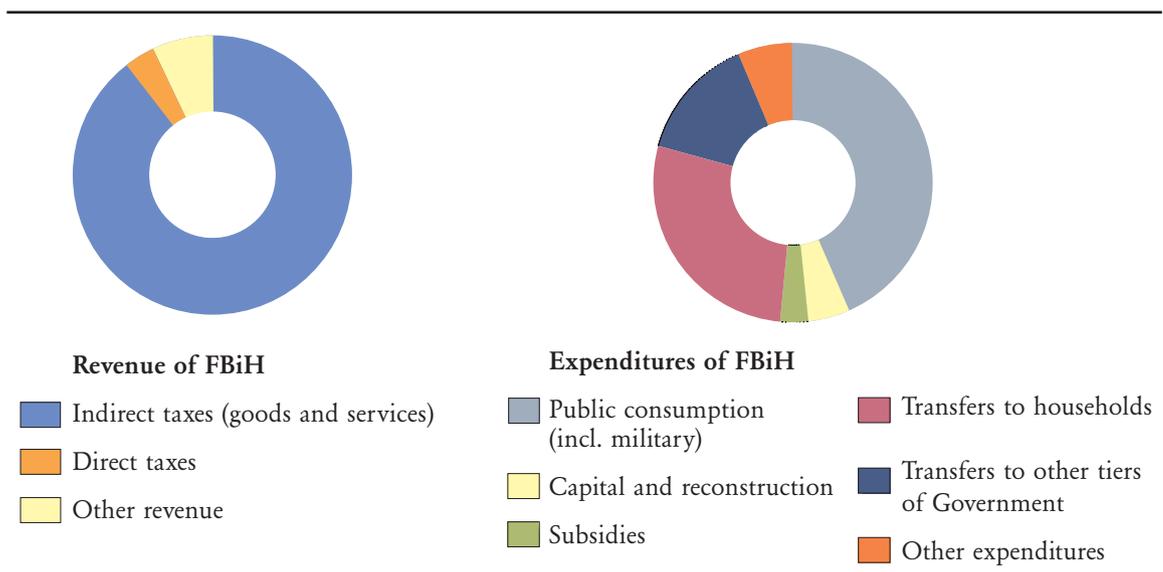
In the RS the central government account (Annex 1, Table 3) is more comprehensive than in the FBiH since, in view of the facts that there are no Cantons, its revenue includes quasi all taxes and the expenditures side covers all levels of education.

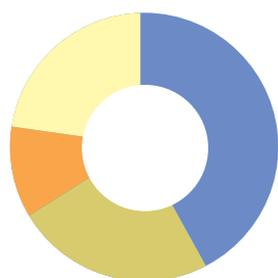
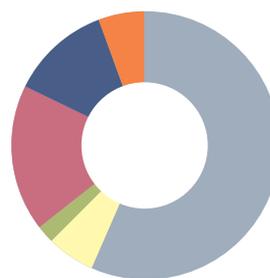
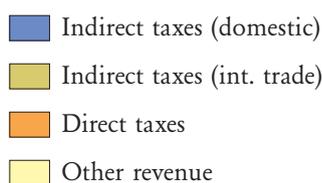
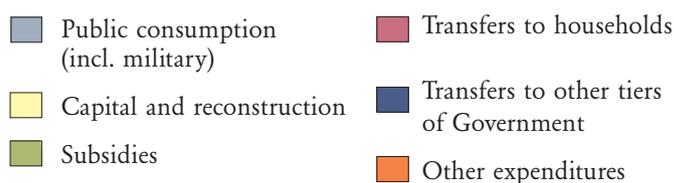
Overall the RS central government account reveals similar characteristics with that of FBiH: high reliance on taxes on goods and services (more than 85% of income), heavy wages and military expenditures and transfers, compression of non wage operational expenditures.

Chart 2 illustrates these broad similarities between the structures of revenue (dominant reliance on indirect taxes, dotted areas) and expenditures (high level of public consumption, including military expenditures, and transfers to households) of the two Entities.

The deficit is higher as a % of the Entity's GDP but the accounts are not strictly comparable.

Chart 2 – Structure of revenue and expenditures of FBiH and RS central governments (average 1998–2002)



**Revenue of RS****Expenditures of RS**

2.2.3 Assessment of the fiscal system in Bosnia and Herzegovina

The fiscal system fulfils three functions: (i°) to raise the resources needed to finance the public administration and government policies; this is the main role of the taxation system; (ii°) to allocate resources between the various policy objectives: this is the function of the budgetary allocation process, as well as the transfer and the investment policies; (iii°) to send the right signals to markets so as to induce the private sector to behave in a way consistent with the policies decided upon; this is achieved through pricing and subsidy policies, but results also from the other functions, taxation and budgetary allocation process.

The fiscal system must be analysed from the point of view of its scale, its integrity and its efficiency.

The scale refers to the importance of the public sector in the economy. There is no universal or optimal norm and the magnitude of the functions fulfilled by the public sector results largely from historical evolutions and political choices. However, there are technical constraints in terms of economic growth and sustainability. The size of the sustainable macro-economic deficit is a major issue in this regard.

The central government accounts of the Entities and the analysis of their budgetary revenues and expenditures provide only a partial and fragmentary view of the fiscal system and it is not sufficient to assess it against this criteria. The consolidated macroeconomic account is needed which encompasses all fiscal operations of all tiers of governments on the whole of the national territory.

For Bosnia and Herzegovina, according to the Government Finance Statistics (GFS) manual of the IMF, the consolidated government account would be the consolidation of the accounts of the 162 entities of Table 1. The major feature of the general Government consolidated account in BiH is that it does not exist, it is not established by any national institution and so far no institution has been formally assigned the responsibility to draw it.

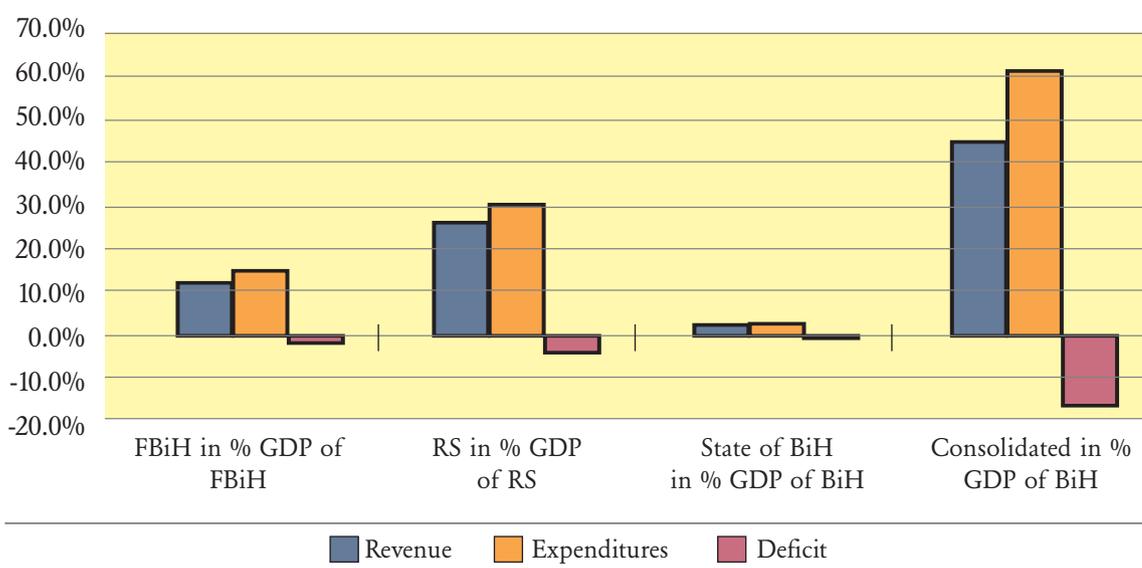
With great efforts two attempts have been made by the international financial institutions, one by the IMF⁴

4 IMF, Bosnia and Herzegovina, Staff Report for the 2001 Article IV consultation, IMF Country Report n° 02/52, February 11, 2002.

and one by the World Bank⁵ and they differ on many points, which shows the difficulty of the task (however, the messages are comparable). The difficulty comes not only from the number of government tiers but also because at every level numerous transactions are conducted off budget and therefore not recorded.

Annex 1, Table 4 presents the consolidated account drawn by the IMF⁶. In terms of magnitude of the fiscal system. It is immediately apparent when comparing this account with the central government accounts of the Entities and the State account which have been commented above that the latter provide only a very partial image of the public finance situation over the whole of BiH. Chart 3, drawn from data of Annex 1, visualises this.

Chart 3 - Entities central and State of BiH governments' accounts and general consolidated account



On Chart 3 the revenue, expenditure and the deficits (on cash basis before budgetary grants) of both Entities, of the State and of the consolidated general government are presented in percentage of the respective GDPs. Whereas the revenue, expenditures and deficit of the Entities in percentage of their GDP are not particularly high, the consolidated aggregates reveal an extremely high size of the public sector in the economy and a very high fiscal deficit (though declining in the last periods). On average over the last 5 years expenditures amount to close to 45% of GDP, revenues to more than 60% and the deficit is around a worrying -17%. Such magnitudes⁷ are clearly not sustainable in the medium term and will constitute an impediment to sustainable growth if they are not curbed. If they persisted they would imply an inconsistency between the fiscal and the monetary policy which might jeopardise the currency board arrangement.

5 World Bank, Bosnia and Herzegovina, From Aid Dependency to Fiscal Self-Reliance. (PEIR: Public Expenditures and Institutional Review, mid-2002) (Not for Circulation).

6 The IMF consolidated account included in Annex 1 is comparable with the central government accounts of the Entities presented in the other tables of this annex. However, the consolidated account compiled by the World Bank (table 2.1 p. 31 of the above mentioned paper) is more comprehensive because it identifies the total expenditures of the different tiers of Government and the off budget operations. In our discussion we will therefore make use of both sets of data. They are not strictly comparable but they provide useful indication on the orders of magnitudes various fiscal indicators. All figures should of course be regarded as order of magnitude rather than as accurate accounting data.

7 These figures should be taken as crude orders of magnitude only. The GDP figures do not include the large gray economy and public finance data are in no way accurate nor comprehensive.

Table 3 is constructed using the data presented in the World Bank PEIR

**Table 3: Structure of General Government Account
by level of Government in % of GDP of BiH in 2000.**

	Structure in % of BiH Consolidated General Government			Structure in % of GDP of BiH		
	Revenue	Expenditure	Balance	Revenue	Expenditure	Balance
State of BiH	0.5	1.1	5.1	0.28	0.71	-0.44
FBiH	72.5	71.9	67.9	40.24	46.66	-6.43
Federation's central government	17.4	15.7		9.66	10.19	-0.53
Extrabudgetary funds	22.4	20.2		12.43	13.11	-0.68
Cantons	22.8	22.2		12.65	14.41	-1.75
Municipalities	4.5	4.9		2.50	3.18	-0.68
Off budgets operations	5.4	8.9		3.00	5.78	-2.78
RS	26.5	26.6	26.7	14.71	17.26	-2.56
Republic's central government	15.2	14.4		8.44	9.35	-0.91
Extrabudgetary funds	6.0	7.5		3.33	4.87	-1.54
Municipalities	2.1	1.9		1.17	1.23	-0.07
Off budget operations	3.2	2.8		1.78	1.82	-0.04
Total: Consolidated BiH 1¹	100.0	100.0	100.0	55.50	64.90	-9.40

1 Including Brčko

Source: Computed from World Bank PEIR, table 2.1

In Table 3 the revenue, expenditure and fiscal balance of the State, the Entities, the sub-entities, the extra-budgetary funds and the off budget operations are all net of intergovernmental transfers. The different components can therefore be added. In the left three columns they are expressed in % of the consolidated general government account. This shows the distribution of total revenues, expenditures and deficit according to the different tiers of the Government. It highlights the difference between the decentralised structure of the expenditures and revenues in the FBiH (the Federation total revenues are 72.5% of the total consolidated revenues of the General government, but the revenue of the Federation's central government are only 17.4%, most revenues being assigned to the cantons and extra budgetary funds; the same is true for expenditures) and the RS (the RS revenue are 26.5% of consolidated general government revenues, and more that half, 15.2%, are assigned to the Entity's central government).

In the three columns of the right of Table 3 the figures are presented as percentages of the GDP of BiH which permits to show the contribution of each level of Government to the macro-economic aggregates. It shows in particular that the consolidated general government deficit which amounts to 9.4% of GDP is the sum of relatively small deficits of the State (-0.44%) and the central governments of the Entities (-0.53% for the central government of FBiH and -0.91% for the central

government of RS) but very important deficits from the other tiers of the Entities governments. In the FBiH, all sub-entities, extra budgetary and off budget accounts exhibit large deficits, which together amount to nearly 6% of the GDP of BiH, whereas in the RS it is essentially the extra budgetary funds that put the burden on the deficit.

This brief analysis shows that:

- The size of the fiscal sector in BiH is much higher than what is revealed by the budgets of the State and the governments of the entities. It exceeds by far usual international standards and leads to deficits which are clearly unsustainable and have to be curbed;
- The problem needs to be addressed consistently at all level of governments. Imposing a hard budget constraints on the Central Government budgets of the Entities and the State is not a sufficient solution because it is only a partial remedy and it risks either to let subsist massive slippages at the lower levels. Alternatively, if the Entities can pass on the budget constraints to the lower tiers, the danger is that basic services to the population will further deteriorate or even stop being provided. It would result in insufficient maintenance and development of human and physical resources and would undermine the efforts so reduce poverty.

The **integrity** of the fiscal system relates to its progressivity and its "fairness", and to its capability to collect all taxes due and to manage and implement whatever appropriations may be decided. It depends on the design of the tax system and the budgetary allocations. It also requires both an administrative capacity to manage technically the budgetary process and a control capacity to ensure the strict accountability of the budget execution and the public administration.

In BiH the following observations can be formulated in this regard:

- As already emphasized (see Chart 2 and Annex 1) the Entities rely essentially on indirect taxes as the dominant source of revenue. There is thus very little progressivity in the tax system;
- The description of the taxation system in annex 6 shows that progressivity in the income taxes is very limited (it even used to be regressive in RS, and is still regressive in Brčko);
- There is abundant evidence that the accountability of the tax administrations is weak, the fiscal losses important and tax enforcement unequal and subject to wide differences. The question will be analysed more in depth in Chapter 3 for the indirect taxes;
- Large sources of income come from grey and black economy activities which are not or insufficiently taxed;
- Property taxes in practice are little or not enforced;
- The rigid fragmentation of revenue allocation and expenditures responsibilities limits strongly or even prevents vertical (from high to lower incomes) and horizontal (from developed to less developed areas) redistribution. This is true across Entities but also within Entities, particularly in the FBiH where cantonal revenues are not necessarily adapted to responsibilities and needs;
- The system lacks transparency with many transactions conducted off budget.

The **efficiency** of the fiscal system relates to its effectiveness in influencing the allocation of resources in favour of sustainable growth and balanced development. In this regard it is particularly important that the fiscal system strengthens the single economic space on the whole national territory. There are many indications that the taxation regimes as well as the pricing and investment policies of the different tiers of government are not going into that direction. It will be shown in

Chapter 3 for the indirect taxes which will be reviewed. A quick look at Annex 2 also shows differences in the social security regimes (with differences between Entities as large as of 5% of gross wages net of social security contributions), and wages taxes which are clearly distorting competition between enterprises of the two Entities. Double taxation, in the case of some indirect taxes but also potentially in the case of workers resident in an Entity and being employed by an enterprise of the other, is another obstacle to the integration of the economic space.

