



USAID TAX ADMINISTRATION MODERNIZATION PROJECT (TAMP)

Toward an SME-Friendly Revenue System

in Bosnia and Herzegovina

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Tax Administration Modernization Project

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Acronyms

BiH	Bosnia and Herzegovina
CAFAO	Customs and Fiscal Assistance Office
CPC	Central Processing Center
DTC	Direct Tax Committee – a subgroup of the IAG-T
EU	European Union
FBiH	Federation of Bosnia and Herzegovina
GTZ	Gesellschaft für Technische Zusammenarbeit, German Technical Assistance Corporation
IAG-T	International Advisory Group on Taxation
IC	International Community
IT	Information Technology
ITA	Indirect Taxation Administration
IMF	International Monetary Fund
KM	Convertible Mark
MoF	Ministry of Finance
OHR	Office of the High Representative of Finance
OTFA	Office of Tax and Fiscal Analysis
SME	Small and Medium Enterprise
SOW	Scope of Work
TA	Tax Administration
TAFBiH	Federation Tax Administration
TAMP	Tax Administration Modernization Project
TARS	Tax Administration of the Republika Srpska
TIN	Taxpayer Identification Number
USAID	United States Agency for International Development
USG	United States Government
UST	United States Treasury
VAT	Value-Added Tax

Executive summary

Private-sector led economic growth requires, among many other things, an enabling environment that poses as few obstacles to private sector investment and competitiveness as possible. One aspect of this enabling environment is a tax system that is economically efficient, with rational and fair tax policies, low costs of tax administration and compliance, and high rates of compliance among taxpayers. This report focuses on the tax aspects of the enabling environment.

This report assesses the obstacles that tax policy and tax administration impose on the fair and efficient operation of the SME sector in BiH, and makes recommendations for the improvement of the tax system, while ensuring revenue needs are met.

The report comes to some disturbing findings. For instance, uncoordinated and poorly designed tax policies impose, in nominal terms, very heavy burdens on labor and business and distort economic decision making. The institutional set up in the country has led to a plethora of tax rates and tax bases, causing confusion and uncertainty among businesspersons who cannot be sure what their requirements are, and belies the notion of creating a “single economic space.”

Despite the many inroads that the foreign-funded assistance activities, particularly the EU’s Customs and Fiscal Assistance Office and USAID’s Tax Administration Modernization Project (TAMP), have been able to make, there are continuing problems, some of which must be seen as legacies from the Yugoslav past and outdated attitudes toward taxpayers and taxpayer control. TAMP, when fully implemented will reduce these remaining administrative hurdles.

Implementation of the recommendations in this report will require considerable effort by a large cast of players. Assistance in tax administration modernization must be completed and expanded into specific areas that until now have not received adequate attention, namely systemization of audit, collection and enforcement functions. These efforts must be accompanied by deep policy reform, such as the implementation of the new income tax laws and the elimination of a number of the so-called citizen taxes. Property tax needs to be reformed and it should be implemented solely for and by municipal governments. Legislation needs to be drafted, enacted and implemented to regulate the entire revenues systems of BiH. Policy dialogue must begin immediately and interlocutors must be found and educated. Capacity to carry out policy analysis and policy design and implementation and sector monitoring and control is sorely required.

The progress in tax administration modernization that has been achieved already, and it is appreciable, provides a solid basis for initiating a complete rationalization of the tax system.

The next steps should begin today.

Acknowledgements

Preparation of a report of this scope in such a short amount of time would not have been possible without the assistance of many people and the willing and candid participation of the persons interviewed. We interviewed several private sector individuals for this study, but we decided not to include their names in the annex in order to protect their privacy and encourage their candor. We thank them for their taking the time to talk to us and regret that we cannot openly acknowledge them here. We thank the many government officials, in each of the Entities and Brcko, who provided us with their candid assessments, statistical information, and technical input, without which this project would have been a theoretical exercise rather than a practical undertaking.

The study team benefited from the complete cooperation of the international community, who took time to meet with us, provided us with reports on their activities, and provided data when they could. It is clear that the role of the IC will be essential to achieving the reforms indicated in this report. We thank them for their cooperation in this project and for their anticipated cooperation into the future.

We very much appreciate comments from Bill Lawrence, Marc Campbell, and Darlene Berthod, all of whom reviewed the drafts of this report and provided us with their comments, which we have tried to incorporate into the final paper to the extent possible.

Last, and certainly not least, we must thank our colleagues working for TAMP, starting with the translators and drivers. In particular, thanks go to Sam Greer, who assured full cooperation and who gave this study highest priority. Sam also explained the progress that has been attained in tax administration, what remains to be done, and how the tax administration can be further strengthened to facilitate greater private sector development, and provided a lot of substantive and editorial assistance in putting together this report. Rajko Tomas, located in the RS, opened all the necessary doors, compiled and analyzed data, collected and interpreted laws, and made sure that we understood the situation in the RS. Thanks also go to Ted Kill and Charlie Speer, both of whom reviewed the various versions of the report for factual and editorial content.

Of course, while we benefited from the assistance of all those mentioned, any factual errors, misunderstandings, or misinterpretations are our own. The findings, recommendations and opinions expressed in this paper should not be construed as reflecting those of the USAID or DAI.



Toward an SME-Friendly Revenue System

in Bosnia and Herzegovina

Mark Gallagher

Tax Administration Modernization Project

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A well-designed tax system can be poorly implemented, but a poorly designed system cannot be well implemented.

1. Introduction and background

The focus of this report is to recommend changes in the revenue systems in the two Entities of Bosnia and Herzegovina (BiH) and the District of Brcko with the intention of reducing impediments to private-sector business development, especially that of small and medium enterprises (SME).

The report provides information about how many of the country's taxes and so-called fees actually work in practice and analyzes these with regard to their impact on the business climate. The report focuses on tax administration matters as well as tax policy issues, both of which directly affect business. The report is based on a large number of interviews with government officials, private businesspersons, and members of the international community; the analysis of many laws, particularly tax laws; and, statistical analysis of revenue and other data.

Although this report is one of the few reviews of the Bosnian tax system, especially as it analyzes the situation from the municipal up to the Entity level, it still is not quite complete.¹ Some taxes or other revenue sources were not included in the analysis. The issues related to sales tax, excises and customs duties, and VAT

¹ World Bank did treat several related issues in its June, 2003 report *BiH, Creating an Efficient Decentralized Fiscal System*.

and the establishment of the Indirect Tax Administration (ITA) are not treated in this paper. In addition, the nature of the various entitlement funds (pensions, health, child protection, and unemployment) is not included in the analysis, even though they comprise a major share of government revenues.

1.1. Background

This report is being prepared at a time when the sales tax, a major revenue source throughout BiH, is planned to disappear and to be replaced by a State-wide Value Added Tax (VAT). This VAT, all excises, and all international trade taxes will be the domain of a new State-level Indirect Tax Administration (ITA), and therefore not treated in this report.

Last year, revenue performance throughout BiH was positive. In the Federation, total revenues, excluding customs and excises, increased by 12%. In the RS, revenues, again, excluding customs and excises, increased by 14%. On a gross basis, i.e., including customs and excises, revenue growth was only seven percent in the Federation and 10% in the RS. Brcko enjoyed a 28% increase in revenues, despite a 20% decline in its customs revenues.

With the opening of the Bosnian economy to Europe and greater trade partnering with its neighbors, the role of import duties as a revenue source is on a secular decline and domestic taxation must be developed for alternative government funding. Customs duties declined three percent last year in the Federation, two percent in the RS, and 20% in Brcko.

With the creation of the ITA, the introduction of the VAT, and the reductions in import duties, the need for overall tax reform is even more urgent. The assimilation of these changes into a healthy and SME-friendly public revenue system urgently depends upon the development of new means for distributing fiscal revenues among the levels of government, although this issue has not been covered in this report.

1.2. The International Community (IC)

Working on taxation reform is not easy in any country. In BiH this is especially complicated by the fact that there are actually three tax administrations where in other countries only one tax administration would exist. Add to this that despite the small size of the country, there are many entities of government that are authorized to create taxes and fees. Any sustainable tax reform, whether administrative or policy, must entail the building of some degree of consensus. In BiH's complicated ethnic balances and numerous government levels, the ability to build consensus and find and encourage champions of reform is uniquely challenging.

The International Community (IC) has been providing assistance to the Entities and Brcko District in the areas of tax administration, investigation, enforcement and policy for a number of years. The IC's work has been coordinated in meetings of the International Advisory Group for Taxation (IAG-T) that has been led by

representatives of the Office of the High Representative. The current chair of the IAG-T is Mr. Mark Campbell. The specific work of the various donor agencies of the IC is reviewed in some detail in Chapter 9 of this report.

Much of the IC's focus over the years has been on building the basic infrastructure for good tax administration. This has included streamlining and automating the core basic business processes of the tax administrations in each of the Entities and in Brcko. This work has also included creating a solid, customer-friendly taxpayer registration system, and creating the unique taxpayer information system.

IC assistance has gone into strengthening custom and excise tax administration, especially from the perspective of enhancing enforcement. Other assistance along these lines has been provided to the Large Traders Units, where investigation of tax fraud, evasion, and smuggling has been enhanced and provided training and technical support. With regard to domestic or direct taxation enforcement efforts, most attention, rightfully, has been focused on enforcement of the sales tax.

The IC has provided assistance to the tax authorities in developing strategic plans, restructuring their organizations around functions rather than tax types, right-sizing their staff, harmonizing tax treatment of citizens and economic agents, and encoding these changes in the new "rulebooks."

The IC has been involved in a number of tax policy endeavors. For instance, it is with IC support that the country will move to a comprehensive, one-economic-space Value Added Tax (VAT) that will be administered by a single Indirect Taxation Administration (ITA). The ITA will also administer all customs and excise taxes in BiH.

In the area of direct tax policy reform, all focus has been on creating a new and sound income tax law that provides coherent treatment of individual and corporate taxpayers, as well as sole traders (or proprietors). This has been pilot tested in Brcko and has now been submitted to the Entity MoFs for discussion and implementations.

While policy reforms have been slow in coming, tax administration reform is moving rapidly. The basics of administering appropriate tax policies are being put in place. In the area of indirect taxation – except for sales taxes, for the time being – policy and administration reform are being implemented simultaneously. In terms of direct taxation and the collection of most other public revenues, such as fees for services, policy reform is nascent. Deeper policy reform is urgently required in this area and this must be matched with continued organizational, procedural, legal, and enforcement reform and capacity building.

1.3. Organization of the report

For the reader's convenience, the next section of this paper presents the overall summary of findings and recommendations, which is followed by a brief discussion of the methodology used in the preparation of this report. This is then

followed by a summary listing of some of the most important impediments to small and medium enterprise development in Bosnia. The next sections present the major revenue sources, from a revenue and policy perspective, for the Federation, the cantons, and the municipalities in the Federation, and for the Republika Srpska and its municipalities, as well for Brcko District. This is followed by a systematic analysis of the nature of the various taxes.

These sections are then followed by discussion of a number of tax administration issues that particularly impede private sector development. The next section focuses on the institutional set up for tax creation and administration. Then, a “gap analysis” discusses the roles that international donors have been playing in tax system modernization, both policy and administration, and identifies the areas that donors have not been adequately addressing but should be.

The final chapter provides some final comments about the importance and urgency of the reform program recommended here.

2. Summary of findings and recommendations

2.1. Findings

1. Most of the country’s taxes date back prior to the collapse of Yugoslavia, are incoherent, non-synchronized, create serious economic distortions, are inequitable, impossible to enforce, and if enforced would essentially eliminate any possibility for private sector economic development.
 - a. Most of the so-called citizen taxes are imposed on the same base multiple times, treat different sources of income differently, and are poorly enforced.
 - b. The so-called “sign tax” is not a sign tax but rather a business-licensing fee. It, in fact, has nothing to do with signs. Once this is clear to the reader, the absurdity of the sign tax diminishes.
 - c. The taxes on wages, when coupled with contributions to the various funds, if actually paid, would represent a considerable burden on labor and discourage formal sector employment.
 - d. Profit taxes include so many loopholes and tax holidays that they result in almost no revenue collection.
 - e. The property tax is imposed throughout the country, but it is very poorly designed. It is a tax on area rather than value and it does not include land. Municipalities have been stealthily applying their own versions of the property tax under the guise of fees or charges for services. At the same time, a tax on the sale of property, with the property value as the basis, is also imposed.

- f. The tax situation is worst in the Federation, then followed by the RS. Taxation in Brcko District is less problematic than in the rest of the country.
- g. Nominally, the tax system discriminates heavily in favor of capital and against labor. Considering that Bosnia is a labor-surplus country, as evinced by high unemployment, this policy is in direct conflict with economic reasoning.

2. Tax administration continues to impede private sector development.

- a. The RS has not yet adopted the tax certification process recommended by TAMP, although it has the information technology (IT) systems in place to greatly streamline this process right now.
- b. The Federation has been slow in the implementation of certain aspects of its modernization.
- c. The Federation continues its cumbersome certification process.
- d. Brcko District, however, has streamlined its certification process.
- e. In the Federation, the tax payment process is onerous, especially for small- to medium-sized businesses. This is not the case in the RS or Brcko.²

3. Donor assistance in the area of taxation has a number of gaps.

- a. Donor actions on policy aspects of taxation have mainly focused on establishing a VAT, the creation of the Indirect Tax Administration, the reform of excises, and the development of new income taxes, both for individuals and corporations. While these foci are quite appropriate, many of the country's taxes have had too little attention, especially with respect to their impact on the business climate. This study is a partial attempt to rectify this situation.
- b. No effort has gone into helping build the capacity of Bosnian institutions to analyze and design tax and revenue distribution policies.
- c. USG assistance has been devoted to automation and database development of most aspects of tax administration, but support for audit and enforcement is outside the current scope of this assistance.

