

A COMMON INDIRECT TAX SYSTEM IN BOSNIA AND HERZEGOVINA – CONTINUING STALEMATE OR A NEW CHAPTER IN SUSTAINABLE FEDERALISM IN BOSNIA AND HERZEGOVINA?*

- An Analysis of the Issues Surrounding the Allocation of Revenues from Indirect Taxes -

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INTRODUCTION

During the period from 2004 to 2006 Bosnia and Herzegovina made a significant step forward in its economic reforms by developing and establishing a single indirect taxation system, becoming one of 123 countries (Bird et al, 2001) around the world to adopt a value-added tax (VAT). This reform measure has brought about several key developments for Bosnia and Herzegovina. Firstly, the “self-corrective” nature of VATs has enabled a boost in tax compliance, increasing the range of legal entities reporting on their business activities and paying taxes. Secondly, there has been a removal of tax from intermediate products, which is normally the case with retail sales taxes (RSTs), resulting in the expansion “of the tax base to include a wide range of services that, for the most part, were not subject to tax ... thus [leading] to a considerable expansion in the range of consumption subject to tax” (Bird et al, 2001). For the budgets of the governments in Bosnia and Herzegovina this has led to a surge in tax revenues on almost all levels (albeit temporarily, according to the International Monetary Fund – IMF estimates¹).

Institutionally, the introduction of the VAT has led to the merging of entity customs administrations into the Indirect Tax Authority (ITA), which is administered by the State of Bosnia and Herzegovina, thus centralizing the collection, recording and allocation of indirect taxes (which include VAT, excises and other import and export related surcharges). Most importantly, VAT has introduced an independent source of financing for the State institutions of Bosnia and Herzegovina which were, until then, dependent on contributions from the entity levels. However, progress achieved thus far in this very important reform, as well as in the overall system, risks being undermined. The current system of allocation of indirect taxes between the State, entities (The Federation of Bosnia and Herzegovina and Republika Srpska) and Brčko District governments is based on an assessment of relative proportion of final consumption, as reported by tax payers in tax returns. This basis for allocation and the way it is implemented in practice (via ad hoc decisions rather than

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¹ See the IMF country Report No. 07/268; June 2007.

standing regulations) is proving to be very problematic for several reasons, and has resulted in constant political disputes, tensions and dissatisfactions².

During the Third Economic dialogues between the European Commission and Bosnia and Herzegovina held in Sarajevo on 17th October 2007, the (then) Chairman of the Managing Board of the ITA, Mr. Peter Nicoll, stressed this issue and stated that a permanent, or at least a more stable form of revenue allocation must be developed by the end of the year to avoid problems in year 3 in the implementation of the indirect tax system in Bosnia and Herzegovina.³ Interestingly enough, for many other federal states (or supra-federations, like the European Union) the introduction of VAT has also meant a “reshuffle” in revenue assignment and allocation between federal constituents (Bird et al, 2001).

However, if one takes a broader perspective on this issue, the introduction of VAT, the centralization of indirect taxes and their assignment to the State level of Bosnia and Herzegovina has, in fact, opened a new chapter in the development of sustainable federalism in Bosnia and Herzegovina. Rather than just looking at the narrow short-term issue of how much “piece of the VAT cake” each level should get, the role of VAT, i.e. the indirect tax system, should be observed as an instrument for the forging of a more purposeful, rather than inadvertent, cohesion between each of the levels of government in Bosnia and Herzegovina, as well as introducing mechanisms to ensure public expenditure efficiency and effectiveness. This paper aims to present a wider debate on the arrangements of fiscal cohesion, partly by stressing the main areas of improvement in the current system, and partly by presenting relevant comparative experience of other federal countries in this area.

THE INDIRECT TAXATION SYSTEM IN BOSNIA AND HERZEGOVINA

Institutional Arrangements

The reform of the indirect tax system in Bosnia and Herzegovina has been a gradual process. Before the actual introduction of VAT on 1 January 2006, this significant reform aimed primarily at the implementation of article I.4 of Annex 4 of the General Framework Agreement (the Constitution of Bosnia and Herzegovina), which establishes a single economic space in Bosnia and Herzegovina, started during 2004, with the unification of customs administrations into the ITA and the shifting of customs policy to the State level (World Bank, 2007).

The ITA, which is based in Banja Luka, functions as an independent administrative body established in concurrence with relevant administrative laws and is regulated as the *only* body in Bosnia and Herzegovina primarily responsible for “implementing legal regulations regarding indirect taxation and policies determined by the Council of Ministers at the proposal of the Board⁴, as well as for the payment and allocation of indirect taxes on the territory of Bosnia and Herzegovina”.⁵

² Since the completion of this paper, a standing order for fixed coefficients of allocation has been adopted. However, the fragmentation and inefficiency and ineffectiveness of the fiscal system in BiH as described through this paper remain valid.

³ Office for Macroeconomic Analysis, Bulletin, no.27, October 2007.

⁴ Referring to the Managing Board of the Indirect Tax Authority.

⁵ Article 4 of the Law on the Indirect Taxation System in Bosnia and Herzegovina (“Official Gazette of BiH“, No. 44/03 and 52/04).

