



BiH Corporate Income Taxation: Making It Both Adherent to the EU Standards and Conducive to BiH Competitiveness

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EXECUTIVE SUMMARY

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 4 million people it has the 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. In addition to this obvious problem which hampers desperately needed expansion of BiH private sector, corporate income taxation system in BiH lacks 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 2009, according to its commitment from 2007 EU Partnership.

Two of the most pressing issues of the current Bosnia and Herzegovina (BiH) are the need to smoothly progress on the long road ahead towards the EU accession and the need to foster the much needed development of the BiH economy's private sector. This research attempts to provide information and advice for policy decision makers to adjust corporate income taxation policy in the way which will contribute to both of the above-mentioned priorities by: a) laying out specifications of the EU required standards and recommendations in the field of corporate income taxation (CIT), as defined in the Code of Conduct of Business Taxation¹, b) identifying potentially harmful measures of the BiH entity CIT systems and examining them against the criteria set by the Code of Conduct, and finally c) offering specific policy recommendations for ways in which BiH should adjust CIT taxation systems to converge to the EU 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), this 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)². These measures are examined against the five characteristics of harmful corporate tax competition laid out in the EU Code of Conduct of Business Taxation.

¹ In further text referred to as Code.

² CIT in Brcko District is not a subject of this study.



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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 needs to be changed in order to be in line with the Code of Conduct on Business Taxation. If this measure is found not harmful, RS should consider introducing it as well. Secondly, it was concluded that measures for investment in machinery are not harmful; therefore RS should consider extending it after 2008. Should the measure for investment be found harmful in FBiH (previous measure discussed above), FBiH should consider introducing this measure instead. However, should the investment measure in FBiH turn out *de facto* not harmful, RS should consider introducing the same measure instead of current more narrowly defined exemption for investment in machinery, in order to provide more extensive investment incentive. Thirdly, it was concluded that, while with the latest reform 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.

After outlining three possible policy options for addressing the above mentioned three issues of BiH's corporate income taxation systems, 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 country 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), provided that they are not harmful by the EC Code of Conduct of Business Taxation.



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Introduction

Two of the most pressing issues of the current Bosnia and Herzegovina (BiH) are the need to smoothly progress on the long road ahead towards the EU accession and the need to foster the much needed development of the BiH economy's private sector. One of the ways to encourage private sector investment is to increase its competitiveness through making its currently complex and three-tiered corporate income taxation system³ as simple as possible and as familiar as possible to the major trading market of the BH economy, which is the EU market. For this country, the issue of taxation policy is important and timely for the following reasons⁴:

³ CIT in Brcko District is not a subject of this study.

⁴ Extracted from Carsimamovic (2006).

⁵ Source: International Monetary Fund (2007) and Agency for Statistics of BiH, 2006 data.

⁶ Source: Agency for Statistics of BiH, 2007 data.

⁷ Source: Agency for Statistics of BiH, 2007 data.

⁸ Source: International Monetary Fund (2004), World Bank (2006)

⁹ Source: World Bank (2007).

¹⁰ Since these indicators did not capture the recent changes in CIT legislation in FBiH which came to force at the beginning of 2008, it is expected that the indicators will improve in next year.

¹¹ European Commission (2007a).

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

Total government expenditure takes up around a half of country's gross domestic product⁵, 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 direct investment (companies such as *Mittal Steel*, *Volkswagen*, *Global Ispat*, and *Bimal Brcko* for example). In a country with relatively low GDP per capita (4,960 KM or 2,536 EUR annually),⁶ high unemployment (around 45% according to number of registered persons at unemployment bureaus and 29% according to the Labor Force Survey based on the International Labor Organization standards)⁷ and an extensive grey economy (around 40% of official GDP, according to IMF and World Bank estimates⁸), sound direct taxation policy can be utilized as a tool for increasing competitiveness. Current high complexities of the BiH CIT systems are reflected in indicators from the *Doing Business in 2008* study⁹ which shows BiH lagging behind in ease of taxpaying behind its neighbors and direct competitors. In comparison of the *Doing Business* indicators for SEE region in the area of paying taxes, BiH shares the last place with 12 tax forms a company needs to file for CIT annually (which takes into account the method of payment or withholding, the frequency of payment or withholding and the number of agencies involved). Furthermore, in estimate of total CIT burden expressed as a share of profits, BiH ranks next to last (only Albania scores higher) with 22% of profits having to be paid out for CIT¹⁰. Simplification, harmonization 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 and administration dispersed at numerous government levels.

2. Taxation reform momentum should be used.

BiH 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 across the country. 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 2009, according to its commitment from 2007 EU Partnership¹¹.



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 of BiH* and *EU Integration Strategy of BiH*.

This study will attempt to provide information and advice for policy decision making to adjust corporate income taxation policy in the way which will contribute to both of the above-mentioned priorities by covering the following:

- 1. The paper will lay out the EU required standards and recommendations** in the field of corporate income taxation (CIT), as given in the Code of Conduct of Business Taxation¹².
- 2. The study will then identify the possible measures of the BiH entity Laws on CIT which potentially may not be in accordance with the Code of Conduct.**
- 3. Finally, the research paper will offer specific policy 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.

¹² European Commission (1997).

PROBLEM DESCRIPTION

Why Is Corporate Income Taxation Important?

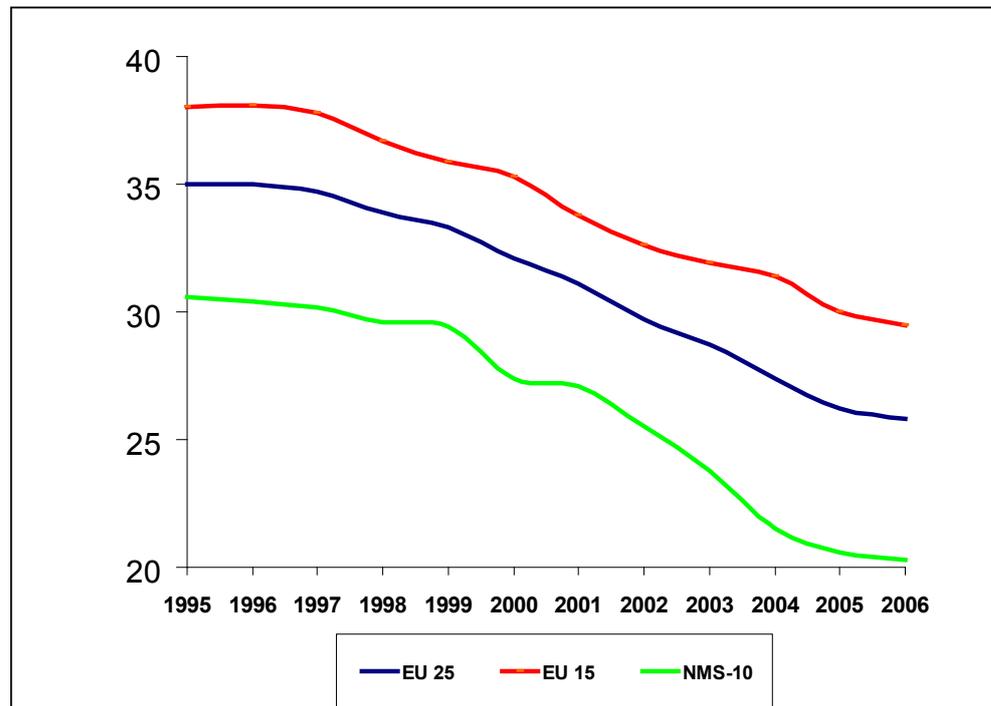
A corporate income tax is a levy placed on the profit of a firm and represents an important source of revenue for most of the governments in the world. Corporate taxation policy also serves as a tool for governments to attract foreign direct investment. Several empirical studies confirm the influence of tax policy on mobile factors, which supports the hypothesis of strategic interaction of tax policies on mobile factors.¹³

From a macroeconomic perspective, policy decision makers are interested in designing fiscal policies that will eventually result in higher overall growth of an economy. Lee and Gordon (2005) find that the (statutory) corporate tax rate is significantly negatively correlated with economic growth in a cross-section data set of 70 countries during 1970-1997, controlling for many other determinants/covariates of economic growth. Their study suggests that reducing the corporate tax rate by 10 percentage points increases the annual growth rate by around 1.1 percent. However, despite the evident trend of globally decreasing statutory rates (shown in Figure 1 below), the aggregate information reported in their and other studies is not able to show detailed links between tax rates and growth, and most research in this field is inconclusive¹⁴.

¹³ Extracted from Carsimamovic (2006). See e.g. Brueckner and Saavedra (2001); Devereux, Lockwood and Redoano (2002); and Devereux and Griffith (2003).

¹⁴ Extracted from Carsimamovic (2006).

FIGURE 1:
DEVELOPMENT OF STATU-
TORY TAX RATES (%)¹⁵



¹⁵ Source: European Commission (2006a).

CIT in BiH: Historical Overview

In order to discuss the policy problem and offer solutions, it is important to firstly discuss historical background information on the corporate income taxation legislation in BiH, as well as the position of corporate income taxation policy in the cycle of a policy-making process this study is aiming to influence.



In the Socialist Federal Republic of Yugoslavia, a corporate income tax as such did not exist. In a provision of the Law on Taxation of Income of Basic Organization of Associated Labor – BOAL,¹⁶ it is stated that income of BOALs is taxed at a proportional rate, which may differ across sectors, groups and subgroups of economic activity in line with current year's adopted Economic Policy Plan of Socialist Republic of BiH. For example, in the period of 1986 to 1990, the rate of tax on income of BOALs in line with the Economic Policy Plan of Socialist Republic of BiH was 2 percent.¹⁷ A second piece of legislation with some theoretical connection to CIT system was the Law on Taxing Non-Residents,¹⁸ which taxed profit of foreign investors in BOAL at 10%, while income of non-residents investing in business and professional activities was 3.5% for foreign legal entities and 30% for foreign natural persons. In the post-war period, statutory corporate income rates decreased as evidenced in RS, where the statutory rate was set at 34% in 1992, which decreased to 30% in 1990, while regressive rates of 20%, 15%, 12% and 10% were in enforce in the period between 1998 and 2001.¹⁹ In 2001, RS adopted modernized CIT legislation with a 10% rate.²⁰ The new legislation adopted in 2006 retained the 10% rate, whereas corporate income reporting, withholding taxes, tax exemptions (reinvestment can be deducted in 2007 and 2008), accelerated depreciation and a simplified system for small enterprises were changed.

In FBiH, on the other hand, the rate of 30% has been applied from 1997 to 2007.²¹ In that CIT system which was in force in FBiH until 2007, there were seven exemptions in the CIT tax return form: for newly established company (100% deduction in the first year of business, 70% for the second and 30% for the third), for the free custom zones (100% deduction for five years), for foreign investors (100% deduction for five years), for reinvestment of the retained earnings (100% for reinvestment for production purposes, and 75% for other reinvestment), for CIT paid in operations in other countries, for the amount of CIT already paid by non-residents office abroad and for the withholding tax. With such an extensive list of possibilities, even with the high statutory rate of 30% in FBiH, typically a firm only paid little. In December of 2007 (in force on January 1st 2008²²), the new Law was adopted with the 10% statutory rate in FBiH as well. This new Law both reduced the statutory rate from 30 to 10% and reduced the number of exemptions and deductions to the following three:

- 11 A taxpayer whose exports exceed 30% of total income (turnover), within the tax year profit is exempt from profit tax for that year.
2. A taxpayer investing in production not less than 20 million KM over the period of 5 consecutive years in the Federation is exempt from profit tax during the period of 5 years, starting with the first year when taxpayer has to invest at least four million KM.
3. A taxpayer – business unit of a non-resident, established within or with the HQ or management and supervision of business activities outside of the Federation, but within Bosnia and Herzegovina, shall be exempt from profit tax payment for profits realized in the Federation²³.

