



The Fiscal Decentralization Initiative
for Central and Eastern Europe

Bosnia and Herzegovina on the Path to Fiscal Equalization

by
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Executive Summary

Bosnia and Herzegovina's (BiH) administrative arrangement is very specific, the result of the Dayton Peace Agreement's division of the country into two entities and one district. The Republika Srpska (RS) and the Federation of BiH (FBiH) were established, the latter composed of 10 cantons (five cantons with a Bosniak majority, three cantons with a Croat majority, and two cantons with a mixed population). From the municipal level, the FBiH is, in fact, composed of 10 mini-states, because the cantons enjoy sovereignty when it comes to decision-making with regards to the policies of local communities.

Upon analysis of the administrative arrangement in BiH, it is necessary to point to the deficiencies that have occurred due to the inefficient central government of BiH, inadequate fiscal decentralization, and the lack of cooperation between the various types of governments. The BiH Constitution defines a decentralized political, administrative, and fiscal government structure, but the practice is still very far from decentralization. Fiscal decentralization stopped at the entity level (RS) or the cantonal level (FBiH), since local authorities have limited authority in decision-making.

The solution to this problem is to establish a greater role for local self-governance, especially towards revenue realization and the determination of public service responsibilities. Many contradictions exist regarding revenue allocation. Local governments do not have autonomy in terms of distribution of tax revenues and their revenues are very low. Consequently, local governments do not find themselves responsible for any inefficient delivery of public services. There are horizontal imbalances in tax capacities, mostly the result of the current tax revenue distribution on the basis of its occurrence, an inefficient definition of revenue distribution between government levels, and unstable entity and cantonal fiscal policies.

Taking into account the above issues, as well as the problems that will come with the introduction of VAT,

the BiH authorities should start planning a new way of financing local self-governments and developing a new law on financing the local functions. This law should define new sources for financing the more than 30 percent of local self-government revenues that will "disappear" when the sales tax is replaced by the value added tax.

It is also necessary to define a new system of fiscal equalization, because the current one is extremely inefficient, especially in the FBiH. One of the first efforts by an entity government to introduce fiscal equalization was in RS, which uses the principle of the level of municipal development to set up the share of sales taxes to each municipality. There should be more precise definition of formula for allocating conditional and unconditional grants, as well as the eligibility criteria for these grants.

As presented in this report, the overall system will have to be restructured:

- Single transfer account should be regulated by law, all public revenues and expenditures should be included in the General Ledger, and a consolidated balance on the state level should be created;
- The amount of resources for equalization purposes should be determined through a formula, which should be specified as the fixed percentage of state budget revenues;
- Legal authority is needed for special-purpose resources to finance local activities, specific investment programs, and entrusted activities;
- Transfer the responsibility for managing the property sale tax and for determining the tax rates to the local self-governance level.

Basic Government Competencies

During 1991 and 1992, the Socialist Federal Republic of Yugoslavia broke apart into five countries. After that, the Socialist Republic of Bosnia and Herzegovina was

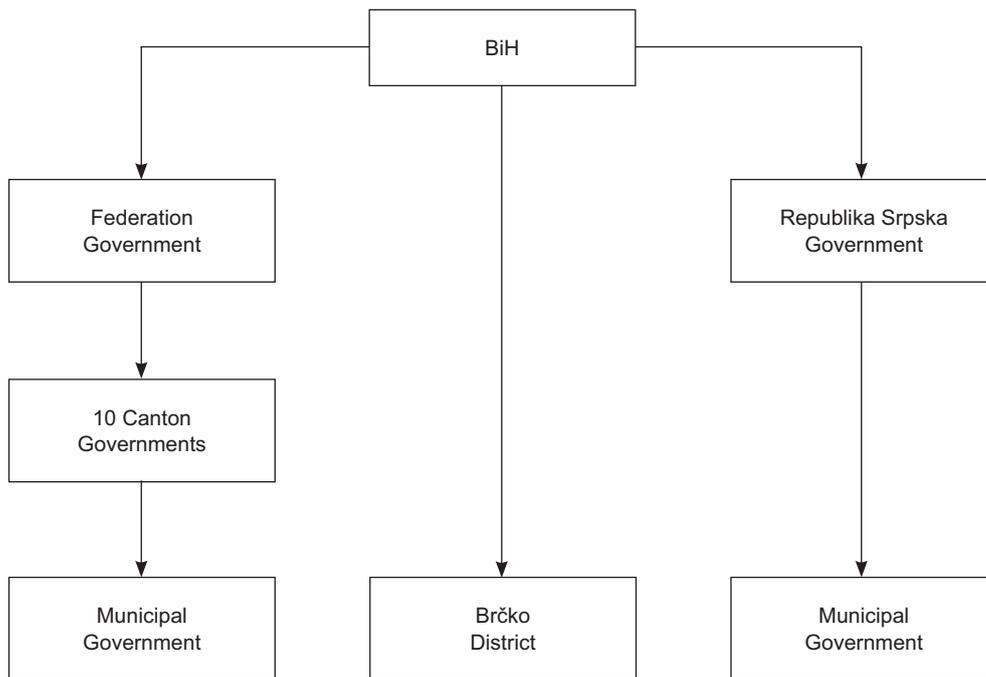
divided into Republika Srpska, Herzeg-Bosnia, and Republic Bosnia and Herzegovina. After several unsuccessful attempts by the international community to solve the crisis in Bosnia and Herzegovina, through political, diplomatic, and military engagement, the Peace Agreement was signed after four years of war.

The Dayton Peace Agreement (DPA) in Bosnia and Herzegovina (BiH) was signed in Paris on December 14, 1995. The DPA meant the end of the war, and BiH was divided into two entities: the Republika Srpska (RS) and the Federation of Bosnia and Herzegovina (FBiH). Each entity got the elements of a state with limited sovereignty, together making one country (Bosnia and Herzegovina). The DPA on BiH consists of eleven annexes, which de-

termine the basic principles of the government system, as well as civil and military issues. The political system in BiH is a parliamentary democracy, with the presidency having three members (representatives of Bosniaks, Croats, and Serbs). The competencies of the institutions at the level of BiH are limited.¹

The agreement on the borders between the entities and related issues includes arbitration over the area of Brko. The Final Arbitration Award determined a special regime of administration in the Brko area, as a unit of local self-government under the sovereignty of BiH. The District of Brko was established on March 8, 2000, by enforcing the Statute of the District Brko.

