



From Lack of Single Economic Space within Its Own Borders to Coping with the Competitive Pressures within the EU: Mission Impossible for BiH?

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Why Does Corporate Income Taxation (CIT) in BiH Matter?

Policy decision makers are interested in designing fiscal policies that will eventually result in higher overall growth of an economy. More specifically, corporate income taxation serves as a tool for governments to attract foreign direct investment and give incentives to domestic private sector growth. For Bosnia and Herzegovina, the issue of income taxation policy is important and timely for the following reasons¹:

1. Sound corporate income taxation policy represents an essential tool in fostering much needed private-sector investment.

Public sector takes up almost half of country's gross domestic product², while private sector lags behind and mostly depends on few large companies, which were successful in pre-war period and are reaping the benefits of intermediate production of raw materials after their post-war privatization mostly through foreign investment. In a country with relatively low GDP per capita (around 4960 KM or 2536 EUR annually),³ high unemployment (45% according to number of registered persons at unemployment bureaus or 29% according to the Labor Force Survey based on the International Labour Organisation standards)⁴ and an extensive grey economy (around 30-50% of official GDP, according to IMF and World Bank estimates), sound direct taxation policy can be utilized as a tool for increasing competitiveness. Simplification, harmonisation and alignment with the EU standards of the BH direct taxation policies would aid in reaching broad society-level goal of encouraging both foreign investment and domestic entrepreneurship and reducing overwhelming grey economy fostered by the current complex taxation systems

with many possibilities for exemptions and deductions and administration dispersed at numerous government levels.

2. Taxation reform momentum should be used.

had recently gone through an intensive reform of its indirect taxation system and administration. Thus, after successful indirect taxation reform, the momentum should be used to continue with direct taxation reform.

And indeed, this process has started with new laws on both corporate and personal income taxation that have been adopted in both entities, (in RS in September of 2006 and in FBiH in December of 2007). While the new legislations brought the entity CIT systems closer to each other, the obvious shortcoming is that this type of taxation is still not completely harmonized. In addition, newly adopted entity legislations also lack analyses of the extent to which the two entity systems adhere to the EU Code of Conduct on Business Taxation, which BiH will have to adhere to by 2008, according to its commitment from 2006 EU Partnership⁵.

3. Lastly and most importantly, numerous and different, taxation policies directly hamper the functioning of the single economic space.

BiH can use the process of adjusting its CIT taxation to reflect EU standards as a tool for gathering political will to simplify currently extremely complex taxation system which is not harmonized among the entities of Federation of BiH and Republika Srpska. By doing so, BiH would improve the functioning of a single economic space within the country, which is one of the goals from Medium Term Development Strategy and EU Integration Strategy of BiH.

How is Bosnia and Herzegovina expecting to cope with competitive pressure and market forces within the EU in which a-500-million-people market function as a single one, when with population under four million people it has three separate systems of corporate income taxation? This lack of single economic space prevents creation and entrance of large companies that are able to take advantage of economies of scale through vertical and horizontal integrations which are hard to create in such a small country, let alone each entity separately.

¹ Extracted from Čarsimamovic (2006).

² Source: Agency for Statistics of BiH for GDP data for 2006 and ministries of finance for fiscal data.

³ Source: Agency for Statistics of BiH, 2005 data.

⁴ Source: Statistical agencies of FBiH and RS for number of registered unemployed and Agency for Statistics of BiH for Labor Force Survey data.

⁵ European Commission (2007a).

Why Is It That the Current CIT Systems in BiH Need Fixing?

The complex direct taxation system in BiH provides incentives for existence of informal economy. Non-existence of a single systematic law on all tax obligations prevents capital and labour mobility. Currently, revenues from direct taxation in BiH are very low by international standards. In the EU-15, direct taxes comprise around 33% of all tax revenues, while in the NMS area, 25% of all tax revenues collected are direct⁶. This compares to only 12% in BiH⁷. Low tax revenues from corporate tax reflect, in part, the complexity of the system (which discourages the formal sector) and the many loopholes/tax-holidays (which lead to perverse behavior). The three-tiered system (two entities and Brcko District each with its own CIT systems) has equity considerations (different treatment of incomes across the entities) and efficiency considerations (distortion of the location decision).

Current entity systems consider a company from other entity as a non-resident company, just as if it were from entirely different country. This is a serious obstacle for existence of single economic space. Domestic and foreign companies face difficulties in achieving economies of scale, horizontal and vertical integration and creation of clusters for which BiH has potential (e.g. automotive and aluminium clusters are already established, incorporating several companies and their success has opened up doors for looking into possibility of enlargement of these

and creation of new clusters, whose efficiency could be improved if corporate taxation systems were harmonized).