² This is not the case in the RS or Brcko. Although TAMP has identified and reported this onerous process, efforts for correction of the process is outside the purview of TAMP and must be taken at MoF level.

- d. CAFAO had been working with audit, but has not developed the IT systems that comprise the very building blocks of modern audit selection, risk management, or information-rich audit and collection.
4. The institutional set up of the country, particularly in the Federation, is contrary to best management practices.
- a. Cantons set tax policy, municipalities benefit, and TAFBIH administers these taxes and fees.
 - b. Fees and charges that are actually taxes are created outside of law and as part of decrees or rulebooks amendments.
 - c. The tax system is Hydra-like. Eliminate one tax and it returns in another form or unaltered at a later date.

2.2. Recommendations

1. Reform tax policy

- a. Immediately implement the profit and income tax laws.
- b. At the same time, most of the citizen taxes on personal incomes must be eliminated.
 - i. The citizen/property income tax that charges a 30% tax on interest earned should be abolished and incorporated into the personal income tax.
 - ii. Eliminate the taxes on the income earned from patents, innovations, and copyrights, and incorporate this income with all other personal income into the personal income tax.
 - iii. Eliminate the citizen tax on incomes.
 - iv. Eliminate the specific citizen tax on agricultural incomes and incorporate this into the personal income tax.
- c. Eliminate the wage tax and incorporate this into the personal income tax.
- d. Eliminate the tax on consumption of alcohol and soft drinks and incorporate this into the normal excises.
- e. The World Bank is planning a study of the pension and health funds within a few months. The results of this study should be closely reviewed and actions should be complimentary to the tax reform program.

- f. The property tax should be reformed. It should be based on property values, extended to include all real estate, including residences (in Federation), as well as land. Ideally, this should be solely a municipal tax with national or entity-level legislation, and administered by municipalities.
- g. The tax on vehicles and boats requires a separate analysis. This can be a solid revenue source for municipal governments.
- h. The tax on the sale of property should be reduced to a much more reasonable rate. It should not discourage taxpayers from registering their property sales or transfers.

2. Improve tax administration:

- a. Eliminate the multiplicity of tax payments required in the Federation.
- b. Reduce the frequency of tax payments (NB: this may be obviated with the introduction of VAT).
- c. Streamline the tax certification process, immediately in the RS, as soon as possible in the Federation.
- d. Complete the implementation of TAMP II activities.
- e. Adopt the amended Rulebook on Organizational Structure for the Federation Tax Administration that provides a formal requirement for a CPC, establishes appropriate IT positions and enhances requirements for taxpayer service and education.
- f. Implement the Federation CPC in Mostar, immediately.
- g. Deepen the concept of customer service in the tax administrations.
- h. Implement the taxpayer education and service activities immediately and make these constant activities of the tax administrations.
- i. Build the information system links and reporting and selection systems required for tax audit selection, informed tax audit, tax audit monitoring and performance monitoring.

3. Build institutional capacity in the areas of tax and fiscal policy analysis.

- a. Develop and support within the MoF of RS and Federation the Office of Tax and Fiscal Analysis (OTFA).
- b. This would supplement the planned council of Finance Ministers that will be part of the ITA.

- c. Eventually, when conditions warrant, these two OTFAs could be merged into a single state-level institution.
 - d. The OTFA would be responsible for qualifying all taxes proposed by governments and recommend changes. In the Federation, only those cantonal taxes that receive authorization from the OTFA will be collected by the TAFBIH.
4. Legal/institutional reform. Assuming it is not possible to introduce constitutional change, the following should be developed:
- a. Organic Law on public revenues in the Federation. This law would prescribe the types of taxes and fees that cantons should introduce, define how these would be qualified or authorized by the OTFA, and provide authorization for the TAFBIH to collect only taxes approved by the OFTA. This Law will be superior to any other cantonal tax law. If possible, the law would also define the taxes and revenues that may be charged by municipalities. At a minimum, this law would have to deal with:
 - i. Real estate taxation,
 - ii. Municipal authorities for real estate tax administration,
 - iii. Implementation of the profit and income taxes,
 - iv. Authorization of all tax and fee types and levels,
 - v. Coordinate the taxation among levels of government,
 - vi. Derogations.
 - b. Organic Law on public revenue in the RS. This law would establish the guidelines for establishing Entity-level taxes and define the fees, charges, and other revenue sources for municipalities. This would be similar to that for the Federation, but would obviously not need to concern itself with cantonal authorities.

Both of these laws should clearly establish how taxes can be created and make clear the difference between a tax and a fee. This applies not only to cantons and municipalities but also to tax and fee creation at the Entity level.

3. Methodology

A number of steps were taken in the preparation of this report. These include:

- 1. Review of a number of relevant documents, as listed at the back of this report. It is interesting to note that there are actually very few documents dealing expressly with the issues that this report addresses.

2. Review of a large number of legal documents, also listed at the end of this document.
3. Based on the review of these laws and constitutions the distribution of competencies and authorities in BiH was tabulated. See Annex D.
4. Collection and analysis of revenue and expenditure information from the various levels of government.
5. Interviews with a number of independent, private businesspersons. These interviewees were asked to explain their business and to identify the most important obstacles to their growth and development in BiH. They were not directly asked to identify impediments caused by the tax system.
6. Interviews with members of the International Community involved in tax issues in BiH, especially members of the International Advisory Group – Taxation (IAG-T) and its subgroup the Direct Tax Committee (DTC).
7. Interviews with individuals from the International Community, as well as nationals, involved in issues related to SME and broader private sector development.
8. Interviews with government officials, in particular, officials from the MoFs and tax administrations from the Entities and Brcko.
9. Comprehensive analysis of all of the important, and some less important, taxes and revenue sources for each level of government with a focus on simplification, process streamlining, and with a view toward addressing the various issues raised by businesspersons and the others interviewed. The analysis is not quite symmetrical among the Entities and Brcko, mainly because this would be somewhat duplicative. In addition, the progress being made in Brcko clearly outpaces that in the Entities.
10. The comprehensive analysis also includes the application of the best practice guidelines discussed in Annex B: A Guide to Good Taxation. Some specific issues treated here include simplicity, equity, economic efficiency, and compliance.
11. Although the purpose of this report is to provide findings and recommendations for action by the International Community and the BiH governments at all levels, it also provides information, analysis and data that can serve useful for gaining better understanding of the system as well as laying down a starting point for future analyses.

4. Impediments to SME development

There are many impediments to the SME development in Bosnia and Herzegovina. Indeed, there are many impediments to business development, regardless of business size. Several reports were reviewed in the preparation of

this analysis. In addition, interviews were held with a number of small business owners in both the Federation and the RS.

The following list of impediments reflects the sentiments of several of our interlocutors as well as items found in the various reports. The tax-related impediments are marked √.

1. Regulations, in general, change too frequently, making it difficult to plan and difficult to comply.
2. Business registration/licensing has been a drawn out process and impedes formalization, or delays it.³ √
3. Relatively high costs of establishing a new business.⁴
4. Accounting rules for taxation are unclear, difficult for small businesses to manage, and impede establishing business in a variety of municipalities. This includes the problem that tax inspectors do not seem to be very familiar with tax law or accountancy and they often apply the law in different ways on different occasions. √
5. Getting land for construction.
6. Getting licenses to construct buildings.
7. Unannounced tax inspections. √
8. Difficulty in getting some customers, especially Government-Owned Enterprises, to meet schedules and to pay on time.
9. Difficulty in resolving business disputes.
10. Wide variety of taxes for payment to three levels of government and the entitlement funds. Tax payments must be made in multiple payments. √
11. Inspections other than for taxes. For instance, multiple sanitary as well as labor inspections. Regulations indicate the number of employees that business should employ and pressure employers to employ this number, even when this would be uneconomical.
12. Very high, nominal wage taxes, including social fund payments, total to 69% of salaries in the FBiH, 52% in the RS, and up to 46% in Brcko.

³ This is tax related, since a business must complete the registration process before getting a Taxpayer Identification Number (TIN).

⁴ In 2002, average company founding costs in BiH were 51.8% of the GDP per capita (GDP per capita 2,504 KM / ,1206 US\$ per capita). It takes 59 days to establish a company in BiH / 4 days in USA.
Source: Doing Business in 2004 Bosnia and Herzegovina, Country Profile

Businesses generally underdeclare the wages they pay to reduce this burden. ✓

13. Tax holidays for “new” businesses encourage businesspersons to open and close their businesses to take advantage of these tax holidays. This then leaves them without a formal business history against which they can borrow from the formal banking system. ✓

Two specific tax-related issues identified in the *Analytical Report on Administrative and Regulatory Costs Survey for Bosnia and Herzegovina* are highlighted and repeated in the next two points:

14. In both the RS and the FBiH most of the subjects are of the opinion that the registration of a new enterprise, obtaining a work permit, customs regulations, labor regulations, expert and skilled labor force, or environmental regulations do not represent obstacles for the functioning and growth of their businesses.⁵
15. In both the RS and the FBiH, most of the subjects are of the opinion that the tax rates, tax regulations/administration and unfair competition of the gray/shadow economy (monopolistic practices) do present obstacles for the functioning and growth of their businesses. The assessment in both the RS and the FBiH is that these are very serious obstacles.” ✓

It is interesting to note that in most of the conversations with business people, the issues of taxation did not arise as impediments to business operations until prodded. Nonetheless, once prodded the issues of multiple payments, differences of taxation among localities, and the exorbitant taxes on wages, were all emphasized. All but one of the businesspersons interviewed freely admitted to underdeclaring their wage bill. The one businessperson who claimed to make all the legally required tax payments is no longer in business.

Text Box 1: Milan Zoric, Small Businessman (an almost factual interview)

⁵ This seems to dispel a commonly held belief and directly contradicts bullet point “2.” above.

Milan Zoric, a former employee of a State-Owned Enterprise, established a limited liability company that sells carpeting and flooring to businesses. The company has four employees, including Milan.

Milan's biggest problems in doing business in BiH, according to his own ranking, include: a lack of business ethics among Bosnians, difficulty in getting customers to pay on time, difficulty in getting goods and services from clients on time, especially from state-owned enterprises. Milan has established a very good reputation of being able to meet contract terms and get his goods delivered on time. Indeed, this seems to be about his most important value-added. Recently, a foreign manufacturer investing in BiH, contracted for the purchase of supplies from Milan instead of ordering them direct from the Bosnian manufacturer.

When asked about the burden of taxes, fees, and tax inspections on his business, Milan was hesitant. He clearly felt that these were secondary or tertiary to the problems already mentioned. When pressed however, he admitted that he would never be able to remain in business if he actually paid the taxes on wages as specified in the law. Milan's employees officially receive the minimum wage, though their per diems and other "perks" make their take-home packet several multiples of this. The tax inspectors know and acquiesce in this subterfuge. They know that no businesses can afford to pay these wage taxes. Milan did not complain about the tax inspectors, indeed, he says they seem to really know what they are doing and do not mistreat him. Milan feels that in part this is because he is not a "fat fish" and keeps under the radar by remaining small. Milan also mentioned that it took two months to get his company registered.

5. The structure of revenues in Bosnia

5.1. Revenues in BiH

The following chart presents the distribution of revenues throughout BiH. There are a number of items purposely not included to ensure full comparability. This chart excludes the contributions to the four funds: health, retirement, children's fund, and the unemployment fund. It also excludes the revenues from utilities that are only included in the Brcko budget. These revenues are not included in the budgets of the other jurisdictions because these services are provided by public enterprises that directly charge for these services, whereas in Brcko these services are purchased by the Brcko government and sold to Brcko residents and firms.

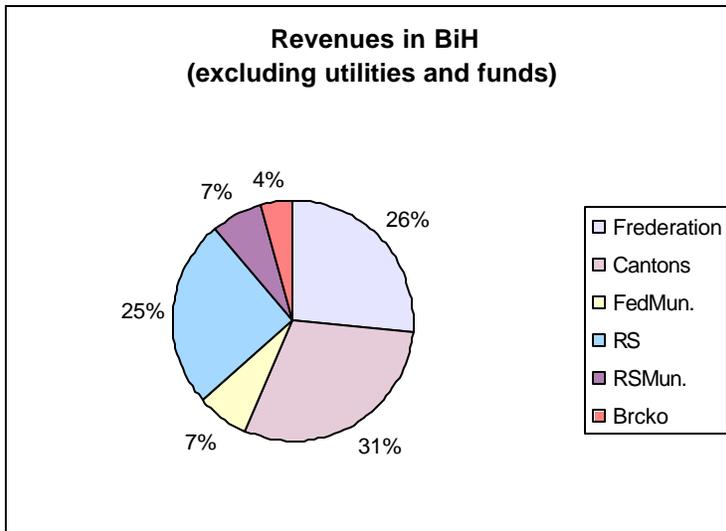


Figure 1: Revenue distribution in BiH

It is interesting to note the large share of revenues enjoyed by Brcko District. Although its population only comes to about two percent of the total population of BiH, it enjoys about four percent of public revenues, i.e., it has about twice the per capita revenues as the rest of the country.