Figure 1.
Bosnia and Herzegovina—Structure of Government



¹ **Legislative authority:** Parliamentary Assembly of BiH (House of Representatives and House of Peoples); **Executive authority:** Presidency of BiH and Council of Ministers of BiH; **Judicial authority:** Constitutional Court of BiH, High Judicial and Prosecutors Council of BiH, Court of Bosnia and Herzegovina, Public Prosecutors’ Office of BiH, and Public Attorney’s Office of BiH.

Today, BiH is in a transitional period (see key economic indicators in Appendix 1.). Currently, BiH is taking measures towards development of its own Mid-term Development Strategy that acknowledges its own economic potential. The financial system of BiH passed a long and difficult road from the war economy to self-sustainability. Before the Central Bank of BiH (CBBiH) started to work (1998), the financial sector did not exist in this country. Four currencies were used, there were 76 commercial banks, mostly state owned, but none of them worked in the whole territory of the country. When the CBBiH and currency board were established, the country achieved more financial stability, inflation was reduced, and citizens started to trust again in BiH's currency and financial sector.

With the DPA, BiH was constituted as one of the most complex system of government in Europe. This decentralized government was established to promote political stability and democratic participation in decision-making processes. But the complexity of the organizational structure in BiH complicates reforms in all fields and creates the need for additional efforts in the introduction of new practices and procedures at all levels of government (Appendix 2).

Bosnia and Herzegovina

The central government of the state of BiH is limited and the state's competencies are specific, while the two entities and the Brčko District are autonomous in terms of politics, administration, and fiscal policy. The state competencies include monetary policy, military defense, foreign policy, foreign trade policy and customs fees, regulatory competencies related to international and inter-entity criminal laws, telecommunications, transport systems, traffic control, immigration, refugees, and asylum policy. It is important to point out that each entity has its own constitution and they conduct functions that are not exclusively assigned by the BiH Constitution.

District Brčko

As already mentioned, the Brčko District was established as a single administrative unit of local self-government. The district is an entity with its own legal competencies, which are necessary for carrying out its functions, including the competency for acquiring rights and obligations. Functions and authorizations of the District include: economy, finance, customs administration, public property, public services/infrastructure, culture, education, health protection, protection of the environment, social protection, administration of justice, legal

service, police, housing issues, urbanism and planning, and other functions necessary for the functioning of the district as an independent administrative unit of local self-governance according to the statute.

The revenue administration of the district is responsible for all revenue collection, fund investments, and reporting to the assembly regarding revenues available for the annual budget, revenue planning, and the financial situation of the district.

Federation of Bosnia and Herzegovina

The Federation of Bosnia and Herzegovina is composed of ten federal units (cantons). Each canton has its own constitution, which is used as a basis for cantonal legislation. Within its own competencies, the Federation makes its own constitution, laws, and other regulations that must be in accordance with the BiH Constitution. This Constitution determines exclusive competencies of the federation, common competencies of the federation and cantons, which can be realized together or separately. Competencies that are not exclusively assigned to the federal government are given to the cantons, and they are defined as the cantons' special competencies.

The federal Constitution determines exclusive competencies of the Federation, such as citizenship, making regulations on finances and financial institutions of the Federation, its fiscal policy, the prevention of terrorism, electric-power policy, and the funding of activities of the federal government and its institutions established by the federal government through taxation and debt incurred in foreign countries.

Common competencies of the federal government and cantons can be realized together or separately, or by the canton, in the case of which it is coordinated by the federal government. Common competencies include human rights, the healthcare system, environmental protection, infrastructure, social policy, law implementation, tourism, and use of natural resources.

Cantonal competencies include police, education, culture, housing policy, public services, regulating the use of local land, regulations for the improvement of the local business environment, humanitarian activities, conducting social policy and the establishment of social protection services, financing of activities of the cantonal government and its agencies through taxation, debt incurring or through other resources, and other functions in accordance with legal regulations.

Municipalities and cities of the Federation are autonomous communities with local self-governments. Every municipality, when implementing its competencies,

takes all necessary measures for the purpose of ensuring the protection of rights and freedoms determined by the Constitution. The competencies include finances and tax policy, in accordance with federal and cantonal laws, common infrastructure, urban planning, public transport, and other competencies of the city entrusted by the canton or transferred from the municipalities.

Republika Srpska

The Constitution of RS is based on local self-governance, where municipalities and cities are defined as local self-governance units. Unlike the Federation, the RS has a single-level local self-government system. Each municipality has its own competencies and delegated competencies. Municipal competencies include the creation of a development program; managing development; town planning; urban implementation plans; budget design and reporting on the final state of accounts; planning the use of municipal land and business premises; organization of communal police; communal activities planning; construction and maintenance of local roads, streets, and other sites important for the municipality; and taking care of citizens' needs in terms of education, culture, health, social protection, and information. Implementing laws, other regulations, and general enactments of the RS and city, whose implementation is entrusted to the municipality, ensures regulations and general enactments

of the municipality, establishing bodies, organizations, and services for the needs of the municipality, and performing other duties determined by the Constitution, law, and municipal statute.

The political, administrative, and fiscal structures in the two entities are not harmonized. The differences exist on cantonal level and on the local administration level, too (Table 1.).

Governments' Fiscal Autonomy

The complex structure of fiscal system in BiH and basic competencies of government with respect to revenues and expenditures are presented in Tables 2. and 3.

With the exception of custom duties and excise taxes, regulated by the state but administered by the entities, all other taxes are regulated and administered at the entity level (see Appendix 3.).

Regarding expenditure assignment, the entities are entitled to all public expenditure responsibilities that are not particularly assigned to the state by the Constitution. The same standard applies to cantons, but in both entities municipalities precede their local public function based on their own statute, consistent with the entities' legislation.

Revenues and Expenditures of the State of BiH

Table 1.
Administrative Structure of BiH

Government levels	BiH	Federation	RS	District	Total
Central government	1				1
Entity		1	1		2
Canton		10			10
Local self-government (municipalities and cities)*		80	62		142
District				1	1
Total	1	91	63	1	156

Note: * Until enforcement of the Law on Changes and Amendments to the Constitution of the Federation of Bosnia and Herzegovina and the Statute of Mostar, BiH had 148 municipalities. Since then, six city municipalities ceased to exist as legal entities. The City of Mostar became a legal successor of the municipalities and took over all the rights, duties, obligations, and responsibilities of the former city municipalities. The Constitution determines that two or more municipalities that have territorial and urban connections in terms of needs of its citizens should form a city as a unit of local administration and self-governance.