The ITA establishes and maintains the tax accounting and reporting systems needed for monitoring indirect tax payments, tax arrears and for tax revenue allocation. Aside from the Central Office in Banja Luka the ITA has four regional offices (in Banja Luka, Mostar, Tuzla and Sarajevo) which are responsible for managing the customs offices and customs/border terminals within their territorial responsibility. The location and authorities of these branches have been determined based on economic principles with the primary aim of ensuring an effective and efficient service to tax payers and “providing support to the functioning of a unique economic territory in Bosnia and Herzegovina”.⁶

Although legally reporting to the Council of Ministers (CoM) on its activities, the ITA is governed by a cross-governmental Managing Board which is responsible for approving the ITA’s budgets, internal operational rulebooks and, in general, overseeing the operations and functions of the ITA. However, the responsibilities of the Managing Board go beyond operational supervision of the ITA. The Managing Board also develops proposals concerning indirect taxation policy for consideration by the CoM and it is responsible for resolving disputes in decisions regarding the allocation of indirect tax revenues. The composition and major roles and responsibilities of the Managing Board are presented in Figure 1.

Figure 1: Composition and responsibilities of the ITA Managing Board



⁶ Article 6 of the Law on the Indirect Taxation System in Bosnia and Herzegovina (“Official Gazette of BiH”, No. 44/03 and 52/04).

Article 19 of the Law on the Indirect Taxation System in Bosnia and Herzegovina⁷ regulates that all decisions of the Managing Board must be made by consensus. The Chairman of the Managing Board is charged with determining whether consensus has been reached. When deciding on the allocation of indirect tax revenues, in the absence of a consensus, decisions are made by simple majority which must include the votes of all three ministers of finance.⁸

The organizational structure of the ITA is not bound by entity borders, which makes it a truly Bosnia and Herzegovina-wide institution, existing to uphold the indirect taxation system in the entire country. On the other hand, the existence of a cross-entity Managing Board ensures that entity interests are not in any way contravened by the fact that the indirect taxes are, in effect, levied, administered and collected by the State of Bosnia and Herzegovina level⁹. However, until recently, due to the allocation scheme described in the next section, the Managing Board of the ITA spends the smallest proportion of its time analyzing indirect taxation **policy** and recommending changes to it (World Bank, 2007).

Allocation of Indirect Taxes in Bosnia and Herzegovina

The allocation of indirect taxes in Bosnia and Herzegovina is regulated primarily by the Law on the Indirect Taxation System¹⁰ and the Law on Payment to the Single Account and Revenue Allocation¹¹, as well as by a series of related ancillary regulations. Mostly due to opposing political interests, the fixed percentages for indirect tax allocation to the State, entity and Brčko District governments was not initially formally regulated. As a result, coefficients for allocation were left to be decided on an ad hoc basis during the meetings of the Managing Board of the ITA. The overall allocation scheme is presented, in simplified form, in

⁷ Official Gazette of BiH, No. 44/03 and 52/04.

⁸ As explained on the web site of the ITA of BiH, http://www.uino.gov.ba/b/O_nama/Upravni_odbor.html

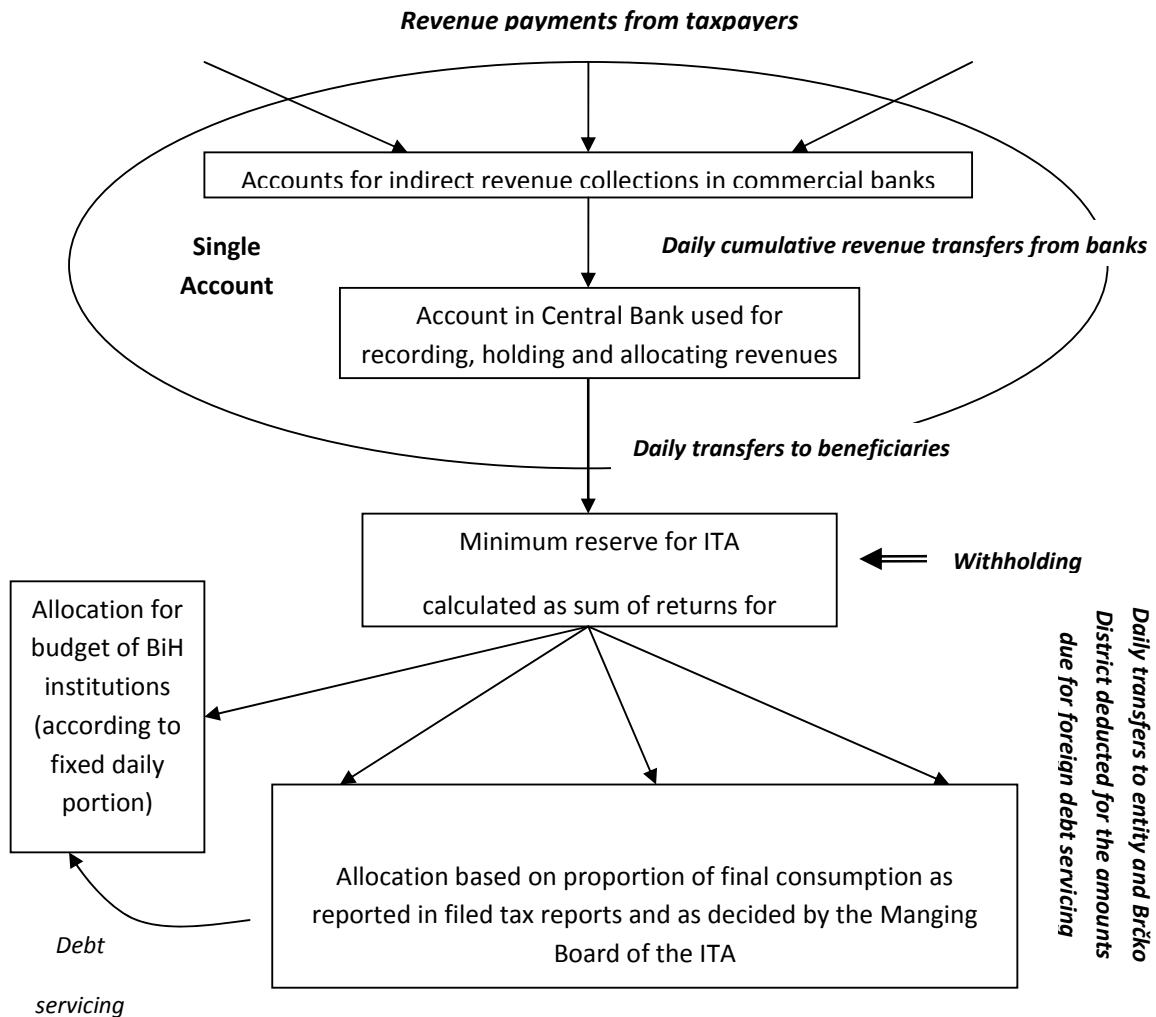
⁹ However, it must be noted that the constitutional framework of BiH a priori prevents any type of unilateralism and any circumstance in which entity interests can be contravened (with the exception of decisions imposed by the High Representative in accordance to Bonn Authorities).