2.3 Major issues with the current trends

The object of this study which is to investigate sustainable financial resources for the State institutions of BiH is indeed important and it will be argued in Section 4 that there is a case for complementing or substituting the system of transfers from the Entities with own resources originating from fiscal revenue. However, the analytical overview of the fiscal system in BiH conducted under Section 2.2 shows that it is not sufficient to address the problem by trying to find innovative sources of revenue for the State. A systemic approach is needed in order to ensure globally a fiscal system which serves adequately the populations and is reasonable in terms of size/sustainability, integrity and efficiency.

This implies the recognition that a number of current trends are not sustainable, a point which will be developed in this section, and that there are a limited number of basic essential functions which must be fulfilled or at least coordinated at State level. This latter issue will be developed in Section 2.4. The quest for sustainable resources for the State institutions of BiH must be conducted with the view of its contribution to the solution of both problems.

The major issues with the current trend may be regrouped under three headings.

2.3.1 Difficulty to face declining external financing and growing State responsibilities

The dependency of foreign intervention remains critical in a number of essential areas (political, military, economic, financial). This is evidently the result of Dayton and indeed it permitted the establishment of peace and the reconstruction of the country after the war. However, such situation is by definition transitory and inevitably (one should say "hopefully" for it is the sign of the success of the effort undertaken so far) international intervention will be reduced. This will have two major consequences:

- 1° An increasing number of functions and responsibilities are already or will have to be taken over by the State (Public Debt management, Central Bank, State Border Service, Trade negotiations, European integration through the participation in the Stabilisation and Association process, new State agencies in relation with the provision of regulatory framework for network industries, etc.) This trend will continue and will be intensified by the gradual retrenchment of the International Community, notably OHR/PIC, which continues to assume several functions, many of which are in the economic field. They will most likely have to be taken over by the State. Under Dayton they were assigned to the OHR precisely because they could not be fulfilled by the Entities and because there was not yet an adequate corpus of State institutions able to take over these duties. At present the State does not have the necessary powers nor the resources. Institutional building at State level must therefore prepare for this eventuality.
- 2° International financial aid and concessional lending will decline as the reconstruction process comes to an end. Since the need for high growth and economic catching up will subsist for

many years, BiH will have to finance important current account deficits. It is unlikely that BiH can go to the financial international markets before a long period of time. It will therefore be of the utmost importance to manage most efficiently the public finance at all levels, to channel domestic savings to domestic investment and to attract foreign direct investment. The last two points require the development of an "entrepreneurship friendly" regulatory framework and in particular the creation of a single economic space. The gradual withdrawing of the international community will also have to be matched by increased domestic responsibilities in terms of development investments and policies. This will require a medium term approach and a coordination of the macro-economic consistency of these activities. The State cannot be absent in this area.

2.3.2 Fragile stabilisation and lack of macroeconomic consistency

BiH has operated an impressive post war economic revival achieving high growth rates and stabilising inflation (with gradual convergence across Entities) thanks to substantial aid flows and a successful Currency Board arrangement. However these achievements are extremely fragile. It has already been pointed out that the financing of the current account deficit will be a severe constraint. Fiscal adjustment will be another one. So far it has been done in a rather ad hoc way and forced by external pressure. There is no domestic institution empowered to draw the macro-economic framework under which the fiscal adjustment must take place. So far the hard budget constraints has been imposed to the State and the Entities by the International Financial Institutions, but there is no "in house" strategic planning of the fiscal adjustment at the level of the country and the Entities and sub-entities. It has been shown in Section 2.2 that while the deficits of those institutions which are under the control of the IFIs are gradually curbed to sustainable levels, sub-entities, extra-budgetary funds and off budget operations contribute to the formation of a consolidated fiscal deficit which is clearly unsustainable.

On the one hand the IFIs cannot for ever take on the responsibility of managing the macro-economic consistency in BiH, on the other hand the current situation threatens the consistency between the monetary and the fiscal policies and therefore puts potentially the Currency Board at risk.

The need to develop institutional responsibilities and technical capabilities to design and monitor the implementation of a macro-economic strategy has been duly recognised by the international community. Several proposals have been formulated among which the efforts of the World Bank to promote the elaboration of a Medium Term Economic Framework to ensure that the budget effectively contributes to the realisation of the policy objectives, and a UNDP institutional building project at State level to support the management of the overall development strategy by the State government. So far there has been little materialisation of these attempts.

2.3.3 Fragmentation of the economic space

BiH needs to develop of a competitive supply side economic base which can provide employment and revenue to the people. This requires important investments, domestic and foreign and a single economic space on the national territory.

The current taxation system is in many respects not compatible with single economic space and many occurrences subsist where economic operators conducting business across the Entities face situations similar to that they would encounter if they worked with different states (double taxation, double administrative burden, etc.), or even worse. The point has already been mentioned in Section 2.2 and will be analysed more in detail in Section 3 for the indirect taxes.

2.3.4 Excessive limitation of the redistributive capacities of the fiscal system and insufficient accountability

The complex fragmentation of the fiscal system and the allocation of most fiscal revenues on the basis of the derivation principle provokes a large mismatch between responsibilities and resources of the different levels of government without possibility to redress the resulting inequalities. To take an extreme example, since cantons have the responsibility to organise education from primary to higher level and get their resources mainly from the sales tax collected on consumption taking place on their territory, a canton with an ageing population and a large fraction of the international community (KFOR, diplomats, NGOs, etc.) would be in a situation of financial surplus whereas a canton with a young demography and a population with a low purchasing power would face the impossibility to finance its education sector. There are no or insufficient mechanisms to redress such situations. They are a major factor to explain that although public expenditures are as high as 65% of GDP the public authorities are not able to provide the basic services which meet the demands of the population and the development goals of the BiH society: education, health, social protection.

Compounding that problem the lack of accountability of the fiscal system results in low mobilization of resources, shocking lack of equity, difficulty to operate any business, loss of confidence of investors.

These factors are serious impediments to social cohesion.

2.4 The essential functions of the State

The improvement of the financing of the State institutions must be viewed in the perspective of providing an adequate response to the issues raised in the previous sections. Therefore, it must be submitted to two conditions:

- The State finance must be analysed taking into account the global architecture of the different fiscal systems existing in BiH, so as to increase globally the efficiency of resources mobilisation and allocation;
- Reinforcing the State and its revenue must be accompanied by a more than proportional reduction of the fiscal accounts at other levels.

Strengthening existing sources of revenue of the State institutions and inventing new ones to cover additional functions that could be assumed by the State may be a necessary but certainly not a sufficient condition to solve the problems mentioned. It is essential to focus on the essential functions of the State and to secure resources allowing their effective and efficient conduct by the State Institutions.

In BiH many functions that are elsewhere regarded as State responsibilities are empowered to the Entities (Defence, taxation and control of revenue, etc.). It is not the objective of this study to advocate for a strong State with numerous responsibilities; this is a choice that belongs only to the people of BiH. However, it is reasonable to ask the question: within the given historical and political context what are the minimal functions the State must be able to fulfil in order to secure the viability of BiH as a whole, and of its Entities and sub-entities?

Two considerations permit to answer this questions:

- 1° The responsibility for the macro-economic stability. This is a normal function of every State, federal or not, and it is an imperative requirement for joining the EU. It implies the capacity at State level establish and monitor the global macro-economic framework of the nation. In the area of public finance it requires in particular the ability to collect and organise all the information needed to consolidate the macro-financial aggregates and to coordinate and monitor over the medium term the consistency of the fiscal and the monetary policies in view of ensuring economic stabilization and sustainable growth at the level of the whole country. So far BiH has no internal institution empowered with these responsibilities. There must be a central responsibility for collecting information and coordinating policies, and a central point to manage the trade offs required by the consistency of policies and the compliance with the macro-economic constraints.
- 2° The organisation and regulation of a single economic space propitious to the development of a supply side which can provide employment to the people and allow Bosnian enterprises to face the competition of EU markets. The single economic space is a requirement of the Constitution of BiH and is a requirement of the Stabilisation and Association process. Linked to this are a number of conditions (unicity of trade policy, control of customs, capacity to combat fraud and crime, to guarantee phyto-sanitary standards, etc.) which can only be met at State level.
- 3° Coordination of the poverty reduction strategy. This is a far reaching responsibility. Whereas poverty reduction depends on the development of the private sector and on efforts at all levels of the governments and the civil society - particularly at the lower levels which are directly in contact with the poor and deliver the basic services to the population - the State has an indispensable role to play in providing the adequate regulatory framework and in coordinating the strategy. The needs to guarantee macro-economic stability, to improve fiscal coordination, harmonization and accountability, and to create mechanisms addressing vertical and horizontal imbalances are recognized in the interim PRSP together with that of increasing the resources of the State. The affirmation in the Preamble of the Constitution of the promotion of the general welfare as one of the overarching principles of BiH is also a clear indication of the State responsibility in this area.

3. Adapting fiscal governance to the essential functions of the State

Many aspects of the fiscal system should be improved (direct taxes and social security are certainly not optimal!) but in view of the limited time and the scope of the study, the following areas will be explored:

■ Taxation of goods and services (customs, sales taxes, excises, VAT):

The reason for analysing in priority the indirect taxes is that they are the main fiscal resource at present. They are entirely collected at Entity level and fully allocated to the Entities and sub-entities (see Table 4). In the context of the present study it is important to analyse these taxes because their collection and allocation has implications on the single economic space and has many weaknesses in terms of efficiency and accountability. There is also currently a debate on VAT and this form of tax is planned for 2004. A reform of taxes on goods and services could therefore be used both to contribute to an improvement of the overall fiscal system in BiH and to allow for an allocation of parts of the proceeds to the State institutions.

With regard to its contribution to the State revenue, the analysis of indirect taxes in relation with the financing of the institutions of BiH has a double dimension:

- Improving the efficiency of indirect taxation is directly beneficial to the Entities finances and therefore reduces the weight of the transfer to the State or alternatively could permit its relative increase; the improvement of the efficiency of indirect taxation can come from diverse measures, including a single centralised tax administration operated at State level; these options, likely to improve State finance do not necessarily entail a change in the current allocation of the tax revenues across the Entities and sub-Entities.
- The allocation of a fraction of the revenue of a tax to the State institution is a separate issue which is independent of whether the tax is collected by a centralised or decentralised administration. This point will be dealt with in Section 4.

Table 4: Taxes on goods and services (2001)

	Thousand KM				Distribution of Revenues by Entity				Geographical Distribution of Revenues			
	FBiH	RS	BD	Total	FBiH	RS	BD	Total	FBiH	RS	BD	Total
Taxes on goods and services	1,500,535	541,514	80,089	2,122,138	78%	71%	75%	76%	71%	26%	4%	100%
Customs (international trade)	620,000	187,300	27,008	834,308	32%	24%	25%	30%	74%	22%	3%	100%
Sales tax on goods and services ¹	604,335	216,714	20,553	841,602	31%	28%	19%	30%	72%	26%	2%	100%
Excise and road fee	276,200	137,500	32,528	446,228	14%	18%	31%	16%	62%	31%	7%	100%
Taxes on profit and income	236,886	92,997	5,086	334,969	12%	12%	5%	12%	71%	28%	2%	100%
Other own revenues	186,328	132,137	20,996	339,461	10%	17%	20%	12%	55%	39%	6%	100%
Total	1,923,749	766,648	106,171	2,796,568	100%	100%	100%	100%	69%	27%	4%	100%

¹ Includes cantonal and municipalities sales tax revenue in FBiH (not included in FBiH budget)

Source: Data communicated to OHR by fiscal authorities.

- Potential benefits associated with the regulatory functions of the State.

As indicated in Section 2.4 organising the single economic space and meeting the specific requirements for European integration are typical State functions. It is therefore relevant in the present study to review what these functions are currently, what improvement they require and to explore if they can produce additional revenue for the State.

- Specific fees and administrative taxes.

These are currently the exclusive own resource of the State institution. The existing situation will be reviewed in order to see if it is appropriate to consider possible additions or alternatives while avoiding the danger of raising a multiplicity of ad hoc fees and taxes.

3.1 Customs duties

3.1.1 Description of current system

Foreign trade policy and customs policy are assigned to the State of BiH by the Constitution. BiH has a four rates tariff system (0%, 5%, 10% and 15%). It has negotiated free trade arrangements with Croatia, Macedonia, Slovenia and FRY, and will further liberalise its trade with the progress of the negotiations to access WTO and to become a candidate to the EU.

Although the policy is set at State level, it is implemented by the Entities which have each, including the Brčko district their own tax administration. Implementation regulations are, however, identical. Imported goods must be accompanied by the international Single Administrative Document which is handled at the border entry point. The goods are authorised to leave the border on presentation of a bank guarantee for the amount of tax due. Inland clearance and payment of duties may take place at any custom station in the country and the tax revenue is collected by and assigned to the Entity of the point of clearance. If the goods are "missing" i.e. not cleared, the bank guarantee is executed and the revenue remain with the Entity of the border crossing point.

The extremely long border offer many possibilities of fraud. There are about 400 crossing roads (Bosnia was one of the republics of Yugoslavia with no international border) and only 20 are official border crossing ones. Only these 20 are controlled (no "flying brigades" e.g.). There is a general tendency to consider that resources are insufficient and therefore only X% of the area will be controlled so long as international community or whoever does not supply additional resources. There is fear that if one attempts to control everything with the existing resources it will be more difficult to mobilise external funding.

The system is managed by two customs administrations⁸, with about 1200 staff for the FBiH and around 800 for RS. Many of these staff are ex-military and their number tend to be growing. In addition to the two headquarters there are 10 custom houses in FBiH and 8 in RS, plus a large number of inland custom stations (points of clearance, warehouses, unloading).

In order to have a quantified view of the importance and the evolution of the various indirect taxes, the CAFAO data presented in Annex 3 will be used. Whereas Table 4 gave the global picture of tax revenues across Entities and the Brčko district but only for one year, the CAFAO figures do not cover Brčko but they offer the advantage of being more comprehensive, they identify within the FBiH the revenue allocated to the federation and to its sub-entities, and they cover several years. As usual in

8 Brčko has a tax department.

BiH data from different sources may be inconsistent, so that data from Table 4 should not be mixed with those of Annex 3.

Table 1 on Annex 3 gives the absolute amounts of revenue collected. Custom duties are entirely allocated to the federation in FBiH. Table 2 shows that their share in the total revenue of FBiH has substantially increased (from 19.7% in 1999 to 34.1% in 2001) while it remained stable, around 23% in RS. As a logical consequence Table 4 shows that the distribution of custom tax revenue between FBiH and RS has moved from respectively 72%-18% to 81%-19%. Table 5 and the corresponding chart on custom duties show the rapid progression of custom duties in the FBiH compared to the RS.