This historical decrease of reducing statutory rates in BiH illustrated in paragraphs above corresponds to the global trend of decreasing statutory rates (shown above in Figure 1)²⁴.

The subject of this study are Law on Corporate Income Taxation of RS adopted in September of 2006 and in force since January 1st 2008 and Law on Corporate Income Taxation of FBiH adopted in December of 2007 and in force since January 1st 2008.

¹⁶ Official Gazette of Socialist Republic BiH, 39/85 and 42/87.

¹⁷ *Law on Rate, Exemptions and Deductions for Income Taxes of Basic Organization of Associated Labour in the Period from 1986 to 1999* (Official Gazette of Socialist Republic BiH, 39/85).

¹⁸ Official Gazette of Socialist Republic BiH, 11/86.

¹⁹ *Law on Corporate Income in RS* (Official Gazette of RS, 14/92, 11/93, 19/93, 8/94, 24/98, 51/01) and *Rulebook on Implementation of Corporate Income Tax Law* (Official Gazette of RS, 70/01).

²⁰ *Law on Corporate Income in RS* (Official Gazette of RS, 91/06) and *Rulebook on Implementation of Corporate Income Tax Law* (Official Gazette of RS, 129/06).

²¹ *Law on Corporate Income in FBiH* (Official Gazette of FBiH, 32a/97, 29/00) and *Rulebook on Implementation of Corporate Income Tax Law* (Official Gazette of FBiH 31/98, 36/98, 4/01, 4/03).

²² *Law on Corporate Income in FBiH* (Official Gazette of FBiH, 97/07)

²³ Historical overview of CIT in BiH extracted from Carsimamovic (2006).

²⁴ European Commission (2006a).

Therefore, this policy study will examine the issue of corporate income taxation in the evaluation stage of policy making process. More specifically, this study will examine the extent to which those two entity systems adhere to the EU Code of Conduct on Business Taxation, and offer 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.

CIT in BiH: Characteristics and Indicators

The general government in BiH has an extremely large number of autonomous parts (Institutions of BiH, Government of Federation of BiH, 10 cantons in FBiH, 79 municipalities in FBiH, 2 official cities in FBiH, 3 extra-budgetary funds in FBiH, Government of Republika Srpska, 63 municipalities in RS, 2 official cities, 4 extra-budgetary funds in RS, and Government of Brcko District), which complicates fiscal management significantly. The entities operate different direct taxes. Less attention has been devoted to the necessity of direct taxation reform so far (in comparison to the indirect taxes, which were harmonized at the state level in the past few years), given the lower contribution direct taxes make to the budgets. The underlying characteristic of the current direct taxation system is its high complexity, with legislation that is non-synchronized and impossible to enforce completely, since income sources are treated in an inconsistent way. Consequently, the complex direct taxation system provides incentives for existence of informal economy. Non-existence of a single systematic law on all tax obligations prevents capital and labor mobility. The situation is especially complicated in the entity of FBiH, where cantonal levels have a mandate to make tax legislation, which has to be administered by the entity-level tax administration, while municipalities use the collected revenues²⁵.

²⁵ Extracted from Carsimamovic (2006)

Currently, revenues from direct taxation in BiH (including CIT, personal income tax and property tax) 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 direct²⁶. This compares to only 12% in BiH²⁷. Figure 2 shows the collection of the CIT revenues in FBiH and RS over the last five years. It is evident that, while the revenues from CIT are constantly increasing over time, the total amount of revenues in 2007 is still low, which is also shown in Figures 5 and 6.

²⁶ Source: European Commission (2006a).

²⁷ Source: Central Bank of BiH, Government Finance Statistics for 2006.

FIGURE 2:
CIT REVENUES IN BiH ENTITIES²⁸

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

²⁸ Source: Ministry of Finance of FBiH, RS Tax Administration and RS Ministry of Finance.

Comparatively low tax revenues from corporate tax in BiH 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 aluminum 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). The recent elimination of numerous complicated exemptions and tax holidays is likely to result in higher overall effective rates of corporate taxes. Indeed, the budget execution data for 2007 show that in RS, CIT revenues grew by 120% in 2007 (total CIT revenues grew from 31 to 68 million KM) – the first year of the new CIT Law which eliminated some exceptions and deductions - in comparison to previous year. It is expected that the revenues from CIT will grow even stronger in FBiH in 2008, which will be the first year or implementation of new FBiH CIT Law, despite the fact that the statutory rate will decrease from 30% to 10%, due to drastic decrease in exceptions and deductions, which were much more expensive in FBiH in comparison to old RS CIT system.

The current complexities of the BiH CIT system are reflected in indicators from the Doing Business in 2008 study, which shows BiH lagging behind in ease of CIT-related taxpaying behind its neighbors and direct competitors (see Figure 3 below).

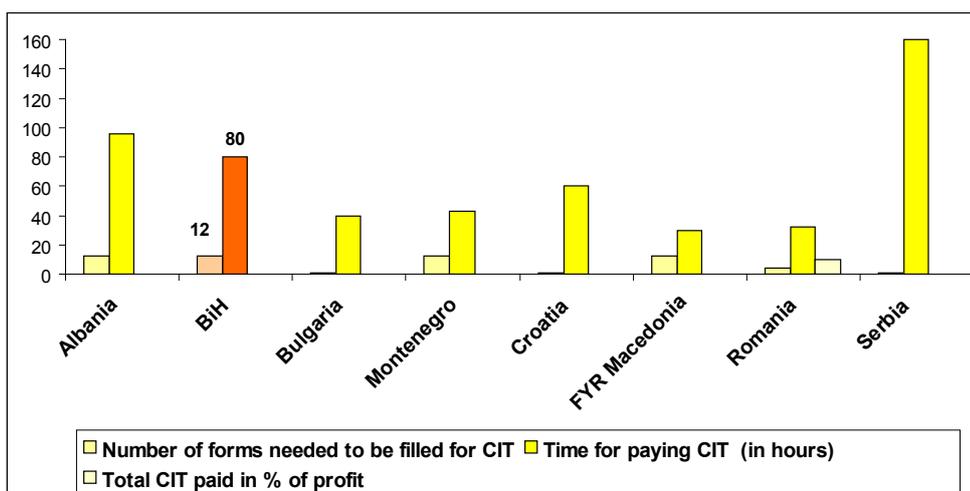


FIGURE 3:
DOING BUSINESS IN 2008
INDICATORS FOR CIT²⁹

²⁹ Source: World Bank 2007 (Doing Business in 2008).

In comparison of the Doing Business indicators for SEE region in the area of paying taxes, BiH shares the last place with 12 tax filings a company needs to file for CIT annually (which takes into account the method of payment or withholding, the frequency of payment or withholding and the number of agencies involved for the standard case). Furthermore, in estimate of total CIT burden expressed as a share of profits, BiH ranks next to last (only Albania scores higher) with 22% of profits having to be paid out for CIT³⁰.

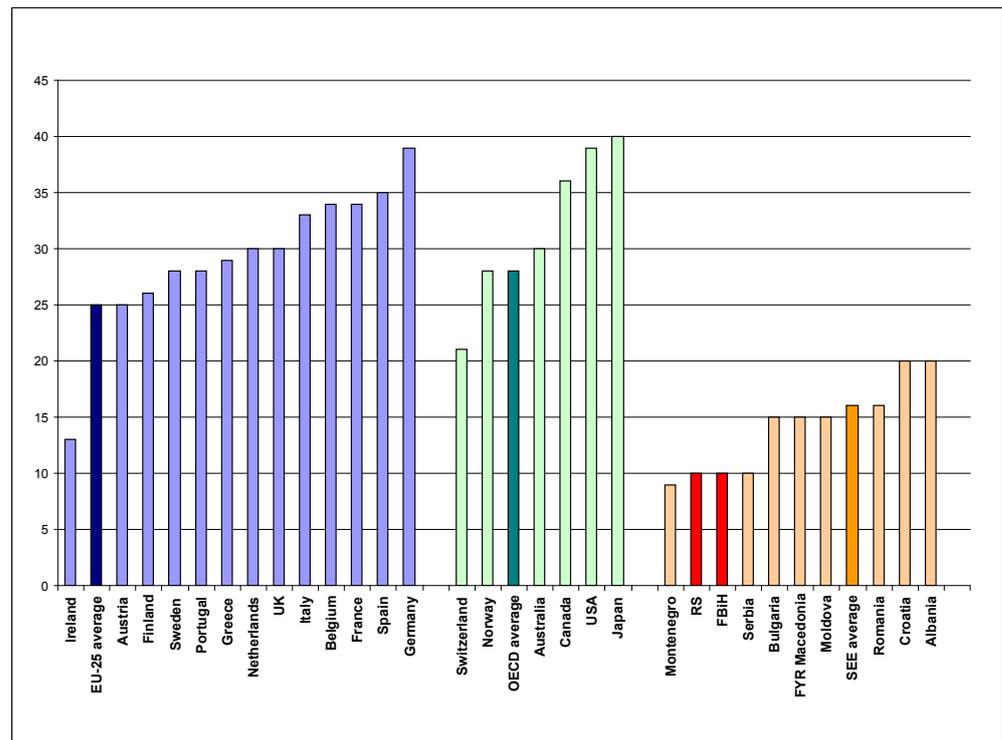
Statutory tax rates and aggregate ratios of CIT receipts to total tax revenues and GDP are the two most widely used measures in cross country empirical research, with the aim of approximating the overall corporate tax burden in the economy. A global comparison of statutory tax rates is given in Figure 4 below. Statutory rates in BiH (both FBiH rate and RS) are favorable even on the competitive SEE market. The average statutory corporate income tax rate in the EU of 25% is much higher than the 10% in FBiH and RS, which rank lowest next to Montenegro in the global comparison. While law statutory rates increase the competitiveness of BiH

³⁰ Since these indicators did not capture the recent changes in CIT legislation in FBiH which came to force at the beginning of 2008, it is expected that the indicators will improve in next year.

companies, such low rates are at the same time may be considered an additional warning sign for the European Commission to more closely examine whether the BiH CIT systems are “too competitive” in the sense that they may also incorporate measures deemed as harmful under the Code of Conduct on Business Taxation. In other words, it needs to be examined whether the BiH CIT systems include the measures which may be considered as affecting the decision of business location by providing non-residents with a more favorable tax treatment than that which is generally available for the residents of that same country.

FIGURE 4:
STATUTORY TAX RATES (%)³¹

³¹ Source: Institute for Fiscal Studies (2005) and OECD Investment Reform Index (2006b) for SEE countries.



As previously mentioned, among the most frequently used measures of the corporate income tax burden are ratios of CIT receipts in relation to some macroeconomic base, approximated by some macroeconomic aggregates, such as total tax revenues and GDP.

From Figure 5 it is clear that BiH as a whole and the entities as well rank last internationally in terms of the ratio of corporate tax receipts in total tax receipts. While corporate income tax is significantly contributing to government revenues around the world, its contribution to BiH government revenues is miniscule. The main reasons are the extensive exemption scheme which was in force in previous years and captured in the data presented in Figure 5 (especially in FBiH), weak auditing systems, and the voluminous grey economy. However, the trend is increasing mostly due to strengthening of auditing system and base broadening³².

³² See Rozner, Sahinagic and Marjanovic (2005).

