



USAID
FROM THE AMERICAN PEOPLE

USAID ASSISTANCE IN FISCAL REFORM

TAX MODERNIZATION IN BOSNIA AND HERZEGOVINA

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BOSNIA AND HERZEGOVINA

USAID ASSISTANCE IN TAX MODERNIZATION

I. PROJECT DATA

Level of Funding: Phase I: \$2,119,898 / Phase II: \$10,638,878.01

Period of Assistance: Phase I: 2001-2002 / Phase II: 2003-2006

Types of Assistance:

1. Technical Assistance (in conjunction with US Treasury and other donors)
2. Equipment and Materials (including hardware, software and data communications infrastructure)
3. Training (including formal and on-the-job training and international study tours)

Areas of Assistance:

1. Tax Administration Business Processes
2. Automation
3. Capacity Building
4. Tax Law and Policy Analysis

Main Counterparts:

1. Tax Administrations
2. Ministries of Finance

II. THE PROJECT: BACKGROUND, PRINCIPAL RESULTS AND IMPACT

From 2001 to mid-2006, USAID provided more than \$12 million in assistance to Bosnia and Herzegovina's (BiH) three constituent governments—the Federation of Bosnia and Herzegovina, the Republic of Srpska, and Brcko District—to modernize their tax systems and strengthen their institutional capacity to administer taxes. USAID's tax assistance in BiH focused in the first phase on building the capacity of the three domestic tax administrations: the Tax Administration of the Republic of Srpska; the Tax Administration of the Federation of Bosnia and Herzegovina; and the Tax Administration of Brcko District.

With USAID support, the Federation, Republic of Srpska, and Brcko District tax administrations centralized and automated their tax databases, instituted centralized tax processing, and installed a variety of hardware, software and data communications infrastructure, laying the foundations for "paperless" tax administration in BiH. These changes vastly improved the way the tax authorities performed their core functions and interacted with the public, and ultimately enhanced their ability to collect public revenues. Between 2001 and 2004, the most active period of USAID's tax administration assistance, tax revenues throughout BiH grew at an annual rate of more than 15 percent—roughly triple the rate of economic growth—without substantial changes in tax policy. Even after 2004, when collection of sales and excise taxes—two of the main tax handles in BiH—

became the domain of the new, separate State-level Indirect Tax Authority (ITA)¹, taxes collected by the Entity and Brcko tax administrations have continued to grow apace. In the Federation, for example, these revenues have continued to grow by more than 10 percent compared to the pre-ITA period.

These results illustrate that in some instances, a tax administration reform project can have significant returns through strengthening administration, even without accompanying policy changes. In 2004, as the scope of assistance expanded into the tax policy realm, USAID established active partnerships with the Federation and RS Ministries of Finance and with Brcko District's Revenue Agency. It was arguably through the successes in its tax administration work that USAID built the confidence among local counterparts and the International Community to delve into bold tax policy reforms at that point.

A. Background and Economic Context of the Project

US economic assistance to BiH began with the signing of the Dayton Accords in December 1995. The Accords represent the peace agreement among the three major ethnic groups in Bosnia—Bosniacs (Muslim), Croats, and Serbs—and also form the BiH constitution. The Accords recognize two “Entities” in the country. One, the Republic of Srpska (RS), is mostly populated by Serbs. The second entity is known as the Federation of Bosnia and Herzegovina, which consists of ten Cantons, similar to counties in the US. Bosniacs and Croats are the main ethnic groups in this Entity. In addition, the District of Brcko, a small sliver of land bridging two non-contiguous parts of the RS, was established later, in 1999. Its population includes a mix of the three major ethnic groups. Overall, the BiH population, accounting for all three jurisdictions, is estimated to be around 4 million,² with roughly 90,000 registered taxpayers in the Federation, 60,000 in the RS, and a little over 4,000 in Brcko District.

In 2001, the BiH tax system was in flux. A decade after the disintegration of Yugoslavia, taxes were beginning to play a more important role in government finances as the currency board, adopted in 1997, eliminated the option of printing money. With the economy beginning to slow after several years of rapid postwar growth, and customs revenues declining as the country reduced tariff rates and opened to trade, the ability of the BiH governments to collect non-trade taxes was becoming increasingly critical.

Yet, the tax system was operating on weak foundations. Tax offices were in poor condition and lacked adequate hardware and communications infrastructure. Archives were in disorder, taxpayer registries were outdated, and assessments were poorly enforced. Tax reporting was onerous and requirements unclear, complicating both administration and compliance. Furthermore, tax offices were highly decentralized, leaving tax administration open to corruption and local influence. As a result, compliance rates were low and tax evasion was rampant.