3.1.2 Problems and issues

The major problem is the large scale of fraud and tax evasion. Accurate figures are of course not available. However, CAFAO's investigations permit to form an idea of the magnitude of the problem with known custom frauds totalling approximately 183 million KM since 2000 and revenue losses estimated to be of the order of 375-400 million KM⁹ per year. Compared to the total revenue from custom duties these are impressive figures. There are basically three factors contributing to this state of affairs:

- The objective factor of the geography and the numerous border crossing points already evoked;
- Insufficient qualification and professionalism of the administrations. The staff are often former militaries without knowledge of custom work. There is also a tendency to consider that resources are insufficient and therefore only a limited percentage (the 20 crossing points) is controlled. The alternative to try to control the whole area, for instance with "flying brigades" and random checks, is not pursued because it is feared that it would make it more difficult to advocate the need for additional donor resources;
- General lack of accountability of the custom administration and competition between Entities (particularly Brčko) in order to get clearance on their territory have led to massive under valuation of imports. This is the main source of revenue loss and CAFAO¹⁰ has drawn the attention of the authorities and reminded the State administration that it has the responsibility and the power to monitor and control the Entities' customs administrations. This has not been followed by visible changes in part because ethnical obedience's of the individuals tend to take precedence on their obligations to their country;

Other causes of revenue losses are the manipulation of the rates and lack of control of goods.

In addition to cost ineffectiveness and important revenue losses for the Entities this ill-functioning of the tax administrations and the general level of corruption impose high operation costs to the economic operators, in particular those who respect the rules. They are also a significant obstacle to the creation of a single economic space.

9 CAFAO: Revenue Loss from Tax and Customs Fraud in BiH Identified by CAFAO, 1/10/2002.

10 According to CAFAO under valuation alone would involve 300 million KM revenue loss per year. As a side remark that involves also a massive under valuation of the imports in the balance of payments. Indeed, comparing for 2001 the custom duties according to CAFAO (835 million KM) to the value of imports for that year according to the Balance of Payments statistics of the Central Bank of BiH produces an "implicit rate" of import duties close to 10%. The revenue losses due to under valuation therefore corresponds approximately to an under valuation of 3 billion KMs and would double the current account deficit if all other things remained equal. This shows the extreme fragility not only of the fiscal data but also of the balance payments data and calls for a dramatic improvement of all macro-economic data.

3.1.3 Possible improvements

Basically three options can be envisaged:

- 1° Continue with the system as it is: it would at least require that the State undertakes strict monitoring of the tax collection and custom control by the Entities administrations. This might not be sufficient without dramatic reform of the tax administrations.
- 2° An option proposed by CAFAO would be to maintain the existing administrations but to transfer all tax proceeds into a single account. This would entail two advantages: it would eliminate the incentive to attract clearance on the territory of a particular Entity and it would allow a better control of the collected funds. A new allocation mechanism should be devised. It could be either an agreed sharing formula or an allocation based to the turnover (gross output) of each region which could be identified by the sales tax (or by reported final sales in the case of VAT, see *infra*).
- 3° The best solution, however, according to CAFAO experts would be the creation of a new State customs administration which would substitute to the previous Entities ones. The allocation mechanisms would be as under solution 2° but in addition a complete rationalisation of the customs administrations could be undertaken and the new administration being established at State level cooperation with the State Border Service would be easier and fruitful.

According to CAFAO the efficiency gains would be important: the total customs staff could be reduced by 600-700, the 18 custom houses could be reduced to 4 covering territories which would not necessarily comply with existing Entities boundaries.

Creating a State Customs Administration would require manageable legal changes: minor formal adaptation of the custom and tariff laws and a redrafting of the custom service law. Transforming customs into a national administration would involve risk that cannot be underestimated:

- During the transition period, the motivation of the people fearing to be laid off or belonging to custom stations that will be suppressed will tend to be very low. It is imperative to pay attention to the problem to avoid revenue loss;
- There is a danger that the system be high jacked by Entities or sub entities who would create their own system to collect revenue.

The whole operations, therefore, would require good preparation and acceptance. But it would clearly be in the interest of the country as a whole and of each Entity.

3.2 Excise duties

3.2.1 Description of the current system

Excises are the jurisdiction of the Entities, collected by the Entities tax administrations (customs administration for the excises on imports, domestic tax administration for other excises), with the revenue fully assigned to their respective central governments. Under the pressure of the International Financial Institutions which made it a conditionality of their support, excises are quasi harmonised across Entities. They are levied in the form of specific taxes on the traditional excisable goods: alcohol, petrol and petroleum products, coffee, soft drinks, and as an *ad valorem* tax of 35% on tobacco products. A road fee, currently 0.15 KM per litre of petrol at the pump, is levied in FBiH and in RS but not in the Brčko district.

Up to recently excises were collected at the production point (for locally produced goods) or the import (clearance) point, and the revenue remained with the collecting Entity. This blocked inter-Entity trade because when goods produced/imported in one Entity were traded in the other, the latter also claimed excises, thus generating double taxation.

In international transactions the usual principle is that the tax belongs to the country of consumption which means that excisable goods are exported free of excise duties and submitted to those of the importing country they enter. Straight application of this rule in BiH proved impracticable because of the lack of confidence: while the Entities would accept to exports duty free goods to other countries, they would not accept it for goods sold to the other Entity. Under World Bank insistence the following system has therefore been adopted: the tax is paid by the first buyer in the Entity of production or import; in case of further sale to a registered buyer in the other Entity, the excise duty will be paid again in the other Entity but on basis of the proof of this payment the first buyer will get a tax credit in his own Entity. The system is far from perfect :

- It is heavy and if the buyer in the second entity is slow to do the administrative steps the first buyer supports the double taxation for a long period;
- To make it administratively manageable only a few companies are authorised to sell across the whole country. For the others double taxation remains the rule, so that they not trade across the whole territory.

Here again, therefore, the Entities' management of the tax constitutes an obstacle to the single economic space.

Table 4 and Annex 3 provide figures and orders of magnitudes for the excise duties. They account for 10% to 20% of the Entities total revenue. They are on a declining trend in FBiH and exhibit a very strong recovery in 2001 in RS after a sharp decline in 2000. These fluctuations of revenue are linked to the inadequacies and the changes in the collection methods, to the activities of the refinery in RS (the main source of excises), and the improvement of the tax administration in RS over the latest year.

3.2.2 Problems and issues

There are three problems:

- Difficulty of harmonisation: the single economic space on a territory of the exiguity of that of Bosnia and Herzegovina with internal regions so much intertwined¹¹ does not allow for different excises and excise rates. This is has been the motto of the international financial institution who tried to force harmonisation. With three legislative authorities and three implementing administrations it proved a formidable effort and a waste of energy. As an example, the far from perfect agreement recently arrived at under World Bank pressure for the payment of excise duties on inter-Entity trade took nearly two years to negotiate. During this time inter-Entity trade was hampered. Any kind of future adaptation will face the same obstacles. Harmonisation is not yet complete, in particular with Brčko;
- The current arrangement does not establish a single economic space for excisable goods but permits only a few authorised traders to avoid double taxation, with administrative complications, while double taxation remains the rules for the others;
- Lack of accountability and inefficiency of the tax administrations are a pervading problem. There are no revenue losses on the domestic excises but well on imported goods. There exist no estimation separate from that of revenue losses on imports.

11 Thus a situation that can in no way be compared to that of the United States or Brazil, or even the European Union.

3.2.3 Possible improvements

The two options that can be considered are:

- 1° Continue under the current system. Unless cooperation and confidence between Entities is greatly improved the drawbacks in terms of administrative complications and lack of levelling of the single market would subsist. Improvement on the tax collection could come from a reform of the customs administration (for the excises on imported goods).
- 2° The creation of a single administration at State level. If the creation of a State customs administration were undertaken then there should be no alternative to creating a state excise administration combined with the customs administration since the latter collects most duties.

3.3 Sales tax

3.3.1 Description of current system

The sales tax is under the jurisdiction of and administratively managed by the Entities. In the FBiH the tax administration of the federation collects the tax but the revenue is entirely assigned to the cantons and municipalities on the basis of the derivation principle. In the RS the central tax administration collects the revenue which is assigned to the central government of the Entity.

As for other taxes gradual harmonisation has been imposed by the international financial institutions in order to avoid excessive distortions on the economic space. Currently the sales tax general rate 20% in both Entities (with some differences of rates for certain categories of goods) and in a band from 8% to 18% in Brčko district. It should be noted that by international standards 20% is a high rate for a sales tax (but a frequent one for a VAT). Most countries with properly working sales taxes have rates not higher than 10% (USA, India). The reason is that with a sales tax it is quasi impossible to avoid taxing enterprises inputs¹².

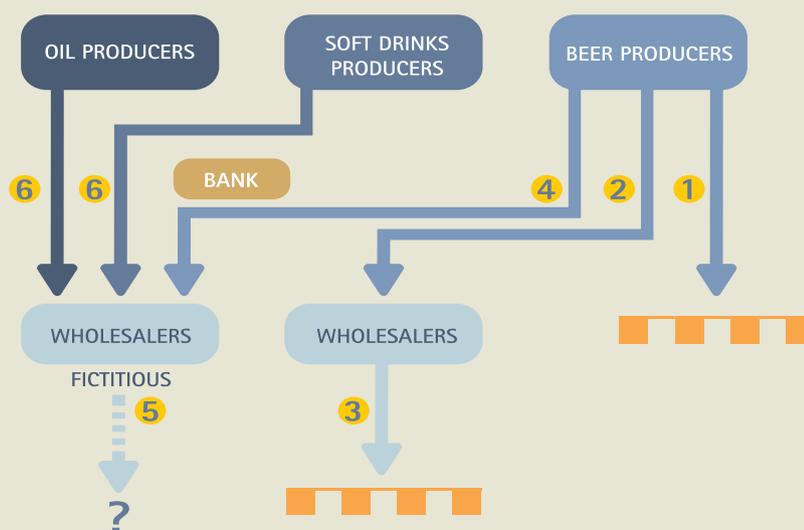
The administration of the tax and the collection mechanisms evolved over time in BiH. Initially the sales tax was paid at producer or import point. The tax revenue was allocated to the Entity of the first buyer which provoked additional useless transactions because Entities had an incentive to have a first buyer on their territory. (These " fictitious " first buyers provoked a distortion in the allocation of tax revenue but no loss of tax revenue). As an interim step to prepare for VAT and allow for allocation of revenue at destination, the IMF pressed for collection at retail point. This created an enormous opportunity for fraud and the emergence of fictitious companies (see box). CAFAO estimates that revenue losses on the sales tax are of the order of 500 million KM per year.

Table 4 and Annex 3 provide quantitative information on the magnitude and distribution of sales tax in BiH. For the FBiH the sales tax is the most important source of revenue, amounting (CAFAO data) to more than 40% of total revenues, whereas in the RS its relative share in revenue is in the range 16-22%. The tables of Annex 3 also show the allocation of the sales tax to cantons and municipalities in the FBiH: Table 2 shows the importance of the sales tax as the major resource for the cantons which benefit (Table 3) from 86% to 90% of the proceeds of this tax.

12 A study in the US in 1989 concluded that 40% of sales tax proceeds were from business purchases (Ebill, L., Keen, M., Bodin, J.P., and Summers V. "The Modern VAT", IMF 2001.

Collection of sales tax at retail point. Example of fraud mechanism.

Beer producers usually sell part of their production to their own network of retailers (arrow 1) or to wholesalers (arrow 2) who in turn sell to retail points (arrow 3). Under the system of tax collection at retail point, the sales tax is paid by the retailers and remains in the Entity where the retailer is registered. This generated the creation of fictitious wholesalers (arrow 4), i.e. companies buying from the beer producers, and settling their invoice (free of sales taxes since they are not retailers) through a bank account in conformity with the legal obligation. However, beyond this point there is no trace of buying retailers (arrow 5) and therefore no tax collection. Investigations through the banks or the registers generally end to companies which are empty shells. The suspicion that one is in presence of organised crime on a large scale is based on the fact that enquiries conducted by CAFAO have shown a surprisingly large number of sales from companies (oil producers, soft drink producers, arrows 6) to the same fictitious wholesalers and paid through bank accounts from the same banks. The system gets more sophisticated when one takes into account inter-Entity transactions and the fact that many of these products are charged excises and sales tax. CAFAO tracked the sales chain from one company whose production had a market value of 90 million KM. It found that 40 million KM went through the legal channels (arrows 1, 2 and 3), and 50 million were lost through fictitious companies.



3.3.2 Problems and issues

The major problem is clearly the inadequacy of the current system of collection and the massive losses generated. It is compounded by the lack of efficiency and accountability of the fiscal administration as already mentioned for the other taxes.

Two other more general problems may also be pointed. First, the high rates of the sales tax in BiH may be counter productive and induce enterprises to choose to operate in the grey economy. Second, the allocation mechanism across Entities, and across cantons and municipalities in FBiH,

does not contribute to allocate the resources where they are most needed. This point is common to all indirect taxes in BiH but is particularly crucial with the sales tax given its importance for the sub-entities in FBiH.

3.3.3 Possible improvements

The level of sales tax losses is really creating an emergency situation. Broadly two options can be envisaged:

- Improve the current system. In the short run the following measures could be adopted:
 - The trade registration system needs to be strengthened in order to reduce the possibilities of creating fictitious companies;
 - Tax collection should be moved upward from retailer to wholesaler; tax revenue should then be put in a single account and from there transferred to the Entities and sub-Entities using a formula.

In the longer term the rates should be revisited.

- The type of administrative reform (in terms of professionalism and accountability of the administration in particular) that would be needed in BiH to operate efficiently the sales tax (practically the creation of a new administration) would be just as important as the one needed to introduce a VAT, which is a superior tax. Given the importance of the issue this will be the object of the next section.

3.4 Implementing a VAT

The implementation of the VAT has been recommended by the International Financial Institutions and it is a requirement for European integration insofar as EU member States are not allowed to have sales tax at national or sub-national level. Its adoption is viewed in the interim PRSP as a desirable reform to redress the inefficiencies of the tax administration and limit fraud. Not least, it is a Government commitment with implementation targeted to the year 2004, reaffirmed in "Our Reform Agenda".¹³

The advantages of the VAT justify such consensus in its favour. A VAT is "*A broad-based tax levied on commodity sales up to and including, at least, the manufacturing stage, with systematic offsetting of tax charged on commodities purchased as inputs - except perhaps on capital goods - against that due on outputs*"¹⁴ This rather cumbersome definition encompasses the two main characteristics of the VAT: (1°) it is levied at multiple stages of production with the sellers required to charge the tax on all their sales but being able to claim all taxes paid on their inputs; (2°) it is a tax on consumption.

Its advantages on alternative taxes on consumption are many. Unlike turnover tax it avoids cascading and does not induce distortions of production decisions. A retail sales tax (i.e. a sales tax levied at the point of sale of the final product as in BiH) would also avoid these distortive effects but VAT is superior on two grounds:

13 Bosnia and Herzegovina. Council of Ministers BiH. Ministry of Foreign Trade and Economic Relations. Office of the BiH Coordinator for PRSP: Our Reform Agenda. An Agenda for Reform Agreed Between the Government of Bosnia and Herzegovina and the International Community.