Beyond the numbers represented in this pie chart, it should be kept in mind that contributions to the country's four sets of funds represent a total of 33% of all publicly collected revenues in the country. These funds are for pensions and invalids, health, child welfare, and unemployment. The contributions to these funds come from payroll taxes, which are discussed in Chapter 6 of this report.

5.2. Revenues in the Federation

For all practical purposes, all taxes and fees within the territory of the Federation of Bosnia and Herzegovina are administered by the Federation Tax Authority (TAFBIH), while almost all payments are made via the banking system. The TAFBIH administers the receipt of tax and fee declaration, maintains all payment records, assesses and audits tax and fee declarations, and distributes all forms for the calculation, recording and payment of all taxes and fees. The TAFBIH undertakes the administration of the tax and fees on behalf of the Federation, the cantons, and the municipalities.⁶ The TAFBIH also is responsible for the collection and enforcement of a number of social contribution funds, namely: pensions, health care, and the unemployment fund.⁷ These contributions are not distributed to levels of government but instead are distributed to specific extra-budgetary institutions.

⁶ Some forms are distributed by cantons. TAFBIH will soon take this over and require unified forms.

⁷ The RS has the same funds plus a fund for child protection.

5.3. Federation-wide revenue sources

The following chart illustrates the shares of public revenue allocated to the recipient institutions in the FBiH.

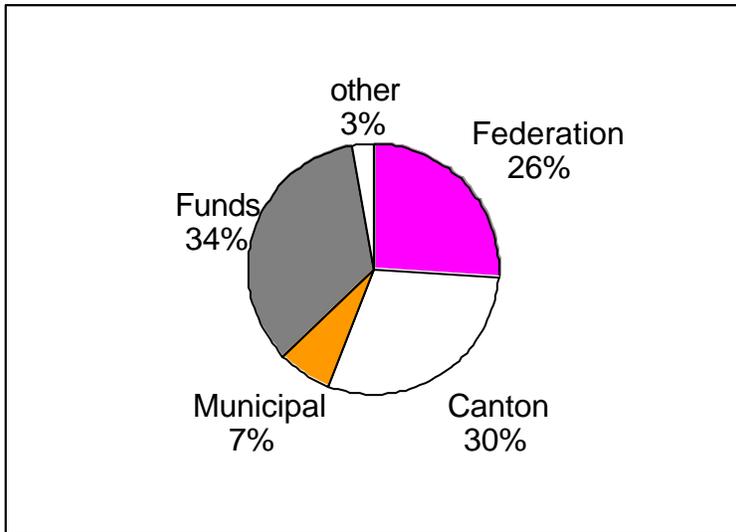


Figure 2: Revenue distribution in FBiH

As is obvious from the Figure, other than the social funds, the cantonal budgets take the largest share of the revenues collected within the territory of the FBiH, followed by the Federation, with the municipal budgets receiving by far the smallest share.

5.4. Federation-wide revenues

In 2003, only about one-third of tax revenues for the Federation, cantons, and municipalities came from customs. Less than an additional third came from Sales Tax, including the “sales tax on high tariff goods” that is now collected either in customs or *ex fabrica*.

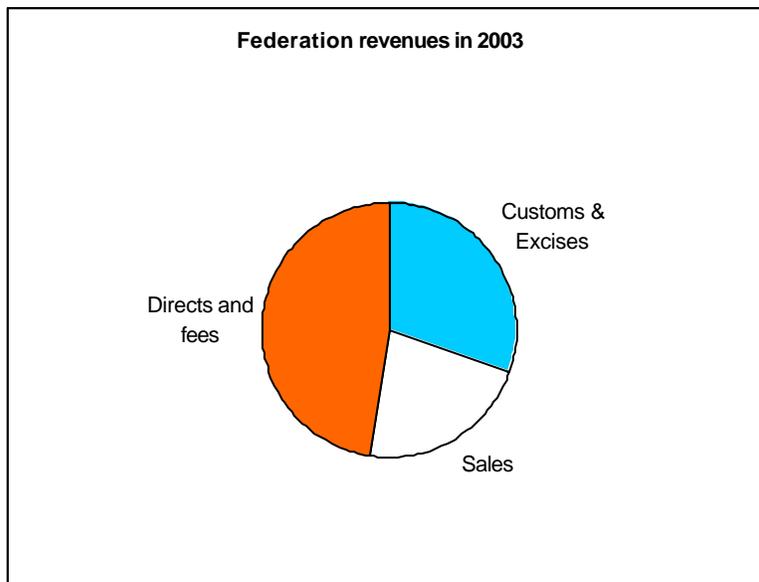


Figure 3: Sources of revenue throughout the Federation

The collection performance for Federation-wide revenues on an overall basis showed improvement compared to 2002, having grown by about seven percent. However, there is considerable variance in growth performance from revenue source to revenue source. For instance, revenue from customs and excises on customs each fell by three percent in 2003, mainly due to lowered tariff rates. The star performer was the “road tax” that is actually an excise on petroleum. This increase came about, at least in part, due to special enforcement efforts spearheaded by CAFAO. An important performer was the “sales tax on high tariff items,” which increased by 35%. However, of considerable surprise was the 32% increase in revenue performance of the profit tax. There are reasons to believe that this increase may be due to the great efforts, supported by TAMP, to facilitate the registration and maintenance of a clean registration of new taxpayers and the deregistration of fictitious taxpayers.⁸

5.5. Federation Government revenues

Customs and excise duties are collected by the Federation’s Customs Office. These include all customs and excise duties. In 2003, customs and excises came to about 87% of total Federation-Government revenues. All other revenues are collected by the Tax Administration of the Federation of Bosnia and Herzegovina (TAFBiH). The profit tax only contributed about two percent of Federation Government revenues. The rest of the Federation Government’s revenues came from other taxes, fees, fines and certain other non-tax revenues.

⁸ At the end of December 2002 there were 32,669 registered business taxpayers in the Federation. By December 2003, the number of registered business taxpayers had risen to 77,009, a greater than doubling of the taxpayer database.

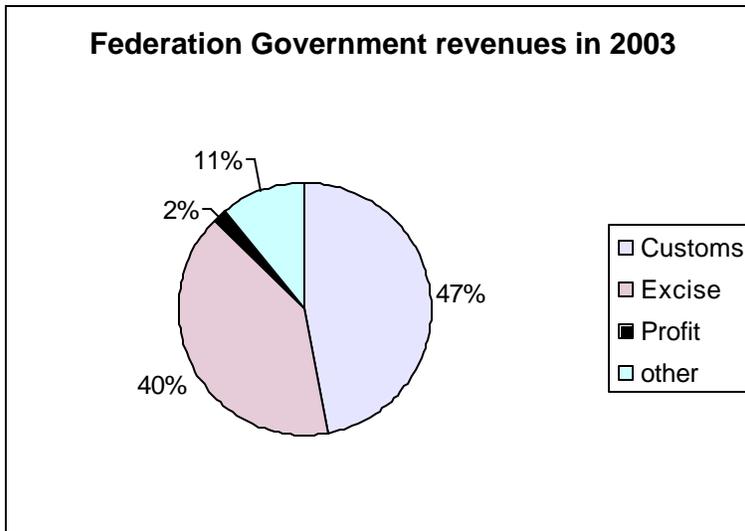


Figure 4: Federation Government revenues

As has already been mentioned, this study does not deal with the issues of revenue allocations among the levels of government in BiH. However, given the secular decline in the collection of import duties and possibly excises, the vulnerability of the Federation Government to revenue shortfalls must be highlighted. The introduction of the VAT must take into account not only how cantonal and municipal finances will be compensated for their loss of sales tax revenues, but also how the opening up of Bosnia and Herzegovina to freer international trade will affect the Federation Government's fiscal system.

5.6. Cantonal revenues

The next chart shows the revenue sources for cantonal budgets, on an aggregated base, for 2003. The largest single revenue source for cantons was sales tax. This includes three separate streams: ordinary sales tax on the sale of goods, sales tax on high tariff items, and sales tax on sales of services. The ordinary sales tax on the sale of goods was the most important source, followed by that on high tariff goods, then that on sales of services.

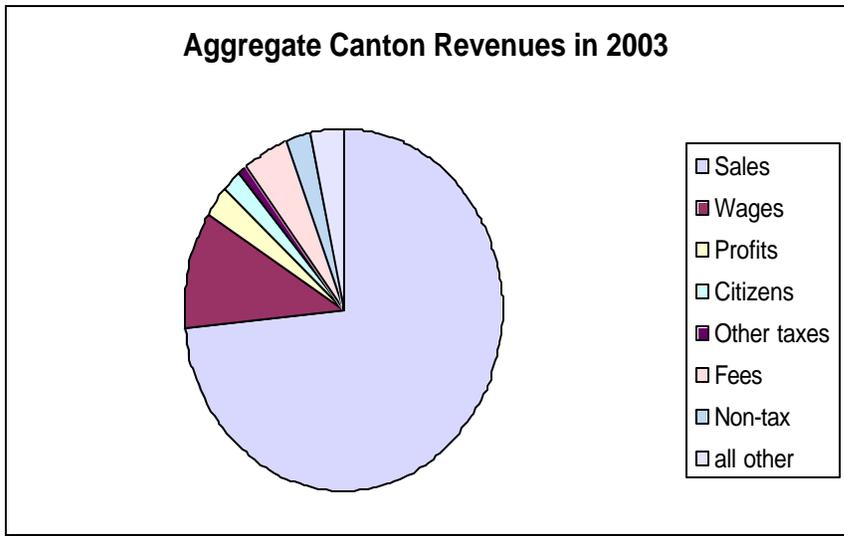


Figure 5: Canton revenues in 2003

5.7. Federation municipal revenues

Federation municipalities depend heavily on revenues from sales taxes and citizen taxes. “Fees” are the third largest category of municipal government revenues. Fees include a number of different types, but largely, they represent a charge upon immovable property to cover the costs of providing street lighting and paving, trash haulage, and parks.

Enterprise earnings or revenues from municipal economic activities is also an important source of municipal revenues.

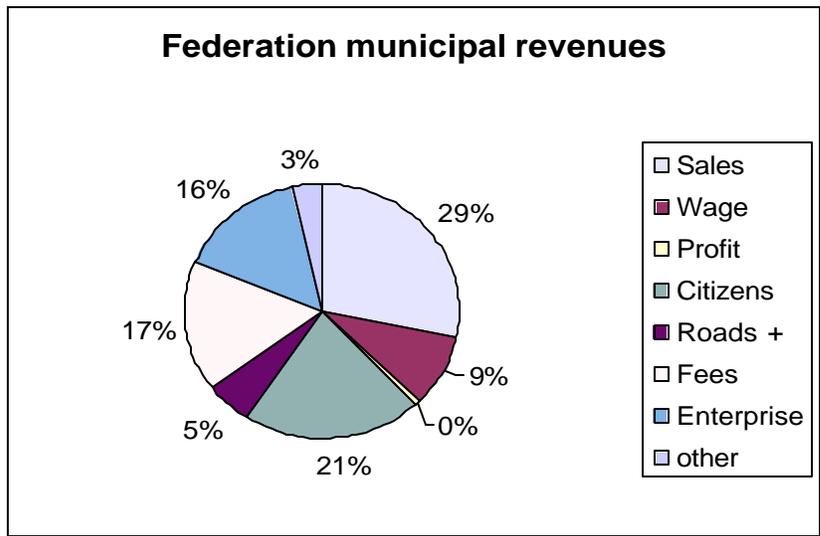


Figure 6: Municipal revenues in the Federation in 2003

The following chart shows the sources of revenues for one municipality in the Sarajevo canton. This is not a typical municipality, but it is the largest. From this chart, it is clear that this municipality’s most important single revenue source is

“income from entrepreneurial activities.” This income is neither a tax nor a fee, *per se*, but rather the income that the municipality gains from renting space, public lands, and facilities. The next largest revenue source is the sales tax on real estate transfers. This is then followed by “fees” such as for marriage licenses, cadastre or land plots, construction permits, and other fees. Budgetary transfers from the canton then comprise almost one-quarter of revenues, which are grants meant to help cover the municipality’s current expenditures.

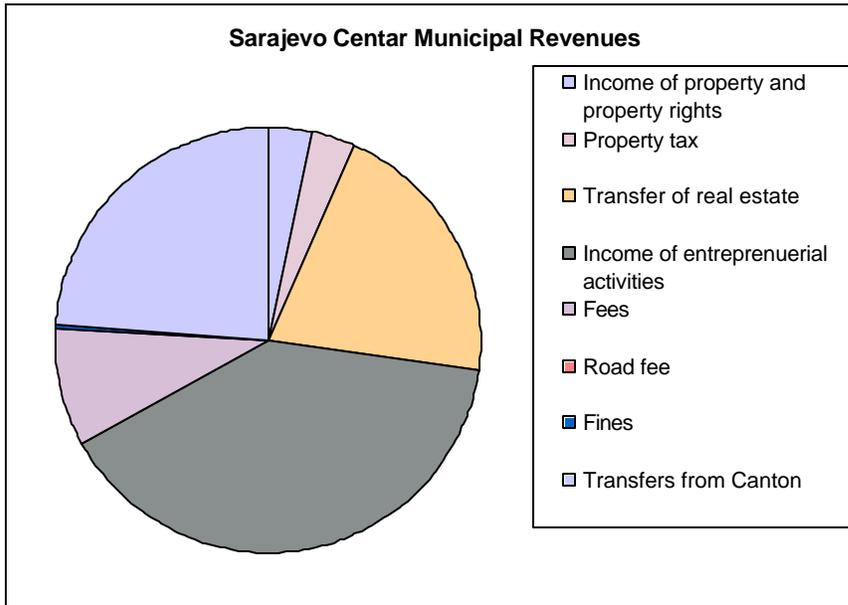


Figure 7: Revenue sources for the Sarajevo Centar municipality

5.8. Republika Srpska-wide revenues

As in the Federation, essentially all governmental taxes, fees and other revenues are collected by the Tax Administration of the Republika Srpska (TARS). Revenues in RS are shared between the Republic and the municipalities. There is no cantonal level of government.