¹ In January 2005, the Indirect Taxation Authority (ITA), took over responsibility for all operations of the old customs authority as well as domestic excises and sales taxes from the RS, FBiH and Brcko District tax administrations. A State-wide Value Added Tax, also administered by ITA, replaced the Entity-level sales taxes on January 1, 2006. The ITA's establishment left the RS, FBiH and Brcko tax administrations with responsibility for *direct* taxes only.

² BiH population figures remain in debate since the last nationwide census was conducted before the war.

Against this backdrop, and with strong support from the International Community, the Entities and Brcko District embarked on parallel efforts to modernize and streamline their tax institutions with the goal of achieving more centralized, efficient and harmonized tax administration. US Government assistance in support of these efforts was first provided by the US Treasury (UST). In close collaboration with USAID and other members of the International Community, UST helped the three governments usher through new tax administration laws. The new laws introduced the concept of taxpayer self-assessment; laid out the framework for a taxpayer registration system based on a unique taxpayer identification number (TIN); and, instituted new, functional organization structures with centralized management oversight and special divisions for taxpayer registration, taxpayer services, larger taxpayer control, and internal audit.

While the UST efforts were already underway, the USAID Mission in BiH launched the Tax Administration Modernization Project (TAMP), which became the main vehicle for US Government assistance in the tax area from 2001 to 2006. TAMP's broad objective was to assist in implementing modern tax processes to improve efficiency, reduce corruption, achieve more standardized taxpayer treatment throughout BiH, and bring the tax system closer to EU standards.

The project was implemented in two "phases" spanning two Task Orders. TAMP I (September 2001-November 2002), the "design" phase, designed a new set of business processes; developed automation recommendations; and, designed the systems architecture, logistics, and human resource requirements for each of the three tax administrations. In an effort to avoid duplication of donor efforts, TAMP I did not address audit and enforcement functions, which were on the agenda of a separate European Union-funded assistance program.

TAMP II, which started in January 2003, was the "implementation" phase, and focused on assisting the Federation, the RS, and Brcko District to develop automated systems and implement the new business processes designed in the first phase. In August 2004, USAID extended TAMP II by 22 months—from August 31, 2004 to June 19, 2006—and expanded its scope to address critical tax policy issues, through which the project became a key player in reforms related to income and real estate taxation. Simultaneously, the project began to provide the tax administrations technical assistance and training in audit and enforcement, while EU assistance shifted to the establishment of the new, State-level Indirect Tax Authority and a State-wide Value Added Tax (VAT).

Below is a brief review of the principal accomplishments of USAID assistance, particularly under TAMP II. While results varied from Entity to Entity—in terms of tax administration efficiency, revenue yield, or other measures—it is clear that through USAID assistance, the tax authorities were able to develop the basic data systems and implement the key organizational changes needed to accommodate more comprehensive tax reforms in the future. In this respect, the project seems to have produced sustainable results. A follow-on USAID assistance activity (known as the Tax Reform Activity, or TARA) began in June 2006, which is to assist the BiH's constituent governments to build on the modernization efforts already completed, and to devote new attention to rationalizing tax policy to create a simpler, fair and business-friendly tax system.

B. Outcomes and Impacts in the Project's Principal Areas of Assistance

With the tax administration laws in place and the design of new systems and processes detailed in the Tactical Plan produced during the design phase, USAID quickly mobilized its technical assistance

team to implement the tax administrations' redesigned business processes and develop the automated systems to support them. The most significant outcomes and impacts are highlighted below.

1. Sound, Clean Taxpayer Registries

A crucial early initiative was the implementation of the new taxpayer registration systems provided for in the new tax administration laws. USAID assistance in this area actually began in mid-2002, during the course of TAMP I design activities, but continued with the launch of TAMP II in early 2003. Prior to the TIN system, taxpayer registries were out of date, inconsistent, and full of entries for defunct and "ghost" taxpayers to whom real traders would book transactions in order to avoid the tax liability. These entries had clogged the system for years and made enforcement of tax collections extremely difficult.

Working in coordination with US Treasury, the TAMP II team helped the tax administrations develop automated taxpayer registries with harmonized administrative procedures for taxpayer registration, a standardized registration database, and uniform data elements for all three tax administrations. Among other things, harmonized registration systems for the first time enabled effective data sharing on taxpayers among the three jurisdictions, providing an effective tool for improving fraud abatement and tax compliance. Project staff also developed new forms and educational materials for taxpayer registration, developed manuals and training materials, and provided training in the application of the new registration procedures to tax administration staff.

Simultaneously, between 2002 and 2003, the three tax administrations launched campaigns to clean up their taxpayer registries and re-register active taxpayers in their new registries, assigning a unique 13-digit TIN to each registrant. The tax administrations managed to clear their tax rolls of thousands of invalid entries and substantially raise the number of legitimate taxpayers enrolled on their master files. In the RS, registered businesses grew 35% between 2002 and 2004. In the Federation, the same figure almost tripled over the same period, greatly expanding the legitimate taxpayer base.