14 Liam Ebrill, Michael Keen, Jean-Paul Bodin and Victoria Summers: "The Modern VAT", IMF, Washington 2001.

- The method of collection secures revenue more effectively because the purchasers will need proper invoices from their suppliers in order to be able to reclaim the VAT on their inputs, and, probably even more important, because the tax is collected at many points along the production chain under the VAT against a collection at the final stage only for the retail sales tax. While the VAT system may be administratively more complicated it is less vulnerable to tax evasion;
- It is nearly impossible to avoid that a significant proportion of the retail sales tax falls on business inputs thus creating distortions.

The main questions to resolve in view of the implementation of VAT in BiH are:

- Will the tax be established at Entity (and Brčko District) level or at national level?
- How will the revenue of the tax be allocated to the various Entities and sub-entities?
- How many tax rates will be introduced and what will be their magnitude?

It is generally considered that the VAT is a tax that is properly levied only by the central Government¹⁵, although tax revenue can be shared between the different levels of Governments. All the federal member states of the EU have central VAT and this is the case all over the world with the exception of Quebec which operates a VAT on its own, and the states of Brazil. These are in no ways examples relevant for BiH.

The reason why VAT is best regarded as a central government tax is that the application of "the destination principle" is extremely complicated within a federal state. The destination principle means that the total tax paid in relation to a commodity is determined by the rate levied in the jurisdiction of its consumption (in practice final sale is used as a proxy) and that all tax revenue go to the government where the final sales occur.

The destination principle is applied by zero rating exports and taxing fully imports. Its application in a federal state implies that the different states may have different tax rates and that inter-state trade takes place at the zero rate. It is evident that such system would lead to many complications in a federal country:

- The difference of rates across states, especially in a small country as BiH, induces cross border shopping and numerous distortions;
- Since the destination principle involves zero-rating exports the possibilities for fraud are evident. No doubt that in BiH they would be fully exploited.

The IMF has recently produced an "aide mémoire"¹⁶ for the implementation of VAT in BiH. The proposal can be summarised as follows:

- VAT will be established on the whole territory of BiH and the tax base will be defined in a State law;
- Each Entity will define the tax rates, within a limited range, administrate the tax and collect the revenue on the basis of the final sales;

15 See for instance, Ebrill and al., op. cit., chapter 3 and chapter 17.

16 Bosnia and Herzegovina: VAT - A Way Forward. IMF. Fiscal Affairs Department, April 25, 2002. Restricted for Circulation

- Inter-entity sales to registered taxpayers will be charged at a special rate, 1% or 2% lower than the lowest standard Entity rate;
- Registered taxpayers in each Entity will mention on the output side of their VAT periodic reports: the amount of exports at the zero rate, the domestic sales at the rate of the Entity, the inter-entity sales at the special rate. On the input side of their VAT reports they will mention imports and domestic purchases (i.e. to Entity registered operators), and purchases from the other Entity at the special rate;
- Each Entity will keep the net tax revenue collected from its own registered taxpayers and the Entity which has net revenue from sales to registered taxpayers in the other Entity (sales taxed at the special rate) will repay it to the other Entity to which it is due under the destination principle¹⁷.

Table 1 of Annex 4 illustrates this mechanism with a simple numerical example.

The proposal is extremely ingenious because it permits to apply the destination principle to the special case of BiH without zero rating inter-Entity trade, a solution¹⁸ which would probably lead to massive frauds. Moreover, it permits to operate without changing the current structure and to leave full autonomy (within a pre-agreed band of rates) to each Entity. Finally it provides a (marginal) incentive to conduct inter-Entity trade taxed at a lower rate. However, it is surprising because it goes against the general view, already mentioned, that VAT is best operated at central level. It goes also against the opinion that was clearly voiced in the IMF Staff Report for the 2001 Article IV Consultation of February 2002¹⁹. In fact, this proposal has been designed under the hypothesis that the introduction of a State tax would require a constitutional change, an assumption that is not correct as will be demonstrated in Section 4.2.3.

As it is proposed the mechanism presents many drawbacks. The first one, which is fundamental, is that it does not naturally lead to a levelling of the single economic space but on the contrary maintains existing fragmentation and subordinates harmonisation to political negotiations. Second, the system of tax clearing on inter-Entity trade works only with two partners. In order to solve the problem of Brčko the Fund proposes that the State should assign to the District a VAT rate which should be the same than that of one of the Entities. Sales between Brčko and each Entity should be treated as inter-Entity sales. Trade surplus between Brčko and one Entity would give rise to a transfer from Brčko to that Entity. Although this clumsy solution would permit to include the Brčko District in the allocation pattern of VAT revenue it would not solve the problem of the allocation of the tax revenue to the cantons in the FBiH. For this the IMF recommends to use a sharing formula. A final remark is that to work properly the mechanism requires that

17 Since it relates to a final sale in the other Entity.

18 It could be argued that zero rating exports is the system applied within the EU. However, one should keep in mind that in the case of the EU the system results from sovereign states organising their pre-existing systems to create a single economic space. Moreover, even with the strong and experienced administrations of the EU member states frauds remain significant and difficult to fight. Finally the complexity of the system should not be neglected (as an example the VAT manual for Belgium is a 835 pages document).

19 § 39 of that document needs to be quoted in full: " A future VAT could at one stroke resolve the issue of financing the State and place BiH's indirect tax system on a sound footing, but preparations have stalled over a fundamental design issue - whether the tax should be at the Entity or at the State level. Federation and State authorities favor a State-level VAT while the RS authorities consider that the Dayton Accords place taxation under the authority of the Entities. The staff emphasized two points. First, a well functioning VAT system would be a more reliable revenue source for the State as well as the Entities than the existing sales tax system. Second, robust enforcement of a VAT would require an integrated tax administration or closely cooperating tax administrations with access to a common database. The staff urged the authorities to try and agree on a model for an integrated country-wide VAT that meets the political concerns of both Entities."

periodic (monthly or quarterly) clearing between the Entities takes place effectively and without delays otherwise if intra-regional trade is asymmetric (for example, if sales from RS to FBiH systematically exceed those of FBiH to RS) the "exporting" Entity might be penalized. Penalty interest or other sanctions should be envisaged to force rapid compensation.

The International Advisory Group on Taxation (IAG-T) has reacted to the IMF proposed mechanisms expressing a strong opposition on grounds which are similar to those just mentioned. It proposes instead to set up a single State VAT administration and a single system of rates (number and values) across the whole territory of BiH. Allocation of VAT revenue across the Entities and the cantons would be done on the basis of the final sales. For this VAT returns would mention distinctly VAT sales to other registered operators (who can recover VAT) and final sales. Table 2 of Annex 4 presents an example of a single VAT law and administration where the revenue would be allocated to the Entities according to the location of final sales.

In this example, only two entities are considered. The assumption is that there is one national VAT rate, 18%. Enterprises are not any more asked to indicate intra-Entity sales, but they have to indicate final sales. VAT on final sales is 1800 in FBiH (final sales concluded in FBH, the assumption being that a final sale takes place at the location of the seller) and 1440 in RS. Interpreting literally the IAG-T paper one would conclude that the national VAT administration would retransfer these amounts to the respective Entities. However, in the example the amount to be transferred to the Entities is superior to the net VAT revenue cashed in by the VAT administration during the period. This, of course, is a special case since overall the VAT on intermediate sales boils down to nothing and only the VAT on final sales is levied. However, on a month by month basis, it is not the case (department stores may incur heavy expenses during 8-9 months in the year and realise most of their turnover around a few peak periods, Christmas-New Year, etc.). There will be months where the VAT on final sales will be inferior to the net proceeds, although cumulated over a period corresponding to a full production cycle net proceeds will be equivalent to VAT on final sales. To avoid cash management problems for the VAT administration, a simple solution illustrated in the bottom lines of the example of Annex 3, would be to allocate tax revenue proportionally to the regional distribution of final sales. An alternative solution could also be to allocate revenue according to a sharing formula, as proposed by the IMF for the allocation of VAT revenue to cantons in the FBiH. This would of course depart from the "destination principle" but it has never been said that the destination principle should apply inside the borders of a sovereign state. It must be added that with a single VAT law and administration, and collection based on the distribution of final sales or on a formula, the number of beneficiaries of the allocation process does not matter.

Besides the question whether VAT should be State or Entity based, the introduction of the tax requires decisions on the number of tax rates and their magnitude. There is a trade off between equity and efficiency. The less tax rates the simpler the administration of the system. On the other hand lower rates for basic needs (food in particular) might be justified. In any case the number of rates should be kept to a minimum and exemptions should be avoided.

Regarding the rate itself, it should take into account the existing sales tax situation and the situation in neighbouring countries. On these ground a value around 20% (say between 18% and 22%) would probably be justified in BiH. It should be noted that 20% is the current rate of the sales tax, a rate exceptionally high for this type of tax²⁰ but close the international practice for VAT rates.

20 Well functioning sales taxes have generally rates lower than 10% while most VAT systems have rates superior to 18%-20%. A major reason is that high retail sales tax have distorting effects since there is always a proportion of a retail sales tax that fails on enterprises inputs (see supra).

3.5 Regulatory functions of the State in network industries

The major utilities, because they are natural monopolies and/or fulfil social goals cannot be exclusively ruled by the market mechanisms and require regulation on the production and right of entry (competition), the pricing policies (tariffs), and the services to fulfil. For technical reasons they are network industries requiring coordination of their operations on the national territory or even internationally.

Given the importance of these industries and the extension of their network the higher the level of regulation, and the closer the cooperation between the regulatory authorities, the better.

The general situation is that the Entities own and operate their utilities. The separation between the regulatory and managerial functions is often unclear creating conflicts of interest and making it difficult to enforce strict accountability. In FBiH some utilities are owned by the Entities and operated by the cantons. At present utilities are generally inefficient, they are fragmented across Entities and operated with insufficient coordination. As a result in this area the single economic space is not a reality. This situation is a result of the collapse of Yugoslavia and the separation of the networks during the war. Many regulatory functions are still fulfilled by the Entities with more or less coordination; in some cases the State is the regulator.

Annex 5 of this report provides a brief overview of the situation of the main utilities in BiH from the point of view of ownership, operation and regulation.

Different responses are currently provided to address these problems; they are complementary:

- The change of ownership i. e. the privatisation of the sector is viewed by the international institutions as a major necessary reform to increase its efficiency. It is also a reform that is delayed in view of its very delicate character and the need to reorganise the sector in advance of privatisation. In some cases (railways) rationalisation of ownership (merger) rather than privatisation should be the solution;
- Annex 9 of Dayton on the "Establishment of BiH Public Corporation" provides for the organisation of a Commission to operate joint public facilities. It is viewed as a requirement for the functioning of the State and the State institutions;
- The Commission started its work only last year and the first public corporation, Commission for the Roads, was created in 2000. A Commission of Electricity is foreseen in the Law on Electricity but has not yet been implemented;
- The creation at the initiative of OHR of new State institutions with a regulatory responsibility (The Department of Civil Aviation, the Communication Regulation Agency).

Budgetary implications of these reforms are important but limited from the point of view of the State. Since the utilities are owned and operated by the Entities their privatisation and restructuring will essentially improve the Entities budget, not because of the privatisation proceeds, but hopefully because it will increase profitability and accountability and therefore more tax revenue. It will also greatly improve the competitiveness of the private sector by reducing its costs.

The concentration of regulatory functions at State level is a rationalisation much needed and an essential reform. In most cases its budgetary impact will be nil or marginal since these functions are at best cost recovering.

3.6 Specific administrative fees and taxes

The administrative fees and specific taxes constitute the essential of the own revenue of the State government but a minor share of its budget (see Annex 1, Table 5). Out of 27.7 million KM own resources in 2001, revenue from administrative fees and charge represent 20 million, the rest being the revenue from regulatory institutions of which CRA (see Section 3.5 and Annex 5) is the main contributor.

The Administrative fees are established by two OHR decisions imposing the Law of July 30, 1999 and its Amendment of December 14, 2000. The 1999 Law enumerates the documents and actions of BiH institutions submitted to administrative fees as well as the fees. It is a long list of fees for such documents as passports, registration of inter-Entity bus lines, vehicle registrations, etc. The 2000 Amendment provides that the competent Ministry may introduce additional administrative fees and modify the tariffs. These changes must be reasonable.

Whereas the introduction of new services, e.g. classified identity cards, may justify additional administrative fees it is unlikely that this source can provide sustainable revenue for the State institutions of BiH.

4. Conclusions and recommendations

4.1 Conclusions

- 1° The current fiscal organisation does not provide for a formal centralisation or coordination of responsibilities in three fundamental areas:
 - The consistency of the fiscal and monetary policies to guarantee stabilisation (and medium term viability of the Currency Board) and allow for sustained growth. The information basis is missing and so far there is no responsibility to compile it. The policy mechanisms to enforce fiscal discipline (such as for instance "a convergence and stabilisation pact" or more direct authorities on the fiscal operations of the various tiers of government) do not exist and currently the role of watchdog is assumed by the IMF who imposes hard budget constraints on the Entities and prevents borrowing by the sub-Entities. In this situation if the Entities pass on the hard budget constraint to the sub-Entities the latter can only accumulate arrears or reduce the services to the population. Though effective this method it not optimal, in particular to conduct the poverty reduction strategy to which the State and the Entities are committed. The interim PRSP recognises this need which will required strengthened capabilities and responsibilities of the State;
 - Organising the single economic space. In addition to being a necessity for a well functioning economy that provides favourable environment to domestic and foreign investors, it is an obligation under the Constitution (Article 1, n° 4) and a requirement in the process of the Stabilisation and Association process;
 - Correcting vertical and horizontal inequalities across the country. The rigid system of allocation of tax revenue on the derivation basis limits the redistributive capacity even inside the Entities (at least in the FBiH). The narrow responsibilities and financial resources of the State do not allow for capital expenditures aimed at promoting inter-Entity infrastructures and levelling development across the country.
- 2° Even if progresses in tax mobilisation can be observed over the last months, the current management of indirect taxes at Entities level is inefficient in terms of tax mobilisation and results in a fragmentation of the economic space, counterproductive for the producers, investors and the consumers.
- 3° The current mechanism of financing the State quasi exclusively through transfers from the Entities offers the advantage of being simple but currently its magnitude is insufficient to allow for the necessary development of new functions by the State. Moreover, it requires negotiation at every budgetary round and therefore depends on the political goodwill of the Entities (in terms of agreeing the amount, of doing the payment and doing it in time); it is therefore not easily predictable and limits the scope for a medium term policy.
- 4° Budgetary impact of improving regulatory functions of State.

It is a common characteristic of most utilities in BiH that the regulatory and managerial structures are split across the Entities, their operations are economically inefficient and they do not generate revenue at their potential level. The causes are mainly inadequate operational structures that are overstaffed and more accountable to various vested interests groups than to the citizens. The results are important misallocation of resources, insufficient maintenance

and dramatic lack of investment. In several sectors the problems are addressed through (i°) restructuring in view of later partial and total privatisation, (ii°) organisation of operational cooperation across Entities with the creation of public corporations, and, (iii°) the creation of regulatory agencies at State level.

All these moves go in the right direction and should be pursued. From the budgetary point of view it would, however, be a mistake to expect direct important resources for the State budget. Improving operations will bring revenue directly in the form of dividends to the owners (the Entities) and corporate taxes. The regulatory functions should be as much as possible raised to the State level but they will not bring significant additional revenue since they are at most cost recovering.