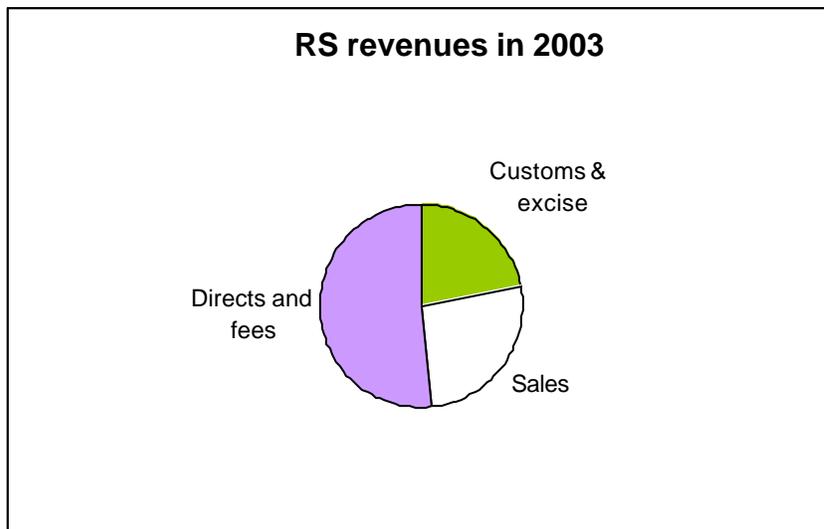


Figure 8: Sources of RS revenues in 2003

The overall structure of revenues in the RS differs from that in the Federation in that direct taxes and fees are more than half of all RS revenues, whereas they are only slightly less than half in the Federation. The greater difference is that Customs and Excise in the Federation provide 30% of all revenue compared to only 22% in RS. Of course, this also means that the sales tax is somewhat more important a revenue source in RS than in the Federation.

Revenue performance in RS outpaced that in the Federation last year. For instance, overall revenue growth in the Federation was only seven percent compared to 10% in RS. However, it must be kept in mind that due to trade opening, customs and excise revenues declined about two percent. Indeed, customs revenues alone experienced a 12% decline. This compares to a 17% increase in sales tax, most likely supported by the move to border and ex fabrica collections, and a 12% increase in direct taxes and fees, in large part brought about due to special enforcement efforts of TARS, increased company registration, and improved data systems.

5.9. RS-Government revenues

The following chart illustrates the sources of revenue for the RS-Government budget. This is much more diversified than that of the Federation-Government budget, which draws fully 87% of its revenues from customs and excises, as compared to only 40% for the RS-Government budget. The RS-Government also participates in the sales tax revenues as well as sharing in fees and compensations (see section on fees and compensations as property tax). Since there is no cantonal level in the RS, the RS-Government directly shares in these revenues.

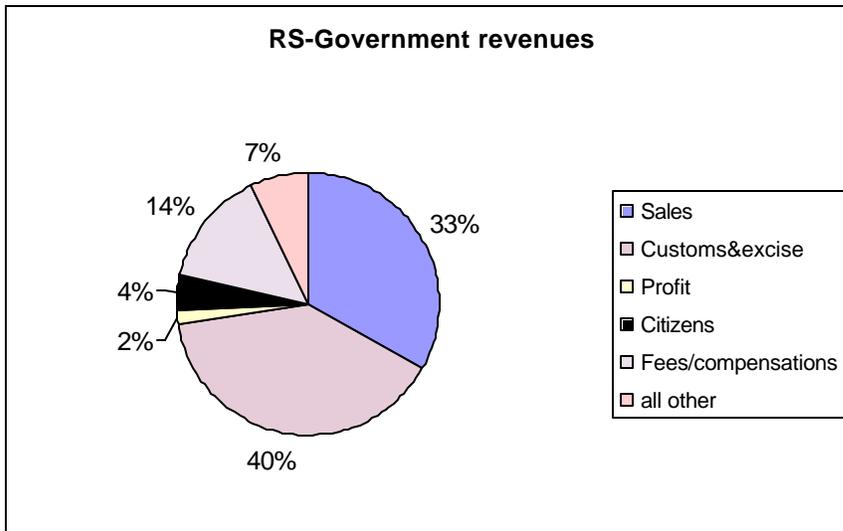


Figure 9: RS-Government revenues

Although trade opening and the coming VAT and ITA represent important changes, most for the better, in BiH, they also represent some fiscal risks for governments in BiH. What is clear from this analysis is that the fiscal risks to the Federation-Government are somewhat higher than for the RS-Government. A new fiscal federalism is required for BiH, but especially for the Federation Government.

5.10. RS municipal revenues

The next chart illustrates the sources of municipal revenues in the RS.

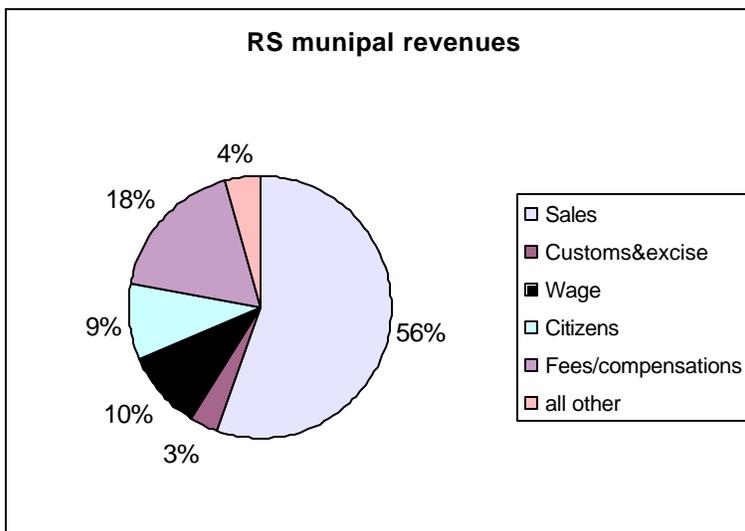


Figure 10: RS municipal revenues

Sales taxes play a much greater role in municipal finance in the RS compared to the Federation. How VAT revenues will be distributed will be of particular concern to RS municipalities.

An important difference between municipal revenues in the Federation and the RS is that the RS municipalities generally do not have access to revenues from “entrepreneurial activities”. In the Federation, municipalities were left with a large number of properties that they lease out for private sector use and which generate considerable revenues. In the RS, these properties were consolidated under the ownership of a single public enterprise with intentions of eventually privatizing all of these properties.

5.11. Revenues in Brcko District

Brcko is blessed with a wealth of public revenues. Due to its unique situation in the country, it has been granted the right to keep unto itself customs and excise revenues that it is able to collect on its own territory. Having a direct bridge into Croatia across the Sava River, combined with somewhat lower excise tax rates, the District has been able to entice international truckers to bring their goods in via the Brcko route and pay these two taxes to the Brcko coffers. It is interesting to note that customs revenues declined in Brcko last year, as it did throughout the country, yet excises increased, contrary to the rest of the country.

The following chart shows the sources of revenue for Brcko as well as the growth in these revenues between 2002 and 2003.

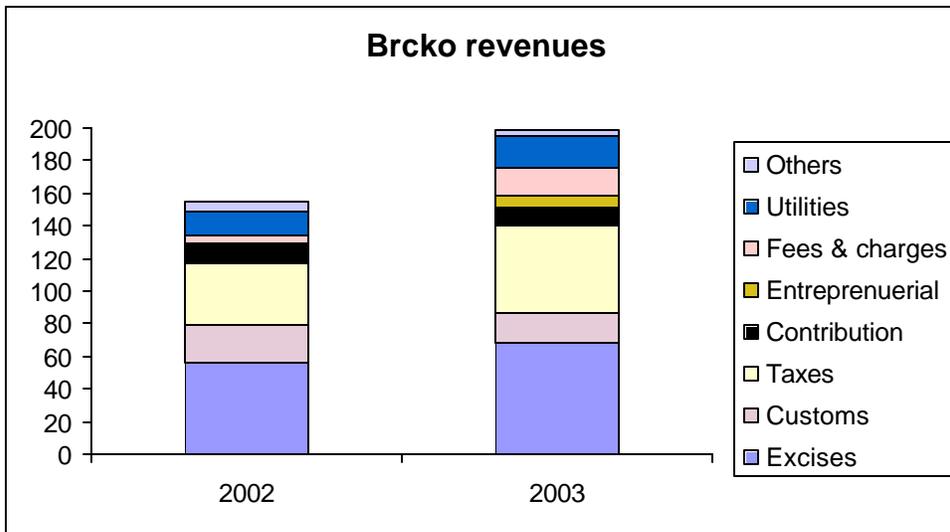


Figure 11: Brcko revenues

Brcko, which is about the size of Centar Municipality in Sarajevo, took in almost KM 196 million compared to Centar’s KM 12 million. Banja Luka has about two and a half times Brcko’s population but only received a little over one-third the revenues (KM 70 million).

It should be kept in mind that Brcko's revenues cannot be directly compared to these municipalities since they are required to provide their residents with services that are beyond those provided by municipalities, such as police, courts, and all levels of education. Therefore, Brcko's expenditure requirements are similar to those of a municipality and canton combined.

In addition, Brcko sells electricity and water to its residents, which it purchases from public enterprises in the two Entities. The charges for these services are not in municipal or cantonal budgets in the Entities.

Brcko's revenues grew by 28% last year, despite a 20% decline in import duties. The sources of this growth were excises, which grew 22%, taxes (property, income etc.), which grew 20%, and fees and charges (essentially, the second "property tax"), which doubled.

6. The nature of taxes in BiH

6.1. Corporate profit tax

Although the corporate profit tax in most countries is an important source of government revenues, in the Federation it provides only a paltry one percent of government revenues, of which about 37% of it goes to the Federation budget, 61% to cantonal budgets, and two percent goes to municipal coffers.

This tax has a single, proportional tax rate of 30%. The law specifies acceptable deductions from revenues to arrive at the taxable profit. It also allows for accelerated depreciation for certain equipment, such as that for pollution abatement, science and research, education and training of staff (this is unclear since it is not usually a capital expense), and computer equipment in general.

The corporate profit tax is extremely generous with tax holidays for new companies. For instance, first year corporations are not subject to profits tax and their tax liability is discounted by 70% in their second year, and by 30% in the third year. Companies establishing operations in free zones are not subject to the profit tax for five years. Oddly, companies going out of business before five years after their establishment are required to repay the tax holidays they have enjoyed. It is not clear how defunct businesses are forced to make this refund.

Two other very interesting shelters are included in the law. First, if a company reinvests its retained earnings, this is credited against the tax obligation. (I.e., a company reinvesting all of its earnings is not subject to the profit tax at all.) If a corporation earns profit and that profit is used to fund other investments (law says "personal") then that investment is 75% creditable against the corporate profit tax.

Foreign investors are welcome in Bosnia. For instance, if a foreigner invests in a business in Bosnia and his ownership represents at least 20% of total capital, the company's tax obligation is decreased for five years in proportion to the participation of foreign capital in the total permanent capital of the firm.

Is it any wonder that this tax yields only one percent of government revenues in the Federation?

6.2. Wage tax

The Federation wage tax includes tax on wage and wage-related income. It also includes earnings of persons who are not salaried but who independently perform economic and business activities as their basic employment.

The wage tax is a flat tax, although it is applied at different rates for different sectors. For instance, for the first twelve specified categories (art. 6) of “regular employment” the flat rate was recently reduced from 15% to 5% of the taxable income. For the next three categories of income (art. 7, items one and two), such as earnings of professional sportsmen and members of Parliament, the flat rate is 30% of income. Compensation for transport to and from work and compensation for meals during work hours are taxed at 50%. Until a recent amendment, the income tax liability was reduced by 30% for non-resident experts who work in a corporation located in the Federation.

The wage tax is shared between cantons (83% average) and municipalities (17%)

The wage tax is not a comprehensive personal income tax since it does not include many sources of earnings for individuals, such as dividends paid from corporations, capital gains from investments, or interest earnings from savings accounts or bonds.

The application of differentiated tax rates according to the type of income rather than according to the income earner’s level of income is referred to as “schedular” and is generally not considered a good practice in taxation. It differentiates tax treatment not according to the ability to pay of the taxpayer but rather by an arbitrarily established schedule that seems difficult to explain or justify, based either on economic or social grounds.

The wage tax establishes the requirement for withholding from salaries. The law does not specifically contemplate a simplified system for withholding for SMEs.