¹⁰ Official Gazette of BiH, No. 44/03 and 52/04.

¹¹ Official Gazette of BiH, No. 55/04.

Figure 2 below.

Figure 2: System of allocation of indirect tax revenues in Bosnia and Herzegovina



Based on the assessment of final consumption as reported in tax returns, the Federation of Bosnia and Herzegovina (FBiH) receives on average around 65% of indirect tax revenues that are eligible for allocation, the Republika Srpska (RS) around 32% and Brčko District the remaining 3%. The exact percentages of allocation, however, are never certain.

The amount of consumption varies not only between localities, but also between time periods (as is illustrated in

Table 1).

Table 1: Allocation coefficients between levels of government in Bosnia and Herzegovina for the period January – December 2007¹²

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Dec
FBiH	64.7967	65.05	65.05	65.05	65.05	64.88	64.58	64.58	64.58	64.58	64.58	64.58
RS	31.5142	31.57	31.57	31.57	31.57	31.57	31.87	31.87	31.87	31.87	31.87	31.87
Brčko District	3.6891	3.38	3.38	3.38	3.38	3.55	3.55	3.55	3.55	3.55	3.55	3.55

Source: Office for Macroeconomic Analysis, Bulletin no. 27, October 2007

Given the large amounts of indirect taxes in question, even a difference of less than half a percentage point in the allocation coefficients during the year can mean up to hundreds of thousands of KM less (or more) of indirect tax revenues between two consecutive months. Bearing this in mind, it is no wonder that such heated debates arise around percentages and that so much scrutiny is undertaken of the information about ‘final consumption’ that is reported in tax returns.

Aside from the obvious dissatisfaction with the amount of revenues that it allows to each of the recipients (which, in all honesty, will always exist in any tax revenue allocation system between levels of government), in terms of revenue planning, it puts the entities and Brčko District in a less favorable position than the State of Bosnia and Herzegovina institutions. This is because the State institutions are able to estimate their revenue, on a daily basis, more accurately than is the case with other recipients.¹³

Secondly, it puts a great burden on the ITA to report promptly on returns made to tax payers (which are excluded from the revenue amounts subject to allocation), as well as revenue payments due. Likewise, given the basis of allocation, the ITA must ensure the accuracy of information from the tax returns in order to ensure the validity of tax allocations. As a result, much of the ITA’s time and effort is dedicated to verifying the information on tax returns for taxes already paid, rather than ensuring enforcement of collection of taxes that are due, or tracking taxes that are not even reported.

Another inadvertent effect of this allocation scheme is that each of the governments has a perverse incentive to ensure that spending (public or otherwise) is very much kept within its territorial “boundary” given this directly reflects on the amount of the allocation coefficients. This diminishes the positive role the indirect tax system is meant to have regarding the creation of a unified economic space through the unhindered flow of goods, people and capital. Given the high proportion of

¹² Through a Decree of the High Representative for BiH, the coefficient for Brčko District is fixed to 3.55, while the coefficients for the entities are to be calculated based on the relative proportion of final consumption in both entities. This Decree has been in place since 1 June 2007.

¹³ The proportion allocated daily to the State of BiH is according to Article 12 of the Law on Payment to the Single Account and Revenue Allocation (Official Gazette of BiH, No. 55/04) calculated as “the amount approved in the State of BiH budget for the current year multiplied by the coefficient derived when 1 is divided by the number of working days of the Indirect Tax Authority in the current year”.

public spending in the overall GDP, each level of government also maintains an interest in increasing public spending in their localities since this contributes to the increase of the allocation coefficients.

Needless to say, the nitpicking that comes about as a result of this allocation scheme diminishes the policy role of the Managing Board of the ITA and is a source of high political tension. It places large administrative and accounting burdens on the ITA and diminishes overall trust in the system. Probably the most “problematic” aspect of the current scheme is that it prevents any of the levels of government to look further than the immediate needs of ensuring revenues for financing their budgets and towards a more holistic appraisal of the entire system. The current discussions of the issues disregard the very obvious fact that the system is fragmented; with lower level governments (namely cantons and municipalities) explicitly excluded from the allocation schemes determined on the State of Bosnia and Herzegovina level. The issue of the allocation of indirect taxes to lower level governments is thus left to be regulated in various different ways by their responsive “upper-level” governments. Fiscal equalization policies, therefore, are currently not at the forefront of the design of the indirect tax system allocation schemes.