2. Centralized Tax Databases

The new taxpayer registration system formed one piece of a centralized tax accounts database that each tax administration developed with USAID assistance. The new database effectively integrated three sub-databases: the taxpayer registry, containing basic taxpayer information (name, address, TIN, etc.); a payments registry, reflecting tax payments made to the taxpayer's account; and a declarations registry, reflecting the taxpayer's reported tax liabilities.

The TIN formed the backbone of the centralized tax database, providing a unique "address" to which to direct all transactions for a particular taxpayer, no matter where the transaction took place. Once the systems were brought on-line, the TIN enabled quick and accurate posting to each account and gave tax authorities the ability to match information from various sources, making it easier to track and monitor taxpayers. Use of the same numbering system throughout BiH also made it possible to share tax account information among the tax administrations and the more than 120 tax offices (including cantonal and local/branch offices) countrywide.

An early decision by TAMP's information technology (IT) team to develop applications using "Freeware," rather than one of the costly "off-the-shelf" software packages, proved to be a wise one. Using Freeware with a primarily local IT team not only saved USAID significant budgetary outlays

for software and associated services. It also gave the tax administrations open access to the source code underpinning the databases, and gave them the freedom to make changes as they saw fit. When the RS Tax Administration decided to revert from the Firebird platform to Microsoft SQL in 2005, it was able to do so without losing any of the functionality of the systems developed with TAMP support.

3. Centralized Tax Processing

Aside from the taxpayer registries and centralized databases, the overarching and unifying achievements of USAID assistance were the establishment of Central Processing Centers (CPCs) and a data communications network to support centralized data management. In 2002 TAMP I's design team made the recommendation to move to centralized tax processing, in large part because the introduction of taxpayer self-assessment and taxpayer education programs greatly reduced the need for face-face contact with tax authorities. The CPCs were seen as a simple solution to cope with the large quantities of data that were beginning to flow into the system from taxpayers.

Working in close collaboration with the tax administrations, TAMP advisors developed a combination of new technologies to support the operation of the CPCs, including electronic scanning to upload paper filings; simplified and automated tax forms; automatic safeguards to detect errors; and, automated programs to generate notices for late filing, stop filing, and other tax-related events. TAMP assisted with the procurement of computers and other equipment and consulted on office layout and the design of new workstations. Project advisors also provided on-the-job training and developed functional manuals for managing the various aspects of CPC operations, from data entry and tax accounting to error correction and notice generation. In addition, TAMP staff worked closely with the tax administrations to simplify and rationalize tax forms. In the Federation, 55 different Entity and cantonal tax forms were consolidated into five and then automated for CPC use. Simultaneously, the tax administrations began to provide taxpayers free access to forms and information at local and branch offices, and initiated seminars to educate taxpayers on how to fill out the new forms and calculate their tax liabilities.

TAMP's active support led to the establishment of CPCs in the RS and Brcko District in less than 18 months. For the Federation, an initial "Testing and Processing Center" was set up in the capital, Sarajevo, but the tax administration later opened a permanent CPC site in the southern city of Mostar, which was on-line and fully operational by the second half of 2005.

4. Microwave Data Communications Network

To ensure reliable and efficient data transfer, TAMP designed and deployed a microwave-based data communications system that, when completed, connected all tax offices and the CPCs via a high-speed, low-cost network. At the project's outset, the available communications options in BiH were costly, unreliable and slow. TAMP's IT team took the decision to leverage new technologies, using Motorola's Canopy[®] wireless broadband platform, circumventing the local telecommunications monopoly. Wireless devices were installed on radio and television towers situated throughout the country, with each device providing connectivity to tax offices within its line-of-sight. Once deployed, communications costs were swiftly halved by the introduction of the network.

The microwave network led to rapid efficiency gains for all three tax administrations. An individual declaration filed in one tax office could now be received, transferred to the CPC, entered into the system, and then posted to the taxpayer's account within a matter of hours. In less than a year of

operations, the CPCs managed to catch up with and surpass the huge backlogs of filed declarations and bring taxpayer accounts up to date. Among other things, this made it easier to identify taxpayers for audit and prioritize collections enforcement.

“Real time” access to the centralized tax database not only improved the tax administration’s ability to track and monitor taxpayers, but also provided new conveniences for the taxpaying population. For instance, it greatly improved the process of issuing taxpayer certifications—certificates issued by the tax administration showing that a taxpayer is in good standing with the tax authorities—which are still needed to obtain certain licenses and permits in BiH. Indeed, a taxpayer could now walk into a local tax office and obtain a statement of his tax standing in a matter of minutes.

5. Forging a Tax Policy Reform Agenda

After a period of neglect of tax policy reform across Bosnia’s many tax entities, USAID in early 2004 commissioned a report that showed that the existing tax system placed undue burdens on taxpayers, was littered with taxes that generated little revenue, and severely impeded business growth. The report and subsequent discussion between the International Community and BiH counterparts sparked new interest in an agenda for reform of the direct taxes.