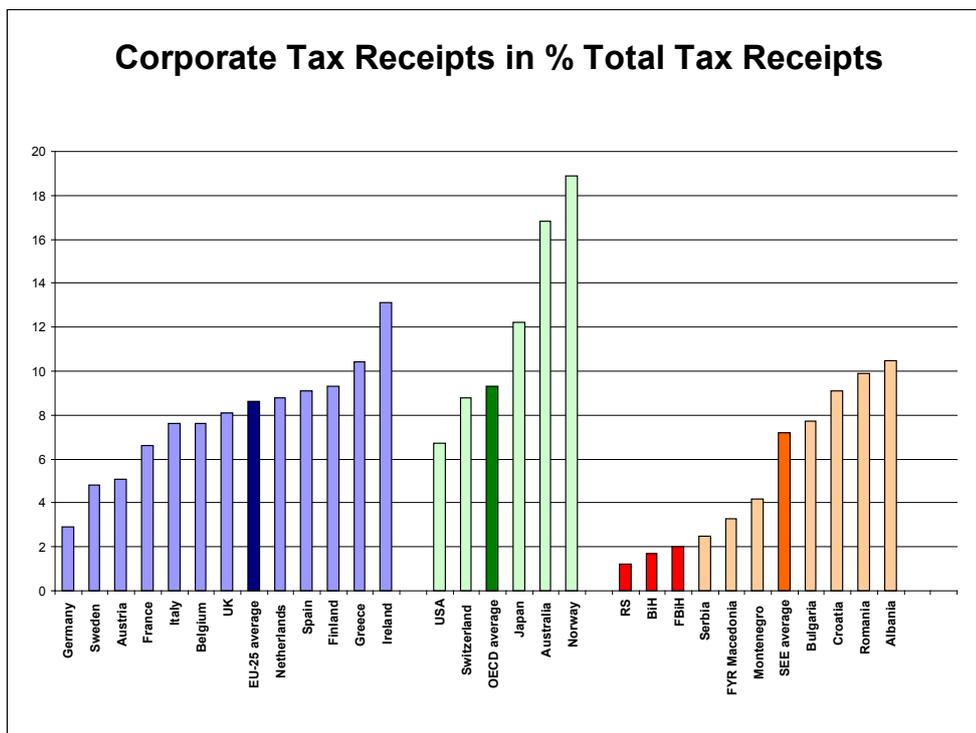


FIGURE 5:
CORPORATE TAX RECEIPTS IN % OF TOTAL TAX REVENUES³³

³³ Source: OECD in Figures (2006a), IMF's Articles IV for SEE countries, and Central Bank BiH, IMF, Medium Term Expenditure-Frameworks of finance ministries, and statistics agencies for BiH GDP data.

Figure 6 illustrates that corporate income tax receipts as a share of GDP, both in BiH state and in the entities, is at the bottom of the range internationally. Furthermore, within the direct tax revenues, CIT revenues expressed in % of GDP of 0.8% in 2007 (173 million KM of CIT revenues in 2007 as a share of 20,687 million KM of BiH GDP in 2007, according to Directorate for Economic Planning estimates) are much comparatively lower than EU-15 average of 3.5 % of CIT revenues in GDP and OECD-average of 3.4% of CIT revenues in GDP³⁴.

³⁴ Source: OECD, Ministry of Finance of FBiH, Tax Administration of RS and Ministry of Finance of RS.

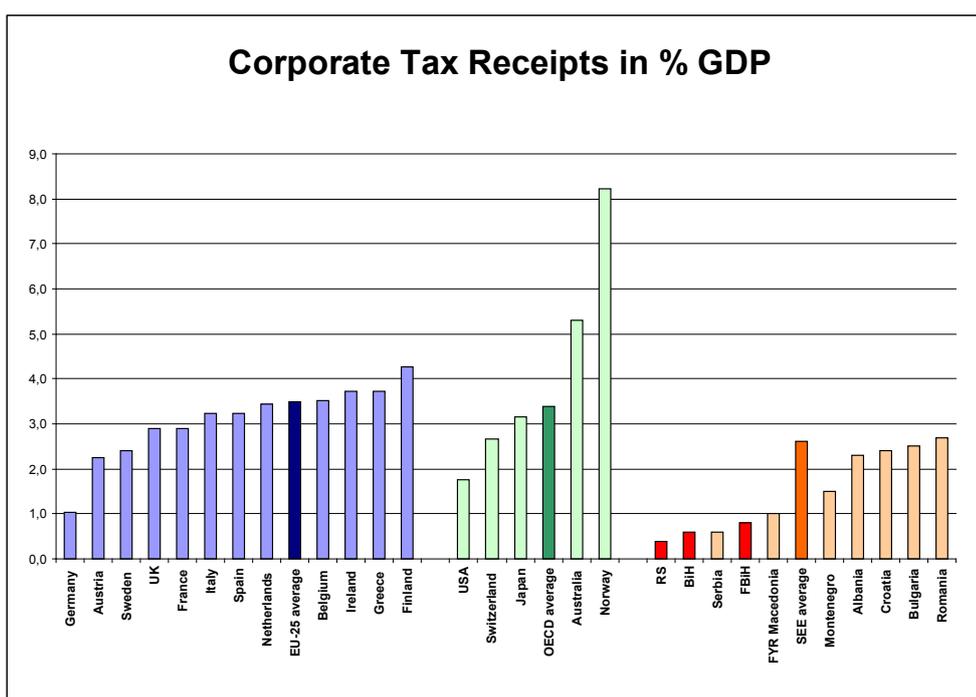


FIGURE 6:
CORPORATE TAX RECEIPTS IN % OF GDP³⁵

³⁵ Source: OECD in Figures (2006), IMF's Articles IV for SEE countries, and Central Bank BiH, IMF, Medium Term Expenditure Frameworks of finance ministries, and statistics agencies for BiH data.

BiH authorities have adopted new Laws on Corporate Income Taxation adopted in RS and FBiH in 2006 and 2007 respectively. Underlying economic rationale for this recent reform was is to reduce administrative costs (of companies and of the administrative system itself) through simplification and partial harmonization of the CIT system, hence improving competitiveness/performance. Both economic theory and EU experience in the last decade 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 productivity³⁶.

³⁶ Source: European Commission (2006a).

While adoption of the new legislation on CIT in both entities (as explained in the previous section of this chapter) is welcome, the new laws need to be analyzed from the perspective of adherence to the EU Code of Conduct on Business Taxation. Furthermore, the new legislation needs to be considered from the perspective of whether it is possible to provide additional incentives for private sector growth, while at the same being in line with the EU Code of Conduct of Business Taxation³⁷. Finally, while new entity laws are much more similar in comparison to previous legislation on corporate income, complete harmonization i.e. adoption of a single country-wide law should be considered. Non-existence of a single systematic law on all CIT obligations prevents capital and labor mobility.

³⁷ European Commission, (1997).

The cross-country comparisons of the various measures of the corporate income tax burden leads to the following conclusions:

1. In terms of statutory rates, FBiH and RS rate of 10% is globally and regionally competitive.
2. The importance of corporate taxes in financing government is much lower in BiH than in other countries, both in the region and globally. However this share has been increasing in both entities in the last five years.
3. The CIT burden, as measured by the share of corporate tax revenues in GDP, is very low in BiH, both from a global and a regional perspective.
4. Complete CIT harmonization is advisable at the BiH level.

CIT in EU: Historical Overview

The main goal of the EU when it comes to the taxation is "to ensure some Member States' tax policies do not have an undesirable impact on others and to provide real sovereignty for EU citizens and their representatives through common action"³⁸. Thus, the goal of the EU is not to standardize/unify the national taxation systems of its member states, but rather to just simply ensure that the tax systems of the EU countries (and candidates) are compatible with each other but also with the main aims of the Treaty establishing the European Community, mainly the right of establishment (further discussed in the next paragraph).

The European Commission requires since 1977 a uniform basis for indirect taxation³⁹ (VAT and excise) for all consumption products regardless of origin, for the sake of creation of internal market. While indirect taxation harmonization is a precondition for fulfilling freedom of movement of goods, one of the basic cornerstones of the EU, EU member and candidate countries do not have responsibility to align direct taxation⁴⁰ policies, unless a direct taxation system directly affects the four freedoms of the EC Treaty or the right of establishment⁴¹, which means that any discrimination with respect to the establishment and pursuit of economic activities is prohibited.

³⁸ Source: European Commission (2000).

³⁹ As defined in European Commission (2000), indirect taxes are those levied on production and consumption and are not borne by the 'taxable persons' (traders or industry) who pay them, collecting the tax on behalf of the government and passing it on in the price to the final consumer on whom the burden falls (examples include VAT and excise duties).

⁴⁰ As defined in European Commission (2000), Direct taxes are those paid and borne by the taxpayer and include income tax, corporation tax, wealth tax and most local taxes.

⁴¹ See European Commission (2000).



As the possibilities of EU enlargement were at its height in the 1990s, debates were heated on the ways in which taxation distorted corporate investment decisions. As a result, the EC commissioned an expert committee to examine the extent to which the direct taxation systems affected the single market. The committee recommended partial harmonization of corporate taxation systems, especially as they pertain to transfer pricing and the treatment of losses. Corporate income taxes are of special interest since company taxation is an easily available instrument employed by national governments competing for increasingly mobile firms, investment, and profits. Several recent studies estimating tax reaction functions between countries (e.g. Brueckner and Saavedra, 2001; Devereux, Lockwood and Redoano, 2002; Devereux and Griffith, 2003) support the hypothesis of strategic interaction of tax policies on mobile factors. It was expected that the accession of ten new member states (NMS) in May 2004 would increase the downward pressure on company tax rates in the EU. The NMS on average already have considerably lower company statutory tax rates than the old member states, and it is probable that they will reduce company taxation further. Consequently, in 1997 a Commission communication was adopted, the “Code of Conduct for Business Taxation” – a non-binding agreement among the Member States to abstain from harmful tax competition regarding investment activities, including FDI.⁴² Code of Conduct covers legislative, regulatory, administrative and *de facto* tax measures, which have, or may have, a significant impact on the location of business activities in EU. In other words, purpose of the Code was to identify only such measures which affect the decision of business location by providing non-residents with a more favorable tax treatment than that which is generally available for the residents of that same country. The Code defined these measures as harmful, and identifies criteria against which all potentially harmful measures are to be checked. Even though this Code is not legally binding, but it has political force. Under this Code, the EU states obliged to eliminate/adjust tax measures that constitute harmful tax competition and not to introduce any such measures in the future. This Code of Conduct does not address the form of competition through lowering the CIT rates. In 2001, EC produced the study “Company Taxation in the Internal Market”, which stressed the importance of definition of uniform tax base, rather than tax rate.⁴³

⁴² See European Commission (1997).

While the corporate community supports creation of a common tax base, which would simplify the EU-wide business activities, there is a lack of agreement on CIT coordination among member states, due to fears of loss of national sovereignty and fears that harmonization of the corporate tax-rates would follow. Consequently, new flexible approaches are envisaged, such as the peer pressure procedure. Agreement on some minimum CIT rate may be feasible on economic ground. Such a minimum may be stipulated by a combination of the protection of the integrity of the PIT, the presence of flat tax rate systems with uniform rates and to a lesser extent dual income tax systems as found in the Nordic countries, the ineffectiveness of very low rate in the presence of residence based systems in countries with large FDI, and the prevalence of source based CITs⁴⁴

⁴³ See European Commission (2001).

CIT in EU: Code of Conduct on Business Taxation

European Union adopted on 1 December 1997 a Resolution on a Code of Conduct for business taxation. The Resolution provides for the establishment of a Group, within the framework of the Council, to assess the tax measures that may fall within the Code. The Council subsequently confirmed the establishment of the Code of Conduct Group on March 9th 1998. The Group reported regularly on the measures assessed⁴⁵. In regards to the criteria for harmful taxation practices, Code of Conduct on Business Taxation specifies:

⁴⁴ This section extracted from Carsimamovic (2006).

⁴⁵ European Commission (1999).

“Without prejudice to the respective spheres of competence of the Member States and the Community, this code of conduct, which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community.

Business activity in this respect also includes all activities carried out within a group of companies.

The tax measures covered by the code include both laws or regulations and administrative practices.

B. Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code.

Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.

When assessing whether such measures are harmful, account should be taken of, inter alia:

1. whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or
2. whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or
3. whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or
4. whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or
5. whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way.⁴⁶

⁴⁶ European Commission (1997).