Table 2.
Revenues Structure and Revenue-sharing Powers in BiH

Tax	State	Entities				
		Federation			Republic Srpska	
		Federation	Cantons	Municipalities	Republic	Municipalities
<i>Custom Duties</i>	Regulates	100% Administers and Collects			100% Administers and Collects	
<i>Excise</i>	Regulates	100% Administers, Collects			100% Administers, Collects	
<i>PIT (Payroll Rate)</i>		Regulates, Administers, Collects (PIT 5%)	80%	20%	Regulates, Administers, and Collects (10% 75%)	25%
<i>PIT (Citizens Income Tax)</i>		Administers, Collects	Regulates 20%	80%	Regulates, Administers, and Collects	100%
<i>CIT (Corporate Income Tax)</i>		100% large enterprises Regulates, Administers, Collects	100% other enterprises		100% Regulates, Administers, Collects	
<i>Sales Tax</i>		Regulates, Administers, Collects	70–80%	20–30%	100% Regulates, Administers, Collects	Shared with municipalities
<i>Property Tax (Real Estate and Transfer)</i>		Administers, Collects	Regulates 20%	80%	Regulates, Administers, Collects	100%
<i>Road Taxes</i>		Administers, Collects 45%	55% Road Tax and 55% Motor vehicle registration	45% Motor vehicle registration	100% Regulates, Administers, Collects	
<i>Tax, Fees, Utility Charge, Fees for Natural Resources</i>		Administers, Collects	Some have regulatory power	Some have regulatory power	Regulates, Administers	Some have regulatory power for 100% of fees
<i>Social Security Contribution</i>		Regulates, Administers, Collects	100% earmarked extra-budgetary funds		100% earmarked extra-budgetary funds	
<i>Privatization</i>		80% (20% to pension fund)	80% (20% to pension fund)		85% (10% pension, 5% restitution fund)	

Table 3.
Expenditure Assignments in BiH

Function	State	Entities				
		Federation			Republic Srpska	
		Federation	Cantons	Municipalities	Republic	Municipalities
Social Welfare	Social assistance (refugees)	Pension System	Social assistance—joint	Social assistance—joint	Pension system	Social assistance
Immigration, Refugees, and Asylum Policies	Immigration, refugees, asylum policies	Refugees and displaced people			Refugees and displaced people	
Justice, Internal Security, and Police	International and inter-entity criminal law forces	Internal affairs, justice, and police	Police		Internal affairs, justice, and police	
Public Transportation	Regulates national, inter-entity	Intra-entity	Regional intra-canton	Local traffic	Intra-entity	Local traffic
Energy		Electricity transmission lines			Electricity transmission lines	
Defense, Economic, and Social Programs, Reconstruction Programs		100%			100%	
Roads		Highways, railways	Local roads		Highways, railways	Local roads
Education			Universities, research institutes, teachers' salaries, and student transportation	Pre-school and primary school partial maintenance and student transportation	Universities, research institutes, teachers' salaries, and student transportation	Pre-school and primary school partial maintenance and student transportation
Healthcare		Primary healthcare and medical research	Ambulance services and healthcare supplies		Primary healthcare and medical research	Ambulance services and healthcare supplies
Public Utilities				100%		100%
Housing and Spatial/City Planning			Housing policy	City planning	Housing policy	City planning
Culture, Sports, Recreation, Parks, Street Lighting			Museums, theaters	Culture, sports, parks, street lighting	Museums, theaters	Culture, sports, parks, street lighting
Fire Protection			100%		100%	
Social Security Contribution		Regulates, administers, and collects	100% earmarked extra-budget fund		100% earmarked extra-budget funds	
Privatization		80% (20% to pension fund)	80% (20% to pension fund)			

Revenues and expenditures of the state are very limited. The state of BiH has its own revenues, entity transfers, and extra revenues. Its own revenues include administrative fees and revenues from its own activities that represent the “source revenues” (fees for documents and passports issued by BiH) for financing public bodies. Extra revenues of BiH include the resources from succession of the ex-Yugoslavia, reparation of war damages, and specific international transfers.

According to the Dayton Agreement, the transfers to the entities are defined as two-thirds for the Federation and one-third for RS. Despite this regulation, the actual transfer is negotiated between the entities and the state.

In BiH the public accounts cover all 156 units of the government (Table 1). It is important to note that a consolidated budget of all BiH governments does not exist, and currently there is no BiH institution with the responsibility to prepare a consolidated budget. The IMF and World Bank compiled a consolidated budget for BiH, based on the available data, but they encountered many roadblocks; numerous government budget levels and some transactions are unrecorded in the budgets.

Revenues and Expenditures of Entities and Cantons

In BiH, it is necessary to make a clear distinction between the competencies of tax policy, administration, and revenue collection on the one hand, and allocation of revenues and taxes on the other. Entities and sub-entities (cantons) pass the laws on all taxes (except customs, set at the BiH level), and they define the tax base, tax rates, and exemptions. Cantons and local self-government units in the Federation regulate certain taxes, while in RS all taxes are regulated by the central RS government (with the exception of administrative taxes, court fees, and allowances; see Table 2.). Administration and collection of taxes in Brko District falls under its own competence. Customs, its base, and tariffs are determined at the state level, but implementation is managed at the district level.

All revenues are collected by the central tax administration. They are shared on the basis of origin. Based on this revenue-sharing principle, local self-government units with larger economic potential will have more revenues. In RS and the Federation, resources from social contributions are used for extra-budgetary funds in the entities.

Entities bear responsibility for all expenditures that are not explicitly defined to the state level by the BiH Constitution. Identically, the cantons have the same

responsibilities for all the expenditures that are not explicitly defined as the responsibility of the Federation, according to the Federal Constitution. The local self-government units perform their functions according to their own statutes that must be in accordance with entity and BiH laws.

The Federation is responsible for expenditures of the executive, legislative, and judicial bodies, and the expenditures related to reconstruction and capital costs from international grants, concessions, and transfers. These transfers of the Federation are divided into three groups: transfers to the state, transfers for common and social needs, transfers to cantons and municipalities.