The approaches taken by other federally constituted countries vary. However, most federations that do share similar centralized indirect taxes, namely VAT, with other levels of government, do so based on fixed coefficients, structured around fiscal equalization considerations that apply to all levels providing public goods and services.

COMPARATIVE PERSPECTIVES ON VAT ALLOCATION

The decision to centralize the collection and administration of indirect taxes, most prominently VAT, in essence goes against conventional wisdom concerning tax assignment in decentralized countries or federations (Bird et al, 2001). Retail sales tax (RST), which has been supplanted by VAT in most countries, was more often than not the revenue of sub-national governments and usually not subject to tax sharing among different levels of government. This was also the case in Bosnia and Herzegovina, with the RS, Brčko District and the cantons in the FBiH as the primary beneficiaries of the previous RST.

However, for most federations, such arrangements were no longer feasible under the new VAT taxation regime. Some of the reasons for this stems from the fact that levying VAT on more than one basis could have highly distorting economic and fiscal effects and likewise, make administration and compliance needlessly costly (Bird et al, 2001). This is why VAT was mostly centralized in developed federations around the world with varying degrees and methods of revenue-sharing at sub-national levels of government (see

Table 2).

Table 2: Sales tax in Federal Countries (Bird et al, 2001)¹⁴

Country	Is there a Federal VAT?	Is there sales tax on sub-national levels?	What is the type of sales tax in the sub-national governments (SNGs)?
Germany	Yes	No	SNGs share in VAT revenue
Austria	Yes	No	SNGs share in VAT revenue
Switzerland	Yes	No	None
Belgium	Yes	No	None
Australia	Yes	No	All VAT revenue goes to SNGs
Canada	Yes	Yes	Some have VATs, some have RSTs
United States	No	Yes	Most have RSTs

It is only for large, territorially dispersed federations, such as Canada, that sub-national value-added taxation systems are considered sustainable taxation arrangements¹⁵ (Bird et al, 2001). Nonetheless, for a country the size of Bosnia and Herzegovina, the initial approach of centralizing indirect taxes (a majority relating to VAT) is a sound one. However, as explained in the previous section, the allocation criteria are proving to be very troublesome. It creates larger-than-usual uncertainties in financial and budgetary planning because it is dependent on negotiations during the fiscal year between key political actors. Likewise, as the European Union (EU) is also coming to realize in efforts to assign VAT revenues within the EU, if economic cohesion entails obliterating borders within a particular economic space, it is extremely difficult to determine, in a transparent and fair way, points of destination-based final consumption for purposes of VAT allocation (Bird et al, 2001).

This is why “many have argued that the ‘German solution’ of a centralized VAT, with some of the revenues shared with the states on a formula basis, is probably the best approach” (Bird et al, 2001). With the unification of Germany the formula used for allocating VAT has changed, with the Federal government foregoing a larger portion of VAT than was the case before unification. Furthermore, as of 2004, the Federal Government is committed to additional supplemental financing of the new Eastern Federal states in order to ensure that their standards fall into line with their older Western counterparts, at the same time alleviating some of the supplementary financing provided until then by the Western states. The fixed percentages used until 2004 to allocate VAT vertically are presented in Table 3.

¹⁴ It must be borne in mind that for most of these countries VAT does not constitute a substantial portion of total tax revenues. For most of these countries the “largest” taxes, personal income and profit taxes, are usually exclusive revenues of the federal levels.

¹⁵ However, it must be borne in mind that value-added tax has been difficult to implement in general in North America, with the U.S. failing to implement VAT taxes to this day (Bird et al, 2001).

Table 3: Allocation of total VAT revenues in Germany in percentages and in order of allocation¹⁶

The amount in %	To Whom?	At what Stage of Allocation?	Rationale
5.63%	Federal Government	Up Front	Because of the contributions by Federal Government to the Statutory Pension Scheme
2.2%	Municipalities	Before further allocation to other levels	on a per capita basis (implying a strong implicit equalization effect) (Spahn, 1995)
50.4% ¹⁷	Länder	After first two allocations	Same as previous
49.6%	Federal Government	After first two allocations	Same as previous

Under the same scheme, VAT was also allocated horizontally, with 25% of the share of the total VAT allocated to the Länder going up-front to those Länder in fiscally weaker positions. Disregarding at this time the specificities of the German allocation scheme and the exact percentages used in Germany for allocating VAT revenues, a key feature of this particular allocation scheme is its *holistic approach to revenue allocation in order to achieve greater equalization*.

This is attested to by the plain fact that the allocation scheme guarantees a portion of VAT revenues to municipalities, regardless of the fact that municipalities are administratively responsible to the Länder. Therefore, fiscal equalization, both vertical and horizontal, is the key determinate of the allocation scheme. A holistic approach to fiscal equalization is completely lacking in the current fiscal system of Bosnia and Herzegovina, as is explained in the following section.

Inter-governmental Indirect Tax-Sharing in Bosnia and Herzegovina

Naturally, fiscal relations in Bosnia and Herzegovina cannot be observed solely through the prism of the indirect taxation system of Bosnia and Herzegovina. Although indirect taxes are the only taxes shared between the State level, entities and Brčko District, there is further revenue sharing between the entities and their constituent units. However, the overwhelming majority of total tax revenues for all levels in Bosnia and Herzegovina (over 85% according to 2008 statistics of the Office for Macroeconomic Analysis of the ITA) relates to indirect tax revenues.