The Code adds the provision that Member States commit themselves not to introduce new tax measures which are harmful within the meaning of this code. Member States also have to respect the principles underlying the code when determining future policy and that Member States commit themselves to re-examining their existing laws and established practices, having regard to the principles underlying the code, followed by amendment of such laws and practices as necessary with a view to eliminating any harmful measures as soon as possible taking into account the Council's discussions following the review process.

Furthermore, the Code adds in paragraph M that it is advisable that principles aimed at abolishing harmful tax measures should be adopted on as broad a geographical basis as possible. To this end, Member States commit themselves to promoting their adoption in third countries⁴⁷.

⁴⁷ European Commission (1997).



As previously mentioned, the Code envisaged establishment of a group to assess the tax measures that may fall within the scope of the Code and to oversee the provision of information on those measures. The group was to select and review the tax measures for assessment in accordance with the provisions laid in the Code. Consequently, in 1999, Group on Assessment of Code of Conduct for Business Taxation evaluated CIT systems of original 15 member states⁴⁸. The Group identified 271 potentially harmful measures (all listed in Appendix 1). On further evaluation of each of the 271 measures against the five criteria defined in the Code (and listed above), the Group concluded that the 66 of them are indeed harmful (presented in Appendix 2)⁴⁹:

⁴⁸ European Commission (1999).

Member States and their dependent and associated territories have now introduced or are in the process of introducing revised or replacement measures in substitution for the 66 measures.

⁴⁹ This Group also subsequently identified 65 potentially harmful measures in the twelve countries that recently joined the EU, found 65 potentially harmful measures.

Potentially Harmful Measures of Entity CIT Systems in BiH

On the basis of these firstly identified 271 potentially harmful measures, this study defines the measures which may be found potentially harmful in the CIT systems in BiH (the subject of this study are Law on Corporate Income Taxation of RS in force since January 1st 2007 and Law on Corporate Income Taxation of FBiH in force since January 1st 2008), and compares them against the five criteria defined in Code of Conduct on Business Taxation:

1. tax benefits reserved for non-residents;
2. tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
3. granting of tax advantages even in the absence of any real economic activity;
4. the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD;
5. lack of transparency.

Federation of Bosnia and Herzegovina

1. Exemption for exporters

The CIT Law in FBiH cites:

“A taxpayer who shall realize the exports exceeding 30% of total income (turnover), within the tax year profit is determined for shall be exempt from profit tax for that year.”

This measure is newly introduced in new FBiH CIT Law, and has replaced measure in the previous Law which stipulated the exemption of paying CIT to the companies operating in the free zones.

According to the OECD Report on Harmful Tax Competition (1999),

“There are good reasons for the international community to be concerned where regimes are partially or fully isolated from the domestic economy. Since the regime’s “ring fence”

ing” effectively protects the sponsoring country from the harmful effects of its own incentive regime, that regime will have an adverse impact only on foreign tax bases. Thus, the country offering the regime may bear little or none of the financial burden of its own preferential tax legislation. Similarly, taxpayers within the regime may benefit from the infrastructure of the country providing the preferential regime without bearing the cost incurred to provide that infrastructure.”

This measure, therefore, needs to be examined with special caution having in mind that its integral condition is exports, thus comprising transactions with non-residents. However, this study’s preliminary conclusion is that since this measure sets the condition of exports at only 30% of company’s turnover, it may not be harmful in this sense, since most of the income did not necessarily have to be export-related income from non-resident transactions. In examining whether this measure is harmful, EC’s Group for Code of Conduct on Business Taxation may look at *de facto* actual number of companies which will be using this exemption once the Law is enforced. Furthermore since the Rulebook for the new CIT Law in FBiH is not established yet (the Law states that Federal Minister of Finance shall prescribe Rulebook for the implementation of this Law for the following: methodology of determination of a profit tax base in tax balance; depreciation rates; manner of accelerated depreciation and manner and due-dates for filing tax returns and tax balance; forms for filing and calculation of withholding tax, procedures for acquiring the rights on tax holidays etc.), the fifth criteria (whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way) can only be determined once the Rulebook is published.

Study concludes that this measure is probably not harmful, but further investigation is needed after the Rulebook is prescribed and actual implementation started.

MEASURE: 1. Exemption for exporters in Federation of BiH	Criteria 1: whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents	Criteria 2: whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base	Criteria 3: whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages	Criteria 4: whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD	Criteria 5: whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way
Is it harmful?	Probably NO, but needs further investigation	Probably NO, but needs further investigation	Needs further investigation when the Rulebook on implementing this new Law is defined.	Needs further investigation	Needs further investigation when the Rulebook on implementing this new Law is defined.

2. Exemption for investment

The CIT Law in FBiH⁵⁰ cites:

“A taxpayer investing in production not less than 20 million KM over the period of 5 consecutive years in the Federation shall be exempt from profit tax during the period of 5 years, starting with the first year when taxpayer has to invest at least four million KM. Shall this taxpayer over the period of 5 years fail to reach prescribed investment amount, s/he shall lose the right to tax exemption, and unpaid profit tax shall be determined according to the provisions of this Law, and increased for the penal interest that shall be paid onto the untimely paid public revenues.”

⁵⁰ Law on Corporate Income Tax in FBiH, “Official Gazette of FBiH” 97/07



This measure is available to both residents and non-residents. As for the condition of real economic activity taking place, since investment would automatically imply economic activity, this measure is also not harmful in that sense either. Therefore, in this measure is also probably not harmful under Code of Conduct of Business Taxation, but further investigation is needed after the Rulebook is prescribed and actual implementation started, especially having in mind the high threshold of 20 million KM (or 4 million average per year) may be not attainable for domestic companies, so this measure may *de facto* be used mostly or exclusively by the non-residents.

MEASURE: 2. Exemption for investment in Federation of BiH	Criteria 1: whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents	Criteria 2: whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base	Criteria 3: whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages	Criteria 4: whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD	Criteria 5: whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way
Is it harmful?	Probably NO, but needs further investigation.	Probably NO, but needs further investigation.	NO	NO	Needs further investigation when the Rulebook on implementing this new Law is defined.

3. Incentives for research and development

The CIT Law in FBiH cites:

“All costs pertaining to research and development shall be recognized as expenditures in tax balance.”

This measure is also available to both residents and non-residents. Therefore, this measure is probably not harmful under Code of Conduct of Business Taxation, but further investigation is also needed for this measure after the Rulebook is prescribed and actual implementation starts.

MEASURE: 3. Incentives for research and development in Federation of BiH	Criteria 1: whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents	Criteria 2: whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base	Criteria 3: whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages	Criteria 4: whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD	Criteria 5: whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way
Is it harmful?	NO	NO	NO	No OECD rules in this area	Needs further investigation when the Rulebook on implementing this new Law is defined.

Republika Srpska

Reduced rate for micro-enterprises

The CIT Law in RS cites:

“Legal entity with the status of small tax payer (with less than 9 employees and total annual revenues in preceding year not exceeding 100,000 KM, provided that not more than 50% of its total revenue comes from a single client) pays the corporate income tax at the rate of 2 percent).”

One of potentially harmful measures among 271 measures originally defined for EU- 15 was reduced rate for small and medium size enterprises (e.g. examined in Spain). Since this measure is available to both residents and non-residents and it is clearly defined that the economic activity has to be taken, this measure is probably not harmful under Code of Conduct of Business Taxation.

MEASURE: 4. Reduced rate for micro-enterprises in Republika Srpska	Criteria 1: whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents	Criteria 2: whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base	Criteria 3: whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages	Criteria 4: whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD	Criteria 5: whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way
Is it harmful?	NO	NO	NO	No OECD rules in this area	Needs further investigation

2. Incentives for scientific and development research

The CIT Law in RS cites:

“Expenditures that are recognized and deductible from revenue also include (...) research and development expense as prescribed in the Rule Book”

This measure is also available to both residents and non-residents. The Rulebook gives clear definition of research and development activities ensuring that the real economic activity is taking place. Therefore, this measure is probably not harmful under Code of Conduct of Business Taxation.

MEASURE: 5. Incentives for scientific and development research in Republika Srpska	Criteria 1: whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents	Criteria 2: whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base	Criteria 3: whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages	Criteria 4: whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD	Criteria 5: whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way
Is it harmful?	NO	NO	NO	No OECD rules in this area	NO

3. Investment into machinery and equipment

The CIT Law in RS cites:

“For a taxpayer making an investment into machinery and equipment, at the territory of Republic of Srpska, and which is attributable to performance of own registered production activity, the tax base shall be reduced for the amount of the respective investment. Tax base reduction for the amount of investment as specified in Paragraph 1 of this Article shall be valid until December 31, 2008.”

This measure, like the upper two is available to both residents and non-residents. As for the condition of real economic activity taking place, since investment into machinery would automatically imply economic activity, this measure is also not harmful in that sense either. This measure is thus probably not harmful under Code of Conduct of Business Taxation.

MEASURE: 6. Investment into machinery and equipment in Republika Srpska	Criteria 1: whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents	Criteria 2: whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base	Criteria 3: whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages	Criteria 4: whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD	Criteria 5: whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way
Is it harmful?	NO	NO	NO	NO	NO



Concluding Remarks on Potentially Harmful Measures in BiH

Out of the six identified potentially harmful measures (identified on the basis of 271 potentially harmful measures identified by the EC's Group on Code of Conduct on Business Taxation for EU-15 in 1999), it can be concluded with a lot of certainty that four of them will not be found harmful by the EC's Group on Code of Conduct on Business Taxation.

The remaining two are two measures in the new CIT Law in FBiH:

1. Exemption for exporters

2. Exemption for investment

These two measures are probably not harmful either, but this termination is non-conclusive since further investigation needs to be performed after Rulebook is prescribed and after these measure are enforced, to investigate whether *de facto* measures are used mostly or exclusively by the non-residents, which would make it harmful.

On the basis of analysis outlined above, it can be concluded:

1. 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 needs to be changed in order to be in line with the Code of Conduct on Business Taxation. If this measure is found not harmful, RS should consider introducing it as well.
2. Measure for investment in machinery are not harmful, therefore RS should consider extending it after 2008. Should the measure for investment be found harmful in FBiH (previous measure discussed above), FBiH should consider introducing this measure instead. However, should the investment measure in FBiH turn out *de facto* not harmful, RS should consider introducing the same measure instead of current more narrowly defined exemption for investment in machinery, in order to provide more extensive investment incentive.
3. Finally, with the latest reform, two CIT systems are brought much closer than they were in the past. However, complete harmonization of the tax base and exemptions needs to be preformed in order to unify economic space in BiH, 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.

Potential Limitations of the Study

Examining adherence of a country to Code of Conduct on Business Taxation has one inherent potential limitation. Detailed analysis and final evaluation of a country's adherence is done by the expert Working Group on Code of Conduct on Business Taxation, which after long and careful analysis of all taxation specificities determines potentially harmful tax provisions. Since this study is limited in time and resources and done by a single author, it used potentially harmful provisions for other EU countries previously identified by the Group on Code of Conduct and compared them with the provisions in FBiH and RS CIT Laws in order to find the measures which the Working Group on Code of Conduct on Business Taxation may identify as potentially harmful. However, while the Group had previously defined as many as 336 potentially harmful provisions (271 were identified for EU-15 and 65 for the twelve newest EU member states), the list of potentially harmful provision determined in this study is not necessarily exclusive.

Furthermore, while this study will lay out recommendations for setting the corporate income taxation systems in BiH at the optimal place for increasing BiH competitiveness, it needs to be recognized that a country's competitiveness is optimized only when, in addition to its corporate income taxation system, its taxation on labor is optimized as well. Therefore, for overall BiH competitiveness to be maximized, further policy recommendations are needed to improve BiH systems of personal taxes and social contributions.