In the Federation, most public expenditures are managed by the cantons, according to the principle of subsidiarity. Cantonal budgets cover the expenditures of the executive, legislative, and judicial cantonal bodies; education; social protection; culture; etc. In practice, they face many difficulties due to the lack of cooperation and coordination between the cantons, and the large number of requests from extra-budgetary beneficiaries (Health, Pension, and Unemployment Funds).

The Constitution of RS and the Law on Local Self-Governance define the general framework for financing the local self-government units. The central RS budget is less complex than the one in the Federation, because the RS is not divided into cantons.

In the 2000, the tax revenues in both entities were mostly related to basic taxes (income tax, sales tax, excises, and customs fees).

Tax revenues as percent of respective GDP² in the Federation are 40.3 percent and 36.9 percent in RS, while non-taxes (such as allowances, charges, concessions, privatization revenues) in the Federation are 8.0 and 6.5 in RS. In the Federation, of those belonging to public revenues (72.6 percent of total), 17.4 percent was allocated to the government, extra-budgetary beneficiaries took 22.4 percent, off-budget grants took 5.4 percent, while only 4.5 percent went to the municipalities. In RS, of those belonging to public revenues (26.6% of total), 14.4% was allocated to the government, extra-budgetary beneficiaries took 7.5 percent, off-budget grants took 2.8 percent, while only 1.9 percent went to the municipalities (Appendix 2.).

The biggest horizontal disparities can be noticed on the municipal level in both entities. Using the data from

² World Bank Live Database and World Bank Country Studies

2002, it is obvious that bigger municipalities realize more revenues from tax collection. With reference to other fiscal factors relevant for tax collection, it is a fact that big companies are located in larger cities, where they gain profits; therefore, the tax on profits increases the collected revenues on the local unit level.

Intergovernmental Finances

Composition of Local Government Revenues

The lack of fiscal autonomy, paired with the unsolved problem of revenue sharing at the local government level, resulted in insufficient sources for financing the allocated functions. In the Federation, some rights and decisions-making powers are transferred to cantons; however, municipalities in both entities have little or no influence on fiscal policy. Local authorities have significant autonomy in setting their own local taxes, but fiscal decentralization was not completed.

Nine cantons out of ten (except Canton Sarajevo) in the Federation adopted the Law on the Allocation of Revenues. This legislative gap is overcome through transfers from cantons to municipalities by providing “negotiated” grants. This way the canton keeps its privileged status and local authorities are not regarded responsible for inefficient service provision.

In Republika Srpska, the existing Law on Local Self-Governance³ determines the revenue-sharing criteria on the basis of development and needs of the municipality, which is an attempt by RS authorities to address equalization concerns among governments.⁴ A decision on the criteria for evaluating the development rate in the municipalities of RS was adopted in 2003. Ten criteria are defined as the basis for determining the level of municipal development.⁵

³ *RS Official Gazette*. No. 35/99.

⁴ Article 35 of the Law categorizes local government according to the degree of development (under-developed, non-developed, extremely non-developed) and applies a shared proportion in percent, respectively.

⁵ Criteria: realized municipal budget per inhabitant; average paid gross salary per inhabitant; number of unemployed compared to number of employed; ratio of displaced persons; refugees and returnees in total population of the municipal population per km²; number of fixed and mobile phones per 100 inhabitants; number of internet connections per 1,000 inhabitants; realized gross salaries on municipality level per inhabitant; number of children under five years of age per 1,000 inhabitants.

Local Self-government Revenues

Municipal Tax Revenues

This group of revenues are completely controlled and collected by entity governments; however, they are returned to the local administrations.

The sales tax is shared with municipalities in both RS and the Federation. In RS, these taxes are shared with municipalities depending on their development. In the Federation, depending on the legislation of each canton, these revenues are allocated to municipalities to the value of 20 percent to 88 percent. Based on the data on revenue realization in BiH collected in 2003, the revenue share of the sales tax exceeds 30 percent of the total budget revenues. These taxes will cease to exist upon establishment of the VAT, when BiH will have to find a solution for financing of local communities to the value of over 30 percent. (See Appendix 4.)

Personal income tax (PIT) has two forms: flat-rate “wage tax,” which is the payroll tax minus social security contribution paid by the employer, and the “citizen income tax” that is applied for all other personal incomes. In RS (currently PIT is 10 percent), there is just one personal income tax, which covers all types of income. The entity regulates, administers, and collects the PIT and shares it with municipalities 75:25 percent. The Federation regulates, administers, and collects the taxes and their base (currently PIT is five percent); the cantons determine the sharing rates, which are usually less than 80 percent for the cantons and 20 percent for most municipalities; and in some cases it makes up to 88 percent for municipalities. The collection of these taxes is reflected in the municipal revenues according to the place of work for the flat-rate “wage tax,” and according to residential address for the “citizen income tax.”

Revenues from agriculture and forestry are area-based (cadastre) revenues or actual revenues from these activities. According to the Law on Citizens’ Taxes, the rate of this tax is 10 percent, and the tax is paid on a quarterly basis.

The property and property transfer taxes in the Federation are, in general, shared between cantons and municipalities (80:20 percent), where sharing between the cantons and some municipalities goes from 25 percent to 100 percent in favor of selected municipalities. In RS, all collected taxes go to municipalities. In both entities, the procedure and payment method for this tax is regulated, but in practice, collection of these taxes is at a very low level.

Property in BiH is a complex issue. Eighty percent of current land records are taken from registries dating from the Austro-Hungarian period, and which have not been updated since the Second World War. Approximately 20 percent of property was destroyed during the last war in BiH. The development of new laws (Law on Property, Law on Obligations, Law on Land Register, and Law on Cadastre) in BiH is ongoing. It should solve the outstanding problems in this area.

Tax on inheritance and donations is paid by the inheritors or gifted parties. The tax rate for heritage and donations makes three percent for real estate and 10 percent for movable property. The tax basis is the market value of the inherited or donated property. Tax on donations is not paid for items valued up to BAM 5,000 (EUR 2,500) (except motor vehicles).

Tax on the sale of fixed assets and rights is paid in the process of transfer, including the allowance payments, as follows: actual rights on immovable property (land, business premises, garages, and other constructions), permanent right to use city construction land, and the right to build on that land. This tax is calculated according to the rate of three percent, and the agreed price is used as the tax base, unless it is lower than the market value.