5° Administrative fees and specific taxes.

This should not be a privileged avenue to increase State revenue. Already too many ad hoc taxes and user fees are raised at Entity. Adding other ones at State level would be counterproductive. Cost recovery and administrative fees to avoid abusive use of administrative facilities should be the principle but this should not be a source of profit for the Government.

A different issue would be that of environmental taxes, which may be desirable to improve natural resources management and are not much developed in BiH. Such taxes should be designed within a coherent environmental policy, evidently defined at State level, but their primary objective should be the improvement of the environmental resources not the provision of financial resources for the State.

4.2 Recommendations

According to its terms of reference this study is intended to investigate how to secure in a sustainable way additional financial resources to fund the expanding responsibilities of the Institutions of BiH. The analysis has shown that the problem must be answered in such a way that the solution also improves the global efficiency of the fiscal system in BiH. Finally, it is a major constraint that the proposed solution is legally feasible.

A preliminary recommendation is to increase the financing of the State Institutions with own fiscal resources rather than with transfers (though without necessarily substituting to the transfers at least in the first period) because fiscal resources have important advantages:

- They do not require to be renegotiated at every budget round and are therefore more predictable;
- They evolve with the economic basis;
- They pave the ground for more significant State responsibilities in the areas of overall stabilisation (command of the fiscal policy) and redistribution.

Our recommendations regarding the own resources to raise will articulated in three parts. Section 4.2.1 will show how it is immediately possible to increase State financing under the current non disputed interpretation of the Constitution in a way that would also contribute to an improvement of the fiscal system. Section 4.2.2 will formulate alternative recommendations which could provide equivalent resources for the State institutions but would further improve the design of the overall fiscal system of the country. These recommendations may not appear immediately compatible with the legal possibilities open by the Constitution. For this reason Section 4.2.3 will elaborate on the legal feasibility of these recommendations.

Before entering into the details a general point should be stressed. If the reforms proposed are adopted they will increase the resources of the State and its fiscal responsibilities. All the analysis conducted in this study, and in particular the issues highlighted in Section 2.3 points towards the need to improve the consistency of the macro-economic policies. This and the essential functions of the State identified under Section 2.4 claim for a considerable capacity building effort at the level of the State institutions of BiH in order to develop the technical capabilities to design consistent policies with a medium term objective, to collect and analyse the information allowing to monitor them, to control their implementation and to assess their results. This capacity is generally lacking at present in BiH. Therefore, developing the State financial resources would be unproductive if it was not accompanied by a considerable institutional building effort to address this deficiency.

4.2.1 Financing State Institutions with customs revenues

Customs policy is a non disputable and explicit competence of the State. Nothing in the Constitution limits, explicitly or implicitly, this competence to the regulatory aspects of customs policies. It is a general rule in legal matters that the competence to regulate a tax involves also, unless otherwise specified, the competence to administer it and to collect and assign its revenues.

Unifying the customs administrations into a State administration, centralising the revenue collection and reorganising the allocation to assign a fraction of the tax revenue to the State is therefore a legally non objectionable solution. It would both allow for increased and sustainable resources for the State Institutions and improve the fiscal system as evident from the analysis conducted under Section 3.1.

This solution is certainly viable and has precedent examples: in the EC import duties are fully assigned to the Commission Budget. It should certainly be seriously considered and should be regarded as the bottom line solution if better alternatives are not found. However, the gradual integration of the BiH economy into the world economy and the move in direction of the EU will induce a structural change in the source of revenues and a move away from tax based on international trade towards domestic taxes. For this reason, a more ambitious recommendation to redesign more radically the indirect taxes and to allocate a fraction of the proceeds of a State VAT tax to the financing of the State Institutions is presented in the next section.

4.2.2 Redesigning the indirect taxes system

The major problems with the indirect taxes and the possible options to address them have been analysed in Section 3. The recommendation of this study is to unify indirect taxes (customs, excises, VAT) into a single system administrated at State level.

There will be a transition period, probably of the order of 18 to 24 months to move from the sales tax to a VAT and to create a new central administration. This transition period should be devoted to organise the new administration, acquire the equipment, prepare the procedures and train the staff. During this period it is important that tax collection continues normally and is improved as much as possible. In particular the sales tax which will remain the main domestic indirect tax during the transition period should be improved as much as possible. However, although it is tempting, it would probably be a mistake to return during the transition period to a system of taxation at first buyer point/import point. It would introduce an additional reform in the transition period and puzzle the people since the previous change bringing taxation at retailers point was presented as a preparation for VAT. Rather it would be preferable to conduct and apply as soon as possible the technical improvements which would also be needed for the implementation of the VAT. The strengthening of the Enterprises registration system for instance.

Unifying the indirect tax system and bringing it at State level will have implications on the legal aspects, the administration of the tax, and the allocation of the revenues:

- Tax laws. The customs law is already a state law so that no change will be needed except at administration level. VAT should be made a State law. Excise laws should be fully harmonised and ideally replaced by a State law.

The VAT law will have to specify the tax basis, the number of rates and the rates. A single rate would be the preferred solution to simplify administrative procedures.

- Tax administration.

The unifying of the Customs administration into a single State administration should be the first step. This new administration might recruit the best elements of the existing administration. It will normally also take over excises on imports. While the sales tax would continue to be collected as now the new State administration should prepare, with international assistance, for handling also VAT. This intermediary phase will require cooperation with the existing administrations and their gradual transformation and restructuring to eventually become part of the new State administration. This new State administration will not be a simpler merger of the previous ones but a completely redesigned and restructured body which will recruit its staff mostly in the existing fiscal administrations. However, it will inevitably be important streamlining and accompanying measures will be needed to guarantee acceptance of the process.

- Allocation of tax revenues.

Revenue should continue to be assigned to the Entities although a fraction should be earmarked as own resources for the State.

Allocation to Entities: customs revenue could remain assigned to the Entities and be allocated on the basis of the place of clearance; since there will be one state administration the incentive to allow competitive under valuation in order to get the revenues will disappear. Revenue from excise taxes can remain allocated to the Entities but the criteria should change. The tax should be collected from the first buyer and the revenue should be allocated on the basis of the volume of final sales in the respective Entities. This can be estimated on the basis of the sales tax figures and, when it is in place, from the VAT returns. VAT revenue should be allocated to the Entities according to the distribution of final sales which will be known by requiring VAT returns to mention distinctly final sales. It will be necessary to decide whether inside the FBiH the VAT revenue will be allocated to the cantons according to the distribution of final sales or according to a sharing formula. It is essentially a political question but technically both options are equally feasible.

A fraction of the revenue should be allocated to the State. The simplest would be to earmark a fraction of the VAT rate that would not be retransferred to the Entities and remain for the State budget.

These recommendations are justified because they bring improvements to all the aspects of the fiscal system (sustainability, integrity, efficiency).

- They will make it easier to develop sound and viable sources of finance for the institutions of BiH and allow for a redefinition of a more appropriate fiscal architecture in which the State has the means to fulfil the essential functions which are assigned to it (in particular unification of the single economic space and role of central interlocutor for the EU).

- Centralising management of indirect taxation will contribute to the macro-stabilisation by rationalising the process of coordination and elaboration of the overall macroeconomic framework (advantage in terms of scale (predictability-programming) and sustainability).
- These reforms will increase the effectiveness of resource mobilisation and reduce losses of revenue thus generating advantages advantage in terms of sustainability and integrity.
- They will contribute to the unification of the economic space whereas the current system induces its fragmentation (advantage in terms of efficiency).
- VAT would help bringing the grey economy in the formal sector. The grey economy is a combination of activities of numerous small businesses and informal self employed who try to survive by managing all sorts of small jobs, and of unrecorded operations of large registered enterprises who operate outside the formal sector with more or less open complicity of existing power structures. In BiH this second category seems to be particularly important giving the grey economy a definite characteristic of fraudulent economy. In that respect a well implemented VAT would greatly help bringing it back in the formal sector.

Overall these recommendations aim at providing resources for the State with the view of improving the situations of the Entities. They go in line with "Our reform agenda" issued by the Governments of BiH and the analysis developed in the PRSP.

4.2.3 Legal basis in support of these recommendations

The recommendations formulated under the previous section may appear impossible to implement under the current Constitution. The purpose of this section therefore is to demonstrate that they are compatible with a reading of the Constitution which has been elaborated by the Constitutional Court of BiH.

1° The system of allocation of powers according to the Constitution of BiH.

On principle the system of allocation of powers is regulated by Article III of the Constitution of BiH. Article III paragraph 1 thereby enumerates the responsibilities of the institutions of BiH, whereas paragraph 3 states that all governmental functions and powers not expressly assigned in this Constitution to the institutions of BiH shall be those of the Entities. The conclusion which can often be heard therefore is that all responsibilities not expressly enumerated under paragraph 1 of the said Article are those of the Entities. However, this is a wrong conclusion as the Constitutional Court of BiH has clearly elaborated in its Partial Decision II, paragraphs 11 through 13, of case U5/98 (Official Gazette of BiH, n° 17/00)²¹.

Hence, the BiH Constitution creates powers not only within this general system of allocation of powers under Article III. In creating institutions of the State of BiH, the Constitution also confers upon them more or less specific powers, as can be seen from Article IV. 4. as regards the Parliamentary Assembly and Article V.3. as regards the Presidency of BiH which are not necessarily repeated in the enumeration under Article III. 1. The Presidency of BiH, for instance, is vested with the power of civilian command over armed forces in Article V. 5. a., although Article III. 1. does not expressly refer to military affairs as being within the responsibility of the institutions of BiH. It must thus be concluded that matters which are not expressly enumerated

21 Available in English under the web site of the Court: <http://www.ccbh.ba>

in Article III. 1. are not necessarily within the exclusive competence of the Entities in the same way as the Entities might have residual powers with regard to the responsibilities of the institutions of BiH. Reference can be made, for instance, to the responsibility of the institutions of BiH with regard to foreign policy and foreign trade policy expressly mentioned in Article III. 1. a. and b., since the Entities also have, for instance, a right to establish special parallel relationships with neighbouring states or to enter into agreements with states and international agreements according to Article III. 2. a. and d.

Moreover, if one reads the entire Constitution of BiH in a systematic way, it becomes clear that it establishes basic constitutional principles and goals for the functioning of Bosnia and Herzegovina as well as a catalogue of human rights and fundamental freedoms which must be seen as constitutional guidelines or limitations for the exercise of the responsibilities of Bosnia and Herzegovina as well as the Entities. Alinea 4 of the Preamble of the Constitution of BiH has to be seen as an integral part of the Constitution according to the third partial decision of case U5/98 (Official Gazette of BiH, n° 23/00). According to this alinea, the Constitution was adopted in order to "promote the general welfare and economic growth through the protection of private property and the promotion of a market economy". Furthermore, Article I. 4. of the Constitution provides for freedom of movement throughout Bosnia and Herzegovina and explicitly states that neither Bosnia and Herzegovina nor the Entities shall "impede full freedom of movement of persons, goods, services and capital throughout Bosnia and Herzegovina" as a necessary prerequisite for the existence of a common market. Both the catalogue of human rights and the constitutional safeguard of a common market under Article I. 4. have thus to be seen as overarching principles of the Constitution and form the basis for regulation of those matters through the Parliamentary Assembly of BiH.

Furthermore, Article IV. 4. c. confers the responsibility on the Parliamentary Assembly for such other matters as are necessary to carry out its duties or as are assigned to it by mutual agreement of the Entities.

Finally, Article III. 5. provides for so-called additional responsibilities of the institutions of BiH in the same way: either through agreement of the Entities whereby paragraph 2 of the said Article imposes an obligation on the Entities to begin negotiations on such other matters – with utilization of energy resources and cooperative economic projects already expressly mentioned by the Constitution –, or if these responsibilities are necessary to preserve the sovereignty, territorial integrity, political independence, and international personality of BiH, in accordance with the division of responsibilities between the institutions of BiH. Moreover, the Constitution expressly provides for the establishment of additional institutions as are necessary to carry out such responsibilities.

2^o Financing the institutions of BiH

Against the factual situation that the current mechanisms of state financing result almost exclusively from transfers from the Entities, the Constitution clearly establishes a competence of the institutions of BiH. Article III. 1. e. designates "finances of the institutions and for the international obligations of Bosnia and Herzegovina" a matter falling into the responsibility of the institutions of BiH. This provision has then to be seen in context with Article IV. 4. which confers on the Parliamentary Assembly not only the power to approve a budget for the institutions of BiH, but also the responsibility for deciding upon the sources and amounts of revenues for the operations of the institutions of Bosnia and Herzegovina and international obligations of BiH. Hence, one of the essential functions of every state, namely overall macro economic stability must be seen as an implied power of the institutions of BiH.

Moreover, the power of the Parliamentary Assembly to decide on the sources and amounts of revenues is the constitutional basis for the regulation of the entire tax system on state level. It is thus in the hands of the Parliamentary Assembly to decide which types of taxes shall be levied by the state and which shall be left to the Entities. Article VIII. 3. has to be seen then in context with the provisions of Articles III. 1. e. and IV. 4. b. by expressly mentioning those revenues as specified by the Parliamentary Assembly so that the rest of the revenues required by the budget has to be provided by the Entities in the ratio as prescribed by that provision (two-thirds by the Federation, one-third by Republika Srpska). Hence, Articles IV and VIII can be seen without a contradiction, insofar as the state has the responsibility to introduce a VAT on state level as one of the sources of revenues of the institutions of BiH whereby the power to enact legislation includes, without any other constitutional authorisation, also the power to decide on the tax administration and the allocation of revenues.