The wage tax must be analyzed in conjunction with the various “citizen taxes” that are created at the cantonal level of government. These citizen taxes cover other sources of income that are not included in the wage tax. A comprehensive personal income tax should be prepared that includes all personal income and provides equitable tax treatment across earnings.

6.3. Payroll taxes

As already pointed out, cantonal income taxes are a heavy burden on income. Apart from the cantonal income tax, the wage tax and the contributions to the various funds impose a significant direct tax on labor. Indeed, in the Federation, these four taxes (wage plus the three payroll taxes to fund the four entitlement funds) impose an overall marginal tax rate of 69%.

Consider:

net salary: 600 KM

gross salary : $600 \times 1,47059$ (coefficient) = KM 882,35

Contributions from gross salary, **paid by employer**

-contribution for pension fund :	17%
-contribution for health fund :	11,96 %
-contribution for Health (solidarity)	1,04%
-contribution for unemployment fund FBiH :	0,60%
-contribution for unemployment Canton Sar.:	1,40%

Total contributions (from salary) :	32% = 282,35 KM (882,35 x 32%)
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Contribution on gross salary, **withheld from employee's salary.**

contribution for pension fund:	7 %
-contribution for health fund:	3,68%
-contribution for health (solidarity)	0,32%
-contribution for unemployment fund FBiH:	0,15 %
- contribution for unemployment fund Cant. Sar.	0,35%

Total contributions (on salary) :	11,5 % = 101,47 KM (882,35 x 11,5%)
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Total contributions (on gross salary)

32%
11,5%
<hr/>
43,5%= 383,82 KM (282,35 +101,47)

Wage tax : 5% on net salary = 30 KM ($600 \times 5\%$)

Total contribution and wage tax: $383,82\text{KM} + 30 \text{ KM} = \text{KM } 413,82$

Summary

Net wage 600 KM

Contribution and wage tax 413,82 KM = 68,97 % of net salary.⁹

Applying a similar analysis to wage and the four payroll taxes of the RS as was applied above for the Federation, yields an overall tax rate on labor of 52%, net income in the RS.

Consider:

Tax on wages = 10%

⁹ Net salary is the salary the employee receives after deduction of her portion of the wage and payroll taxes.

Contributions include the following rates:

Pensions and invalid insurance = 24%

Health insurance = 15%

Unemployment = 1%

Child protection = 2%

Combined tax rate on labor = 52% net of employee's withheld taxes.

From discussions with tax authorities in Brcko District, it seems that the payroll tax may range from about 40% to 46% of net wages, depending on whether the employee is included in the RS or the Federation funds.

6.4. The pilot reform of income taxes

GTZ has been providing assistance to tax policy reform in BiH. This assistance has focused specifically on the drafting of new tax legislation for income taxation. With this GTZ assistance, a comprehensive tax on incomes from profits, wages and other sources has been drafted, enacted, and has been in operation in Brcko, in part, since July 2003. The personal income tax portion of the tax took effect in July 2003, while the profits tax portion took effect in January 2004. (in Brcko only)

This new income tax has many features that make it a great improvement over the current, complex set of uncoordinated taxes on incomes. Some of these are:

1. It avoids double taxation of personal income.
2. Dividends are not taxed.
3. It has almost no exemptions.
4. The profit tax is applicable for corporations and self-employed or "natural persons."
5. It has a single rate of taxation rather than multiple rates. This single rate is applicable to both the personal income tax and the corporate income tax.
6. All income is treated the same, unlike the schedular nature of the current mix of taxes.

There are other features that are still of concern. For instance, the IMF and others have raised concerns about the treatment of equity versus borrowed capital. In addition, this special treatment also imposes somewhat higher accounting and documentation requirements on the taxpayer. Finally, the concern has arisen that the capacity of the tax administrations to take on this reform at this time, given the onset of VAT and the ITA in January 2006, might overburden the tax administrations.

Although the data were not available in tabular format, Brcko reports that the revenues from the new personal income tax for the period it was in effect in 2003 yielded about one-third more revenue than had been expected.

6.5. The nature of “citizen taxes”

The following discussions on canton-created taxes are mainly based on the Sarajevo Canton tax law. There are variances among cantons in the taxes that are applied, but the Sarajevo law seems to be illustrative. On average in 2003, about 24% of these taxes went to the cantons, about 68% went to municipalities, and the remaining 8% went to other institutions.

In Sarajevo Canton, the following taxes are in effect:

1. Profit tax for individuals.
2. Property tax.
3. Tax on income from property and property rights.
4. Tax on income from copyrights, patents, and technical innovations.
5. Tax on gifts and inheritances.
6. Tax on gambling winnings.
7. Tax on income from agricultural activities.
8. Income tax of physical persons (individuals).
9. Tax on consumption of alcohol and soft drinks for catering/restaurants).

Text Box 2: Asja the sculptor

Asja, a sculptress with a taxable income of 50,000KM per year must pay about 25,000KM in terms of the individual income tax plus the tax on patents, copyrights and technical innovations. *Asja*'s older, non-artistic brother, who earns all his income of 100,000KM in salary working for the German Embassy only has to pay 5,000KM in taxes.

These are generally referred to as “citizen taxes” and apply, in varying ways, in all of the cantons in the Federation. While they may vary to some extent in terms of rates, the structure of these is common throughout. Citizen taxes are on individuals or “physical persons”.

These taxes are established by cantonal law, collected by TAFBIH, and distributed to cantons and municipalities.

In cantons, this tax on income from copyrights, patents, and technical innovations is imposed on individuals who earn income from these three sources. This includes written works, oral presentations (lectures, speeches, etc.), drama and musicals, choreography and pantomime, work of folklore origin, cinematography, painting, sculpture, architecture and other fine work, cartography, encyclopedias, anthologies, awards on compensations, music work with words, music work without words, music performances, patents and other technical innovations.

This tax is imposed on residents as well as foreigners who obtained the income (for instance, performers) within the canton.

The tax rate on these various intellect-based activities varies. For instance, there is a 50% tax on sculpture income, tapestries, and ceramics; a 35% tax on artistic photography in the field of science, culture and the economy, such as frescos, graphs, and emails; a 30% tax on paintings and graphics, translations of music; a 15% tax on performing arts, such as concerts.

The tax on copyrights includes a variety of rates. It is very interesting to note, for instance, that the tax on income from the copyright of rock music, the rate is 20%, but for classical music is only 5%.

In the RS, citizen taxes are of the same nature as those collected in the Federation, although there seems to be more of them. Citizen taxes in the overall scheme of the RS's fiscal system are rather small, comprising less than four percent of total governmental revenues.

Table 1: List of citizen taxes in RS

Annual income tax for citizens
Income tax from copyright, patents and technical improvements
Income tax for agriculture and forestry
Tax for lottery gains
Income tax for revenues from other sources for citizens
Revenue tax for insurance in case of loss of gain or loss of compensation for endured damage
Income tax for revenues from agriculture
Tax for capital revenues
Tax for revenues from rent or sub-rent of real-estate and movable property
Income tax from capital gains
Income tax from other capital gains
Flat tax for revenues from real-estate
Income tax for entrepreneurs
Flat rate income tax for independent business activities
Property tax
Inheritance and gift tax
Sales tax for real-estate and rights
Tax on use of motor vehicles
Tax for use of mobile phones
Tax for use and keeping of boats, sailing equipment and yachts
Tax for use and keeping of airplanes and air crafts
Tax for keeping and carrying weapons
Tax on revenues from organizing lottery and amusement games
Tax on lottery gains

6.6. Personal income tax

This tax is applied to physical persons who have income above triple the canton's average annual salary. The law allows for deductions for family dependents.

It seems from the law, and this has been confirmed in interviews with TAFBIH staff, that all the income from patents, innovations, copyrights etc. discussed in the previous paragraphs, are also included in this taxable income basis. The tax rate for the personal income tax is a flat 5%. This means that for a taxpayer who earns her living from the sale of sculptures, assuming no allowances (an extreme and not actually achievable situation) the composite tax would be almost 55% of this income.

6.7. Property tax¹⁰

The property tax is a tax on premises (constructions) and on garages, passenger vehicles, motorcycles, boats, casino tables, slot machines, and other machines for gaming.

The property tax as applied to premises is only on personal property that is used for vacationing or for weekends. Personal residences are not taxed.¹¹ The tax is usually assessed at a specific rate of money per measurement. For instance, in Sarajevo Canton the property tax minimum is for 3KM per square meter of a building's construction.

The property tax in RS is similar to that in the Federation except that since 2001, it also includes residences in the taxable base. Like in the Federation, however, the tax is based on the area of the construction, with higher charges sometimes being imposed based on the location of the property.

6.8. Tax on the sale or transfer of property

In both Entities taxes are collected when a property is sold. The basis of the tax is the value of the property. The seller is required to declare the value of the property via the bill of sale, and the tax is imposed on the buyer. The TARS may disagree with the declared value and impose a higher (never lower) value. The taxpayer may then request the TARS to reconsider its valuation by providing additional information, such as the age or condition of the building being purchased.

6.9. Tax on income from property and property rights

This tax is imposed on the income that an owner of a property gains from renting the property to a tenant, either to a person or to a business, either entrepreneur or legal person. This tax is paid by physical persons. The tax is also on loans bearing interest made by physical persons to legal entities or entrepreneurs. The tax also applies to individuals who sell moveable property within three months of its purchase, when there is a profit.

¹⁰ This section is actually based on the Gorazde property tax legislation.

¹¹ Residences are only taxed when they are rented to a renter. In which case, the land lord must pay the tax on income from property. See below.

The tax charged on lending of money is at 30% of the profit, excluding costs of earning the income. The tax charged on rental income property is a minimum of 20%, but municipalities are free to impose a higher rate.

The only two stated exemptions from this tax apply to income from insurance (both life and casualty) and income from loans to the government, i.e. the State of BiH, cantons, and municipalities.

6.10. "Fees and Charges"

There are myriad fees collected by TARS and it is not always clear what the nature of these fees is. These fees are listed in the following table.

Table 2: Fees and charges in RS

Revenues from rent on land
Administrative fees for the Republic
Special fee for the Republic
Fee for showing films on TV and in public transportation
Dog registration
Other administrative fees for services of Ministry of Interior
Fee for approval...
Special fee for the Republic for oil derivatives
Charge...
Municipal administrative fees
City administrative fees
Court fees of the Republic
Retail fee
Charge for use of mineral resources
Communal (NB: Communal = Municipal) fees for animal keeping
Communal fees for businesses
Communal fee for keeping motor vehicles and connecting equipment
Communal fee for use of space in public areas
Communal fee for keeping game equipment
Communal fee for arranging musical shows in restaurants
Communal fee for use of glass showcases for display of goods outside of business premises
Communal fee for bill-boards
Communal fee for use of parking space for motor vehicles
Residence fee
Communal fee for use of free areas for camping
Communal fee business premises and sailing equipment on water...
Communal fee for boats
Communal fee for restaurants and other catering and entertainment facilities
Communal fee for use of bank (river) for business purposes
Communal fees for other subjects to fees
Charge for landscaping of construction land
Charge for use of construction land
Charge for roads
Charge for foreign road motor vehicles
Charge for roads paid during motor vehicle registration
Charge for use of mineral raw materials
Charge for change of purpose for agricultural land

Charge for construction of public shelters
 Charge for Motor Vehicle Association of RS
 Charge for use of forests, compensation for cut wood - legal entities
 Charge for cut wood used for trading – citizens
 Charge for use of other forest products
 Funds for forest reproduction
 Funds for reproduction of forests realized from sale of forests
 General water supply charge
 Charge for supplied water - legal and physical persons
 Charge for used water - legal and physical persons
 Charge for used water – agriculture
 Charge for water taken for commercial purposes-legal and physical persons
 Charge for water paid during motor vehicle registration
 Charge for released waste water - legal and physical persons

 Charge for water used for production of electricity and heating-legal and physical persons
 Charge for veterinary - sanitary examinations
 Charge for animal examination and issuing and extending of certificates

 Charge for trading with protected wild herbal and animal species
 Charge for protection from hail
 Charge for use of public utilities of general interest
 Charge for use of mineral waters
 Charge for material taken out of rivers
 Charge for financing surveying and cadastre
 Funds for protection from the fire

 Charge for use of natural resources for electric energy production

These fees and charges represent more than 10% of governmental revenue in RS.

It must be made very clear to the reader that what are referred to as municipal charges are not what would be considered charges in the normal public finance lexicon. Charges or fees are usually amounts of money that a user or beneficiary pays to a provider of a service. The person paying the charge has the right to consume a specific amount of the service based on his or her willingness to pay. Hence, lower consumption of a service would result in the consumer paying a lower amount in charges or fees.

About 30 years ago, municipalities in Yugoslavia began imposing so-called municipal fees for the street lighting, street and road paving and maintenance, and trash collection. Since municipalities were not authorized to impose taxes, they imposed “charges.” These charges are based not on one’s consumption of these essentially public goods – how can the producer of street lighting prevent a pedestrian or driver from benefiting from this public service? Instead, these charges are based on the size of a citizen’s property, i.e., a charge is based on a rate of some amount of money per square meter of constructed space. Municipalities will generally charge higher rates of this charge based on how an area is zoned. In Laktasi Municipality in the RS, the municipal territory is divided into five zone types: the zone that has the greatest access to the five services

supposedly covered by this charge, pay a higher per area charge; the zones with lesser access pay lower charges per area of constructed space.