Branch offices of the tax administration have the data on unit price (per square meter) and market value of different types of property in various parts of a local unit, which makes it possible to dispute radically reduced prices. However, it is important that tax collectors check the property during the sales process. Without such systematic follow-up, it would be difficult to believe what is the value of the stated property.

Tax on property is paid for the following rights to immovable assets: right to ownership of property, housing and business buildings, apartments, office premises, buildings for relaxation and recreation, and other constructions. The surface of the property is used as a tax base, and the tax is paid by the area. The tax on property is more complicated than the tax on the sale of buildings. Upon analysis, it was noticed that these tax revenues had been reducing year to year in some BiH municipalities, while in others these revenues have stayed at the same level (Table 4.).

Reasons for the fall of property tax revenues are complex. Firstly, the taxpayers assess the market value of their property in accordance with parameters of the tax administration in their respective municipalities. Bearing in mind that property inspections are done rarely (in some it is not done at all), taxpayers have the possibility to register their property at a value less than the actual market value.

Secondly, tax administration in some municipalities does not adjust these parameters regularly in relation to changes in the market, although they correct values in the case of property sales. Thirdly, taxpayers do not suffer serious consequences if they fail to register or to pay the property tax. Fourthly, since the tax administration at the state or entity level does not benefit from tax sharing (100 percent of municipal revenue), there is a lack of interest at higher government levels to improve the system of assessment and revenue collection. Finally, there are other reasons in the BiH that explain inefficient tax collection: a large part of BiH territory still is contaminated with landmines; property rights are unsettled and unclear; and there are poor landowners who are unable to pay tax.

Table 4.
Tax on Property in Four Select Municipalities in Federation BiH and RS (BAM 1,000)

	Total for Four municipalities				Laktasi		Kakanj		Prnjavor		Cazin	
	2002	2003	Percent in total 2002	Percent in total 2003	2002	2003	2002	2003	2002	2003	2002	2003
Tax on land and property	458	492	26	27	203	209	105	116	145	115	5	52
Tax on heritage and donations	98	129	5	7	68	93	1	4	22	23	7	9
Tax on transfer of immovable property	1,228	1,235	69	66	355	405	246	313	316	266	311	251
Total tax on property in the sample municipalities	1,784	1,853	100	100	626	707	352	430	483	404	323	312

Increasing the efficiency of property tax collection in BiH is a complex process. At the state level the register (cadastre) should be simplified and completed. Many outstanding problems could be solved by introducing the following new regulations:

- property tax should fall on real estate;
- in addition to the data on physical structures, data should be registered on the value of the construction, the property owner, or user;
- the basis of property tax should be the same as the value of the registered property, not the value reported by the taxpayer;
- the entire process of tax administration (assessing the tax base, setting rates, and tax collection) should be at the municipal level;
- reassessment of property value should be based on information from the register of property transactions and other relevant documents;
- tax rate should be set by the municipal council, should be uniform within any jurisdiction, and should be applicable to all assessed properties.

Non-tax Municipal Revenues

Local non-tax revenues in BiH are not regarded as significant sources of financing. Although a significant increase⁶ has been recorded in the last few years, the fact is that there is still much space for further increase of these revenues, resulting in better services and greater accountability of municipal authorities towards their citizens.

In urban areas, these revenues are more significant, because they cover the municipal administrative fees, communal fees, various allowances (allowance for allocated construction land and use of construction land, allowance for forests and other natural resources), revenues from rent of business premises and garages, land rent, revenues from public services, and other municipal revenues.

In RS, the non-tax revenues are regulated at the municipal level, while in the Federation they are regulated by the municipality or canton. The Law on Communal Fees⁷ stipulates that the communal fees are determined by decision on the municipal assembly. The communal

fee is paid by each company for use of public ground for sports activities, for use of land for parking lots, advertisements, etc. In most municipalities, these allowances are adjusted irregularly, and very often they do not cover basic costs.

In some communities significant local revenues are based on the Law on Allowances for Use of Natural Resources for Generation of Electric Power in the RS⁸ and the Law on Allocation of Part of the Companies' Revenues Generated from the Use of the Hydro-Accumulation Facilities.⁹ In both entities these allowances are municipal revenues, where the hydro-accumulation facilities are located.¹⁰

The Law on Construction¹¹ is used to charge for allocated construction land and its use. The Municipal Assembly makes the decision on the allowance and determines the elements and methods of payment. All physical and legal parties are obliged to pay this allowance for the construction surface owned or used. According to the data, in RS only a few municipalities levy this charge (Banja Luka, Laktasi).

Grants and Transfers

Most transfers in the Federation are made on the basis of negotiations. Transfers between cantons and municipalities are realized on the basis of cost-reimbursement for salaries of primary school teachers and for other specified purposes. In fact, these are cantonal costs, because municipalities do not have the right to decide on these issues. In the Federation, the only "transfers" between the cantons and the municipalities are the derivation-based shared taxes (sales taxes, wage taxes, property taxes, road taxes), as presented in Table 2. Equalization transfers do not exist in the Federation. Transfers between similar levels of government (cantons) do not exist.

In the RS, revenue sharing (tax sharing) is common for all municipalities in the entity. The existing Law on Local Self-governance¹² determines the criteria for revenue sharing on the basis of municipal development and needs, and it is the first effort by RS authorities to address equalization concerns among governments.

⁶ Non-tax municipal revenues are 13 percent of total budgets in BiH for 2003, PRSP BiH, 2004.

⁷ *SRBiH Official Gazette*. No. 21/77, No. 35/88, and No. 26/89.

⁸ *RS Official Gazette*. No. 85/03.

⁹ *FBiH Official Gazette*. No. 44/02.

¹⁰ Municipality Mrkonjic Grad in RS, by virtue of this fee, received for January–June 2004 period BAM 698,611, or 34.7 percent of its 2004 budget.

¹¹ Imposed by High Representative in May 2003.

¹² *RS Official Gazette*. No. 35/99

Fiscal Imbalances

The problem of fiscal imbalance is particularly strong in the Federation, because the compensation between the entity and the cantons is done on the basis of political negotiations.