For the cumulative tax revenues of FBiH, cantonal and Federation municipal budgets, 84.27%¹⁸ include revenues from indirect taxes, while the same is true for 80.73% of cumulative tax revenues

¹⁶ Based on information compiled from the German Federal Ministry of Transport, Building and Urban Affairs and Spahn, 1995.

¹⁷ These are the percentages for allocation to the Federal and Länder governments of amounts remaining after 5.63% and 2.2% have been deducted for Statutory Pension Schemes and to municipalities.

for the RS and its municipalities.¹⁹ Therefore, given the high proportion these revenues represent in total tax revenues, as well as in overall revenues, the allocation scheme of indirect taxes *throughout the whole of Bosnia and Herzegovina* is exceptionally important for sustaining vertical and horizontal fiscal balances.²⁰

Primarily owing to significant donor input²¹, the FBiH and the RS, have, as of 2006, introduced allocation schemes for indirect taxes that seem to address the high vertical and horizontal fiscal imbalances that existed in the tax sharing schemes prior to the implementation of the Bosnia and Herzegovina-wide indirect tax system. Box 1 provides a summary overview of the tax-sharing system established for indirect taxes for the cantons and municipalities in the FBiH and the municipalities in the RS.

Box 1: Indirect tax-sharing schemes for lower level governments in the FBiH and the RS

According to the Law on Allocation of Public Revenues in the FBiH²² the Government of the FBiH used “for the first time a formula for the distribution of revenues to lower level government” (Dervišević, 2006). The revenues from indirect taxes that are allocated in total to the FBiH level are further distributed in the following manner:

- 36,2 % to the FBiH level;
- 51,48 % to the cantonal level;
- 8,42 % to the municipal level;
- 3,9 % for the Directorate for Roads.

Five types of criteria (weights) are used for the horizontal allocation between cantons and municipalities:

- a) size of territory (6% weight for cantons, 5% for municipalities),
- b) size of population (57% weight for cantons, 68% for municipalities),
- c) number of pupils enrolled in elementary schools (24% weight for cantons, 20% for municipalities),
- d) number of pupils enrolled in secondary schools (applicable only for cantonal levels, 13% weight)

¹⁸ Furthermore, based on information collected by the Ministry of Finance of the FBiH of revenue collected in the period January to August 2007, 95.37% of total tax revenues for the Federation level, 83.66% for the cantonal level and 55.55% for the municipal level relate to indirect taxes.

¹⁹ Based on information of the Office for Macroeconomic Analysis (OMA) of the ITA of the tax revenues collected for the first six months of 2007.

²⁰ Based on OMA information this is 71.69% of total BiH-wide revenues reported by the OMA for first six months of 2007. Based on information of the Ministry of Finance of the FBiH for the first eight months of 2007 this is 68.62% of total reported revenues for the FBiH.

²¹ Namely the USAID and Sida funded Governance Accountability Project of BiH.

²² Official Gazette of the FBiH No. 22/06

e) index of development (applicable only for municipalities, 7% weight) which “measures the factor of fiscal capacity of municipalities” and is “calculated as the portion of collected sales and profit tax for a certain municipality in 2005 in comparison to the FBiH average for these taxes” (Dervišević, 2006).

The Law on the Amendments to the Budget System Law of the RS²³ allocates vertically the total revenues allocated to the RS from the single account of the ITA according to the following percentages:

- 73,5 % to the RS level;
- 23,0% to the cities and municipalities;
- 3,5 % to Public Enterprise “RS Roads”;

Horizontal allocation between cities and municipalities is carried out based on the following criteria:

- a) 75% based on the size of population;
- b) 3% based on size of territory,
- c) 15% based on number of pupils enrolled in secondary schools;
- d) 5% based on the number of pupils in elementary schools.

For the FBiH, the current tax-sharing scheme for indirect taxes offer the possibility for an increase in the portion of indirect taxes over a certain period for those municipalities and cantons that historically have had the smallest share of the former RST (Dervišević, 2006). The same is true for municipalities in the RS.²⁴ Changes introduced in the allocation schemes of indirect taxes resulting from the introduction of VAT have, for the first time, presented the concept of objective criteria in inter-governmental revenue allocation. However, there have been some concerns that the allocation criteria used have not fully taken into consideration the expenditure responsibilities of the cantonal and/or municipal governments, which raises questions as to the extent to which fiscal equalization has been achieved.

Another major issue that has arisen in the use of objective criteria is the unreliability of statistical data. Both entities relied on the statistics provided by their respective statistical agencies. However, overall statistical data gathering is fragmented and statistical methodologies differ. Without reliable statistics, the coefficients being used can be subjected to dispute, again leaving the allocation system subject to ad hoc, unsystematic negotiations between the levels of government. However, having different regimes for tax allocation of the State-level administered indirect taxes still creates potential for extreme fiscal imbalances. It also leaves cantons, and in particular municipalities to be vulnerable to, in the best case, fiscal inequalities, and in the worst case, political nepotism.

²³ Official Gazette of the RS No. 34/06

²⁴ See the Decision of the Government of RS on the allocation of indirect taxes to individual municipalities made in June 2007. (Official Gazette of the RS, No. 56/07).

Similar disproportionate representation of sub-entity levels of government is evident in the structure of institutional arrangements for intergovernmental fiscal relations in Bosnia and Herzegovina as described in the next section.