Most of these municipal fees and charges are essentially identical to the property tax in the RS and a bit more advanced than the property tax in the Federation, since residences are not excluded.

In light of the sometimes dubious, often transitory and always territorially diverse nature of charges and fees in BiH, TAMP assistance in this area has been limited to providing the three tax administrations with the basic accounting faculties to match declarations with payments. Given that the ability to match declarations with payments is a core component of TAMP's broader tax accounting effort, the time expended by TAMP on charges and fees has been kept to a minimum.

7. Tax administration obstacles

7.1. Paying taxes

One means of encouraging taxpayer compliance is to facilitate the payment of taxes. This has not been the approach in BiH.

A self-employed person in the Federation seeking to make her monthly wage tax payment will be required to make at least two separate payments, one to the canton and the other to the municipality, this despite the fact that there is a system, referred to as the Revenue Allocation System (RAS), that can make the distribution of the revenue automatically to the different government levels. The municipal governments require separate payments because they do not trust that they will receive their portion of the payment via the RAS in a timely fashion. Some discussions seem to indicate that mistrust among the ethnic groups also contributes to the imposition of this requirement.

Further, a business paying wage taxes and contributions for its workers is required to make at least six payments. One to the Federation Pension Fund, one to the Federation Unemployment Fund, one to the Cantonal Unemployment Fund, one to the Federation Health Fund, one to the Cantonal Health Fund, one to the Federation, one to the canton, and one to the municipality. Assuming that not all the workers in the firm work and live in the same municipality, the total payments made by the firm on a monthly basis will exceed six. For example, if the employees live in two different municipalities, the firm will be required to make 9 separate payments. If they live in three municipalities, then the required number of payments is 10. A small enterprise located in Sarajevo, for instance, may draw its eight employees each from each of the eight municipalities, each of which is in Sarajevo, will need to make 15 wage and wage-related tax payments each month. Again, this is in spite of the fact that the Rulebook allows for a consolidated payment and the technical capability for properly allocating the consolidated payment to the different levels of government is already in place.

This SME must spend about 30 KM monthly on the purchase of the bank payment orders just to make these wage-related payments. Add to this the costs in terms

of bookkeeping and time spent writing each payment order and the financial cost can be quite considerable the taxpayer.

Aside from the financial costs for the taxpayer and the added burdens for the tax administrations, there are likely considerable errors involved in this practice. Each time calculations must be made and data entered, there is room for error. This has not been tested, but it is certainly true.

Another issue is the frequency of payment of some taxes. Although the sales tax is to be repealed and replaced with the VAT, starting in January 2006, at this time, tax authorities require its payment every week. A firm selling a variety of types of goods must make sales tax payments for each of these, i.e., a separate payment order.

The payment of all taxes should be consolidated for all business, large, small and medium, and made in a single payment order. The technology already exists for making the allocations to the different levels of government.

Scheduled tax payments should not be required on a greater than twelve-times-per-year basis.

7.2. Taxpayer Certification

In both the RS and the Federation, taxpayers are required to request “certification” from the tax authorities to allow them to do a number of things. For instance, the purchase of a vehicle for a private enterprise requires first that the taxpayer receive a certification of good stead with the tax authority before the taxpayer is able to purchase the vehicle. A company wishing to import goods under a duty-free regime must seek tax certification in order to attain the right to the duty free import.

The RS has not yet adopted the measures necessary to allow them to implement the tax certification process recommended by TAMP. TAMP has installed the information technology (IT) systems required to support a streamlined registration process, but two major reasons for the ongoing delay in streamlining the process and issuing automated certifications remain. First, there is a backlog of thousands of declarations that have not been posted to the database, and, many taxpayer accounts that are on the data base contain erroneous data. Although these problems are being addressed and will be overcome, they are now a major problem for taxpayers needing certification.¹²

Second, the taxpayer data base is unreliable because of a very high error rate in taxpayer account information caused by decentralized, inadequately controlled data entry. TAMP recommended implementation of a fully centralized tax declaration processing and data entry system for the tax year 2002. However, TARS was unable to relocate staff from the local offices to a CPC for this purpose

¹² Please see footnote 15, below which also explains this item.

without a Rulebook change. Very recently TARS requested TAMP assistance in identifying necessary Rulebook changes to fully staff the CPC and accomplish the TAMP recommendation to centralize data input.¹³

The point of certification, and it should be made clear that many countries of the world impose such certification requirements, is to encourage taxpayer compliance with tax obligations. The evidence from around the world and especially in Bosnia and Herzegovina is that this simply does not work. The author has discussed this issue with taxpayers who blatantly do not comply with aspects of the tax laws, yet who have received taxpayer certification.

In addition to being a generally unproductive venture, the process is onerous for taxpayers in both the RS and the Federation. The process is onerous in both the RS and the Federation.

In the Federation, the delay in establishing a single CPC means that certification still requires the tax authorities request certifying information from other cantonal offices, and in some cases all the cantonal tax offices, by fax. Then each cantonal tax office must seek the information by hand rummaging taxpayer files to determine if the taxpayer has any outstanding obligations.

In addition, the tax administrations require the taxpayer to request separate certification for each transaction. For instance, if the taxpayer seeks certification so she may purchase a vehicle as well as to secure import rights and these requests are both on the same day, two certification requests must be prepared and two certifications must be issued.

The RS should immediately implement the new certification procedures designed by TAMP, pending passage of a Rulebook providing for centralized data processing. The Federation should make immediate progress in implementing its automation plans and establishing the CPC and then directly implementing the new certification processes as designed by TAMP.

7.3. The Rulebook on Organizational Structure in the Federation

The current *Rulebook on Internal Organization of The Federation of Bosnia and Herzegovina Tax Administration* does not include adequate provision for centralized processing of tax declarations, appropriate job descriptions for an information technology staff, and for taxpayer service and education. This is holding up automation of processes, creation of the central processing center in

¹³ When USAID authorized TAMP to rebuild the TARS data base in 2002, the TARS data base had been dysfunctional for several months and there was a large backlog of declarations to be posted. This backlog was subsequently exacerbated by several hundred thousand tax declarations from pensioners that owed not tax. TAMP had earlier recommended elimination of filing requirements for pensioners whose income is below the tax threshold but TARS was unable to implement this recommendation until the tax year 2003. In short, the posting backlog for declarations will be overcome within the next several weeks.

Mostar, and will ensure that the TAFBiH will not be able to streamline the certification and other processes, nor will it enable the development of useful audit-related systems, the backbone of any high compliance tax system.

A number of factors are being addressed by TAMP management, UST, and USAID but which continue to hinder complete application of the TAMP-designed and developed systems. For instance, the TARS continues to input data in a decentralized manner, which leads to a high level of errors and, in part, is used as a justification for maintaining a complicated certification process. Delays in approving the “Rulebook” (this is essentially the regulations for tax administration) in the Federation impede the implementation of the CPC beyond the pilot project in Sarajevo.

8. Institutionalality

This study would be incomplete without a discussion of “institutionality.” For the purposes of this paper, this refers to the structure and distribution of authorities or competencies among the levels of government.

Annex D: The distribution of revenues, expenditures, and competencies presents revenue and spending shares among the various levels of government in BiH, as well as a comparative chart of the distribution of competencies among these same levels of government.

What is quite apparent from this table is that for such a small country there are many levels of government. This imposes a very large burden on the private sector, labor markets, capital markets, and institutional development. The people of BiH must consider if the need to balance ethnic representation really requires as much government as they have. That there are 86 municipalities in the Federation, each with its own mayor, council, and government structures, for only about two million people is clearly excessive. Add to this the ten cantons, also with councils and a selected executive, service providers and all the other structures of government, and there is clearly considerable burden.

It is not enough, however, merely to point out that there are a large number of governmental institutions in BiH. What is particularly important for this study is that the creation of taxes, the beneficiaries of the revenues to be collected, and the responsibility for collecting those same taxes all lie with different parties. For instance, in the Federation the cantonal governments establish the property tax, the revenues of which are to be collected by the TAFBiH, for the coffers of the municipalities. This separation of authorities from responsibilities has led to a poorly designed and poorly implemented tax system, as has already been described.

The creation of new taxes seems to be quite haphazard and outside of the regular legislative process. For instance, in the Federation Official Gazette no.8/04, published on February 13, 2004, the Federation Minister of Finance amended the Rulebook on the manner of paying public revenues in the territory of the Federation. The Minister’s decree established the following two new taxes:

1. Special tax on wages for protection of natural and other disasters, code revenue 719114
2. Special tax on wages for protection of natural and other disasters based on intermittently and temporary contracts, code revenue 719115.

Not only are these two new taxes inconsistent with the notions of good taxation and the recommendations made in this paper, but they are also enacted as government decree rather than as law.

The international community and the authorities at the appropriate entity levels should develop an Organic Law on the Public Revenues of the Federation and an Organic Law on the Public Revenues of the RS. This Tax Guidance Law would provide the guidelines for good taxation in the Federation and RS. This would provide the basic strictures within which tax policy could be set, some of which are touched upon in Annex D.

9. Gap analysis

This gap analysis presents in brief the areas of work within the fiscal sector that are receiving donor attention and then points out those areas of work that require donor attention and assistance, as would be required to help implement the many recommendations in this report.

At present five international organizations or donors are involved in strengthening BiH's fiscal system: USG, the Government of Germany, the European Commission, the IMF and the World Bank.

9.1. US Assistance in Tax Administration Modernization

The US assistance, administered through USAID is assisting TARS, TAFBIH and TABD to modernize tax administration, in most, but not all process areas. This US assistance is referred to as the Tax Administration Modernization Project (TAMP).

Other US assistance, administered through UST has focused on establishing a legal and regulatory framework for a modernized tax administration system. This has included preparing tax administration laws and rulebooks to provide for a unified taxpayer identification number, centralized processing of tax declarations, a system of penalties and appeals and a functional organizational structure.

9.2. German Technical Assistance

German assistance, implemented by the GTZ, has been focused on developing corporate and personal income tax laws and test piloting these in Brcko. The intention is to extend these two new tax laws throughout both the Federation and the RS.

The IC had called GTZ to lead this work based on its successful experience in income tax reform in Croatia during 1993 - 1999. GTZ developed a general

analysis of income taxation, both of individuals and corporations, before starting the project in 2000. When GTZ started the project, they were requested, as a result of the findings of a workshop with representatives from the two entities and Brcko, to focus on the reform of the income tax. A presentation of the concept towards a reform of the present taxes related to the income of natural persons and corporations was made to the IAG-T in February, 2001.

Since 2001, GTZ has been working with a national working group comprising representatives from the Ministries of Finance from the RS, the Federation and Brcko. The agreement reached in that group was to replace the variety of income taxes with a modern comprehensive approach for the whole country. The GTZ approach was accepted by this working level as a concept, which would be much easier to apply than the then current system.

By the time of that the research for this study was being conducted, Brcko had introduced the system, the Federation had come up with a draft on the reform of the personal income tax, which follows the Brcko law, and the RS was still reluctant. The IAGT asked GTZ in 2003 to separate from the comprehensive income tax draft on the taxation of profits for the RS and the Federation. After the draft of this report was presented to the IC, the OHR presented the GTZ-drafted laws to the Ministries of Finance of the two Entities, both of which has subsequently notified the IC of their intentions to implement the new income taxes.

9.3. European Union

The EU assistance is implemented under a project called the Customs and Fiscal Assistance Office (CAFAO). CAFAO has been assisting the TARS and TAFBIH mainly in the enforcement and debt management aspects of taxation. CAFAO's assistance in domestic taxation has focused mainly on the largest taxpayers in the two entities. Assistance has mainly been in terms of training, assistance in undertaking audits/inspections, and some limited amount of equipment.

Much assistance has been provided by CAFAO in terms of enforcement, fraud and smuggling control, and systems development for the state-level Customs organization. CAFAO is also assisting in setting up the Indirect Taxation Administration (ITA), which will be responsible for implementing the new VAT, all customs, and excise. Indeed, CAFAO has been the lead IC participant responsible for the overall drafting of legislation establishing the VAT and the ITA. These revenues will accrue to the State and be distributed to the Entities, according to formulae yet to be developed.

With the ITA's entry into operations early in 2005, CAFAO is planning to withdraw its assistance to the two entity tax administrations. This leaves a very large gap in the IC's tax administration assistance agenda.

9.4. IMF

The IMF is responsible for providing overall macro-fiscal advice to the State and the two Entities. In addition, the IMF is planning to provide limited technical assistance to help the ITA establish a policy analysis group that will focus on analyzing tax and allocation issues at the State level.

9.5. World Bank

The World Bank is planning to study the pension and health funds in both entities. The RFP was recently released and implementation will initiate in the near future.

9.6. The Gap

A number of areas of crucial importance have not been addressed by the International Community.

The technical work carried out by TAMP has included all aspects of tax administration that fall under the purview of TARS, TAFBIH, and TABD, except those related to audit, audit selection and control, inspection, enforcement and criminal investigation.¹⁴ If these aspects of tax administration were automated and computerized information management were implemented for them, TAMP's technical work would allow them to tie directly into the IT systems and operations. Unfortunately, there have been no systems installed for these aspects. Auditors not only are not well trained, they have no computerized information systems, they have no risk analysis capabilities, and they have no data/telecommunications links with the rest of the tax administration. This is a gaping hole that must be filled. A tax administration that has automated all of its systems save audit and collection can expect little improvement in compliance.