Annex 1

Fiscal accounts of the State
and the Entities of BiH

Table 1 - BiH State Government Account

	In million KM					In % of GDP of BiH					% structure of revenue and expenditure				
	1998	1999	2000	2001	2002	1998	1999	2000	2001	2002	1998	1999	2000	2001	2002
				Rev.bdg.	Budget				Rev.bdg.	Budget				Rev.bdg.	Budget
Total revenue	140.0	218.5	275.0	319.6	452.4	1.9%	2.6%	3.0%	3.2%	4.2%	100.0%	100.0%	100.0%	100.0%	100.0%
Own revenue	20.0	31.4	32.4	27.6	49.7	0.3%	0.4%	0.3%	0.3%	0.5%	14.3%	14%	12%	9%	11.0%
Transfer from Entities	120.0	187.1	242.6	269.1	369.7	1.6%	2.2%	2.6%	2.7%	3.4%	86%	86%	88%	84%	81.7%
Administrative budget	30.6	28.4	44.9	64.6	77.3	0.4%	0.3%	0.5%	0.6%	0.7%	22%	13%	16%	20%	17.1%
FBiH	20.6	18.3	30.0	43.1	51.5	0.3%	0.2%	0.3%	0.4%	0.5%	15%	8%	11%	13%	11.4%
RS	10.0	10.1	14.9	21.5	25.8	0.1%	0.1%	0.2%	0.2%	0.2%	7%	5%	5%	7%	5.7%
Debt service	89.4	158.7	197.7	204.5	292.4	1.2%	1.9%	2.1%	2.0%	2.7%	64%	73%	72%	64%	64.6%
FBiH	44.4	70.7	123.5	122.5	181.9	0.6%	0.8%	1.3%	1.2%	1.7%	32%	32%	45%	38%	40.2%
RS	45.0	53.5	74.2	82.0	110.5	0.6%	0.6%	0.8%	0.8%	1.0%	32%	24%	27%	26%	24.4%
Direct repayments		34.5													
Extraordinary revenues				22.9	33.0				0.2%	0.3%				7%	7.3%
Succession				21.6	19.6				0.2%	0.2%				7%	4.3%
Compensation for war damage				1.3	1.2				0.0%	0.0%				0%	0.3%
Transfer to finance elections					10.2					0.1%					2.3%
PRSP Project					2.0					0.0%					0.4%
Total expenditure	138.0	215.7	273.8	351.5	502.2	1.9%	2.6%	3.0%	3.5%	4.6%	100.0%	100.0%	100.0%	100.0%	100.0%
State Border Service			6.0	43.0	51.3			0.1%	0.4%	0.5%			2.2%	12.2%	10.2%
New BiH Institutions				7.2					0.1%					2.0%	
Election Commission					11.4										
Clearance of arrears				10.6	9.3				0.1%	0.1%				3.0%	1.9%
BiH ministries and institutions	51.0	57.0	70.0	86.2	137.8	0.7%	0.7%	0.8%	0.9%	1.3%	37.0%	26.4%	25.6%	24.5%	27.4%
Debt service	87.0	158.7	197.8	204.5	292.4	1.2%	1.9%	2.1%	2.0%	2.7%	63.0%	73.6%	72.2%	58.2%	58.2%
Overall balance (cash basis before grants)	2.0	2.8	1.2	-31.9	-49.8	0.0%	0.0%	0.0%	-0.3%	-0.5%					
Foreign grants for budget support			5.3	31.9	36.2			0.1%	0.3%	0.3%					
Overall balance (cash basis after grants)	2.0	2.8	6.5	0.0	-13.6	0.0%	0.0%	0.1%	0.0%	-0.1%					
Change in arrears (+ increase)				-10.6	-9.3				-0.1%	-0.1%					
Overall balance (comm.basis after grants)	2.0	2.8	6.5	10.6	-4.3	0.0%	0.0%	0.1%	0.1%	0.0%					
Memorandum item:															
GDP of BiH (2002: IMF projection)	7,336.0	8,323.0	9,260.0	10,077.0	10,806.0										

Sources: IMF Recent Economic Development and data provided by authorities.

Table 2 - FBiH Federation Government Account

	In million KM					In % of GDP of FBiH					% structure of revenue and expenditures				
	1998	1999	2000	2001	2002	1998	1999	2000	2001	2002	1998	1999	2000	2001	2002
				Rev.bdg.	Budget				Rev.bdg.	Budget				Rev.bdg.	Budget
Total revenue	682.0	723.7	828.5	1,009.0	1,135.9	12.2%	11.8%	12.4%	13.8%	14.5%	100.0%	100.0%	100.0%	100.0%	100.0%
Tax revenue	645.1	676.5	768.0	914.7	1,052.1	11.5%	11.0%	11.5%	12.5%	13.4%	94.6%	93%	93%	91%	93%
Taxes on goods and services	634.7	658.8	745.5	866.2	1,008.6	11.3%	10.7%	11.1%	11.9%	12.8%	93%	91%	90%	86%	89%
Domestic				866.2	995.5				11.9%	12.7%				86%	88%
Sales tax															
Excise duties				246.2	295.4				3.4%	3.8%				24%	26%
External trade				620.0	700.1				8.5%	8.9%				61%	62%
Profit tax	10.4	17.7	22.5	48.5	43.5	0.2%	0.3%	0.3%	0.7%	0.6%	2%	2%	3%	5%	4%
Non tax revenue	36.9	47.2	60.5	94.3	83.8	0.7%	0.8%	0.9%	1.3%	1.1%	5%	7%	7%	9%	7%
(of w. dividends of public enterprises)				28.5	40.0				0.4%	0.5%				3%	4%
Total expenditure	781.9	800.6	973.5	1,193.2	1,335.1	14.0%	13.0%	14.5%	16.3%	17.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Wages and contributions (excl. army)	77.3	92.5	100.0	119.4	126.2	1.4%	1.5%	1.5%	1.6%	1.6%	9.9%	11.6%	10.3%	10.0%	9.5%
Goods and services	37.0	32.4	29.8	29.5	47.6	0.7%	0.5%	0.4%	0.4%	0.6%	4.7%	4.0%	3.1%	2.5%	3.6%
Military	276.0	291.4	309.6	297.0	256.0	4.9%	4.7%	4.6%	4.1%	3.3%	35.3%	36.4%	31.8%	24.9%	19.2%
Reconstruction and capital expenditures	42.6	26.0	47.2	60.7	66.7	0.8%	0.4%	0.7%	0.8%	0.8%	5.4%	3.2%	4.8%	5.1%	5.0%
Subsidies	20.4	14.1	14.0	11.2	126.6	0.4%	0.2%	0.2%	0.2%	1.6%	2.6%	1.8%	1.4%	0.9%	9.5%
Other transfers to households	235.8	215.9	255.1	372.2	305.8	4.2%	3.5%	3.8%	5.1%	3.9%	30.2%	27.0%	26.2%	31.2%	22.9%
Transfers to pension funds ¹	21.9	6.5	8.8	102.2	20.0	0.4%	0.1%	0.1%	1.4%	0.3%	2.8%	0.8%	0.9%	8.6%	1.5%
Transfers for health	1.3	0.1	0.7	1.0	1.2	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	0.0%	0.1%	0.1%	0.1%
Transfers for education	3.3	1.4	4.9	5.1	5.6	0.1%	0.0%	0.1%	0.1%	0.1%	0.4%	0.2%	0.5%	0.4%	0.4%
Transfers to war invalids	209.3	207.9	240.7	263.9	279.0	3.7%	3.4%	3.6%	3.6%	3.6%	26.8%	26.0%	24.7%	22.1%	20.9%
Transfers to State government	65.0	84.0	153.5	165.5	235.7	1.2%	1.4%	2.3%	2.3%	3.0%	8.3%	10.5%	15.8%	13.9%	17.7%
Administration	20.6	18.3	30.0	43.0	51.5	0.4%	0.3%	0.4%	0.6%	0.7%	2.6%	2.3%	3.1%	3.6%	3.9%
Debt service	44.4	65.7	123.5	122.5	184.2	0.8%	1.1%	1.8%	1.7%	2.3%	5.7%	8.2%	12.7%	10.3%	13.8%
Transfers to cantons & municipalities	7.0	15.9	25.1	18.0	13.0	0.1%	0.3%	0.4%	0.2%	0.2%	0.9%	2.0%	2.6%	1.5%	1.0%
Net lending			-7.0	3.7				-0.1%	0.1%				-0.7%	0.3%	
Clearance of Federation budgetary arrears ²				47.8	77.6				0.7%	1.0%				4.0%	5.8%
Other expenditures and unallocated	20.8	28.4	46.2	68.2	79.9	0.4%	0.5%	0.7%	0.9%	1.0%	2.7%	3.5%	4.7%	5.7%	6.0%
Overall balance (cash basis before grants)	-99.9	-76.9	-145.0	-184.2	-199.2	-1.8%	-1.3%	-2.2%	-2.5%	-2.5%					
Foreign grants for budget support	34.9	14.7	61.1	11.2	11.9	0.6%	0.2%	0.9%	0.2%	0.2%					
Overall balance (cash basis after grants)	-65.0	-62.2	-83.9	-173.0	-187.3	-1.2%	-1.0%	-1.3%	-2.4%	-2.4%					
Change in arrears (+ increase)				-47.8	-77.6				-0.7%	-1.0%					
Overall balance (comm.basis after grants)	-65.0	-62.2	-83.9	-125.2	-109.7	-1.2%	-1.0%	-1.3%	-1.7%	-1.4%					
Memorandum item:															
GDP of FBiH (2002: IMF Projection)	5,602.0	6,142.0	6,699.0	7,309.0	7,853.0										

1 In 2001 an extraordinary transfer of 84 mln KM to clear PF arrears of previous years

2 Pension Fund (12), war invalids (23), other (12.8).

Source: IMF Recent Economic Developments and data provided by authorities.

Table 3 - Republika Srpska Government Account¹

	In million KM						In % of GDP of RS						% structure of revenue and expenditure						
	1998	1999	2000	2001	2001NP	2002NP	1998	1999	2000	2001	2001NP	2002NP	1998	1999	2000	2001	2001NP	2002NP	
				Budget	Budget	Budget				Budget	Budget	Budget				Budget	Budget	Budget	
Total revenue	356.8	654.0	717.5	727.7	727.7	775.9	20.6%	30.0%	28.0%	26.3%	26.3%	26.3%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	
Tax revenue	294.5	561.0	613.0	631.7	631.7	682.0	17.0%	25.7%	23.9%	22.8%	22.8%	23.1%	82.5%	86%	85%	87%	87%	88%	
Taxes on goods and services	148.7	251.6	317.2	304.6	304.6	351.3	8.6%	11.5%	12.4%	11.0%	11.0%	11.9%	42%	38%	44%	42%	42%	45%	
Sales tax	97.8	146.7	170.3	181.1	151.7	188.6	5.6%	6.7%	6.6%	6.5%	5.5%	6.4%	27%	22%	24%	25%	21%	24%	
Railways surcharge					29.4	29.4					1.1%	1.0%						4%	4%
Excise duties	50.9	104.9	146.9	123.5	123.5	133.3	2.9%	4.8%	5.7%	4.5%	4.5%	4.5%	14%	16%	20%	17%	17%	17%	
Property tax on special goods						20.8						0.7%							3%
Taxes on external trade	95.0	144.9	167.1	187.3	187.3	173.7	5.5%	6.6%	6.5%	6.8%	6.8%	5.9%	27%	22%	23%	26%	26%	22%	
Custom duties					131.4	121.7						4.7%							18%
Import duties					55.9	52.0						2.0%							8%
Taxes on income	38.1	62.9	70.8	75.5	75.5	91.2	2.2%	2.9%	2.8%	2.7%	2.7%	3.1%	11%	10%	10%	10%	10%	12%	
Personal income tax	6.3	10.5	7.9	8.3	8.3	13.6	0.4%	0.5%	0.3%	0.3%	0.3%	0.5%	2%	2%	1%	1%	1%	2%	
Wage withholding	30.4	42.5	47.2	49.8	49.8	60.4	1.8%	1.9%	1.8%	1.8%	1.8%	2.0%	9%	6%	7%	7%	7%	8%	
Corporate income tax	1.4	9.9	15.7	17.4	17.4	17.3	0.1%	0.5%	0.6%	0.6%	0.6%	0.6%	0%	2%	2%	2%	2%	2%	
Other taxes & revenue	12.7	101.6	57.9	64.3	64.3	45.0	0.7%	4.7%	2.3%	2.3%	2.3%	1.5%	4%	16%	8%	9%	9%	6%	
Non tax revenue ²	62.3	93.0	104.5	96.0	47.7	47.3	3.6%	4.3%	4.1%	3.5%	1.7%	1.6%	17%	14%	15%	13%	7%	6%	
Fees and charges					40.7	39.2						1.5%							6%
Fines					7.0	8.1						0.3%							1%
Special revenues					48.2	46.6						1.7%							7%
Total expenditure	446.0	765.7	793.0	831.6	824.6	886.6	25.7%	35.1%	31.0%	30.0%	29.8%	30.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	
Wage bill ³	154.6	209.0	206.1	248.2	346.0	335.7	8.9%	9.6%	8.0%	9.0%	12.5%	11.4%	34.7%	27.3%	26.0%	29.8%	42.0%	37.9%	
Goods and services ³	49.5	162.0	153.3	100.5	85.8	137.6	2.9%	7.4%	6.0%	3.6%	3.1%	4.7%	11.1%	21.2%	19.3%	12.1%	10.4%	15.5%	
Military ⁴	70.0	89.2	70.3	66.9			4.0%	4.1%	2.7%	2.4%			15.7%	11.6%	8.9%	8.0%			
Subsidies		12.0	36.6	24.5	18.7	16.3		0.6%	1.4%	0.9%	0.7%	0.6%		1.6%	4.6%	2.9%	2.3%	1.8%	
Transfers to social funds	0.1	28.1	36.7	16.0	16.0	15.2	0.0%	1.3%	1.4%	0.6%	0.6%	0.5%	0.0%	3.7%	4.6%	1.9%	1.9%	1.7%	
Transfers to households	79.1	94.4	94.3	140.1	141.6	140.2	4.6%	4.3%	3.7%	5.1%	5.1%	4.7%	17.7%	12.3%	11.9%	16.8%	17.2%	15.8%	
War invalids	40.1	72.6	80.0	105.2	105.2	109.0	2.3%	3.3%	3.1%	3.8%	3.8%	3.7%	9.0%	9.5%	10.1%	12.7%	12.8%	12.3%	
Refugees		18.2	9.3	28.0	28.0	18.7		0.8%	0.4%	1.0%	1.0%	0.6%		2.4%	1.2%	3.4%	3.4%	2.1%	
Other	39.0	3.6	5.0	6.9	8.4	12.5	2.2%	0.2%	0.2%	0.2%	0.3%	0.4%	8.7%	0.5%	0.6%	0.8%	1.0%	1.4%	
Transfers to municipalities	0.6	2.0	2.5	2.5	2.5	2.0	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.3%	0.3%	0.3%	0.3%	0.2%	
Transfers to the State	55.0	92.5	89.1	101.0	101.0	135.4	3.2%	4.2%	3.5%	3.6%	3.6%	4.6%	12.3%	12.1%	11.2%	12.1%	12.2%	15.3%	
Administration	10.0	10.1	14.9	19.0	19.0	25.8	0.6%	0.5%	0.6%	0.7%	0.7%	0.9%	2.2%	1.3%	1.9%	2.3%	2.3%	2.9%	
Debt service	45.0	82.4	74.2	82.0	82.0	109.6	2.6%	3.8%	2.9%	3.0%	3.0%	3.7%	10.1%	10.8%	9.4%	9.9%	9.9%	12.4%	
Clearance of arrears				35.0	34.8	24.5				1.3%	1.3%	0.8%						2.8%	
Capital and reconstruction expenditures (of which: railways)	12.0	42.3	73.3	56.9	59.7	56.1	0.7%	1.9%	2.9%	2.1%	2.2%	1.9%	2.7%	5.5%	9.2%	6.8%	7.2%	6.3%	
Other expenditures and unallocated	25.1	34.2	30.8	33.0	18.5	23.6	1.4%	1.6%	1.2%	1.2%	0.7%	0.8%	5.6%	4.5%	3.9%	4.0%	2.2%	2.7%	
Net lending ⁴				7.0						0.3%							0.8%		
Overall balance (cash basis before grants)	-89.2	-111.7	-75.5	-103.9	-96.9	-110.7	-5.1%	-5.1%	-2.9%	-3.8%	-3.5%	-3.7%							
Foreign grants for budget support	31.1	27.7	48.2			16.5	1.8%	1.3%	1.9%									0.6%	
Overall balance (cash basis after grants)	-58.1	-84.0	-27.3	-103.9	-96.9	-94.2	-3.4%	-3.9%	-1.1%	-3.8%	-3.5%	-3.2%							
Change in arrears (+ increase)			114.8	-35.0	-34.8	-24.5			4.5%	-1.3%	-1.3%	-0.8%							
Overall balance (comm.basis after grants)	-58.1	-84.0	-142.1	-68.9	-62.1	-69.7	-3.4%	-3.9%	-5.5%	-2.5%	-2.2%	-2.4%							
Memorandum item:																			
GDP of RS (2002: IMF Projection)	1,734.0	2,181.0	2,561.0	2,768.0	2,768.0	2,954.0													

1 A new presentation has been adopted in RS from 2001. The table provides data in the two presentations for 2001, in the new presentation afterwards.