Vertical Imbalance

Vertical fiscal balance means that each tier of government has the available resources to fund its activities. Based on 70 initial assessments conducted by the OSCE Mission to BiH, and reports produced for each individual municipality, in BiH most local governments barely have enough funds to deliver a minimum level of services to their citizens.¹³ Higher levels of government transfer responsibilities to local governments, without allocating funds for them. The same disparity appears among all tiers of government. Some indicators of vertical imbalance in the BiH show the disparity between the realized

revenues and expenditure responsibilities (Appendix 2). Regarding the budget deficit as a percent of respective GDP for 2000, the Federation claimed up to 9.3 percent, while in RS, it is just a bit lower: 8.9 percent.

Horizontal Imbalance

The biggest horizontal disparities can be seen in both entities at the municipal level: big municipalities, in general, realize higher tax revenues (Tables 5 and 6). Larger and more profitable companies are located in larger, developed towns. Tax on local profits increases the collected tax revenues at the local level. The level of horizontal fiscal disparity can be found in the table below.

The RS also shows a very high level of horizontal disparity in its municipalities, although is not like in the Federation. According to data in the Tables 5 and 6, local tax collection is higher in the RS (BAM 56 per capita) than in the Federation (BAM 48 per capita).

Table 5.
Disparities in Local Revenue Capacity and Tax Collection in Federation BiH

	All municipalities		Una Sana Canton		Tuzla Canton		Zenica-Doboj	
	Total revenue	Local tax	Total revenue	Local tax	Total revenue	Local tax	Total revenue	Local tax
Number of municipalities	59	59	8	8	14	14	11	11
Maximum value in BAM (per capita)	15,383	159	1,199	159	1,172	110	1,167	116
Minimum value in BAM (per capita)	17	2	278	28	171	9	121	12
Average value in BAM (per capita)	889	48	465	59	504	48	708	68

Source: ZPP, Federation Ministry of Finance.

Table 6.
Disparities in Local Revenue Capacity and Tax Collection in RS

	All municipalities		Excluding Banja Luka		Excluding Banja Luka & Brčko	
	Total revenue	Local tax	Total revenue	Local tax	Total revenue	Local tax
Number of municipalities	63	63	62	62	61	61
Maximum value in BAM (per capita)	1,588	341	824	341	824	120
Minimum value in BAM (per capita)	44	10	44	10	44	10
Average value in BAM (per capita)	249	56	227	55	224	20

Source: ZPP, RS Ministry of Finance.

¹³ Online: <http://www.oscebih.org/public>.

Fiscal Transfers between Entities

The BiH intergovernmental transfers, either conditional or unconditional, are allocated without a clear formula and adequate monitoring of their use by the grantor. International best practices in this field show that in decentralized states intergovernmental transfers should be based on objective criteria and evaluation. Local governments should be independent in setting their own priorities in terms of expenditures and autonomous in raising revenues. Equalization transfers must be in accordance with their needs and tax capacities, and the receivers should be informed about them in a timely manner.

The existing Law on Local Self-governance¹⁴ determines the criteria for revenue sharing on the basis of municipal development and needs. The RS Law on Local Self-governance stipulates that the deadline for determining development level of municipalities is December 31. Municipal development is the basis for grant allocation from the entity government to the municipalities. The Law on the Budget System also stipulates that municipalities are obliged to adopt the following year's budget by December 31 of the current year. Predictability cannot be expected, because these two laws collide with one another.

BiH is committed to its reforms and started some activities to improve the efficiency of subentity government finances. The framework for tax policy must be redesigned, as well as the tax sharing, tax administration, and local utility fees. The procedure of enacting the laws¹⁵ at the BiH and entity levels is underway. Its purpose is to create a stable decentralized system of government and to achieve the lasting success of the political and economic reconstruction. BiH harmonized and centralized its custom duties on the state level as an important source of financing.

If BiH authorities and the international community are to create a stable decentralized system of government and to achieve the lasting success of the political

and economic reconstruction, then the administrative structure on the state level must be developed, giving priority to the professional civil service. A mechanism of cooperation among different government levels must be established, as well as cooperation between governments at the same level.

In order to direct activities and efforts towards preparations for joining the European Union, the basic problems of BiH have to be identified:

- a lack of fiscal autonomy seriously undermines accountability of local authorities, and reduces significance of local governments' "own revenue sources";
- large horizontal imbalances in tax capacities under the current revenue-sharing system cause unequal tax revenue sharing between entities and municipalities;
- there are insufficient efforts in local tax collection;
- unregulated revenue sharing still causes arbitrary allocation of public revenues among governments;
- poor tax reimbursement mechanisms cause frequent tax arrears;
- unstable and random central and cantonal fiscal policies result in unpredictable local budget revenues and expenditures.

This report aimed at pointing out the problems related to intergovernmental fairness, and can be used as a basis for considering efficient public sector management. Fiscal equalization is a process that BiH governments will have to face as soon as possible. It is obvious that equalization grants do not appear to be acceptable. Specific-purpose grants for programs (e.g., primary and secondary schools) – if based on objective allocation criteria (e.g., number of students) – would improve equity and fairness.

It is also relevant to meet the local public investments' financing needs and to regulate municipal borrowing. This requires strengthening the creditworthiness of subentity governments, which is extremely low at the moment. Achieving creditworthiness on the subentity government level would be possible only if the existing anomalies, such as lack of fiscal autonomy and revenue predictability; weak administrative capacity; lack of transparency in budgeting, accounting, and reporting; unrecognized responsibilities; and, in general, low accountability, are removed from BiH.

¹⁴ *RS Official Gazette*. No. 35/99.

¹⁵ Law on Custom Duties adopted on BiH level, Law on Local Self-governance in RS adopted but raised protection of vital national interest, in procedure: Law on Local Self-governance in Federation, Treasury Law, Law on Financing Institution of BiH, Law on Property, Law on Obligations, Law on Land Register and Law on Cadastre.

Appendix 1. Key Economic Indicators for BiH, 1990–2001

Table A1.1
Key Economic Indicators for BiH, 1990–2001

	1990	1995	1996	1997	1998	1999	2000	2001
GDP (USD million)	10,663	1,867	2,741	3,423	4,169	4,540	4,252	4,796
Per capita GDP in USD	2,429	456	660	816	1,042	1,135	1,093	1,222
Federation	n.a.	606	899	1,167	1,418	1,458	1,373	1,453
Republika Srpska	n.a.	953	540	733	704	821	806	873
Real GDP growth	n.a.	n.a.	85.8	36.6	9.9	9.9	5.9	5.6
Federation	n.a.	105.7	105.6	36.2	8.2	9.5	7.0	7.0
Republika Srpska	n.a.	-38.1	31.4	37.9	15.8	11.3	2.6	1.9
Consolidated Public Service Financed*								
<i>Expenditure (% of GDP)</i>	n.a.	n.a.	85.6	60.9	64.4	71.9	63.9	60.0
<i>Revenues (% of GDP)</i>	n.a.	n.a.	75.5	58.0	57.7	61.0	54.4	54.0
<i>Balance (% of GDP)</i>	n.a.	n.a.	-10.1	-2.5	-6.7	-10.9	-9.5	-6.0

Note: * Covers consolidated general government expenditures including state, entities, and Brčko District.