Other than the assistance from GTZ on income tax reform, the report of the World Bank, and the macro-fiscal policy monitoring of the IMF, the IC has given scant attention to comprehensive analysis of the tax systems in BiH.

Little or no effort has been given by the IC to establishing analytic and policymaking capacity in the area of taxation, or, indeed, fiscal policy. This is illustrated clearly in the recent IMF Art. IV consultation addressed to the BiH authorities, as follows:

“This demanding reform agenda will require a strengthening of your policymaking structures if it is not to falter, especially in the context of a prospective diminution in the role of the Office of the High Representative (OHR). In particular:

¹⁴ While USG assistance through TAMP and UST has covered a broad range of tax administration improvements, authority was not provided to pursue tax policy reform, audit and enforcement, and certain administrative processes.

You lack an institution to establish a target for the annual consolidated fiscal balance and to apportion that target into its Entity and State components. You also lack a mechanism to ensure realization of the consolidated balance target through the year. These institutional gaps are essentially now filled, by default, by the IMF, a practice that should be terminated: this is not our mandate; these institutions form an essential counterpart to the currency board; you need them whether or not you are engaged with the IMF; and they are a core element of the effective exercise of your fiscal sovereignty. We suggest that you develop the ITA Governing Board into a Fiscal Council to undertake these tasks as well as to provide an informal venue for coordination across the whole gamut of fiscal and broader economic issues.”

10. Concluding remarks

A comprehensive and integrated tax reform as prescribed in this study is urgently needed. The current system impedes economic development, makes it costly for small, medium and larger businesses to operate legally in the country, and it turns ordinary citizens into lawbreakers. It is uneconomical, regressive, and impossible to enforce. The onerous tax policies and tax payment and compliance procedures almost force successful businesspersons to break the law. Small businesses stay small on purpose, trying to keep below the tax authorities' radar.

One means of encouraging the growth of the SME sector is to encourage the entry of larger enterprises funded by foreign investment. Such foreign investment can spawn a circle of SMEs that provide services and supplies needed by these larger firms. The structure of taxation in BiH, with different rates or tax bases applied from municipality to municipality, can discourage foreign investment. Without such foreign investment, SME development will be anemic.

The opening of the country to freer trade with its neighbors is leading to secular decline in revenues based on imports. These declines must be made up for with the rationalization of the rest of the tax system. The introduction of the VAT in 2006 does not obviate the need for reform in the rest of the tax system, rather it requires it. A VAT can combine well with a strong customs operation and a solid system of direct taxes to raise compliance and fairness. Most observers consider the VAT to be regressive.¹⁵ Introduction of the VAT must be matched by direct taxes reform to ensure that social incidence of taxation is optimal for society.

The most direct case for urging this reform is that donors have been pouring tens of millions of Euros into improving tax administration and tax enforcement and now is the time to give greater emphasis to the policy environment. If donors do not

¹⁵ There is a school of thought that holds that the VAT is a proportional rather than regressive tax, but this is not a consensus opinion.

deal effectively with the problems uncovered by this study the tens of millions of Euros invested by the collective members of the international community will fail to achieve maximum developmental impact.

The future is hopeful. The efforts to-date on creating the data systems and bringing about real organizational change have laid a solid basis for moving toward an SME-friendly tax system. The opportunity to capitalize on previous efforts should not be missed and the focus for the future should be to consolidate the improvements in the tax systems so far, move into the areas of tax audit and collections, and rationalize tax policy while building policy capacity.

Documents reviewed

The following laws and documents were reviewed in the preparation of this report:

LAWS

1. Constitution of Bosnia and Herzegovina.
2. Constitution of the Federation of Bosnia and Herzegovina, "Official Gazette" of the Federation of Bosnia and Herzegovina, 1/94, 13/97, 16/02, 22/02, 52/02, 60/02, 18/03, 63/03. Translation from OHR
3. Property Tax Law of Gorazde Canton, excerpt from "Official Gazette" no: 6, dated June 01, 1996. Translation from TAMP.
4. Property Tax Law of Sarajevo Canton, excerpts from "Official Gazette" no information on dates. Translation from TAMP.
5. Federation Contributions Law, Official Gazette no. 35, 1998.
6. OHR's Second Decision Amending the Federation Law on Contributions, Dec. 20, 2000.
7. Federation Law on Corporate Income Tax, December 1997.
8. Law on the Changes and Additions to the Law on Corporate Income Tax, 29/00.
9. Federation Law on Wage Tax Instruction.
10. Federation Law on Sales Tax on the Turnover of Goods and Services.
11. Federation Laws on Excise Taxes and Rulebook.
12. Federation Law on Contributions and Instructions.
13. Federation Order regarding payment accounts of revenues.
14. Federation Book of Rules on Taxpayer Return Procedure.
15. Federation Law on Allocation of Public Revenues, "Official Gazette" of the Federation of Bosnia and Herzegovina, 26/96.
16. Decree on Method of Submitting and Processing of Accounting Statements on Successful Business of Legal Entities in the Federation of BiH, 2003.
17. Rulebook on Amendments of the Rulebook on Manner of Payment of Public Revenues of the Budget and Non-Budgetary Funds on the Territory

of the Federation of Bosnia and Herzegovina, Official Gazette of FBiH, no. 8/2004, February 13, 2004.

18. The Law on Taxes of Sarajevo Canton, April 11, 2002.
19. Constitution of Republika Srpska.
20. Law on the Budget System of Republic of Srpska, "RS Official Gazette" no. 96/03.
21. Draft Profit Tax Law for Brcko, Federation, and Republika Srpska
22. The General Regulation on Income Tax of the Brcko District
23. Law on Indirect Taxation System in Bosnia and Herzegovina, Parliamentary Assembly of Bosnia and Herzegovina, No: 132/03

REPORTS

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27. *Analytical Report on Administrative and Regulatory Costs Survey for Bosnia and Herzegovina 2002*. No authors or institutions included with paper.
28. "Bosnia and Herzegovina: Creating a Stable Decentralized Fiscal System," February, 2003. World Bank.
29. IMF, BOSNIA AND HERZEGOVINA: Request for Stand-By Arrangement – Staff Report, August 2002.
30. IMF, BOSNIA AND HERZEGOVINA: Second and Third Reviews under the Stand-By Arrangement, April 28, 2003
31. IMF, BOSNIA AND HERZEGOVINA: 2004 Article IV Consultation Mission Concluding Statement, December 17, 2003
32. Rose, Manfred, *Comments on the Draft of a new Income Tax Law for Bosnia and Herzegovina*, Feb. 03.
33. _____, *Tax Reform and Micro Simulation in BiH*

34. Keen, Michael and John King (2002) *The Croatian Profit Tax: An ACE in Practice*, June.
35. Report No. 24297-BIH, *Bosnia and Herzegovina: From Aid Dependency to Fiscal Self-Reliance*, A Public Expenditure and Institutional Review, World Bank, October 2002.
36. ENHANCING BUSINESS CLIMATE TO ATTRACT DOMESTIC AND FOREIGN INVESTMENT, from the Draft Poverty Reductions Strategy Paper, available from the World Bank, Bosnia, website: www.worldbank.ba.
37. COUNTRY ASSISTANCE STRATEGY OF THE WORLD BANK GROUP FOR BOSNIA AND HERZEGOVINA, June 14,2000.
38. Public Expenditure Conference, *Applying Subsidiarity Principle in the Transition Context: Lessons from South East Europe to Guide the Diagnosis in BIH*, presentation by Margret Thalwitz, Sarajevo, March 4-5 2003.
39. Bosnia and Herzegovina: Creating a Stable Decentralized Fiscal System, presentation by Larry Hannah, World Bank.

Annex A: Scope of Work: Analysis of SME Taxation Issues
January 27 - February 17, 2004

- There are three principal donors at work in taxation reform in BiH.
 - CAFAO/EC is spearheading indirect taxation reform,
 - GTZ is drafting enterprise and individual tax laws (currently being pilot tested in Brcko), while
 - USAID has, to date, focused on the important issue of tax administration modernization (TAMP I and II). This effort was conceived by and is closely coordinated with US Treasury.

- Concern has been expressed at USG senior levels that no donor is really focusing on creating a more tax friendly environment for SMEs in BiH.
- We have arranged for a TDY consultant (January 27 - February 17) who will put together a report that clearly describes:
 - The current reform effort;
 - The full extent of taxes and fees (great and small) that SMEs are subjected;
 - A “gap analysis” of what is not being addressed by the donors, to the detriment of the SME community; and
 - A recommended plan of action

- The recommendations could include a refocusing of the TAMP II activity into one more directly supportive of SMEs (in addition to the ongoing modernization effort).
- The TDY visit will include:
 - A kick-off meeting with USAID and EMB o/a January 29
 - Interviews with IMF, GTZ, CAFAO, OHR, local business leaders, and BiH government counterparts
 - A review and commentary (as to degree of SME “friendliness”) of the draft enterprise taxation laws prepared by GTZ
 - A wrap up meeting where findings and recommendations are presented and discussed with USAID and EMB o/a February 16. Others in the IC community may also be invited to this meeting

Annex B: A Guide to Good Taxation

The rules of good taxation have already been written and do not need to be reinvented for this exercise. That said, it is worthwhile summarizing these rules here.

The best tax is that which is paid by others. This focus, of course, is quite special, but universal, too. The point is that no one wishes to pay taxes; taxes are paid because we are made to pay them, and without systems of control and enforcement, the entire system becomes dysfunctional.

The second best tax system is characterized by a high degree of compliance, where everyone contributes and the personal burden is not considered too onerous or confiscatory. This means relatively low rates and with very few exemptions and exonerations. We refer to this as “horizontal equity.”

It is common throughout the world to introduce a degree of “progressivity” into the tax system. This is the concept of paying according to one’s ability to pay. When we talk about progressivity we mean that the rich ought to contribute not proportionately, but rather, more than proportionately, that is, they should pay a higher share of their incomes. Normally, income taxes are justified by their element of progressivity.

In a market economy, where the role of the state is mainly restricted to the provision of public goods and where the major share of decisions about production, investment, and the employment of national resources is in the hands of the private sector, the tax system ought to have minimal impact over these decisions, i.e., the tax system should have a minimal “distortionary” impact on the decisions of private sector economic agents (consumers, farmers, big business and SMEs, too).

The specific criteria for evaluating any tax system must include the following:

1. *Efficiency*: This economic concept in a market economy is of great importance. In simplest terms, this refers to the degree to which the tax system distorts the decision-making of economic agents in society. This is mainly in terms of how the tax system alters relative prices, or causes prices to deviate from their economic values. The system that best encourages economic growth through high and productive investment, full employment, and high productivity of all the factors of production with the lowest consumer prices possible, is the most efficient tax system.
2. *Simplicity*: The simplicity of the tax system is an important criterion, because any complex and confusing system is open to fraud, collusion, and twisted and distorted application. In general, the tax system must be manageable by the tax administration and compliance should be easy for the taxpayer. It is possible that the most efficient tax system will not be the simplest since it might require a complex and highly capable tax administration, strong legal system, including appeals and tax courts, and a

supreme degree of political will to ward off the assaults of rent-seekers, not all of which is that common around the world.

3. *Equitable treatment*: The system must treat all taxpayers, to the extent practicable, in the same way. This implies that two persons with the same capacity to pay ought to be treated equally by the tax system. This fair treatment has two benefits. One is that it creates a sense of justice or fairness in the system. The second is that it promotes the first two criteria, i.e., equitable treatment is normally less distortionary and it is usually simpler.

Chapter 10 in Tanzi (1991) provides an excellent set of additional criteria for evaluating any tax system.¹⁶ Among them, are the following:

4. *Concentration*: The more concentrated the tax system, in terms of collections from a limited number of taxes, the better. That is, a tax system should focus on a few high-yielding taxes and not waste resources and attention on a great series of low-yield or low-productivity taxes.
5. *Dispersion*: The other face of the coin is that the tax system should not have a large number of taxes with high administrative and compliance costs that bring in little revenues for the fisc.
6. *Erosion*: Tanzi warns governments to avoid eroding their tax bases through exoneration of activities, products or persons because this results not only in inequitable treatment but also in the necessity to raise tax rates over the non-exempt tax bases. This can lead to greater economic distortions and creates greater incentives to fraud. From the collections point of view, erosion reduces the returns to tax efforts and raises the average costs of the overall system.
7. *Objectivity*: To the greatest extent possible, all the tax definitions must be clear in their definition, the taxable event must be well established in law and economic and accounting concepts should be as similar as possible. The tax system should be understandable to the majority of taxpayers.
8. *Compliance*: Tanzi points out that any system must be well enforced. A low compliance system has economic and social effects that are difficult to identify and represent ineffectual tax policy.
9. *Cost*: Administrative costs must be minimized. This is not to say that the administrative costs must be absolutely low, but that the system should be structured and implemented in the most manageable way and that tax administrators, and computerized systems of information and control should be optimized.

¹⁶ Tanzi, Vito (1991) *Public Finance in Developing Countries*, Edward Elgar Publishing, England.