The greatest limitation of the study is that the final evaluation of whether measures are harmful needs to be done by the EC's Group on Conduct of Business Taxation. Therefore, this study should be viewed as giving pointers to which measures are likely to be examined by the EC and on which criteria they will be graded. Conclusions on final level of harmfulness of a measure given in this study should therefore be viewed only as illustrative.

The final limitation of this study is the fact that it does not take into consideration Brcko District in BiH, but rather only the two entities of Federation of BiH and Republika Srpska.



POLICY OPTIONS

Possible Approaches for Making BiH's CIT Systems Both Adherent to the EU Standards and Conducive to Improvement of BiH's Competitiveness

In defining policy recommendation to solve the three issues in BiH entity CIT systems outlined above (1. examining exemptions for exporters and exemption for investment in FBiH and if necessary changing it in order to be in line with the Code of Conduct on Business Taxation, 2. reconsidering to keep exemption for investment in machinery in RS after 2008, and 3. considering complete harmonization of the tax base and exemptions at the BiH level), it is important to consider the final outcomes desired.

There are three possible policy options defined by this study:

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, and
3. Completely harmonizing CIT legislation at the state level, while ensuring the adherence to the EU Code of Conduct.

Criteria Used to Evaluate Policy Options

In the Outcome Matrix below three possible policy options (1. do nothing, 2. examine more carefully whether the two potentially harmful measures in new FBiH need to be adjusted to adhere to the Code of Conduct, and 3. completely harmonize entity systems, while ensuring adherence to the Code of Conduct) are evaluated according to three criteria, i.e. desired outcomes:

1. Countries which join EU after creation of EC's Group for Code of Conduct for Business Taxation in 1999 are obliged to adopt and implement Code of Conduct on Business Taxation as one of the *Acquis* during the process of final negotiation for EU accession. This is the minimum requirement which BiH will have to fulfill in this field. For example, Croatia, whose European Accession document was issued by the EC in November of 2007 will have to commit to the principles of the Code of Conduct for business taxation and ensure that new tax measures are in conformity with these principles as a part of negotiation on Chapter 16: Taxation. Therefore, the first criteria is the following question:

If option taken, would BiH fulfill the Acquis in CIT field at the final allowable stage - as it approaches final EU accession?

2. In addition to the fact that all countries accessing the EU will have to adopted and implement the Code at the time of final accession, BiH also committed itself to the principles of the Code of Conduct for business taxation as one of the short-term commitments from EU partnership to be accomplished by 2009, according to the 2007 European Partnership document. BiH needs to show its seriousness and ability to fulfill its commitments - committing to the principles of the Code of Conduct for business taxation and ensure that new tax measures are in compliance with these principles. While it is possible that EC will issue accession negotiation with BiH even if this goal is not met by 2009 (e.g. adhering to the Code of Conduct was a short-term priority Croatia was supposed to fulfill before Accession Partnership was to take place, and yet it did not happen in that timeframe), it would be preferable that BiH fulfills this priority as soon as possible, thus exhibiting its seriousness and level of accountability. Therefore, the second criteria is the following question:

If option taken, would BiH fulfill its short-term commitments from 2007 EU partnership to be accomplished by 2009 - committing to the principles of the Code of Conduct for business taxation and ensure that new tax measures are in compliance with these principles?

3. Besides the lack of analysis of the extent to which two entity systems adhere to the EU Code of Conduct on Business Taxation, BiH is facing much more pressing problem of non-existence of a single market within its own territory. How is Bosnia and Herzegovina expecting to enter the EU in which a-500-million-people market function as a single one, when with only 4 million people, it has three separate systems of corporate income taxation? Therefore, the third criteria is the following question:

If option taken, would BiH CIT system provide maximum support to competitiveness of BiH private sector?

Evaluation of the Options and Chosen Policy Option

As exhibited in the table below, the third option of completely harmonizing the entity systems is the only one that fulfills all three of the criteria, and therefore is the chosen alternative in this policy study. In the next section of the paper, action plan will be laid out on how the BiH authorities should go about implementing this policy option.

<i>Goals/Criteria</i>	<i>Policy Options</i>		
	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



CONCLUSIONS AND RECOMMENDATIONS

All of the international organizations are expressing worries about BH direct taxation systems⁵¹. In its latest staff report on BiH, International Monetary Fund⁵² recommends that BiH simplifies and harmonizes its entity systems of direct taxes to create a single economic space.

⁵¹ For example see World Bank, 2006.

Even after recent welcomed reforms which harmonized the statutory tax rates and brought closer the corporate income tax bases in the two entities, BiH businesses still have to fill out different tax forms in the two entities. Such a policy poses an obstacle to the following key elements for further development of BiH economy: the functioning of a single economic space in BiH (which is one of the goals from state-wide Medium Term Development Strategy of BiH and also a requirement for further EU integration) and above all to much needed entrance and creation 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.

⁵² IMF (2007).

In order to tackle two of the most pressing issues of the current Bosnia and Herzegovina, which are the need to smoothly progress on the long road ahead towards the EU accession and the need to foster the much needed development of the BiH economy's private sector, this study recommends that the BiH government completely harmonize CIT legislation at the state level, while ensuring the adherence to the EU Code of Conduct.

Proposed Set of Policy Recommendations

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.

- **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 evaluation on potential harmfulness of the exemption envisaged in the new Law on Corporate Income Taxation which was adopted in December of 2007 and enforced starting January 1st 2008.

- **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 completely harmonizing all of the specifications of the CIT bases.

- **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.

It is not debatable that people and politicians of BiH have a common goal of joining EU, and therefore it is clear that the BiH will adopt EU standards in all necessary areas. However, it is advisable that BiH authorities take early initiative in asking the EC to give the final evaluation of the potential harmfulness of the new CIT legislation specifications.

There are some important constraints associated with the potential implementation of this policy choice, particularly in regards to the recommendation that the Council of Ministers of BiH should adopt the strategy of adopting the CIT Law at the state level, having in mind that this recommendation implies that the entities would need to agree to transfer their powers in direct taxation to the state level, which is unlikely to happen given the current political atmosphere. Consequently, while this is preferable choice of fulfilling the purpose of the recommendation, the alternative is presented in which entity Ministries of Finance and entity Tax Administration should adopt Action Plan on completely harmonizing all of the specifications of the CIT bases, which would avoid the necessity of the power transfer from entities to the state.

When it comes to the financial cost of the policy recommendations, given that the changes would be minor in the administration sense, tax administration would have to incur the minimal costs in the case the second alternative is adopted (i.e. not the transfer of powers to state, but a complete harmonization of the entity systems). Similarly, even if the preferred alternative of state-level CIT system were to be implemented, the financial costs would not be excessive, having in mind that the administrative capacities of the entities would simply be transferred to the state (as was shown in the recent transfer of the powers of indirect taxation from entities to the state level and creation of the indirect Taxation of BiH, which was not accompanied by large financial costs and resulted in significant improvement in tax administration efficiency, tax discipline and tax collection).

In addition to this, Bosnia and Herzegovina has a more pressing issue of harmonization of corporate income taxation across entities. Business people leading most of the few successful private companies in BiH would agree that their companies are not successful because of the fact that the BiH governments are giving them incentives to succeed, but rather in spite of the fact that the BiH governments are not working enough on advancing BiH private sector.

Perfect illustration is given by director of one of the most successful BiH companies Ms. Elizabeta Josipović at the Conference "Platform for Action: Towards Sustainable Economic Development through Reforms and Partnership in Bosnia and Herzegovina", organized by Office for High Representative on October 16th, 2007:

"I would like to use this opportunity to say that 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 completely 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 Josipovic, director of Scontoprom d.o.o. Prijedor



APPENDIX

APPENDIX 1: List of 271 potentially harmful measures identified for EU-15 in 1999 Report of the Group for Assessing Code of Conduct for Business Taxation

Measures	i. Member States	On List?	Features
Co-ordination Centres	B	V	Substantially reduced base/cost plus 8%. Withholding tax exemption for dividends, interest, royalties. Requirement to be part of international group
Distribution Centres	B	V	Reduced base/cost plus 5%.
Service Centres	B	V	Reduced base. Cost plus 5-15% depending on type of activity/resale minus 5%.
Basque Country Co-ordination Centres	E	V	Reduced base/cost plus 25% (excludes financial expenses). Requirement to be part of international group.
Navarra Co-ordination Centres	E	V	Reduced base/cost plus 25% (excludes financial expenses). Requirement to be part of international group.
Headquarters and Logistic Centres	F	V	Cost plus 6-10%. Requirement to be part of international group.
Co-ordination Centres	L	V	Cost plus 5%. Requirement to be part of international group. For a few remaining companies qualified up to February 1996, benefits continue to 2001.
Cost Plus Ruling	NL	V	Cost plus 5-15%.
Resale Minus Ruling	NL	V	Resale minus 1-3%.
Intra-Group Finance Activities	NL	V	Fixed margin, is not adjusted as interest rates move.
Holding Companies (ETVE)	E	X	Exemption for qualifying foreign source profits. Comparable taxation required. Exemption from withholding tax and capital gains in respect of qualifying non-resident subsidiaries. Requirement to be part of international group.
Royalty Income - Patents	F	V	Reduced tax rate on income 19%. Does not apply to French source income.
1929 Holding Companies	L	V	Exemption from most taxes. But no commercial activities permitted. And no treaty access.
Holding Companies	NL	V	Participation exemption for dividends includes low tax foreign source. Capital gains exemption and relief for capital losses in certain circumstances
Royalties	NL	V	Fixed rate margins: 7% or less depending on the net royalty income, for royalties and management fees.
International Headquarters Companies	UK	X	Abolished with effect from 4/99.
Holdings (Schachtelbegünstigung - Intra-Group Relief)	A	V	Exemption for foreign source dividends of 25+% subsidiaries includes low tax foreign source. Relief for capital losses and exemption for capital gains
Private Foundations (Stiftungen)	A	X	Applies to non-business activity. Exemption for dividend income.
Holdings	B	X	95% exemption for dividend income. Exemption from capital gains. Comparable taxation required.
Control- and Co-ordination Centres of Foreign Companies in Germany	D	V	Cost plus 5-10%. Requirement to be part of international group.
Holding Companies	D	X	Dividend and capital gains exemption for treaty country participations.
Holding Companies	DK	V	Exemptions for dividends includes low tax foreign source, except for financial activities.
Holding companies with shareholdings in foreign companies.	F	X	Exemption from precompte for foreign source dividends. But no pass-through of credit.

Application of the parent company/subsidiary system to resident companies with share capital (commonly known as SOPARFI).	L	X	Exemption from tax on dividends and capital gains where similar tax regime applies to source.
Holding Companies (SGPS)	P	X	95% income exemption for dividends. Comparable taxation required.
The International Financial Services Centre (Dublin)	IRL	V	10% CT rate, double deduction for rent expense, 100/54% First Year Allowances for new buildings. 10% rate until 2002 for companies qualified up to 1999 (quota for 1998/99). 10% rate until 2005 for companies qualified up to May 1998.
Trieste Financial Services and Insurance Centre	I	V	Exemption from corporation tax. Reduction in local income tax. Applies to Eastern European Investment.
Luxemburg Finance Companies	L	V	Tax applied to fixed margin of 0.25% or 0.125%. Requirement to be part of international group. For a few remaining companies qualified up to February 1996, benefits continue to 2001.
International Financing Activities	NL	V	Facility to create tax-effective reserve equivalent to 80% of profit. Requirement to be part of international group.
Finance Branch	NL	V	Facility to allocate 90% of profits to foreign branch. Not available for passive income from 1999 onwards.
Madeira and Sta Maria (Azores) Free Zones	P	V	Exemption from: CT, municipal & local taxes, withholding tax on interest and tax on royalties. Available to transactions with non residents & financial activities. Companies may qualify up to 2000. Benefits continue until 2011.
Provisions for fluctuations in reinsurance	L	V	Facility to create tax-effective reserve equivalent 20 times premium income.
Aland Islands Captive Insurance	FIN	V	Reduction of local tax from 11.2% to 1.2%, giving 18% tax rate.
Foreign Insurance Companies	S	X	Taxable income of non-resident insurers is calculated as 2% of gross premium income. Applies only to domestic market.
Offices of Foreign Companies under the Law 89/67	GR	V	Exemption from income tax and other direct taxes. Applies only to offices of foreign companies.
Certain Exemptions from Corporation Tax	A	X	(a) Exemption for non-profit seeking credit institutions. (b) Exemption from corporation tax for first five years for associations providing financing for SME's.
Provisions for fluctuation in insurance and re-insurance	D	X	System of reserves to cover liabilities.
Banks and Finance Entities	E	X	More flexible provisions for treatment of bad debts,etc
Business share capital companies (Law 2367/1995, Article 5)	GR	X	Exemption for undistributed profits on SME financing. Restriction of tax to 15% of distributed profits.
Long Term Loans in Foreign Currency	GR	X	Exemption from tax of interest paid on foreign source loans to finance productive investment in Greece.
Finance Centres	F	X	More favourable treatment (deductibility and withholding rules) than the normal regime for interest paid out of France.
Provisions for risks relating to medium and long term credit operations carried out by banks and credit institutions.	F	X	Sets limits for deduction for credit risk provision.