Source: World Bank, PEIR.

Appendix 2. Public Revenues and Expenditures by Level of Government

Table A1.1
Key Economic Indicators for BiH, 1990–2001

	As percent of respective GDP, 2000	As percent of BiH Consolidated General Government, 2000
Revenue		
BiH	55.5	100.0
State	0.3	0.5
Federation	55.5	72.6
FBiH government	13.3	17.4
EBFs	17.2	22.4
Municipalities	3.5	4.5
Off-budget grants	4.2	5.4
RS	53.3	26.6
Central government	30.6	15.2
EBFs	12.0	6.0
Municipalities	4.2	2.1
Off-budget grants	6.5	3.2
Expenditure		
BiH	64.9	100.0
State	0.7	1.1
Federation	64.8	71.9
FBiH government	14.1	15.7
EBFs	18.2	20.2
Cantons	19.9	22.2
Municipalities	4.4	4.9
Off-budget grants	8.0	8.9
RS	62.2	26.6
Central government	33.7	14.4
EBFs	17.6	7.5
Municipalities	4.5	1.9
Off-budget grants	6.6	2.8
Balances		
BiH	-9.4	100.0
State	-0.5	5.1
Federation	-9.3	67.9
RS	-8.9	26.7

Source: World Bank. *BiH from Aid Dependency to Fiscal Self-Reliance*.

Appendix 3. Revenue Sharing in BiH

Revenue Sharing between Cantons and Municipalities in the Federation of BiH

Federation

1. Custom duties from physical and legal persons
2. Custom duties
3. Special taxes – excises
4. Enterprises' profit tax – banks and other financial organizations, companies for insurance and reinsurance of property and persons, legal entities from the sector of *elektroprivreda*, posts, telecommunications, and legal entities from the gambling sector to which this represents the only activity
5. Federation administrative fees
6. Federation courts' fees
7. Fines under federation regulations
8. Revenues from natural resources
9. Donations to federation
10. Other revenues to federation (from property, etc.)

Cantons

1. Sales tax on goods and services
2. Enterprises' profit tax – except for profit tax of enterprises as referred to in item 4
3. Payroll tax
4. Fines under cantonal regulations
5. Donations to canton
6. Other revenues to canton

Article 8 – “Public revenues shall be allocated to municipalities according to cantonal regulations. Municipal councils shall pass regulations on municipal taxes, fees (utility fees, fines, etc.) as well as regulations on taxation (agriculture tax, property tax, tax on income from property, etc.) and in other manners provide the necessary funding.”

Article 10 – “The sales tax on tobacco products shall be paid to a separate account of the Federation of BiH budget, and contribution of individual cantons in the sales tax collected on the basis of tobacco products shall be established by the Minister of Finance on the basis of the following criteria:

- 50 percent of funds proportionally to the ratio which the number of inhabitants of each canton takes the total number of inhabitants of the Federation of BiH as per the latest information by the Federation Statistical Institute,
- 50 percent of funds proportionally to the ratio which cantons respectively take in the total revenue collected in cantons on the basis of sales tax in the previous year.

The Federation Ministry of Finance shall allocate the funds on the basis of sales tax on tobacco products to the cantonal budgetary accounts on a weekly basis.”

Table A3.1
Municipal Revenue Share by Cantons in Percent (Sample)

	Tax on property or real estate transfer	Tax on salaries	Tax on personal income
Canton 1	100%	25%	100%
Canton 2	50%	20%	50%
Canton 3*	n.a.	20%	100%
Canton 4	n.a.	20%	n.a.
Canton 5	n.a.	20%	n.a.
Canton 6	95%**	20%	n.a.
Canton 7	80%***	50%	n.a.
Canton 8	50%****	50%	50%
Canton 9	No regulations on tax sharing		
Canton 10	70%/25%	40%	n.a.

Notes:

- * Different sharing in selected municipalities.
- * Real estate transfer tax.
- * Real estate transfer tax; Mostar City has additional shares.
- * Real estate transfer tax.

Revenue Sharing between Republika Srpska and Municipalities

RS Budget

1. customs
2. excise, except for the excise on oil derivatives
3. profit tax
4. personal income tax as follows:
 - annual tax on citizens income
 - tax on income from royalties, patents, and technical improvements
 - tax on income from capital
 - tax on income from capital proceeds
5. tax on movable property as follows:
 - tax on use of motor vehicles
 - tax on use of mobile phones
 - tax on use of boats, yachts, and floating objects
 - tax on use of airplanes and flying objects
 - tax on possession and carrying of weapons
6. special tax on regular and safe operation of railway traffic
7. tax on organization of lottery and gambling games
8. fees and duties, as follows:
 - special duty on imports, pursuant to the Decision on payment of special duty on imported goods
 - special duty on imported goods
 - special duty paid on export of products
 - administrative fees at the level of RS
 - court fees at the level of RS
 - special fees at the level of RS
 - other fees at the level of RS
9. charges
 - charges on use of natural and other resources of general interest
 - special water charges
 - charges, i.e., resources for environmental protection
 - charge on use of other resources of general interest
10. revenues from illegally gained property and profits
11. other revenues as follows:
 - own revenues earned by budget beneficiaries through their activities (regular, supplementary, donor funds, etc.) that are not contrary to the law regulating their activities, with the approval of the competent ministry and in the percentage defined by the Budget Execution Law or the Budget Execution Decision.
 - other revenues of the RS budget