Annex C: Partial list of persons interviewed¹⁷

Mr. Marc Campbell, OHR and Chair of the IAG-T
Ms. Irina Smirnof, World Bank
Mr. Tarik Sahovic, World Bank
Mr. Chris Miller, Chief of Party of the USAID-Urban Institute Policy Analysis and Dialogue Organizations Project
Ms. Valeria Ficheria, International Monetary Fund
Ms. Berina Salimovic-Mehmedhasic, IMF
Mr. Roland von Frankenhorst, GTZ
Mr. Fahrudin Gvozdar, GTZ
Mr. Mirzet Ribic, Local Initiatives Project II
Mr. Alexander Paine, Southeast Europe Enterprise Development
Ms. Zinaida Elezovic, TAFBIH cantonal Office
Ms. Anne Schwartz, UST
Mr. Heni Cesir, TAFBIH, Branch Office Centar
Mr. Hasib Gibanica, Treasurer, Sarajevo Canton MINFIN
Mr. Steven Farkas, SME Project
Mr. Andre Zabel, CAFAO
Mr. Chris Nesbit, CAFAO
Ms. Britt Tryding, OSCE
Ms. Arlett Stojanovic, OSCE
Mr. Miodrag Kudic, Assistant Minister for Fiscal System, RS MoF
Mr. Ranko Krsman, Head of Municipal Budgets, RS MoF
Mr. Zdravko Mionic, Assistant Minister for Treasury, RS MoF
Mr. Miodrag Duric, Director TARS
Ms. Radmila Stojnic, Head Finance, Banja Luka Municipality
Ms. Vera Mirjanic, Head of Finance, Laktaski Municipality
Mr. Osman Osmanovic, Treasurer, Brcko District
Mr. Akif Peserovic, Assistant Treasurer, Brcko District
Mr. Midrag Trifkovic, Director of Tax Administration, Brcko District
Ms. Chever X. Voltmer, US Embassy
Ms. Darlene Berthod, UST
Mr. William Lawrence, USAID
Mr. John Seong, USAID

¹⁷ To ensure confidentiality, the names of private sector individuals that were interviewed for this study are not included here.

Annex D: The distribution of revenues, expenditures, and competencies

Level of Government	Governing structure	Revenue collections and revenue creation authorities	Service provision and legal bases
State	Presidency 3 members, Council of Ministers headed by Prime Minister, Parliamentary Assembly	0.05% of total BiH revenues are at the State level. Contributions from entities (2/3 Federation, 1/3 RS). Does not have the authority to create taxes and fees.	1.3% of all expenditures take place at this level. The following matters are the responsibility of the institutions of Bosnia and Herzegovina: <ul style="list-style-type: none"> a. Foreign policy. b. Foreign trade policy. c. Customs policy. d. Monetary policy e. Finances of the institutions and for the international obligations of Bosnia and Herzegovina. f. Immigration, refugee, and asylum policy and regulation. International and inter-Entity criminal law enforcement, including relations with Interpol. <ul style="list-style-type: none"> h. Establishment and operation of common and international communications facilities. i. Regulation of inter-Entity transportation. j. Air traffic control. (Constitution of BiH, Arr.III)
Federation	President of the FBiH, 2 Vice-presidents, Federation Government, Federation Parliament (2 Houses)	18% of BiH revenues are at the Federation level. All the revenues are paid into the FBiH Treasury. FBiH revenues are: customs, excises, profit tax on financial organizations, Electrical company Elektroprivreda, Telecom, and Lottery, FBiH fees, FBiH court fees, fines in acc. with Federation regulations, income from natural resources, donations, other (from property etc). Authorities: FBiH shall have exclusive responsibility of regulating finances and financial institutions of the FBiH and fiscal policy of	About 18% of all government expenditures take place in the Federation. The Federation shall have exclusive responsibility for: ¹⁸ <ul style="list-style-type: none"> (a) conclusion of military agreements pursuant to the Constitution of Bosnia and Herzegovina; and cooperation with Standing Committee for Military Matters and Council of Ministers of Bosnia and Herzegovina and other institutions at state level responsible for military and defence matters.¹⁹ (b) Citizenship of the Federation,²⁰ (c) Making economic policy, including planning and reconstruction, and land use policy on the federal level,²¹ (d) Regulating finances and financial institutions of the Federation and fiscal policy of the Federation,²² (e) Combating terrorism, inter-cantonal crimes, drug trafficking and organized

¹⁸ Am. VIII, originally “The Federation Government is to have exclusive responsibility for:” The original letter (a) “Conducting foreign affairs” is deleted.

¹⁹ Am. LXXXIX, originally “Organizing and conducting the defense of the Federation and protecting its territory, including establishing a joint command of all military forces in the Federation, controlling military production, signing military agreements according to the Constitution of Bosnia and Herzegovina; cooperating with the Standing Committee on Military Matters and the Council of Ministers in defense of Bosnia and Herzegovina.

²⁰ Am. VIII, originally under “(c) Citizenship”.

²¹ Am. VIII, original letter (e) “Regulating commerce, including customs, international trade and finance, trade within the Federation, industrial property rights, product standards, securities, and communications” has been deleted.

²² Am. VIII, originally under (f) as “Regulating finance and financial institutions, including establishing and controlling the currency of the Federation, making monetary and fiscal policy, and establishing a central bank”.

Level of Government	Governing structure	Revenue collections and revenue creation authorities	Service provision and legal bases
		<p>FBIH.(Constitution FBIH,art. 1 d)Sect. Division of responsibilities between the FBIH Government and cantons)</p>	<p>crimes, drug trafficking and organized crime.²³</p> <p>(f) Allocating electronic frequencies for radio, TV and other purposes, according to the BH Constitution.²⁴</p> <p>(g) Making energy policy, including inter-cantonal distribution matters, and providing and maintaining the related infrastructure.</p> <p>(h) Financing activities of or under the aegis of the Federal Government by taxation, borrowing, or other means. (Constitution of the FBIH Art.1,Division of responsibilities between Federation and cantons).</p> <p>Both the Federation Government and the cantons are to have responsibilities for the following:</p> <p>Guaranteeing and enforcing human rights; Health;</p> <p>Environmental policy;</p> <p>Infrastructure for communications and transport, according to the Constitution of Bosnia and Herzegovina.²⁵</p> <p>Social welfare policy;</p> <p>Implementing laws and regulations concerning citizenship;</p> <p>Implementing laws and regulations concerning citizenship and passports of citizens of Bosnia and Herzegovina from the Federation territory, and on foreigners staying and movement.²⁶</p> <p>Tourism; and</p> <p>Use of natural resources.</p> <p>(Constitution of the FBIH Art.2,Division of responsibilities between Federation and cantons).</p>
Canton	<p>There are 10 cantons in the Federation, one Prime Minister each, unicameral legislature, cantonal courts</p>	<p>20% of all government revenues accrue to the Federation's cantons. All the revenues are paid into the cantonal Treasury. Canton revenues: sales tax ,profit tax except enterprises mentioned as federation revenue, wage tax, fines in acc. with canton regulations, donations, other revenues(canton fees- canton court fees, fines etc). Authorities: The revenues which belong to the cantons shall be determined by</p>	<p>Almost 25% of all expenditures are executed in the cantons. The cantons shall have all responsibility not expressly granted to the Federation Government. They shall have, in particular, responsibility for:</p> <p>(a) Establishing and controlling police forces, which shall have identical Federation uniforms, with cantonal insignia.</p> <p>(b) Making education policy, including decisions concerning the regulation and provision of education.</p> <p>(c) Making and conducting cultural policy.</p> <p>(d) Making housing policy, including decisions concerning the regulation and provision of housing.</p> <p>(e) Making policy concerning the regulation</p>

²³ Am. VIII, originally under (g) as “Combatting international and inter-cantonal crimes, in particular terrorism, drug trafficking, and organized crime, and cooperating with Interpol.”

²⁴ Added by Am. VIII.

²⁵ Am. IX, originally “(d) Infrastructure for communications and transport”.

²⁶ Am. IX, originally “(g) Immigration and asylum”.

Level of Government	Governing structure	Revenue collections and revenue creation authorities	Service provision and legal bases
		<p>separate FBiH regulations.(Sales tax, profit tax, wage tax). Legislative bodies of the cantons shall pass laws on cantonal fees (court fees, administrative fees, etc.).(Art 7 Law on assignment of public revenues in FBiH)</p>	<p>and provision of public services. (f) Regulating local land use, including by zoning. (g) Regulating and promoting local business and charitable activities. (h) Regulating and ensuring the availability of local energy production facilities. (i) Making policy concerning radio and television facilities, including decisions concerning regulation and provision thereof. (j) Implementing social welfare policy and providing social welfare services. (k) Establishing and implementing cantonal tourism policy; developing tourism resources. (l) Financing activities of or under the aegis of the cantonal government by taxation, borrowing, or other means.</p>
Municipality	<p>The Federation has 86 Municipalities, each with its own Council and Executive elected by Council, municipal courts; City of Sarajevo w/ Mayor</p>	<p>About 5% of all government revenues accrue to the Federation's municipalities. Revenues are paid into cantonal Treasury and canton then forwards its proportion to municipality. Canton establishes the Law, and Municipality councils give ordinance on municipality fees and fines, tax on agriculture, property tax, income from renting property etc). Authorities: Public revenues shall be allocated to municipalities according to cantonal regulations. Municipal Councils shall pass regulations on municipal fees (utility fees, fines, etc.), as well as regulations on taxation (agriculture tax, property tax, tax (missing text) from property, etc.), and in other manners provide the necessary funding(.Art 8 Law on assignment of public revenues in the FBiH).</p>	<p>Federation municipalities comprise about 6% of all governmental spending in BiH. (1) Each canton may confer its responsibilities to a municipality or city in its territory, or to the federal authority.²⁷ (2) Each canton may delegate functions concerning education, culture, tourism, local business and charitable activities,²⁸ and radio and television to a municipality or city in its territory, and is obliged to do so if the majority of population in the municipality or city is other than that of the canton as a whole.²⁹ (Constitution of FBiH, Art.2, cantonal Governments) Less than 6% of all expenditures. Soc. Asst; Pre-school, primary schl maintenance, busses, secondary schl; Ambulances, health care supplies; Trash collection; Sewage treat; Water & publ util; City planning; Culture, sport, parks, street lighting; Libraries</p>

²⁷ Am. XV, originally "Each Canton is authorized to delegate or confer its responsibilities to Municipalities in its territory or to the Federation Government."

²⁸ Am. XV, originally "organizations".

²⁹ Am. XV, originally "to its Municipalities and shall do so to those Municipalities whose majority population is other than that of the Canton as a whole."

Level of Government	Governing structure	Revenue collections and revenue creation authorities	Service provision and legal bases
RS		<p>About 17% of all government revenues accrue to the budget of the Republika Srpska. Authorities: RS (National Assembly of RS) shall have exclusive responsibility of regulating finances and financial institutions of the RS and fiscal policy of RS.</p>	<p>Almost 17% of all expenditures. The Republic shall regulate and ensure: (Constitution of RS, Article 68)</p> <ol style="list-style-type: none"> 1. integrity, constitutional order and territorial unity of the Republic; 2. defence and security; 3. measures in case of the state of, imminent threat of war and the state of emergency; 4. constitutionality and legality; 5. implementation and protection of human rights and freedoms; 6. property and obligation relations and protection of all forms of property, legal status of enterprises and other organisations, their associations and chambers, economic relations with foreign countries, which have not been transferred to institutions of Bosnia and Herzegovina, market and planning; 7. banking and tax system; 8. main objectives and directions of economic, scientific, technological, demographic and social development, the development of agriculture and the village, the use of space, politics and measures for direction of the development and commodities; 9. control of legality of the disposal of means of legal entities and the collection of statistical and other data of general interest; 10. organisation, competence and the work of State bodies; 11. public services system; 12. work relations, safety at work, employment, social insurance and other forms of social care, health care, soldiers and invalid protection, child and youth care, education, culture and cultural resources protection, physical culture; 13. environmental protection; 14. public information system; 15. international co-operation, with the exception of the one transferred to institutions of Bosnia and Herzegovina. 16. financing the exercise of the rights and duties of the Republic; 17. other relations relevant for the Republic, in accordance with the Constitution".
Municipality		<p>2.3% of all governmental spending. Authorities: Public revenues shall be allocated to municipalities according to Republic regulations. Municipal Councils shall pass regulations on municipal fees.</p>	<p>About 2% of all expenditures. The municipality shall, through its bodies, and in accordance with the law:</p> <ol style="list-style-type: none"> 1. enact a development program, urban planning, budget and annual balance sheet; 2. regulate and ensure performing of the municipal activities; 3. regulate and ensure the use of urban construction sites and business premises;

Level of Government	Governing structure	Revenue collections and revenue creation authorities	Service provision and legal bases
		fees.	<p>4. take care of construction, maintenance and use of local infrastructure, and other public facilities of importance to the municipality;</p> <p>5. take care of meeting specific needs of citizens in the areas of culture, education, health and social welfare, physical culture, public information, handicrafts, tourist trade and catering services, environment protection and other areas;</p> <p>6. execute laws, other regulations and general enactments of the Republic whose execution is entrusted to the municipality, provide for the execution of regulations and general enactments of the municipality;</p> <p>7. establish agencies, organisations and services to meet the needs of the municipality, and regulate their organization and work;</p> <p>8. attend to other business as established by the Constitution, the law and the statute of the municipality.</p>
Public Funds		33% of all public revues go to the health, retirement, child protection, and unemployment funds. RS and Federation have separate funds. These combine to this total.	
Brcko		4% excluding utilities. Brcko has the same taxing authorities as the Entities. It sets its own excise tax rates on traffic entering BiH through its jurisdiction.	