2 Includes Special revenues in old presentation

3 Excluding army in old presentation

4 Categorisation suppressed in new presentation

Source: IMF Recent Economic Developments and data provided by authorities.

Table 4 - Bosnia and Herzegovina: Consolidated General Government Account

	In million KM				In % of GDP				% Structure of revenue and financing			
	1998	1999	2000	2001	1998	1999	2000	2001	1998	1999	2000	2001
				Project.				Project.				Project.
General government revenue	3,179.9	3,922.5	4,213.3	4,364.3	43.3%	47.1%	45.5%	43.3%	100.0%	100.0%	100.0%	100.0%
<i>Federation FBiH</i>	2,477.6	2,788.4	2,927.0	2,965.4	33.8%	33.5%	31.6%	29.4%	77.9%	71.1%	69.5%	67.9%
Federation budget												
Cantons and municipalities	1,106.4	1,288.9	1,252.9	1,023.4	15.1%	15.5%	13.5%	10.2%	34.8%	32.9%	29.7%	23.4%
Extrabudgetary funds ¹	879.3	984.3	117.9	1,219.6	12.0%	11.8%	1.3%	12.1%	27.7%	25.1%	2.8%	27.9%
<i>Republika Srpska</i>	598.3	961.8	1,038.2	1,061.3	8.2%	11.6%	11.2%	10.5%	18.8%	24.5%	24.6%	24.3%
Republic budget	357.1	653.8	717.3	703.5	4.9%	7.9%	7.7%	7.0%	11.2%	16.7%	17.0%	16.1%
Municipalities	41.9	62.9	69.2	69.2	0.6%	0.8%	0.7%	0.7%	1.3%	1.6%	1.6%	1.6%
Extrabudgetary funds ¹	261.4	358.7	392.6	433.2	3.6%	4.3%	4.2%	4.3%	8.2%	9.1%	9.3%	9.9%
<i>State BiH</i>	138.0	218.3	274.8	319.6	1.9%	2.6%	3.0%	3.2%	4.3%	5.6%	6.5%	7.3%
<i>Brcko District²</i>			23.5	98.1			0.3%	1.0%			0.6%	2.2%
Consolidated expenditures on a commitment basis	4598	5755.1	6099.3	5649.1	62.7%	69.1%	65.9%	56.1%				
Consolidated expenditures on cash basis	4,450.4	5,514.5	5,721.1	5,806.0	60.7%	66.3%	61.8%	57.6%				
Fiscal balance (commitment basis)	-1,418.1	-1,832.6	-1,886.0	-1,284.8	-19.3%	-22.0%	-20.4%	-12.7%				
Financing	1,418.1	1,832.5	1,902.5	1,297.2	19.3%	22.0%	20.5%	12.9%	100.0%	100.0%	100.0%	100.0%
Domestic		63.0	126.0	155.7		0.8%	1.4%	1.5%		3.4%	6.6%	12.0%
Privatisation proceeds		63.0	126.0	100.1		0.8%	1.4%	1.0%		3.4%	6.6%	7.7%
Succession monies				55.6				0.6%				4.3%
Foreign	1,270.5	1,528.9	1,398.3	1,298.4	17.3%	18.4%	15.1%	12.9%	89.6%	83.4%	73.5%	100.1%
Budgetary loans and grants	188.8	138.5	177.3	163.9	2.6%	1.7%	1.9%	1.6%	13.3%	7.6%	9.3%	12.6%
Foreign financed investment projects	1,081.7	1,390.4	1,221.0	1,134.5	14.7%	16.7%	13.2%	11.3%	76.3%	75.9%	64.2%	87.5%
Accumulation of arrears	147.6	240.6	378.2	-156.9	2.0%	2.9%	4.1%	-1.6%	10.4%	13.1%	19.9%	-12.1%
<i>Memorandum item:</i>												
GDP of BiH	7,336.0	8,323.0	9,260.0	10,077.0								

1 Pension, Health and Employment

2 Started collecting revenue in March 2000

Source: IMF Recent Economic Developments.

STUDY ON POTENTIAL
REVENUE SOURCES FOR THE
INSTITUTIONS OF BOSNIA AND
HERZEGOVINA

Annex 2

**Bosnia and Herzegovina:
Tax System**

Bosnia and Herzegovina: Tax System

Tax type		Legislative authority empowered to pass the tax law	Authority responsible for the administration and collection of the tax	Allocation of the tax revenue			Physical/moral persons submitted to the tax (direct)/collection point (indirect)	Tax base	Tax rate	Main exemptions
				Central gov. of Entity	Cantons	Municip.				
<i>Direct Taxes</i>										
Personal income tax (Individual and unincorporated income tax)	FBiH	Parliament of FBiH	Tax administration of FBiH		± 20%	± 80%	Residents in the Entity (allocation on derivation basis, place of residence)	Schedular. "Citizens' income": small businesses, revenue from property, etc.. Income over approximately 15 000 KM/year	Flat rate 10%	
	RS	Parliament of RS	Tax administration of RS	74% ²	± 20%	26%	Residents in the Entity (allocation on derivation basis, place of residence)	Schedular. "Citizens' income": small businesses, revenue from property, etc.. Income over approximately 10 000 KM/year	Flat rate 10% (previously was regressive 25%-15%)	
	DB	District Assembly. Adopted pre-2002 RS law	?	100%?			?	Income over 10 000 KM/year	Regressive rates: 25%, 20%, 15%	
Wage tax 1	FBiH	Parliament of Federation	Tax administration of FBiH	± 80%		± 20%	Wage earners of enterprises registered in Entity. (Allocation on derivation basis: place of work)	Gross wage net of social security contributions.	5% flat (paid by employer)	
	RS	Parliament of RS	Tax administration of RS	100%			Wage earners of enterprises registered in Entity. (Allocation on derivation basis: place of work)	Gross wage net of social security contributions.	10% (paid by employer)	
	DB	District Assembly							6% (paid by employer)	

Bosnia and Herzegovina: Tax System

Tax type		Legislative authority empowered to pass the tax law	Authority responsible for the administration and collection of the tax	Allocation of the tax revenue			Physical/moral persons submitted to the tax (direct)/collection point (indirect)	Tax base	Tax rate	Main exemptions
				Central gov. of Entity	Cantons	Municip.				
<i>Direct Taxes</i>										
Social security contributions (Retirement, Health, Unemployment)	FBiH	Federation Parliament	Tax administration of FBiH		100%3		Derivation and ethnic basis	Wage net of SS contrib.	Total 47% (25% R, 19 % H, 3% U)	
	RS	Parliament RS	Tax administration of RS	100%3					Total 42% (24% R, 15% H, 1% U).	
	BD									
Corporate income tax	FBiH	Parliament of Federation for large enterprises (banks, insurance, telecom, post, energy production); Cantons for all others.	Tax administration of FBiH	100% (large enterpr.)	100% (other enterpr.)		Legal entities registered in the Entity	Enterprise profit; calendar year; 5 years loss carry forward; various incentives.	Flat rate 30%	Charitable and non profit.
	RS	Parliament of RS	Tax administration of RS	100%			Enterprises registered in the Entity	Enterprises profits; no loss carry forward (abolished in 2000); calendar year; various incentives.	Regressive 20%, 15%, 12%, 10% according to amount of profit.	Charitable and non profit.
	BD	District Assemly (?). Adopted FBiH law but amended the rate					Enterprises registered in the entity	Cf. FBiH	20%	

Bosnia and Herzegovina: Tax System

Tax type		Legislative authority empowered to pass the tax law	Authority responsible for the administration and collection of the tax	Allocation of the tax revenue			Physical/moral persons submitted to the tax (direct)/collection point (indirect)	Tax base	Tax rate	Main exemptions
				Central gov. of Entity	Cantons	Municip.				
<i>Taxes on Goods and Services</i>										
Custom duties	FBiH		Tax administration of FBiH	100% ⁴			Point of entry (guarantee), point of clearance (final)	Imports cif value	0%, 5%, 10%, 15%	
	RS	State Parliament	Tax administration of RS	100% ⁴			Point of entry (guarantee), point of clearance (final)			
	BD									
Sales tax on goods	FBiH	Federation Parliament	Tax administration of FBiH		70-80%	30-70%	Collection point: retail (allocation on derivation basis)	Final sales of goods	20% General rate; 10% foodstuff, construction material, fuel for heating	Exports; Basic foodstuffs
	RS	Parliament of RS	Tax administration of RS	100%					18% general rate + 2% railways rate ⁵	
	BD			100%					Higher rate 18%, lower 8%	
Sales tax on services	FBiH	Federation Parliament	Tax administration of FBiH		70-80%	30-70%	Collection point: retail (allocation on derivation basis)	Final sales of services	10% general rate	Rents, services usually non submitted to VAT, etc.
	RS	Parliament of RS	Tax administration of RS	100%					8% + 2% general rate ⁵	
	BD			100%						

Bosnia and Herzegovina: Tax System

Tax type		Legislative authority empowered to pass the tax law	Authority responsible for the administration and collection of the tax	Allocation of the tax revenue			Physical/moral persons submitted to the tax (direct)/collection point (indirect)	Tax base	Tax rate	Main exemptions
				Central gov. of Entity	Cantons	Municip.				
<i>Taxes on Goods and Services</i>										
Excise duties	FBiH	Parliament of FBiH	Tax administration of FBiH	100%			Alcohol, tobacco, petrol/petroleum products, coffee, soft drinks.	Specific on most products. On tobacco: 35% ad valorem on retail sales price excluding sales tax.	Natural mineral waters, juices.	
	RS	Parliament of RS	Tax administration of RS	100%						
	BD	District Assembly?								
Road fee ⁶	FBiH						Litre of petrol at pump	0.15 KM/litre		
	RS						Litre of petrol at pump	0.15 KM/litre		
				<i>Property Taxes</i>						
Real Estate Tax	FBiH	Cantons	Tax administration of FBiH		20%	80%	Land, building, and structure	Rent (real or computed??)	15%	Extensive list
	RS	Parliament RS	Tax administration of RS			100%			15%	
	BD									
Property tsfr (gifts, inheritance)	FBiH	Cantons	Tax administration of FBiH		20%	80%	Trsfrs of real estate, inheritance, gifts.	Value of tsfr.	?	State organisation. Privatisation
	RS					100%			?	
	BD									

Bosnia and Herzegovina: Tax System

Tax type		Legislative authority empowered to pass the tax law	Authority responsible for the administration and collection of the tax	Allocation of the tax revenue			Physical/moral persons submitted to the tax (direct)/collection point (indirect)	Tax base	Tax rate	Main exemptions
				Central gov. of Entity	Cantons	Municip.				
<i>Other taxes</i>										
Road tax	FBiH	Fed. Parliament for Fed. Road tax; Cantons for reg. Motor vhc. Tax.	Tax administration of FBiH	Road tax: 45%	Road tax: 55%; Motor vhc. tax: 55%	Motor vhc. tax: 45%	Specific, annual.		Specific	Public transport.
	RS	Parliament RS	Tax administration of RS	100%						
	BD									
Utility user charges, levy, etc.	FBiH	Some: Cantons, some Municipalities	Tax administration of FBiH		Some	Some	Specific	Utilities, housing, natural resources	Specific	Charitable, disabled, children, seniors
	RS	Some Republic, Some Municipalities	Tax administration of RS	Some		Some	Specific	Utilities, housing, natural resources	Specific	Charitable, disabled, children, seniors
	BD									
				<i>Privatisation proceeds</i>						
Privatisation proceeds	FBiH			Federation assets: 80% to Fed, 20% to Pension funds. Canton assets: 80% to Canton, 20% to Pension funds.						
	RS									

1 In the FBiH the wage tax is a withholding tax, component of the personal income tax, paid in advance by the employer. It is not creditable against the "Citizens Income Tax".

2 In RS allocation between the republic and the municipalities differs according to schedule (agric.: 100% municipalities; self employed income: 70%-30%; others: 100% republic; average: 74% republic, 26% municipalities).

3 Earmarked to extra-budgetary funds (ethnic based in the FBiH).

4 Percentage of duties on imports cleared in the Entity

5 In the RS the sales tax includes 2% earmarked to an extra-budgetary Railways Fund

6 Is a form of excise duty not applied in BD

Sources: BiH authorities, World Bank PEIR, OHR, CAFAO

Annex 3

Revenue yield for FBiH
and RS (data from CAFAO)

Table 1 - Breakdown of revenue yield for FBiH (Federation, Cantons and Municipalities) and RS. Million KM.

	1999					2000					2001				
	FBiH				RS	FBiH				RS	FBiH				RS
	Feder.	Cantons	Municip.	Total		Feder.	Cantons	Municip.	Total		Feder.	Cantons	Municip.	Total	
Custom duties	345.2409247			345.24	136.62	429.37			429.37	167.37	680.51			680.51	155.03
Sales tax		692.31	69.75	762.05	96.94		695.94	69.67	765.60	114.24		767.11	123.51	890.62	154.54
Excise duties	314.5439824			314.54	83.59	313.59			313.59	67.23	224.97			224.97	135.59
Total g&s	659.7849072	692.31	69.75	1,421.84	317.15	742.96	695.94	69.67	1,508.57	348.84	905.49	767.11	123.51	1,796.10	445.16
Other rev. & fees	17.50226694	231.86	79.60	328.96	264.60	22.60	220.98	82.05	325.63	369.87	44.14	156.77		200.91	244.85
Total	677.2871741	924.16	149.35	1,750.80	581.75	765.56	916.91	151.72	1,834.20	718.71	949.62	923.88	123.51	1,997.01	690.01

Sources: CAFAO

Table 2 - Breakdown of revenue yield for FBiH (Federation, Cantons and Municipalities) and RS. Structure in % by category of revenue.