INSTITUTIONAL ARRANGEMENTS FOR INTERGOVERNMENTAL FISCAL RELATIONS IN BOSNIA AND HERZEGOVINA

The Fiscal Council in Bosnia and Herzegovina was tentatively introduced during 2005, mainly at the behest of the IMF which was concerned about the lack of formal or institutional mechanisms for the coordination of fiscal policy in Bosnia and Herzegovina, particularly in relation to the size and scope of government spending across levels of government in Bosnia and Herzegovina. There was a brief period of success in holding consecutive meetings of the FC in Bosnia and Herzegovina, and even in the implementation in practice of the recommendations of its meetings (most notably during 2005). Unfortunately, the change of government in the RS and the 2006 elections brought about a complete halt to the workings of the FC in Bosnia and Herzegovina and to initiatives to set it up as a legal entity and to determine its role²⁵. The ultimately agreed and adopted Law on the Fiscal Council in Bosnia and Herzegovina defined the role and responsibilities of the FC as described in Box 2²⁶.

Box 2: Role and Responsibilities of the Fiscal Council in Bosnia and Herzegovina

- Coordination of fiscal policy in Bosnia and Herzegovina;
- Adopting the proposal of the three-year “Global Framework of Fiscal Balance and Policy in Bosnia and Herzegovina”, containing proposed fiscal objectives for Bosnia and Herzegovina, entity and Brčko District budgets, proposal of indirect tax macroeconomic projections for total indirect taxes and their allocation; and an upper debt limit for Bosnia and Herzegovina, entity and Brčko District budgets;
- Adopting proposal of short-term and long-term macroeconomic projections;
- Monitoring the implementation of determined objectives and criteria in the execution and adoption of budgets;
- Achieving complete coordination of activities in accordance with agreed budget calendars for State, entity and Brčko District governments,
- Proposing priority measures for enhancing public sector financial management in Bosnia and Herzegovina;
- Adopting all acts necessary for the proper functioning of the Fiscal Council, as well as its budget.

²⁵ Although during 2009 and beginning of 2010, the Fiscal Council has started to operate once more.

²⁶ Article 5 of the Draft Law on the Fiscal Council in Bosni and Hercegovina.

The FC in Bosnia and Herzegovina is comprised of representatives of the State and the two entities (this time around it is the prime ministers and ministers of finance, with the Governor of the Central Bank and President of Brčko District Government acting as observers). It is assumed that coordination with lower levels of government (cantons and municipalities) will be carried out by the competent “upper-level” government. If fiscal equalization considerations were to be put at the forefront of the indirect tax allocation scheme, the FC in Bosnia and Herzegovina should be the forum in which this scheme would be monitored and assessed. In the light of that, the FC in Bosnia and Herzegovina would need to expand its membership to include representatives from cantons and municipalities. There are several arguments for this.

Firstly, indirect taxes comprise a high proportion of the overall amount of tax revenues within cantonal and municipal budgets. This results in a high dependence of cantonal and municipal fiscal positions on such revenue. This ultimately impacts on the quality of public service delivery in this particular revenue source. Fiscal balance can only be achieved, therefore, if there is a holistic and common set of criteria of revenue allocation encompassing all levels of public service delivery in Bosnia and Herzegovina.

Given that indirect taxes are exclusive revenues of the State of Bosnia and Herzegovina (regardless of the executive and legislative arrangements of the State in general and the specific institutional arrangements for the indirect taxation system in particular) the State should have some role in ensuring that objectives of fiscal equalization and equity and quality in public service delivery are met. At the very least, this could be enacted through the representation of cantonal and municipal (“lower”) level governments in State-level forums, established for the purpose of negotiating measures to ensure fiscal policy and balance, i.e. arrangements for indirect taxation allocation.

In all federations, the central government or centrally-led coordination mechanisms play a significant role in closing fiscal gaps, as well as in ensuring a minimum of common standards in public service delivery and effectiveness. There is a very simple reason for this. Although federations score highly in efficiency compared to more centrally administered countries, these scores do not similarly apply when it comes to issues of equity. Devolved decision-making causes federations to become prone to inequalities in public service coverage and provision, and in many cases, the most vulnerable groups within any society are more disenfranchised than similar groups in more centralized or unitary states (Watts, 1999).

Despite the institutional arrangement of the indirect tax system in Bosnia and Herzegovina and despite the fact that indirect taxes are shared between the levels of government (i.e. directly between the State, entities and Brčko District, and indirectly to the other levels of governments, namely cantons and municipalities) indirect taxes collected by the ITA can be considered *exclusive* revenues of the State of Bosnia and Herzegovina, as the CoM, i.e. the State level, is de facto and de jure *politically responsible* for raising this particular source of revenue (Bird et al, 2001). Therefore, ensuring fiscal equilibrium (in the sense that all levels have the comparable fiscal standing needed to deliver the legally mandated public goods and services of each of them), and simultaneously ensuring the effectiveness of their spending (particular for areas of strategic importance for overall economic growth, such as education) should be a natural role that the State of Bosnia and Herzegovina should assume. This would lead to a natural continuation of the reforms implemented thus far in establishing the indirect tax system in Bosnia and Herzegovina.

In that regard another anomaly of the Bosnia and Herzegovina “federation” that needs to be addressed when discussing fiscal equalization in Bosnia and Herzegovina is the fact that the State level of Bosnia and Herzegovina is explicitly precluded from developing any type of transfer scheme to sub-national levels of government (entities, Brčko District, cantons or municipalities). The advantages of well-designed and structured inter-governmental transfers in not only in closing fiscal gaps, but also in the achievement of wider national objectives are yet to be recognized (and allowed for the State of Bosnia and Herzegovina level) and these should be developed as instruments of fiscal policy and fiscal cohesion.