Technical provisions for insurance and reinsurance undertakings.	F	X	Provides specific limits on deductibility of reserves for different kinds of risks.
Incentives for the restructuring of the Banking Sector	I	X	Reduction in corporate tax rate where Italian banks have merged, from 37% to 12.5%
Tax Deduction for Interest on Additional Capital Contributions from Foreign Head Offices to Italian PE	I	X	Provides for deductibility of interest on head office loans.
Exemption of Income on Government Securities	IRL	X	Exemption from tax for the local subsidiary or branch of a non-resident, on income from Irish Government Securities.
Non-resident Companies	IRL	X	Sets conditions for determining residence where there is overseas ownership, etc.
Reinsurance companies	P	X	Part of general tax system.
Independent investment managers	UK	X	Applies the OECD Model Tax Treaty provision for independent agents of non-residents - Article 5 (6).
Scheme for early depreciation of vessels	DK	X	Advance depreciation measure giving relief of up to 30% of total cost spread across the two years prior to delivery.
Shipping Regime - Tonnage Tax	D	X	See paragraphs 62-63 of the Final Report. Replaces normal profit calculations with formulaic measure linked to tonnage.
Ship Management Offices (Law 89/67 and 378/68)	GR	X	See paragraphs 62-63 of the Final Report. Exemption for management of deep sea shipping activities.
Shipping Regime (Law 27/75)	GR	X	See paragraphs 62-63 of the Final Report.. Exemption from corporation tax for vessels flying Greek flag. Replacement with formula-based tax linked to age, tonnage and type of vessel.
Shipping Regime	F	X	Accelerated deduction for investment in jointly owned vessels. Required approval prior to 15 September 1997.
Shipping Regime (Tax regime for shipping companies)	I	X	See paragraphs 62-63 of the Final Report. Only 20% of profits taxable.
Shipping Regime	NL	X	See paragraphs 62-63 of the Final Report. Replaces normal profit calculations with formulaic measure linked to tonnage.
Shipping Regime	P	X	See paragraphs 62-63 of the Final Report. (a) Exemption from CT for Madeira registered vessels. Exemption from tax on dividends for shareholders in such companies. Benefits continue until 2011. (b) 70% exemption from CT for Portuguese resident companies.
Ice-Class Investment Allowance	FIN	X	Allowance for 3% of cost of investment in vessel in each of first two years after commissioning.
Rollover Relief on Disposal of Ships	UK	X	Clawback of tax depreciation deferred where there is reinvestment in ships.
Supplementary staff assigned to scientific research and export management	B	X	Flat rate reduction of taxable profits per supplementary unit of staff.
Tax Credit for Research	F	X	Tax credit given for additional expenditure on research, etc. equal to 50% of additional amount. Reduces corporation tax or income tax.

Research and Technical Development	IRL	X	Exemption from tax on royalty income from patents developed in Ireland. No restriction on deductibility where royalties exempt.
Credits for Investments in Energy Saving Equipment	NL	X	Deduction for expenditure on qualifying energy saving business assets.
Research and Development Expenses	P	X	Additional deduction for incremental research and development expenditure.
Calculation of Net Revenue	GR	X	Deductions on formulaic basis for otherwise non-deductible expenses related primarily to export and tourist businesses and the media.
Audiovisual Investment. Certificates	L	X	Relief for certified audio-visual investment.
Film Industry	UK	X	Accelerated write-off of production costs of qualifying films.
Investment Deductions	B	X	Deductions for various types of investment, with rate dependent on type. Aimed at natural persons, SME's and particularly innovative SME's.
Special Depreciation and Allowances - Agriculture and Forestry	D	X	Investment allowances and other reliefs targeted on small agricultural and forestry businesses.
Incentives for Mining Enterprises	E	X	Free depreciation for mining assets, subject to cap of 30% of tax base.
Mining taxation	IRL	X	Accelerated depreciation and investment allowances for capital expenditure, exploration costs, etc.
10% Manufacturing Rate	IRL	V	10% rate for widely defined class of activities. Benefits expire 2010. New projects eligible for this rate until 2002.
Petroleum Taxation	IRL	V	25% rate for income from production of petroleum.
R&D Allowance	A	X	Deduction for expenditure (other than on fixed assets) for own-use (18%) or third party (12%) research.
Investor model/Film funds	D	X	Accelerated allocation of production phase losses to investors.
Rules for Self-generated Intangibles	D	X	Accelerated deduction of costs incurred on self-generated intangibles.
Relief for Investments in Films and Audiovisual Productions	E	X	Relief for production costs, subject to a cap.
Investigation and Exploitation of Hydrocarbons	E	V	Up to 100% reduction in tax base - mitigated by more limited depreciation, less flexible relief for losses, and a tax rate of 40% (normally 35%)
Shipping	E	X	See paragraphs 62-63 of the Final Report. 90% reduction in corporation tax liability. Restricted to shipping companies located in Canaries and companies operating regular services between Canaries and Spain.
Accelerated Depreciation for Purchases of Software	F	X	Accelerated depreciation.
Accelerated Depreciation for Energy-Saving Equipment	F	X	Accelerated depreciation.
Accelerated Depreciation for Environmental Protection	F	X	Accelerated depreciation.
Deduction of Cooperative Dividends	F	X	Deduction of dividends paid to members in proportion to business with the cooperative.

Tax Exemption of Capital Gains on the Sale of Securities of Companies Established by Special Agreement to Promote Industry, Business and Agriculture	F	X	Targeted capital gains relief, subject to reinvestment requirement.
Exemption from Corporation Tax for the Oil Storage Agency	F	X	Deferral of taxation of profits of government controlled Oil Storage Agency.
Corporation Tax Exemption for Agricultural Cooperatives	F	X	Exemption from corporation tax of mutual activities.
Provisions for Renewal of Mineral Reserves	F	V	Facility to create tax effective reserve up to 50% of taxable profits or 15% of sales proceeds (with reinvestment requirement within 5yrs)
Provisions for Renewal of Oil and Gas Reserves	F	V	Facility to create tax effective reserve up to 50% of taxable profits or 23.5% of sales proceeds (with reinvestment requirement within 2 years)
Press	F	X	Facility to create tax-effective reserve up to 60/80% of profits.
Special Depreciation Rules for the Audiovisual Sector	F	X	Write off of investment in SOFICAs.
Business and Industrial Real Estate Companies	F	X	Measure no longer applicable.
Companies Authorised to Provide Energy-Saving and Heat Recovery Financing (SOFERGIE)	F	X	Exemption for leasing income and capital gains.
Exceptional Depreciation for Participating Interests in Companies Financing Non-Industrial Fishing (SOFIPECHE)	F	X	Write off of investment in SOFIPECHE.
Securities in Innovation Financing Companies (SFI)	F	X	Write off of investment in SFIs.
Incentives for Scientific Research	I	X	Tax credit for additional employment on research and development in SMEs, etc.
Film	IRL	X	Deduction for investment in film production company. (See also C024)
Investments in renewable energy projects	IRL	X	Deduction for investment in company undertaking a renewable energy project.
Tax Exemption for Profit/Gain from the occupation of woodlands	IRL	X	Exemption from tax of profits of commercially managed woodlands.
Depreciation of equipment and tools used solely for scientific or technical research operations.	L	X	Accelerated depreciation.

Shipping Regime	L	X	See paragraphs 62-63 of the Final Report.. Accelerated depreciation. 14% tax credit. Exemption from municipal tax. Capital gains rollover relief on reinvestment.
Film Industry	NL	X	Accelerated depreciation
Employment (T) Zones	B	X	No new qualifying companies since 1990. Benefits expire 2000.
Incentives for Investment in Certain Regions	B	X	Accelerated depreciation and exemption from (local) immovable property withholding tax.
Re-conversion Zones	B	X	Limited exemption for distributed profits. Deduction for certain share repurchases. No new qualifying companies since 1990. Benefits expire 2000-2005.
Enterprise Zones	DK	X	Accelerated depreciation. Benefits expire 2000.
Special Depreciation - Business Investment in Former GDR and West Berlin	D	X	Accelerated depreciation . No new qualifying expenditure after 1998.
Investments Grants - Equipment in Former GDR and West Berlin	D	X	Investment grants.
Tax Advantages - Commercial Investment in FRG/GDR Border Area	D	X	Special depreciation.
Canary Islands REF	E	X	Allowance of 50% of corporate/income tax liability, for sale of locally produced goods. Applies till 2001. Allowance 40% in 2002; 30% in 2003. Facility to allocate 90% of undistributed profits to reserve for investment in Canary islands.
Basque Country - Start Up Relief	E	X	Exemption from corporation tax. No new qualifying companies since 1994. Benefits expire 2004.
Navarra - Start Up Relief	E	X	Exemption from corporation tax. No new qualifying companies since 1994. Benefits expire 2004.
Regional Development Companies	E	X	Capital gains exemption (except for investments lasting 10 years or longer).
Corsica Incentive Regimes I, II, III	F	X	Regime 1: CT and capital gain exemption. Qualifying period ends 2001. Benefits expire 2006. Regimes 2 and 3: CT exemption. No new qualifying companies after 1998. Benefits expire 2006. (Financial services excluded from all 3 regimes).
Tax Free Zones - ZFU	F	X	Capped (Ffr 400,000) exemption for taxable profits. Qualifying period ends 2001. Benefits expire 2006.
Enterprise Zones	F	X	No new qualifying companies since Jan 1992. Benefits expire Jan 2001. 10 year exemption from corporation tax. (Financial services excluded.)
Overseas Départements (OD)	F	X	Range of measures: variously provide for 10 year or 25 year exemptions from CT, investment incentives, etc. (Excludes financial services activity.)
Nord-Pas de Calais - Privileged Investment Zone	F	X	Financial services activities excluded. Provided tax credits for fixed investment. 10 year life: expired May 1998.
Shannon Airport Zone (SAZ)	IRL	V	10% corporation tax rate. Includes financial services activity. Companies qualify up to 1999; eligible for benefits to 2002. Companies qualified up to June 1998 eligible for benefits until 2005. No quotas.
New Investments - Buildings in Run-down Urban Areas	IRL	X	Accelerated write off of construction and refurbishment costs.
Accelerated Depreciation of new buildings in certain regions	NL	X	Accelerated write off of construction costs.

