

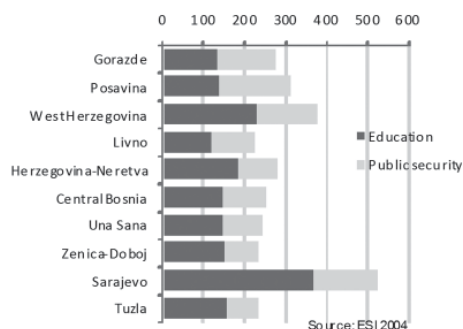


Fiscal equalization in the Federation of BiH

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Why fiscal equalization?

According to some theoretical approaches, the equalization policy takes two forms: i) vertical equalization meaning that “each level of government should have separate and independent revenue sources sufficient to finance the expenditures assigned to that level” (Bird and Tarasov 2002 2), and ii) horizontal equalization implying that (with the assumption that the country values the equal treatment of all citizens nationwide) there should be a system of transfers that would reduce or eliminate the differences in service provision “by tying the transfers to each jurisdiction to relative tax capacity and to the relative need for and cost of providing public services” (Shah 1999 28). In general, the financial equalization policies contribute to a certain equal opportunity between local authorities. Their purpose is to moderate the vertical imbalances, to diminish the tax competition, to limit the risks of uncertainties and also to maintain the social cohesion.



Expenditure inequalities across 10 federal units (in KM per capita)

FBiH model of fiscal equalization

Until the recent introduction of VAT the Central Government in Bosnia and Herzegovina did not have any taxation power. According to Dayton Peace Arrangement, it was given only some minor fees (such as passport issuing), without hav-

ing any of its own revenue sources. Financing of the State expenditures was done by transfers from the entity level. FBiH contributed two thirds to the state budget, while RS's contribution was one third. This asymmetric and decentralized solution for revenue assignment left the central government without any real tax leverage. As a consequence of this there were huge disparities in the revenues of the subnational governments, most notably between cantons and between municipalities. Before the reform of the taxation system the central government or the FBiH government did not have any active policy aimed at decreasing those disparities. The FBiH Government has chosen a formula based approach for distribution of pool of revenues.

At the beginning of 2006 a nation-wide VAT system was introduced in BiH, administered by the central government agency Indirect Taxation Authority (ITA). A framework Law on System of Indirect Taxation (LSIT) and Law on Value Added Tax (VAT) were passed. The tax base and a single rate (17%) are determined uniformly for the whole country. ITA collects all indirect revenues, including excise and custom fees to a single treasury account and has competencies on the whole territory of the country. The Law on VAT and LSIT determine that financing of the central government and servicing foreign debt take priority in distribution of the pool of revenues from the single account (Art. 21). Collection of indirect taxes and customs is now centralized at the state level. Tax policy has also been transferred to the state level, thus effectively leaving entities with very little power in the fiscal domain. The revenues collected to the ITA's Single Account are ceded to the entity level, after the share for financing state budget is transferred, and based on the entity share of the processed VAT invoices, which was the subject of much political debate.

SUMMARY

When one talks about fiscal equalization, one addresses the problem of equal access of all citizens to all public services. This study analyzes the current differences in FBiH in that respect, their causes, as well as the solution selected by the entity government in order to achieve equal access for all citizens.

Differences in per capita revenues and expenditures between subnational units within a state are often understood as a 'natural' result of the diversity of the resources and economic potential of those units. Bosnia and Herzegovina (BiH), with its odd government structure designed to protect power-sharing interests of the 'ethnic' elites, strongly confirm this theory. At this moment, one cannot find any study that explains the main causes of the fiscal differences between the sub-entity units that have developed in the last decade. This paper partly explains these causes and only to the extent necessary in regard to the policy problem that is the focus of the study.

The main policy problem addressed in the study is a certain government failure to provide public services equally throughout the entity (Federation of Bosnia and Herzegovina): huge differences in provision of public services between municipalities as well as cantons have emerged as a result of the lack of any intergovernmental transfer system that would respond to the 'naturally' emerged differences. The magnitude of horizontal and vertical disparities in the Federation of Bosnia and Herzegovina is shown by analyzing the revenue and expenditure level of its government units. This analysis provides a compelling argument that there are enormous horizontal imbalances between municipalities and cantons, which can be remedied only by introduction of some sort of equalization mechanism. In that sense, the importance of indirect taxes will be reiterated, as the sales tax was replaced with VAT.

The paper presents results of an analysis of the new system for allocation of indirect taxes in the Federation of Bosnia and Herzegovina, which was introduced after implementation of the nation-wide value-added

tax (VAT) system in 2006, primarily focusing on its horizontal equalization capacities. As a consequence of the introduction of VAT, an entity derivation based system was replaced with a simple, formula-based system for distribution of indirect taxes between three tiers of governments: entity, cantons and municipalities. The study confirms its main thesis that the equalization mechanism of the new system is designed to allow for fiscal horizontal equalization across the sub-entity units. We tested how well the new system performs in equalizing horizontal disparities. The analysis shows that throughout a six years period there is an evident decrease in share of indirect taxes from the entity pool for some municipalities, and increase for others. In the final year of this period, there is a clear negative correlation between the fiscal capacity indicator and per capita amount of new transfer.