For federations, transfers are considered an “intrinsic feature” (Boadway, 2007) of intergovernmental fiscal relations. This is primary due to the inherent tensions within all federations between, on one hand, the efficiency that is broadly believed to be derived from decentralizing decision-making and, on the other, achieving overarching national objectives “including equality of economic outcomes, equality of opportunity, and economic security, versions of which are often found in a nation’s constitution” and that is usually the responsibility of sub-national government to deliver, but for federal governments to uphold (Boadway, 2007). Transfers are one of the policy instruments federal governments usually use to alleviate these tensions (Boadway, 2007).

In that regard, despite its high level of decentralization (one might even argue an extreme level in some cases); Bosnia and Herzegovina does not function as a functional federation. This is simply attested to by the fact that the State of Bosnia and Herzegovina does not provide any forms of transfers to lower level governments. Furthermore, the State of Bosnia and Herzegovina does not have any means of securing any forms of cohesion within the country (legislative, fiscal or otherwise). A prime reason for this is the “hybrid nature” of the Bosnian-and-Herzegovinan “federation” (FPI BiH, 2007) (see

Figure 3).

Figure 3: Governance arrangements in Bosnia and Herzegovina against “ideal” types of federal systems

	Separate legislation for federal and sub national governments	Strong representation of sub national governments in federal legislature	Little or no harmonization on tax bases and tax rates, decentralized tax administration	Fiscal redistribution between federal and sub national levels
Dual federal system with coordinate responsibilities ²⁷	Yes	No	Yes	No (or very limited)
Cooperative federal system with shared responsibilities ²⁸	No, federal level regulates sub national level implementations	Yes	No	Yes
Bosnia and Herzegovina “federal” system	Yes	Yes	Only indirect taxes shared	No

Adapted from “Governance Structures in BiH: Capacity, Ownership, EU Integration, functioning State”, FPI BiH

It is obvious from the table above that BiH is neither a dual nor a cooperative federation, but rather a combination of both, making the overall governance structure of Bosnia and Herzegovina highly unstable and extremely inefficient (FPI BiH, 2007). This is reflected in the indirect taxation system. The fact that it was centralized and assigned to the State level of government is in line with experiences of other federal countries (as explained earlier), however if Bosnia and Herzegovina were more of a cooperative federation the allocation of indirect taxes would have been done on a more holistic basis, taking into account the fiscal capacities of all levels of government providing public goods and services and using assessments based on solid and unified statistical data. On the other hand, if Bosnia and Herzegovina were more of a dual system none of the indirect tax revenues would be shared with other levels, leaving the resulting fiscal gaps in the lower levels to be resolved through transfers from the State level.

However, transfers in federal governments, aside from equalizing “the fiscal capacities of regional governments to provide comparable levels of public services”, also often serve as an “incentive for [sub national governments] to design their programs in a way that reflects national norms of efficiency and equity, and encourages them to harmonize their policies” (Boadway, 2007). As stated previously no transfers, either conditional or non-conditional, are made from the State to entity or lower levels of government. The use of transfers in entities toward lower level governments (cantons and municipalities) are primarily regulated through annual budget execution laws and, in ef-

²⁷ An example of this type of federal system in Europe is Switzerland.

²⁸ The German federation comes closest to being an example of this type.

fect, are not established as an integral part of overall intergovernmental fiscal relations. Therefore, the effects of these transfers in terms of fiscal equalization would need to be systematically assessed and designed according to these assessments.

This is the time that the issue of the un-holistic, disharmonized and ineffective fiscal system in Bosnia and Herzegovina can be addressed, as there is no risk of State “dominance” in any of the aforementioned issues. There is a potential for a strong coordination mechanism, namely the Fiscal Council of Bosnia and Herzegovina, that can provide “an intergovernmental forum to achieve consensus on the standard of equalization and objectives”, considered a key positive trait in the design of intergovernmental fiscal relations (Shah, 2007).

With that overarching goal in mind, the options outlined in the following section are structured with the aim of eliminating the current weaknesses within the current allocation system of indirect tax revenues, yet building upon some of the potential strengths of the overall fiscal system in Bosnia and Herzegovina.

OPTIONS FOR IMPROVEMENT

Option 1: Retaining current arrangements of indirect-tax revenue allocation

In essence, this option is not simply the status quo. Given that there is political consensus on the need for change in the current allocation scheme of indirect tax revenues, some remedial action will be taken. Most likely the coefficients will be “fixed”, based on an assessment of recent trends in final consumption²⁹. However, the need for an immediate resolution will mean that the allocation system will not fundamentally change. The basis of allocation will still be the relative portion of final consumption and this could adversely affect the free flow of goods and services within Bosnia and Herzegovina, as well as contributing, inadvertently, towards an increase in government spending. Thus, the allocation of indirect taxes will fail to bring about more purposeful cohesion within Bosnia and Herzegovina, and will rather contribute to its continued fragmentation and imbalance.

Option 2: Arrangements based on horizontal and vertical fiscal equalization considerations

This option would require two substantive changes to the overall allocation system that would need to be reflected in respective legislative change. Firstly, a similar allocation scheme, based on objective criteria, such as is now used by the entities for allocation to lower level governments, would replace the current basis of relative portion of final consumption and regulated through State level regulations. Secondly, the FC in Bosnia and Herzegovina would assume the role of periodically assessing and deciding on allocation criteria and, thus, would have to be expanded to include representatives of cantons and municipalities. They could be appointed by the respective entity legislatures, based on the recommendations of the associations of local self-governments. However, associations must truly act as advocates of

²⁹ And this has been achieved since the completion of this paper.

cantonal and municipal governments and must have the technical capacities to be able to engage actively in the discussions of the FC and to act on its collective best interest.³⁰

Option 3: Arrangements based on fiscal equalization and expenditure efficiency and effectiveness considerations

It is common for federal countries to use both revenue-sharing and transfers in order to achieve fiscal equalization, as well as to secure the achievement of objectives deemed of national significance.