Accelerated Depreciation; Investments in Developing Regions	FIN	X	Accelerated depreciation for qualifying investments before 2001. Benefits restricted to SMEs in manufacturing and tourism.
Enterprise Zones	UK	X	Accelerated depreciation for industrial and commercial property. Benefits given for a 10 year period.
SMEs in Northern Ireland	UK	X	Accelerated depreciation on machinery and plant acquired before 12 May 2002.
50% Profit Exemption in Ceuta & Melilla	E	X	50% profit exemption on locally generated income.
Exceptional Depreciation for Buildings Constructed under Urban and Rural Planning Arrangements	F	X	Exceptional depreciation on new construction. Limited to SMEs. Applies to buildings finished before 2000.
Regional Incentives South of Italy Mezzogiorno	I	X	Tax credit against personal business income for the former unemployed. Expired before 1999.
Industrial Free Zones	P	X	Exemption from tax, including tax on dividends, up to 2011. Applies to industrial activities and complementary activities.
US Foreign Sales Companies Ruling	B	V	Available only for US export sales. Limited usage. Cost plus 8% on reduced base.
Informal Capital Ruling	B	V	Up to 90% of profit exempted by reference to notional value of informal capital.
US Foreign Sales Companies Ruling	NL	V	Available only for US export sales. Limited usage. Cost plus 5-15%.
Informal Capital Ruling	NL	V	Profit reduced by reference to notional return on informal capital.
Foreign Business Operations Relief	DK	X	Measure being phased out. In 2000, benefit will be 1/7 of former level of relief. Previously allowed 50% reduction in tax attributable to foreign business operations.
Benefice Mondial and Benefice Consolide	F	X	Consolidation of profits and losses of all branches etc (Mondial) or subsidiaries (Consolide).
Foreign Income	IRL	V	Exemptions for foreign source dividends where the Irish parent/Head Office has a certified investment plan involving additional employment in Ireland.
Newly Created Companies	F	X	Two year tax exemption for start-ups, with relief tapered away over next 3 years.
Tax Holidays for New Businesses	L	X	Relief for 8 years at maximum of 25% of taxable profits. Limited to investment in fixed assets.
Special Depreciation for SMEs	D	X	Additional depreciation of 20% (benefit expires 1999). Advance write-off of anticipated fixed assets acquisitions.
Incentives for SMEs	E	X	Range of SME measures, including accelerated depreciation; tax deductible provision for bad debts (1%); reduced CT rate of 30%.
Micro and Small Enterprises	P	X	Range of small and microbusiness measures, limited to investment and profit retention. Measures to help the young start businesses, with reduced rate.
Special Scheme for Accelerated Depreciation	UK	X	Temporary increase in rate of tax depreciation from 25 to 40% (for one year) for SMEs only.
Scheme for Early Depreciation of Certain Assets	DK	X	Pre delivery depreciation for fixed assets, limited to 30% of excess over DKK 1,047,200.
Incentives for Investment. (Law 2601/98 ex 1892/90)	GR	X	Facility to make tax exempt reserves from undistributed profits, with the size limited to the scale of the investment and the region.
Investments Tax Credits	E	X	System of tax credits ranging from 5-25% for investment in fixed assets, in export related activities, research and development, training, etc. All capped at 35% of the CT liability.

Special Depreciation Arrangements for Assets Intended for Environmental Protection and Energy Saving, and for Assets Adjusting Work Places for Disabled Workers	L	X	Special accelerated depreciation for assets that are environmentally beneficial, etc.
Investment Allowance	NL	X	Deductible allowance for fixed asset investment; sliding scale, tapering to zero at 556,000 NLG.
Tax Incentives for Contractual Investment	P	X	Investment tax credit of 5-20% for domestic projects; 10-20% for direct investment overseas. Requires contract with State and, for domestic projects, minimum 1 billion PTE.
Tax Credit for Investment	P	X	Capped investment tax credit. Measure expired 1998.
Rollover of Capital Gains	D	X	Relief from capital gains on reinvestment in real estate.
Reinvested Capital Gains	P	X	Relief from capital gains on reinvestment in tangible fixed assets.
Small Islands Income Tax Reduction	GR	X	Reduction of 40% of normal tax rates for operations on islands with fewer than 3100 inhabitants.
St Martin and St Barthelemy	F	X	Series of measures to promote local activities (tourism, agriculture, fishing, mineral exploitation, etc) through temporary exemptions, reduced tax base, etc.
Mutual Funds / Portfolio Investment Companies	GR		No assessment required.
Venture Capital Funds and Companies	E	X	Exemptions from corporation tax on dividend income, exemption from withholding tax on dividends, up to 99% relief for capital gains.
Venture Capital Companies	F	X	Exemptions from corporate tax on dividend income and capital gains.
Participation Fund Companies	A	X	Exemption from corporate tax on income. Exemption from withholding tax on inbound and outbound dividends.
Investment Companies	S		No assessment required.
Limits on Taxes on Commercial Income	D	X	Limits maximum marginal tax rate on individuals commercial income to 47% rather than 53%.
Representative Office	E	X	Cost plus 15% on intra-entity activity involving Spanish branch or representing office.
Tax Credits for Job-creating Investment	F	X	Tax credit for additional employment, may be off-set only against the supplementary 10% CT. Expires 2000.
Tax Credits for Staff Training Costs	F	X	Tax credit for additional expenditure on training.
Listed Companies - Reduced Rates	I	X	Reduction of rate during first three years after listing commences.
SGII Companies	P	X	Reduction in rate for 7 years following incorporation, for qualifying real estate investment and management companies.
SCR, SDR and SFE Companies	P	X	Exemption from corporate tax for venture capital, regional development and business production companies. Benefits expired in 1997.
Investment Allowance	A	X	Investment allowance for fixed asset acquisitions.
Tax Exemptions	A	V	Exemption for dividends possible even where from low tax foreign source.
Investment Funds	B		Assessment not required.

Large Scale Productline Investments Financed with Foreign Capital	GR	X	Provision not in force.
National Infrastructure	GR	X	Taxation of foreign companies on basis of withholding applied to gross remuneration because net difficult to ascertain.
Tax Credit for Membership of a 'groupement de prevention agree'	F	X	Tax credit for expenditure on specified financial analysis and support activity during first two years of membership of groupement.
Exemption from Corporation Tax on takeover of ailing companies	F	X	Two year exemption from corporation tax where failing company taken over.
Legal Persons Liable for Corporation Tax whose Objects are to Transfer Use and Benefit of Movable or Immovable Property to its Members Free of Charge	F	X	No application to income generating activities with third parties.
Distribution by Certain Companies of Capital Gains Arising on Liquidation	F	X	Provides lower rate of tax to capital gains and liquidation distributions.
Provisions to Cover Price Increases	F	X	Permits tax-deductible reserve for price rises in excess of 10%.
Provision for Setting up Foreign Branches	F	X	Permits tax-deductible provision for losses of foreign branches/subsidiaries, capped at level of investment.
Provision for Employee Start-Up Loans	F	X	Permits tax-deductible provision for loans, etc. to firms set up by employees.
Provisions for Risks Relating to Medium-Term Credit Transactions by Firms Carrying Out Works or Selling Abroad	F	X	Permits tax deductible provision (up to 10%) for medium term loans to support business abroad.
Regime for Long-Term Capital Gains on FCPR and SCR Securities	F	X	Applies reduced long term capital gains rate to disposals of shares in unit trusts, etc.
Carryover of Losses on Merger (Consent)	F	X	By derogation (with consent) from the normal rules, permits carry over of losses on a merger.
Deferred Taxation in the Event of Merger and Partial Asset Transfer	F	X	Sets conditions for tax deferral on a merger.
Authorised Telecom Financing Companies	F	X	Exemption from CT on profits from transactions with the Post and Telecoms administration. No licences issued since 1989 and applies only to leasing agreements entered into before 1993.
Investment Companies	F		No assessment required.
Reduced rate of 19% on Reinvested SME Profits	F	X	Reduced rate for small companies. Applies to maximum of Ffr 200,000 or one quarter of profit.

Dual Income Tax	I	X	Part of general system that recognises part of profits as the ordinary return on new equity and taxes it at a reduced rate.
IRAP Exemptions	I	X	Exemption relates to productive investment. No new qualifying companies since period 1990-95. Benefits expire before 2005.
Regime for small and medium-sized enterprises	I	X	Tax credit for additional employment in SMEs in certain regions.
Special Depreciation Regime	I	X	Accelerated depreciation to reflect abnormal actual usage.
Special Regime for Investment Funds	I		No assessment required.
Substitute Tax Regime for Corporate Reorganisations	I	X	General regime, at taxpayer option, for taxation on basis of substitute tax at 27%.
Tax Advantages for Certain Trade and Commercial Activities	I	X	Tax credit for SMEs in retail, food and tourism sectors, limited to acquisition of assets.
Specified Collective Investment Undertakings	IRL		No assessment required.
Investment Funds	L		No assessment required.
Venture Capital Investment Certificates	L	X	Relief for holder of venture capital certificates up to maximum of 30% of taxable income of recipient.
Accelerated Depreciation	P	X	Accelerated depreciation to reflect abnormal actual usage.
Investment Funds	P		Assessment not required.
Tax Allocation Reserve of 20%	S	X	General facility to allocate 20% of taxable income to a tax-effective reserve.
Scientific research allowances	UK	X	Accelerated relief for expenditure on scientific research.
Measure aimed at determining the level of taxation of foreign companies operating in Belgium, without legal personality or probative accounts.	B	X	Sets standard methods of calculating minimum taxable profit
Finance Branches	L	V	Facility to allocate profits between head office and branch
Non-standard rulings (including Greenfield-rulings)	NL	V	Variation on standard rulings to deal with specific situations
Cost Plus Rulings	UK	X	Case by case assessment of arm's length mark up. OECD guidelines incorporated into legislation
	ii. European territories under Art. 299.4 of the EC Treaty		
Gibraltar 1992 Companies	UK: Gibraltar	V	Exemption for all income from 25% subsidiaries includes low tax foreign source. No Gibraltar shareholder permitted except where public company. 1% withholding tax applies to dividend to non-EU parent
Captive Insurance Companies	UK: Gibraltar		No separate measure. B12 or B13 applies
Exempt (offshore) Companies and Captive Insurance	UK: Gibraltar	V	Exemption from tax on profits. No Gibraltar shareholders allowed. No trade permitted with Gibraltar residents. No tax on dividends paid to non-residents.
Qualifying (offshore) Companies and Captive Insurance	UK: Gibraltar	V	Flexible tax rate between 2% and 18%. No Gibraltar shareholders allowed. No trade permitted with Gibraltar residents. No withholding tax on interest paid to non-residents.

Shipping and Aviation	UK: Gibraltar	X	See paragraphs 62-63 of the Final Report. Non-resident companies' exemption for Gibraltar source income from shipping.
Development Incentives	UK: Gibraltar	X	Exemption from tax on first tranche of development profits and exemption at shareholder level on these profits when distributed.
	iii. Dependent or Associated Territories		
Deduction for Investment in Mineral Processing	Greenland	X	Additional depreciation for cost (10%) of investment in raw material processing.
Surcharge Exemption for Raw materials Concession Holders	Greenland	X	Special relief for raw material processors: flexibility in loss relief; exemption from 6% surcharge.
-	Faroe Islands		No Measure
Temporary exemption for agriculture, fisheries and craft industries	New Caledonia	X	Temporary exemption from CT for fishery, agriculture and other local activities.
Legal certainty	New Caledonia	X	Tax freeze for metallurgical companies.
Limited taxation on certain rental income.	New Caledonia	X	Exemption/reduced base for rental income from dwellings.
Temporary exemption for the hotel and tourist industry.	New Caledonia	X	Exemption: local hotel and tourist business
Deduction for productive investment.	New Caledonia	X	Immediate deduction for productive investment in local business.
Share in the subscribed capital of certain companies.	New Caledonia	X	Deduction for subscription to the capital of certain local companies.
Exemption for investment.	French Polynesia	X	Exemption from corporation tax for local businesses up to maximum of 30% of approved investments.
Exemption from trading tax and allowances	Wallis and Futuna Islands	X	Agriculture, fisheries, craft exempt from corporation tax. Allowance for job creation.
-	French Southern & Antarctic Territories		No measure
Temporary exemption from corporation tax	Mayotte	X	10 year exemption from CT for companies with approved plans. No new qualifying companies since 1996. Benefits expire 2006.
Deductions for productive investments	Mayotte	X	Deduction for productive investment, applies to hotel, tourism, transport and audio visual sectors.
Share in the subscribed capital of certain companies	Mayotte	X	Deduction for subscription to share capital of companies in F104 or housing companies.
Temporary Exemption for Certain Sectors	Saint-Pierre and Miquelon	X	Exemption (for 5-10 accounting periods) from corporation tax for companies investing in local business activities. Requires approval.
Partial Exemption from Distribution Tax	Saint-Pierre and Miquelon	X	Exemption from distribution tax for up to 10 accounting periods and 9 months.
Deduction for Productive Investment	Saint-Pierre and Miquelon	X	Immediate deduction for productive investment in local activities.