The formula will provide municipalities with bigger revenue raising capacity with smaller per capita amount of transfer and vice versa. Richer municipalities will receive a decreasing share from the entity pool, while poorer municipalities receive relatively larger and increasing shares. This is a strong indicator that in the final year the system achieves horizontal equalization between municipalities. This trend is visible throughout the six year period for municipalities, but the formula for cantons even after the six year period still does not equalize based on revenue capacity.

Finally, the study also covers a number of issues related to familiarity of local government representatives with these changes, their ability to plan their revenues accordingly, and to the measures they plan to undertake to offset negative impact or perhaps how they are going to use the additional revenue inflow. The conclusions in this respect are made after conducting and analysis of a number of in-depth interviews with local-government representatives. A set of policy recommendations is provided for further improvements, focusing not only on the newly introduced system, but also on the necessity for some fundamental changes in regulation of intergovernmental relations in FBiH.

The origin of indirect revenues is no longer traced below the entity level. Therefore, as of 1 January 2006, the derivation principle can no longer be applied for allocation of indirect revenues in the FBiH. The state takes priority in being financed from the Single Account revenues, but there was a need for developing a mechanism for allocation of what is left to the sub-entity governments. These revenues represent a huge portion of the sub-entity income, amounting up to 70 percent of the cantonal income and 21% of municipal.

For the first time after the fall of the socialist state, the BiH central government and entity governments have the opportunity to use their fiscal strength for horizontal and vertical equalization between the entities, cantons and municipalities. Although the fiscal arrangement is more centralized now, the design of this system will have to respect not only economic and social issues but also realities of the political landscape of post-Dayton BiH. FBiH has to take advantage of this reform in order to reorder the intergovernmental relations and to apply a new formula for entity and sub-entity revenues. Unlike with the previous solution when each canton had its own revenue-sharing law, the new FBiH Law on Distribution of Public Revenues (Official Gazette 22/06) employs a distribution formula to allocate the revenues between cantons and municipalities, with gradual introduction over a period of six years. A myriad of cantonal revenue-sharing laws has been abolished and replaced with the a single law, which despite the fact that FBiH is no longer in control of indirect taxes, still allows for an active policy role to be played.

The new transfer system in FBiH has taken historic information on cantonal and municipal revenues as a starting point (year 2005), trying to increase their share in the public revenues through the new transfer system. In general, the transfer system can be used for fiscal equalization between the sub-national jurisdictions. Horizontal inequalities are a natural occurrence, and they reflect the diversity of the resources and economic potential of the sub-government units (SGUs). Mobility of the people and capital from less productive to more productive regions increase efficiency, but the fiscal system should

be designed to have minimal impact on the allocation of the factors of production. Additionally, equalization policy of the government can also be implemented by assigning the own-source revenues to the SGUs, but more typically it is done through a transfer system. Fourth, externalities occur when the SGUs decided to underspend on the service with significant spillover effect. Transfers can be used to correct these anomalies, and at the same time central government can influence spending patterns of the SGUs.

How well does the new system perform?

The government of FBiH has passed a new Law on Allocation of Public Revenues (Official Gazette 22/06), using for the first time a formula for distribution of revenues to the sub-national level. Both entities and Brcko district will receive revenues from ITA's Single Account according to the processed invoices from their territories, and after the revenues are transferred to the state budget for financing its functions.

The new Law envisages a six years phase-in period for implementation of the system. This solution is fully understandable having in mind the magnitude of current horizontal fiscal disparities and level of investments and long-term expenditure in richer cantons and municipalities. The phasing-in period combines percentages of sales tax collected prior to the introduction of new system, and gradual introduction of percentages according to the new formula.

The pool of indirect taxes available for distribution in FBiH is determined as a percentage of the indirect taxes, in the first place VAT collected to the Single Account of ITA. ITA's estimation is that in 2006 about 3.5 billion KM of indirect taxes will be collected. The state budget forecasts KM566 million of indirect taxes to be transferred for 2006 from the Single Account for financing central government functions and service of foreign debt. This leaves an amount of 2.93 billion KM to be allocated between FBiH, RS and Brcko District.

If one takes percentages for June 2006 that allocate 66.77 percent to FBiH, 29.76 percent to RS and 3.46 percent to Brcko District, and applies these to the amount forecasted for 2006, then the amount available for distribution in



FBiH is 1.95 billion KM. Applying percentages for allocation between FBiH level, cantons and municipalities, in 2006 cantons will receive 1.008 billion KM and municipal level 164.9 mil KM. Comparing to the 2005 level, municipalities will receive 72 percent more and cantons 2 percent more of indirect taxes. At the moment, information on loan servicing for FBiH for 2006 was unknown to us. The Federal pool for distribution would decrease after the loan repayment is deducted, and consequently per capita amount calculated for municipalities

A test of the new formula that was conducted using regression analysis shows that coefficients for population, as a proxy for index of relative need were not statistically significant. However, it is far more important that in the final year of implementation there is a clear negative correlation between revenue capacity indication-PIT per capita, and amount of new transfer per capita, which shows that at the end of transition period the formula will provide smaller per capita amount of transfer to municipalities with bigger revenue raising capacity. This is visible from the calculated per capita amounts for 79 municipalities. One can observe a pattern: urban and richer municipalities will receive decreasing shares from the entity pool, while poorer municipalities receive relatively larger and increasing shares. This is a strong indicator that in the final year the system achieves horizontal equalization between municipalities.