A key objective of the RS and Federation reforms was to replace a complex system of income taxes that levied tax differently depending on the type of income with harmonized tax systems based on a low-rate, broad-based tax on global income. USAID, through TAMP, guided the income tax reforms in the two Entities. Shortly after TAMP initiated its tax policy assistance in August 2004, the Entities and other local counterparts became actively engaged in developing the new reform proposals. TAMP also garnered critical support from counterparts in Brcko District to embark on a “pilot” reform to introduce market value-based property taxation in the District.

To build consensus and understanding on the objectives of the reforms, TAMP promoted the formation of a Direct Tax Commission (DTC), with representation from all the international donors engaged in the tax area. The DTC provided an important platform for coordinating tax assistance, discussing reform progress and ensuring that the International Community always spoke with one voice. This gave credence to the reform agenda among local leaders and counterparts and was probably a necessary condition for the reforms to proceed.

Working in close collaboration with Ministry of Finance counterparts in the RS and the Federation, TAMP’s policy team helped draft new personal and corporate income tax laws and regulations; developed micro-simulation models to estimate the impact of policy alternatives on revenues and the distribution of the tax burden; provided formal and on-the-job training in the principles of tax policy and the implications of the reform alternatives; and, worked side-by-side with MOF counterparts to ensure their understanding of the reform options. Project advisors also participated in public forums to discuss the impact of the new laws with representatives of business and labor, and assisted counterparts in preparing presentations on the reform proposals for government and parliament. As a result, three out of the four proposed income tax laws—the personal and corporate income tax laws in the RS, and the personal income tax law in the Federation—went to the enactment procedure in less than 18 months time. All four income tax laws are expected to take effect on January 1, 2007.

In Brcko District, working closely with counterparts in the Revenue Agency, the policy team drafted a new property tax law; developed a model for computer-assisted mass appraisal to simulate the local

property market; and, worked in partnership with the mayor's office and local leaders to advance the reform through the legislative process. In addition to this policy assistance, TAMP helped the tax administration develop and implement a functioning withholding system for the District's income tax, providing an effective prototype for future withholding systems in the Entities.

The reforms in the Entities and Brcko District were still in progress as TAMP assistance ended in June 2006.

III. FACTORS OF SUCCESS

1. Attention to Political Leadership and Local Ownership. The project identified and engaged "champions" for tax reforms and carefully constructed analytical rationales for those reforms. Even with frequent changes in political leadership, especially in the RS, TAMP staff worked patiently with counterparts and managed to forge close relations with key stakeholders who helped keep the reform agenda on track. A senior advisor to the Federation Minister of Finance once remarked that the broad-based, democratic participation sought in bringing the income tax proposals into the public forum was unprecedented in BiH history. Without TAMP's careful attention to this requirement, it is unlikely that the reforms would have gotten so much traction.
2. Flexibility. The ability of the USAID assistance team to adapt quickly to the needs of counterparts and the changing demands of the International Community was essential to the success of the project. In 2004, the project moved quickly to pick up efforts to strengthen audit and enforcement functions when the EU program diverted its attention to the State-level ITA and the introduction of the VAT. The project was also quick to recruit and mobilize the necessary resources to lead and provide new energy to the direct tax reform agenda. This flexibility was essential to the progress made in all aspects of USAID's tax assistance.
3. Competition. An underlying Inter-Entity competitiveness motivated counterparts to work with TAMP to implement tax administration, and later tax policy, changes. RS counterparts in particular worked aggressively to be the first to achieve certain objectives, and often took initiative in expanding on the systems and processes developed with TAMP support. Often this sense of rivalry had a further demonstration effect on other counterparts. In 2005, when tax administration reforms in the Federation were lagging behind those in the RS, TAMP's Chief of Party accompanied the Federation Tax Director to Banja Luka to view first-hand the progress the RS Tax Administration had already made in developing its automated systems. The visit reinforced the importance of IT modernization for the Federation Director, who swiftly accelerated the pace of implementation within his own agency.
4. Innovation. The microwave solution allowed the tax administrations to "leapfrog" the existing communications options, enabling secure, reliable and high-speed data transmission and drastically reducing their communications costs. Once in place, the microwave system became the first communications network with nationwide reach in all of BiH, drawing attention from others in the BiH governments as possible solutions to their data communications needs. Today, the network is used not only by the three tax administrations, but also by the state border police, the ITA, and a number of other Entity and state-level government agencies. In the future, perhaps the privatization of the Post and Telecommunications (PTT) agency would supplant and obviate this microwave infrastructure, but in the present environment the microwave

infrastructure provides a critical intermittent technology solution that would otherwise have been unavailable.