While with the latest reform (mentioned above) the two entity CIT systems are brought much closer than they were in the past, complete harmonization of the tax base and exemptions needs to take place in order to unify the economic space in BiH and simplify taxation procedure for BiH private sector which should be encouraged to grow across entity lines before it is possible to prepare it for future needed unification with the EU. Non-existence of a single systematic law on all CIT obligations prevents capital and labour mobility, consequently the adoption of a single country-wide law should be considered.

CIT REVENUES

in mil KM	FBiH	RS
2003	53	16
2004	63	20
2005	79	21
2006	100	31
2007	105	68

As shown above, the revenues from CIT in both entities are not significant taking into account the size of overall general government sector in BiH of more than 7 billion KM. Consequently, CIT harmonization at the state level cannot be considered as the issue of entities losing control over their revenues, but rather as a pure issue of economic rationale.

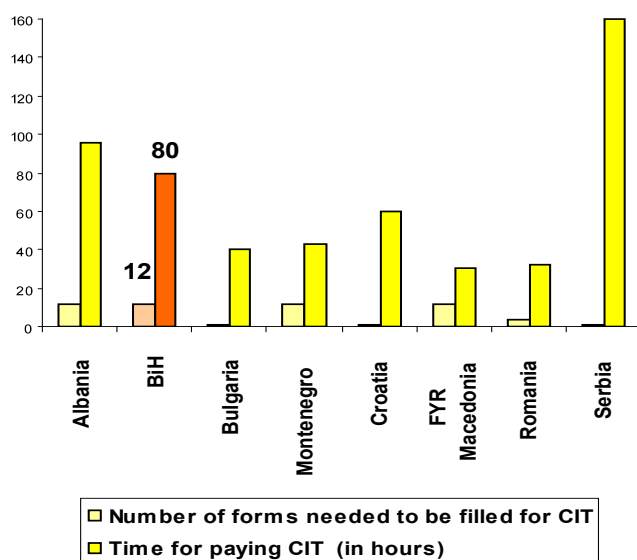
Both economic theory and EU experience in the last decade (as well as the example of doubling revenues in RS in 2007 shown above) confirm that rate-decreasing and base-broadening corporate income tax reform increases country's competitiveness and through reduction of tax-related distortions leads to increased efficiency and productivity. Therefore, it is expected that **further simplification of the CIT system in BiH (which would occur if the entity systems were to merge into the state-side system) would have potential to result in both revenue increase for general government and provision of incentives for private sector growth and informal market reduction.**

CIT revenues in % GDP

BiH	0,8
EU-15 average	3,5
OECD average	3,4

⁶ Source: European Commission (2006).

⁷ Source: Central Bank of BiH.





Policy Study examines the extent to which the two entity systems adhere to the EU Code of Conduct on Business Taxation, and offers recommendations for ways in which BiH should adjust CIT taxation systems to converge to the EU standards and avoid potentially provisions which could be considered as harmful tax competition by the Code of Conduct standards, while at the same time being conducive to improving BiH private sector competitiveness.

On the basis of research and analysis of the previously defined potentially harmful measures for other countries (i.e. comparing measures which were defined as potentially harmful in other countries against the taxation systems in BiH to identify those measures in BiH which EC may found potentially harmful), the study identifies six potentially harmful measures of the current CIT legislation in RS (current Law on CIT of RS was adopted in September of 2006 and is in force since January 1st 2007 in RS) and FBiH (current Law on CIT of FBiH was adopted in December of 2007 and is in force since January 1st 2008 in FBiH). These measures are examined against the five characteristics of harmful corporate tax

competition laid out in the EU Code of Conduct of Business Taxation.

On the basis of the analysis it was concluded that the three issues are needed to be addressed within the BiH CIT system in order to ensure it is in line with the Code of Conduct while at the same time encouraging private sector growth. Firstly, exemption for exporters and exemption for investment need to be examined after the first year of implementation in FBiH, and if de facto harmfulness is determined, the CIT Law Taxation Law needs to be changed in order to be in line with the Code of Conduct on Business Taxation. Secondly, it was concluded that measures for investment in machinery are not harmful, therefore RS should consider extending it after 2008. Thirdly, it was concluded that, while with the latest reform two CIT systems are brought much closer than they were in the past, complete harmonization of the tax base and exemptions needs to take place in order to unify the economic space in BiH and simplify taxation procedure for BiH private sector which should be encouraged to grow across entity lines before it is possible to prepare it for future needed unification with the EU.