Revenues Shared between the Budgets of Municipalities and Towns

1. Revenues from the sales tax on goods and services shall be divided as follows:
 - Between the RS budget and the budgets of developed municipalities in proportion 70:30
 - Between the RS budget and the budgets of medium-developed municipalities in proportion 60:40
 - Between the RS budget and the budgets of underdeveloped municipalities in proportion 50:50
 - Between the RS budget and the budgets of exceptionally underdeveloped municipalities in proportion 40:60
 - Between the RS budget and budgets of towns in proportion 65:35
2. Excise on oil derivatives shall be shared by the RS budget and municipal budgets in proportion 92.50:7.50
3. Tax on citizens income
 - Tax on income from independent activity tax on personal income, which shall be divided between the RS budget and municipal budget in proportion 75:25
4. Charge on changed use of farming land, shared by the RS budget and municipal budgets in proportion 50:50
5. Charge on use of mineral raw materials, shared by the RS budget and municipal budgets in proportion 30:70
6. Confiscated property and proceeds obtained by sale of confiscated objects, falling under jurisdiction of the RS market inspection, shared between the RS budget and municipal budgets in proportion 70:30

Municipal Revenues

1. property tax
2. tax on citizens' income
3. tax on income from agriculture and forestry
4. fines imposed in minor offence procedures for offences regulated by municipal enactments
5. municipal administrative fees
6. communal fees
7. municipal fees for use of natural and other resources of general interest
8. tax on income from lottery games
9. other municipal revenues

Revenues of the Funds

- contributions
- aid
- other revenues

Appendix 4. Introduction of VAT in BiH in 2006

Regarding BiH's postwar administrative structure, each entity had its own Tax Administration that administered and redistributed sale taxes to lower levels of the governments.

During 2004, both entities agreed to set up a state-level Indirect Tax Authority (ITA) to collect all indirect taxes including customs and excise taxes in 2005 into a so-called "Single Account." Once VAT is implemented, the Single Account would first fund the state budget and cover BiH's debt obligations, and the rest of the money would be divided between the two entities and the District of Brko.

In spite of that, the question remained how to divide the Single Account money between the two entities. Finally, it was agreed that ITA would apply a parallel system for tracking "final consumption" across the two entities during 2005. In 2005, the ITA collected all customs and excise taxes and put them into the Single Account. The state made debt service payments, and for the first year of the Single Account's operation the remaining sum was divided between the two entities, with 65.7 percent going to the FBiH and 30.5 percent going to RS, and 3.8 percent to the District of Brko.

On January 1, 2006, however, VAT was introduced as the state tax, and replaced sale taxes, which were tracked and redistributed by final consumption. The shares between the entities are unresolved, and VAT money allocation is based on temporary decisions of the ITA Steering Board. Unfortunately, major disagreements continue about defining what "final consumption" means geographically and on what date the calculation should be based.

But, if we leave that issue to the authorities of the ITA, state, and entities, we cannot deny a replacement for sales tax for local governments in BiH. This issue is fundamental for both entities for two reasons: in FBiH sales tax generated 70 percent of cantonal revenue and 25 percent of municipal revenues in the Federation, and 50 percent of municipal revenue in the RS. Furthermore, the question is answered if local governments will get their VAT share in a fair, transparent, and predictable way.

Intergovernmental Finance in the FBiH

The FBiH law assigns specific percentages of the Federation's share of the Single Account to the Federation, cantons, municipalities, and the Road Fund. This vertical share of Single Account Revenues guarantees each level of government a transparent and predictable revenue

flow. It also ensures that local government's get their share of the Single Account directly from the entity, and not, as it was the case with sales tax, from cantons.

How much each level of government should get from the Single Account was determined by calculating how much sales tax was retained by cantons and municipalities in 2005. It also defines formulas that govern the allocation of the cantonal and municipal shares to individual jurisdictions, and how these formulas will be phased in over a six-year period. As a result, all sub-entity governments now have a stable, predictable, and transparent revenue flow that will radically reduce the disparities of per capita income.

Through parliamentary procedure, local governments' share is to be increased from 6 to 8.42 percent by decreasing the shares going to the Federation and the Road Fund. This was done to strengthen the overall fiscal position of municipalities in the Federation. The Law defines formulas for cantonal and municipal shares of the Single Account to be allocated to individual jurisdictions. These formulas are designed to introduce some measure of fiscal equalization at both levels of government. The formulas for allocating funds to cantons and municipalities are similar but not identical.

The most important variable in both formulas is the number of people estimated to be living in each jurisdiction, the square kilometers in each jurisdiction, and the number of pupils enrolled in a jurisdiction's primary and secondary schools. Also, all municipalities with an index ranking less than 80 percent of the national average will receive funds through this component of the formula on a weighted per capita basis.

To ensure that the formulas do not create budgetary shocks for any individual subentity government, Article 20 of the law states that both the cantonal and municipal formulas will be phased in over a six-year period. This has been done by converting the amount of money each subentity government received from sales tax in 2005 into a "historical" share of the Single Account Revenues. This "historical" share was then "weighted" against the formula-driven share of each subentity government in order to guarantee a smooth transition to the new system. In 2006, the share of the Single Account revenues that all sub-entities receive will be based on 90 percent of their historical share and 10 percent of their formula-driven share. In 2007, 2008, 2009, and 2010, the proportions will be shifted annually to: 70:30, 50:50, 30:70, and 10:90. In 2011, only the formula-driven share will be used.

This provision of the law is designed to harmonize the municipal finance systems of the Federation and to ensure that all municipalities have the revenues they need to provide public services at a reasonable standard.

Intergovernmental Finance in RS

The law assigns specific percentages of RS's share of the Single Account to RS, municipalities, and Road Fund. After deducting RS's external debt obligations, 73.5 percent of the RS's share of the Single Account is retained by the entity, 23 percent are shared with municipalities, and 3.5 percent goes to the "Public Company Republic of Srpska Roads." These shares guarantee each level of government a transparent and predictable revenue flow.

The law also defines the formula used to allocate the municipal share to individual local governments.

This formula is designed to introduce some measure of fiscal equalization at the municipal level. The funds received through the formula are general transfers and can be spent by local governments as they choose, and in compliance with their budgets.

The most important variable in the formula is the number of people estimated to be living in each jurisdiction, the square kilometers in each jurisdiction, and the number of pupils enrolled in a jurisdiction's primary and secondary schools. The law also defines special coefficients to reflect the particular circumstances of specific local governments. For local governments, which after the application of the formula at the end of the six-year period achieve a decline in revenue of more than 10 percent in comparison with their 2004 revenues, additional coefficients will be applied to all the criteria.

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