Analysis of intergovernmental

fiscal transfers in other countries indicate that output-based transfers, i.e. transfers conditioned against the accomplishment of predetermined performance targets, are the most effective forms of transfers (Shah, 2007). The reason for this is that, by this arrangement, funding for achieving national objectives is provided for, whilst retaining the flexibility for sub-national governments to design spending programs. A similar scheme could be incorporated within the indirect taxation allocation arrangement in Bosnia and Herzegovina. Objective criteria could be used for allocating revenues between levels of government, (similar to the system described under option 2), with the addition that a portion of the revenues from indirect taxes be “earmarked” for transfers to lower level governments in order to finance high priority national reform programs designed to achieve set performance targets.

All federal governments use intergovernmental transfer systems to alleviate the tensions within all federations between, on the one hand, the efficiency that is broadly believed to be derived from decentralizing decision-making and, on the other hand, achieving overarching national objectives “including equality of economic outcomes, equality of opportunity, and economic security, versions of which are often found in a nation’s constitution” that are usually under the responsibility of sub-national governments to deliver against, but of federal governments to uphold (Boadway, 2007).

FINAL RECOMMENDATIONS

Bearing in mind the very volatile political circumstances currently pertaining in Bosnia and Herzegovina, stabilization of intergovernmental relations, primarily between State, entity and Brčko District and the rebuilding of trust in the indirect tax system are absolutely imperative at this time.

Therefore, immediate agreement must be made regarding fixed coefficients of relative portion of final consumption by the members of the Managing Board of the ITA. However, this should be seen as temporary solution and the following needs to be changed in the overall system of allocation of indirect tax revenues:

- Fiscal equalization, horizontal and vertical, between all levels of government that provide public goods and services, must be put at the forefront of the indirect tax-sharing system. In

³⁰ In many developed decentralized and federal countries (such as the Netherlands, Germany and others) “most types of institutional intergovernmental arrangements somehow include local government associations as an institutional partner”. This is not without certain key requirements; namely that “(a) the local government associations have the institutional and technical capacity to engage in policy analyses and informed policy dialogues with central government counterparts, and (b) the local government associations are sufficiently representative to be able to credibly speak on behalf of all local governments” (Boex et al, 2004).

the near-term, there must be complete abandonment of allocation based on relative portion of final consumption. The objective criteria agreed must be simple and transparent and based on uniform and reliable statistical information. As far as is possible, the expenditure responsibilities of each of the levels of government must be taken into consideration when allocating revenues.

- The review of and proposals for revenue allocation coefficients thus established must be left to the FC. The Managing Board of the ITA must, therefore, be left to assess and advise on indirect taxation policy and to oversee the management and functioning of the ITA. The allocation arrangements of indirect taxes must be comprehensive enough to include cantons and municipalities. This entails expanding the membership of the FC to include selected members from cantons and municipalities. Associations of local governments should have the technical and organizational capacity to represent the interests of local governments.
- In terms of designing a system of intergovernmental output-based transfers, the State of Bosnia and Herzegovina could go forth regardless of the destiny of the indirect tax revenue allocation scheme and design such a system from its existing budgetary resources for areas that it deems of national importance but over which it has no exclusive authority. The FC (in its expanded membership) needs to have a role in assessing and renegotiating the conditionality of these State-level transfers.

However, there are some major preconditions that need to precede any substantive and meaningful change, not only in this segment of intergovernmental fiscal relations in Bosnia and Herzegovina, but in all aspects of governance in Bosnia and Herzegovina. In fact, these are necessary preconditions for any federal setting (Boadway, 2007). Firstly, there must be “some consensus about the importance of national equity and efficiency objectives” (Boadway, 2007) in relation to the decision-making independence of sub-national governments. The focus placed on these considerations, in effect, creates the fabric and form of society in general. Once these principles have been agreed, the federal, or in the Bosnia and Herzegovina context, the State level, must be given the instruments and authority to uphold these principles.

The strength of the State institutions depends on the value society places on issues of equity and national (or, in the Bosnia and Herzegovina context, inter-national) solidarity. Just as it is imperative to give an equal institutionalized “voice” to cantons and municipalities in issues of intergovernmental relations, the State of Bosnia and Herzegovina must be given its “voice” as well. The strength of this voice depends on the strength placed on the value of equity and solidarity. There is no “European requirement” in this aspect. It is a judgment call that the political decision-makers and the citizens who vote and support them will have to make, and one that will shape the society of Bosnia and Herzegovina for future generations.

Finally, there must be a degree of goodwill and willingness to engage in constructive dialogue and to assess all possible options and their implications. Unfortunately, unlike the arrangements that are negotiated between federal constituents via constitutions, laws, agreements etc., where there is always room for valid disagreements and nuances in approaches, there are no nuances when it comes to the questions of goodwill and willingness for dialogue. They either exist or they do not. Collectively, as citizens and inhabitants of Bosnia and Herzegovina, we either want this country to suc-

ceed as a progressive society or we do not. This paper and the arguments presented therein are based on the assumption that there are no issues regarding the existence of such goodwill, but only issues of how to channel it into wider and more constructive debate.

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