"It is not five minutes to twelve, but rather five minutes after twelve o'clock when it comes to urgency for BiH governments to make necessary provisions to unify economic space and improve business environment. If this does not happen, in a few years most of the businesses will find better environment to work in outside of this country. As we speak, most of the youth of this country are trying to find ways to leave this country. If businesses do the same, you will have no population to be high representatives, prime ministers and ministers for."

Elizabeta Josipović,
director of Scontoprom
d.o.o. Prijedor

POLICY OPTIONS

	1. Do nothing - wait until BiH is candidate for EU to change potentially harmful measures	2. Examining in more detail potentially harmful measures (especially in FBiH) and changing those measure EU Group for Code of Conduct on Business Taxation may find harmful	3. Completely harmonizing CIT legislation at the state level, while ensuring the adherence to the EU Code of Conduct
BiH fulfills the Acquis in CIT field at the final allowable stage - as it approaches final EU accession.	YES	YES	YES
Fulfilling BiH's short-term commitments from EU partnership to be accomplished by 2008 - committing to the principles of the Code of Conduct for business taxation and ensure that new tax measures are in compliance with these principles	NO	YES	YES
Giving maximum support to competitiveness of BiH private sector	NO	NO	YES

After outlining three possible policy options for addressing the above mentioned three issues of BiH's corporate income taxation systems (evaluation of the these three options is shown in the matrix above), the study recommends the following: a) BiH authorities should take the initiative in receiving the final assessment on potential harmfulness of CIT measures by the EC b) the BiH authorities should then completely harmonize CIT

legislation at the state level, and c) in developing this uniform CIT legislation, the BiH authorities should on the basis of future final conclusions of the EC consider having the private sector enhancing exemptions in the new harmonized legislation (such as reduced rate for micro enterprises, reduced rate for large investors both domestic and foreign, and reduced rate for exporters). Proposed set of policy recommendations follows.



Naida Čaršimamović was born in Sarajevo on September 11th, 1980. After graduating from The Third Grammar School in Sarajevo, she continued her studies in the United States, where she earned her Bachelors degrees in Economics and Political Science from Furman University in 2003. In 2005, she graduated from Crummer Graduate School at Rollins University with Master degree in Finance. During her post-graduate studies she also held a post as a teaching assistant for Finance Faculty. Upon her return to Bosnia and Herzegovina, she worked as an Expert Adviser for Public Finance in Directorate for Economic Planning of the Council of Ministers of BiH (which was partially financed by the European Commission) from June 2005 to June 2007. Since July 2007 she has been working as an Adviser for Budget of Institutions of BiH on the Project for Strengthening Public Expenditure Management in Bosnia and Herzegovina, financed by Department for International Development of the United Kingdom Government.

Following are the activities BiH authorities should undertake to implement the policy option of completely harmonizing CIT legislation at the state level, while ensuring the adherence to the EU Code of Conduct.

1. PURPOSE OF ACTIVITY: Confirming that the current provision of the FBiH CIT Law are not harmful

• **IMPLEMENTATION OF THE ACTIVITY:**

Ministry of Finance of FBiH should contact the European Commission to get the initial evaluation on potential harmfulness of the exemption envisaged in the new Law on Corporate Income Taxation which will be adopted in December of 2007 and enforced starting January 1st 2008.

2. PURPOSE OF ACTIVITY: Making decision to harmonize the entity system:

• **IMPLEMENTATION OF THE ACTIVITY:**

- a) Council of Ministers of BiH needs to adopt the strategy of adopting the CIT Law at the state level (while this is preferable choice of fulfilling the purpose of this activity, since the political will may be the issue here, the second alternative is presented) OR
- b) Entity Ministries of Finance and entity Tax Administration should adopt Action Plan on complete harmonization of all of the specifications of the CIT bases.

3. PURPOSE OF ACTIVITY: Including further measures which would be in line with the EU Code of Conduct, while at the same time providing as much support to the development of BiH private sector as allowed by the Code.

• **IMPLEMENTATION OF THE ACTIVITY:**

Entity Ministries of Finance (or same state-level institution which would be in charge of CIT system in the case that state-level administration of this tax were to take place) should on the basis of final conclusion of the EC, consider having the private sector enhancing exemptions in the new harmonized legislation, such as reduced rate for micro enterprises, reduced rate for large investors (both domestic and foreign), and reduced rate for exporters.

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A "Policy Development Fellowship Program" has been launched by the Open Society Fund BiH in early 2004 with the aim to improve BiH policy research and dialogue and to contribute to the development of a sound policy-making culture based on informative and empirically grounded policy options.

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