	1999					2000					2001				
	FBiH				RS	FBiH				RS	FBiH				RS
	Feder.	Cantons	Municip.	Total		Feder.	Cantons	Municip.	Total		Feder.	Cantons	Municip.	Total	
Custom duties	51.0%			19.7%	23.5%	56.1%			23.4%	23.3%	71.7%			34.1%	22.5%
Sales tax		74.9%	46.7%	43.5%	16.7%		75.9%	45.9%	41.7%	15.9%		83.0%	100.0%	44.6%	22.4%
Excise duties	46.4%			18.0%	14.4%	41.0%			17.1%	9.4%	23.7%			11.3%	19.7%
Total g&s	97.4%	74.9%	46.7%	81.2%	54.5%	97.0%	75.9%	45.9%	82.2%	48.5%	95.4%	83.0%	100.0%	89.9%	64.5%
Other rev. & fees	2.6%	25.1%	53.3%	18.8%	45.5%	3.0%	24.1%	54.1%	17.8%	51.5%	4.6%	17.0%		10.1%	35.5%
Total	100.0%														

Table 3 - Breakdown of allocation of revenue yield in FBiH

	1999				2000				2001			
	FBiH				FBiH				FBiH			
	Feder.	Cantons	Municip.	Total	Feder.	Cantons	Municip.	Total	Feder.	Cantons	Municip.	Total
Custom duties	100.0%			100.0%	100.0%			100.0%	100.0%			100.0%
Sales tax		90.8%	9.2%	100.0%		90.9%	9.1%	100.0%		86.1%	13.9%	100.0%
Excise duties	100.0%			100.0%	100.0%			100.0%	100.0%			100.0%
Total g&s	46.4%	48.7%	4.9%	100.0%	49.2%	46.1%	4.6%	100.0%	50.4%	42.7%	6.9%	100.0%
Other rev. & fees	5.3%	70.5%	24.2%	100.0%	6.9%	67.9%	25.2%	100.0%	22.0%	78.0%		100.0%
Total	38.7%	52.8%	8.5%	100.0%	41.7%	50.0%	8.3%	100.0%	47.6%	46.3%	6.2%	100.0%

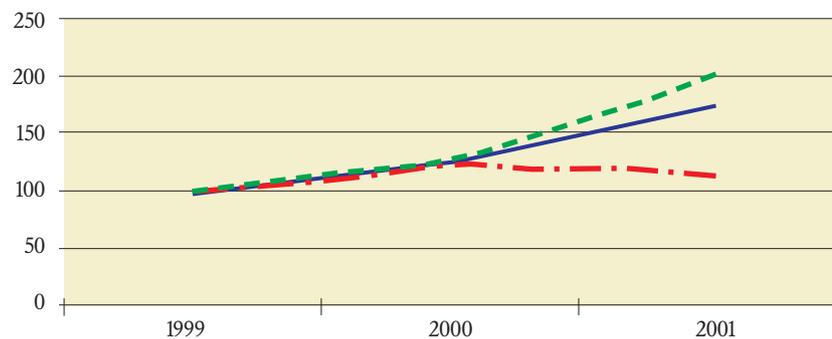
Table 4 - Distribution across Entities of total revenue yield of FBiH and RS.

	1999			2000			2001		
	FBiH	RS	FBiH + RS	FBiH	RS	FBiH + RS	FBiH	RS	FBiH + RS
	Total			Total			Total		
Custom duties	71.6%	28.4%	100.0%	72.0%	28.0%	100.0%	81%	18.6%	100.0%
Sales tax	88.7%	11.3%	100.0%	87.0%	13.0%	100.0%	85.2%	14.8%	100.0%
Excise duties	79.0%	21.0%	100.0%	82.3%	17.7%	100.0%	62.4%	37.6%	100.0%
Total g&s	81.8%	18.2%	100.0%	81.2%	18.8%	100.0%	80.1%	19.9%	100.0%
Other rev. & fees	55.4%	44.6%	100.0%	46.8%	53.2%	100.0%	45.1%	54.9%	100.0%
Total	75.1%	24.9%	100.0%	71.8%	28.2%	100.0%	74.3%	25.7%	100.0%

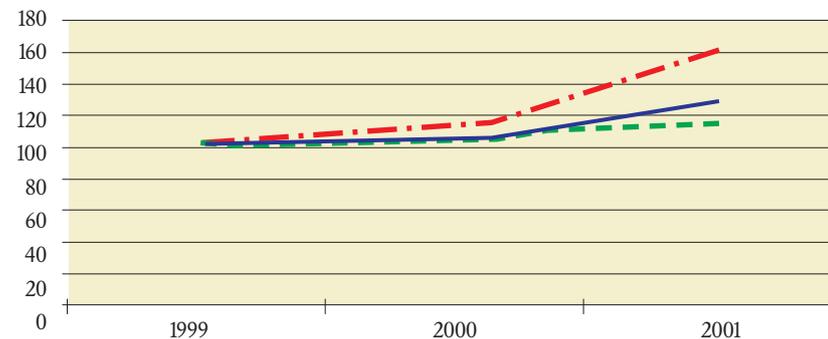
Table 5 - Growth of revenue yield per category of tax in FBiH and RS (Index base 1999 = 100)

	1999			2000			2001		
	FBiH	RS	FBiH + RS	FBiH	RS	FBiH + RS	FBiH	RS	FBiH + RS
	Total			Total			Total		
Custom duties	100	100	100	124	123	124	197	113	173
Sales tax	100	100	100	100	118	102	117	159	122
Excise duties	100	100	100	100	80	96	72	162	91
Total g&s	100	100	100	106	110	107	126	140	129
Other rev. & fees	100	100	100	99	140	117	61	93	75
Total	100	100	100	105	124	109	114	119	115

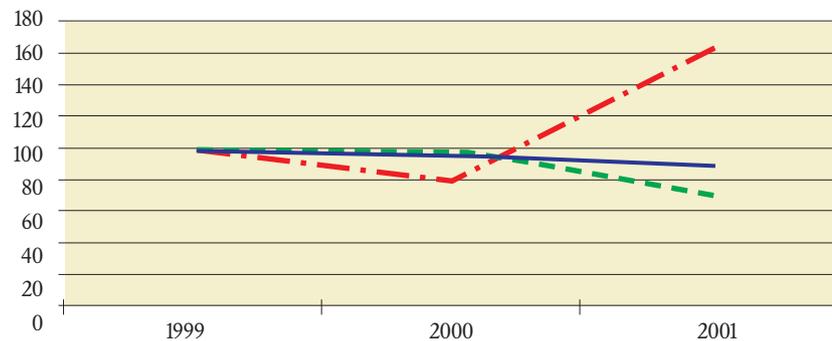
Custom duties



Sales tax



Excise duties



--- FBiH - . - RS . . . FBiH + RS

Annex 4

Examples of different
proposals for VAT
implementation in BiH

Table 1 - Example of monthly (quarterly) VAT report and revenue allocation between entities according to IMF Aide Mémoire.

	Basis in KM	Rate in %	VAT in KM
Company A from FBiH			
VAT charged on invoices during the period			4,380
Exports	4,000	0%	0
Domestic sales at FBiH rate	18,000	19%	3,420
Sales to VAT registered operators in RS (Cy B)	6,000	16%	960
VAT paid during the period			3,270
Imports	3,000	19%	570
Domestic purchases from VAT registered operators in FBiH	10,000	19%	1,900
Purchases from VAT registered operators in RS (Cy B)	5,000	16%	800
VAT due (+) or claimed (-) by cy A to FBiH Min.Fin.			1,110
Company B from RS			
VAT charged on invoices during the period			3,180
Exports	6,000	0%	0
Domestic sales at RS rate	14,000	17%	2,380
Sales to VAT registered operators in FBiH (Cy A)	5,000	16%	800
VAT paid during the period			2,915
Imports	2,500	17%	425
Domestic purchases from VAT registered operators in RS	9,000	17%	1,530
Purchases from registered VAT operators (Cy A)	6,000	16%	960
VAT due (+) or claimed (-) by cy B to RS Min.Fin.			265
Revenue allocation between entities			
VAT collected by FBiH on behalf of RS			960
VAT collected by RS on behalf of FBiH			800
Balance due by FBiH to RS			160
Memorandum item: net amounts received by Entities after reallocation			
Ministry of Finance FBiH			950
Ministry of Finance RS			425

Table 2 - Example of monthly VAT return and revenue allocation between entities according to IAG-T recommendation.

	Basis in KM	Rate in %	VAT in KM
Company A from FBiH			
VAT charged on invoices during the period			4,320
Exports	4,000	0%	0
Sales to VAT registered operators anywhere in BiH at national VAT rate	14,000	18%	2,520
Final sales	10,000	18%	1,800
VAT paid during the period			3,240
Imports	3,000	18%	540
Domestic purchases from VAT registered operators anywhere in BiH	15,000	18%	2,700
VAT due (+) or claimed (-) by cy A to State VAT admin.			1,080
Company B from RS			
VAT charged on invoices during the period			3,420
Exports	6,000	0%	0
Sales to VAT registered operators anywhere in BiH at national VAT rate	11,000	18%	1,980
Final sales	8,000	18%	1,440
VAT paid during the period			3,150
Imports	2,500	18%	450
Domestic purchases from VAT registered operators anywhere in BiH	15,000	18%	2,700
VAT due (+) or claimed (-) by cy B to State VAT admin			270
Revenue allocation between entities			
Gross amount of VAT cashed by national VAT admin			7,740
Net amount of VAT cashed by national VAT admin.			1,350
VAT on final sales			3,240
Allocation between entities according to final sales (IAG-T)			
Amount allocated to FBiH			1,080
Amount allocated to RS			1,440
Allocation between Entities according to proportion of final sales applied to net VAT proceeds			
Amount allocated to FBiH			750
Amount allocated to RS			600

Annex 5

Network Industries

1. Transport

Air transport:

The standard European pattern of civil aviation organisation involves four components:

- The airlines do the transport. The price of their services includes all the costs they support in relation with the other components of the organisation of civil aviation. In BiH there are two airlines, both public companies, Air Bosnia in FBiH and Air Srpska (1 plane) in RS;
- The airports handle the aircrafts and maintain the infrastructures and equipment; their services are charged to the airline companies. They are four civilian airports in BiH (Sarajevo, Banja Luka, Mostar and Tuzla. They are Entity and canton owned and operated.

These first two categories are private or public commercial companies:

- The Air Traffic Service Providers (ATSP) manage the traffic from "gate to gate". They are generally private or cooperative non profit companies. Their costs are charged to the airlines. Currently BiH is member of CEATS (Central Europe Air Transport Services) which also includes Czech Republic, Slovakia, Hungary, Austria, Northern Italy, Croatia and Slovenia and from 2007 will manage a single air space above 7000 feet;
- The Civil Aviation Authorities (CAA) are the regulatory bodies in charge of safety regulations, licences, registration, technical etc.. They are governmental bodies and collect fees from the airlines and airports. In BiH the Civil Aviation Agency is the regulatory authority.

Control and services are operated according to flight level. In BiH the upper level is controlled by CLL, a Croatian ATSP controlling from Zagreb, and by FACTA, a Yugoslav ATSP controlling from Belgrade. Intermediate level is controlled by CLL. Their contract will be ended in 2004. Lower (airport) level is controlled by FEDCAD (FBiH Civil Aviation Department) and RSCAD (RS Civil Aviation Department) for their respective airports. According to the law on civil aviation BHDCA (BiH Civil Aviation Department) is the single control authority. In practice it collects the fees and shares them with CLL and FATCA on the basis of criteria which do not reflect the importance of the services rendered.

This situation is unique in Europe and inefficient. To upgrade BiH civil aviation to European standards and EC/ICIAO (International Civil Aviation Organisation) is aiming at rationalising the services. BHDCA would remain the unique ATSP and replace CLL and FATCA; all fees should remain at State level. BHDCA should also control lower levels.

This rationalisation, though absolutely indispensable in terms of safety and proper functioning of air, traffic would not bring additional resources to the budget since ATSP and control are cost recovery operations thus at best budget neutral. For the years 2001 and 2002 the budgetary expenditures are respectively 1 and 1.1 million KM while the budgetary revenues are respectively 0 and 0.6 million KM

Nevertheless, the current sharing of fees with the Entities exceeds the cost they support so that rationalisation would also be beneficial to the State budget. The main benefit of the rationalisation would not be budgetary but cost efficiency and competitiveness of the domestic airports and airlines.

Road transport:

Road construction and maintenance is under the responsibility of the Entities.

Most regulation is also at Entity level but the State government has passed legislation on the Law on International and Inter-entity Road Transportation, which provides the basis for state level licensing and regulation of international and inter-entity truck and bus transport. A conditionality for a World Bank \$30 million USD under the Road Management and Safety Project under preparation is the enacting of a State law on roads, which would determine the policy development and main principles of road classifications in the BiH road network. A Public Corporation, as provided for in Annex 9 of Dayton, for Roads has recently been established.

Railways

There are two companies owned by the Entities and having altogether 1030 km tracks.

Operation and regulation are at Entity level.

A public Corporation for Railways has newly been created.

2. Telecommunications

The telecommunication companies belong to and are operated by the Entities. There is a general view that they suffer from a lack of accountability and that opening the sector through new entries and privatisation would be beneficial.

In BiH the sector is regulated by the newly created Communication Regulatory Agency (CRA). CRA is a State institution whose function is to regulate the spectrums (i.e. to allocate frequencies to the various types of users and to control that the user stick to their frequency). In addition it regulates telecommunications and the control the compliance of broadcast contents with the code of conduct that has been agreed.

CRA is financed through technical licence fees paid by the users of spectrums; these fees are established on a cost recovery basis and budgetary neutral.

In addition, to its regulatory function CRA collects for the State the levy imposed by the State to the operators (while the Entities impose a levy on the consumers, collected by the TV operators) and may act a technical agent (for instance, to auction a licence to an additional mobile operator).

The budgetary expenditures for 2001 and 2002 and 3.5 million KM each year. Budgetary revenues are 5.8 million KM in 2001 and 10.8 million KM. The revenue includes the State levy collected by CRA for the State (6.8 million KM in 2002). In 2001, year of its creation, CRA benefited from international funding and it is hoped that from 2002 it will be able to balance its operational costs with the licensing fees.

CRA is a member of the European Platform for Regulator Industries. The fact that there is a single operator in BiH is ahead of the EU countries trend where the general tendency is to merge different regulators into a single organisation.

3. Power generation

Up to the time of the war there was a single electricity company (BiH Electricity). During the war companies were created in Mostar and in RS and the network has been split. Currently they are three companies: BiH Electricity and Elektro Privod Herzegovina in Mostar, both owned by FBiH, and EPRS, owned by RS. The three companies cooperate technically and distribute through the whole network.

The companies are currently under restructuring with the view to prepare them for privatisation, a conditionality of the World Bank. Regulation is at Entity's level but tariffs are similar across the country.

4. Water

Water resources management is under the jurisdiction of the Entities and is largely inherited from the communist organisation. The bulk of regulatory functions (legislative, licensing, concessions) is the responsibility of the public water companies: the Vodoprivedas. They benefit from important subsidies, some of which deriving from their licensing and regulatory functions, and 44% of barema revenues are assigned to central development mounds which they control to be reinvested. The suppliers of water to the population are the municipal water supply agencies, the Vodovods. They are in charge of water supply, purification and distribution as well as the collection and treatment of wastewater.

The revenue collection (from baremas) is very low with a collection rate around 45% and there is little political and economic incentive to improve it because the bulk of the revenue goes up the central level and little is returned downward in the form of investment for community water services. Overall the system is characterised by inadequate pricing, insufficient fee recovery, and insufficient investment. The municipal water providers who generate the revenue do not get it to provide investment and support services.

The fragmentation of the regulatory functions and their attribution to bodies which are more concerned with political considerations than with economic rationality and environmental resources sound management seriously hampers the future sector development. The importance of water for the economy and the environment is not adequately appreciated. Bringing BiH in line with the EU requirement will require considerable reforms and investments which the system in its current organisation will not be able to face.

Published by: European Commission Delegation to BiH

Written by:  **ADE**

Print volume: 350

Design and Realisation: Arch Design d.o.o. Sarajevo

Sarajevo, 2003

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