Policy Recommendations

The new system for allocation of indirect taxes in FBiH incorporates both expenditure needs and fiscal capacity indicators. For the first time, a derivation based system is replaced with a clear and simple formula, which will enable municipalities and cantons far more stable budgeting, and hopefully, better local governance. The formula uses simple and verifiable data for the calculation of transfers and it allows for easy modifications, which will certainly take place in the following years. The formula captures the expenditure needs differences across the municipalities and cantons, as well as fiscal capacity differences. In the last year of the transition period, transfers per capita vary negatively with the Personal In-

come Tax per capita indicator at municipal level. This is the indicator that the formula is performing well in correcting horizontal imbalances.

Necessity of capacity building and accountability strengthening at the local level

Though the formula represents somewhat of an enigma for cantonal and municipal authorities, at the end of six years phase-in period poor local governments in FBiH will have at their disposal significantly larger revenues compared to the present system. This is partially improved by the increased compliance and tax collection, inherent to VAT. In that sense, it will be necessary to accompany present reforms of the fiscal sector with parallel projects of capacity building at the local level, especially for inclusive and participatory capital project selection.

The first and foremost task will be to improve financial management in municipalities and cantons through training local officials for project preparation and management. Moreover, it is necessary to improve their accountability by opening channels for communication with citizens and for citizens' active role in local government affairs. Introduction of the program and performance budgeting and multi-year budgeting would be good mechanisms for this.

Local governments need to improve their own fiscal capability

Regardless of whether local governments will receive more or less of indirect taxes, an effort should be made to increase collection of own-source revenues. This is especially important for predominantly urban municipalities, with concentration of valuable real estate and businesses, but is equally important for smaller municipalities. The formula does not contain negative incentives for collecting of own-revenues, but it would be necessary to strengthen the capacity of local governments to collect those revenues.

This will need to be accompanied with reform of the direct taxes in FBiH (Income Tax and Property Tax in the first place), to provide municipalities with more fiscal space for collecting their own revenues - especially important for those municipalities with decreasing indirect taxation revenues.



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More cooperation between different jurisdictions in BiH is needed in order to achieve optimal fiscal balances

Although the legislation regulating allocation of indirect taxes has been harmonized to a certain degree between Entities, it would be of great importance for nation-building efforts to have a State Law uniformly regulating this area for the whole country. This, of course, is hardly achievable in present relations between entities, as there would be necessary to obtain a political consent in the first place and as it would also require harmonization and realigning of revenue and expenditure assignments. Still, potential benefits in terms of creating a single municipal fiscal space, solidarity and cooperation between municipalities should not be neglected in a country such as BiH.

Enhance measurement of fiscal needs and improve the system of transmission of the information to local governments

The formula ingredients might change to include more precise measurement of fiscal need and capacity as it becomes available. These changes would then reflect more accurately the situation in municipalities and cantons, and therefore provide better capture of real needs of local government units. In this light, it is also necessary to work on the mechanism for informing municipalities about changes in the fiscal sphere, not only through official gazettes, but by organizing rounds tables and seminars where changes, such as introduction of this new system, could be discussed. There should also be a mechanism easily accessible for municipalities to assist them in the budget planning process, by providing information on collected indirect revenues for the whole country, and for each entity.

Assure for outright decentralization

The increased flow of revenues for local governments might provide incentives for realigning of the intergovernmental relations in FBiH, by assigning additional responsibilities to municipalities. If this happens it will be necessary to direct reform so that municipalities are not assigned only mandated functions, but that there should be genuine devolution of power to the local level.

Allow for local governments' access to capital markets

Of special importance will be regulation of how municipalities and cantons access capital markets. The conditions are already created which enable some municipalities to borrow even now, and this will become even more realistic as the situation with local finances improves. This requires that the new law is adopted in the course of the fiscal reform, allowing for local governments access to capital markets, but at the same time issuing upper tiers of government from bailing-out municipalities and cantons.

Finally, if the role of local governments becomes more important, there will be a need for central data collection, monitoring and analysis of local governance performance. A new ministry, either at entity level or at the state level, if political reality permits, will need to be established to coordinate efforts in this area and also to harmonize different policy solutions between entities. It is not possible to predict future political developments in BiH, but one can believe that as it was incomprehensible that there would be some model of fiscal equalization introduced in FBiH, one can hope that at some point in the near future there will be a fiscal equalization scheme for the whole of BiH. Only in this way will it be possible to reduce the disparities between the two BiH entities, and through that process additionally strengthen integrative forces in the society.

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