Share in the Subscribed Capital of Certain Companies	Saint-Pierre and Miquelon	X	Deduction for subscription into companies with productive investment in local activities.
Offshore Companies	Netherlands Antilles	V	Companies with non resident shareholders and activities outside Antilles taxed at 2.4/3%.
New Businesses	Netherlands Antilles	X	New industries not qualifying as export industries, eligible for 2% CT rate on profits.
Mutual Funds	Netherlands Antilles		No assessment required.
Captive Insurance	Netherlands Antilles	V	Either taxed on basis of (a) ruling fixing income of ANG 100,000 - taxed at 2.4%; or (b) exemption for 80% with remainder taxable at 24-30%
Free Zones	Netherlands Antilles	V	Profits from Free Zone taxed at 2%.
Rulings	Netherlands Antilles		Awaiting conclusion of work on study of administrative practices.
Shipping and Air Transport	Netherlands Antilles	X	Tonnage tax optional. Alternatively 80% of profits can be deemed to arise outside Antilles and taxed at 10% of normal CT rates. Remaining 20% is taxed at normal rate. Consistent with issue of international competition.
Offshore Companies	Aruba	V	Companies with non resident shareholders and activities outside Aruba taxed at 2.4/3%.
Exempt Companies (AVVs)	Aruba	V	Full tax exemption. Must have only offshore activities. Insurance and banking excluded.
Tax Exemptions and Holidays for New Businesses	Aruba	X	Exemption for new business in certain industries, especially manufacturing. New non-traditional manufacturing entitled to 2% rate (in practice, nil).
Free Zones	Aruba	V	Profits from Free Zone taxed at 2%.
Rulings	Aruba		Awaiting conclusion of work on study of administrative practices.
Captive Insurance	Aruba	V	Ruling fixes income of ANG 100,000 taxed at 2.4%.
Shipping and Air Transport	Aruba	X	80% of profits can be deemed to arise outside Aruba and taxed at 10% of normal CT rate. Remaining 20% is taxed at normal rate. Consistent with issue of international competition.
-	East Timor		No measure
Offshore Banking	Macao	X	Exemption for offshore banking units. (Sovereignty reverts to China on 20 December 1999.)
-	Anguilla		No measure.
Exempt Companies	Bailiwick of Guernsey (including Alderney)	V	Exemption for non Guernsey source income and local bank interest. No Guernsey shareholders permitted.
International Loan Business	Bailiwick of Guernsey (including Alderney)	V	Applies to international loan business. Banks taxed at effective rate of 2%
Unit Trusts and Collective Investment Funds	Bailiwick of Guernsey (including Alderney)		No assessment required.
International Bodies	Bailiwick of Guernsey (including Alderney)	V	Flexible tax rate 0-30%. No Guernsey shareholders. Excludes banks and most insurers.
Captive Insurance	Bailiwick of Guernsey (including Alderney)		No assessment necessary. No companies now eligible. Measure now obsolete (though harmful when it was active)
Offshore Insurance Companies	Bailiwick of Guernsey (including Alderney)	V	Alternatives to F037 or F038 for offshore insurance companies. No tax on underwriting activities or local bank interest. Sliding scale for other income 20% to 0.1%.
Insurance Companies	Bailiwick of Guernsey (including Alderney)	V	Profits computed on ordinary principles. Payment deferred until claims finalised.
-	Sark		No measure.
Tax Exempt Companies	Bailiwick of Jersey	V	Exemption for non-Jersey source income and local bank interest (also applies to collective investment vehicles). No Jersey shareholders permitted

International Treasury Operations	Bailiwick of Jersey	V	Applies to international loan business. Activities taxed at effective rate of 2%
International Business Companies	Bailiwick of Jersey	V	Sliding scale for profit of international operations 2% to 0.5%. No Jersey resident may own shares.
Captive Insurance Companies	Bailiwick of Jersey	V	Insurance businesses not taxed. Investment income taxed at 20% subject to management charge, etc. Can operate as an exempt company.
Tax Exemption Guarantee	Bermuda	X	Protects against possible future legislative change.
-	British Antarctic Territory		No measure
-	British Indian Ocean Territory		No measure
Arising and Remittance Basis	British Virgin Islands	X	Taxes local source income and remitted foreign source income
1% Rate	British Virgin Islands	X	Reduced rate applied to foreign source investment income of resident companies where income exempt overseas.
"Pioneer" Industry Exemption	British Virgin Islands	X	5 year exemption for new industries.
Exemption for new hotels	British Virgin Islands	X	10 year exemption for new hotels.
International Business Companies	British Virgin Islands	V	Exemption from income tax. No local businesses, no insurance/re-insurance business.
Tax Exemption Guarantee	Cayman Islands	X	Protects against possible future legislative charge.
Tax Holidays	Falkland Islands	X	15 year (maximum) exemption for activities with local benefits.
Free Depreciation and Balancing Charges on Ships	Isle of Man	X	Accelerated depreciation. Deferral of depreciation recapture on scale where there is reinvestment.
Special Depreciation for Tourist Premises	Isle of Man	X	Additional depreciation (150% of cost in total).
International Business Companies	Isle of Man	V	Flexible tax rate 1-35%. No Manx resident shareholders permitted. No local business, except bank interest.
Exemption for Non-resident Companies	Isle of Man	V	Exemption for non Isle of Man source income and bank interest. No Manx resident shareholders permitted.
Exempt Insurance Companies	Isle of Man	V	Exemption from tax on part of all of profits earned outside Isle of Man.
Tax Holidays for Industrial Undertakings	Isle of Man	X	Five year exemption for industrial undertakings.
International Loan Business	Isle of Man	V	Applies to international loan business. Banks taxed at effective rate of 2%
Offshore Banking Business	Isle of Man	V	Exemption from tax.
Fund Management	Isle of Man	V	Applies to fee income. Provides 75% exemption from tax
Exempt Public Companies	Isle of Man		No separate measure. F061 applies
Film Industry Tax Credits	Isle of Man	X	Discontinued June 1998.
Reduced Tax Rate for Industrial and Offshore Companies	Montserrat	X	Industrial and offshore companies pay tax at reduced rate of 20% (cf 40%).
International Business Companies	Montserrat	X	Exemption from tax. No local trading or holding of real estate permitted. Business activity effectively ceased after volcanic explosion.

Tax Holidays for Approved Enterprises	Montserrat	X	10-15 year tax holiday for local manufacturing. Additional relief on export profits after holiday.
Exemption for new hotels	Montserrat	X	5 year exemption from tax.
-	Pitcairn Island		No measure.
Tax Holidays	St Helena and dependencies	X	Tax holiday for new local projects.
150% Deductions	St Helena and dependencies	X	150% deductions for expenditure on approved projects.
-	South Georgia & South Sandwich Islands		No measure.
Tax Exemption Guarantee	Turks and Caicos Islands	X	Protects against possible future legislative change.
-	UK Sovereign Base Areas of Akrotiri and Dhekelia in Cyprus		No measure.

APPENDIX 2: List of 66 measures identified as actually harmful out of 271 potentially harmful measures presented in Appendix 1

MEASURES WITH HARMFUL FEATURES		
(i) <u>Member States</u>		
Austria	AAM002b:	Holdings (Schachtelbegünstigung-Intra Group Relief)
Austria	EAM009:	Tax Exemptions
Belgium	A001:	Co-ordination Centres
Belgium	A002:	Distribution Centres
Belgium	A003:	Service Centres
Belgium	E001:	US Foreign Sales Companies Ruling
Belgium	E002:	Informal Capital Ruling
Denmark	AAM021:	Holding Companies
Finland	B008:	Åland Islands Captive Insurance
France	A006:	Headquarters and Logistic Centres
France	A012:	Royalty Income - Patents
France	CAM058	Provisions for Renewal of Mineral Reserves
France	CAM059:	Provision for Renewal of Oil and Gas Reserves
Germany	AAM019:	Control and Coordination Centres of Foreign Companies in Germany
Greece	B011:	Offices of Foreign Companies under the Law 89/67
Ireland	*	B001: The International Financial Services Centre (Dublin)
Ireland	*	C024: 10% Manufacturing Rate
Ireland	****	C025: Petroleum Taxation
Ireland	*	D017: Shannon Airport Zone (SAZ)
Ireland		E007: Foreign Income
Italy	***	B002: Trieste Financial Services and Insurance Centre
Luxembourg	**	A007: Co-ordination Centres
Luxembourg		A0013: 1929 Holding Companies
Luxembourg	**	B003: Luxembourg Finance Companies
Luxembourg		B007: Provisions for fluctuations in reinsurance
Luxembourg		Z002: Finance Branches
Netherlands		A008: Cost Plus Ruling
Netherlands		A009: Resale Minus Ruling
Netherlands		A010: Intra Group Finance Activities
Netherlands		A014: Holding Companies
Netherlands		A015: Royalties
Netherlands		B004: International Financing Activities
Netherlands		B005: Finance Branch
Netherlands		E003: US Foreign Sales Companies Ruling
Netherlands		E004: Informal Capital Ruling
Netherlands		Z003: Non Standard Rulings (including Greenfield-rulings)

Portugal	*	B006:	Madeira and Sta Maria (Azores) Free Zones
Spain		A004:	Basque Country Co-ordination Centres
Spain		A005:	Navarra Co-ordination Centres
Spain		CAM025:	Investigation and Exploitation of Hydrocarbons
(ii) <u>European territories for whose external relations a Member State is responsible under Article 299.4 of the EC Treaty.</u>			
UK: Gibraltar		A017:	Gibraltar 1992 Companies
UK: Gibraltar		B012:	Exempt (offshore) Companies and Captive Insurance
UK: Gibraltar		B013:	Qualifying (offshore) Companies and Captive Insurance
(iii) <u>Dependent or associated territories</u>			
Aruba		F027:	Offshore Companies
Aruba		F028:	Exempt Companies (AVVs)
Aruba		F030:	Free Zones
Aruba		F032:	Captive Insurance
British Virgin Islands		F056:	International Business Companies
Guernsey (incl Alderney)		F037:	Exempt Companies
Guernsey (incl Alderney)		F038:	International Loan Business
Guernsey (incl Alderney)		F040:	International Bodies
Guernsey (incl Alderney)		F042:	Offshore Insurance Companies
Guernsey (incl Alderney)		F043:	Insurance Companies
Isle of Man		F061:	International Business Companies
Isle of Man		F062:	Exemption for Non Resident Companies
Isle of Man		F063:	Exempt Insurance Companies
Isle of Man		F065:	International Loan Business
Isle of Man		F066:	Offshore Banking Business
Isle of Man		F067:	Fund Management
Jersey		F045:	Tax Exempt Companies
Jersey		F046:	International Treasury Operations
Jersey		F047:	International Business Companies
Jersey		F048:	Captive Insurance Companies
Netherlands Antilles		F020:	Offshore Companies
Netherlands Antilles		F023:	Captive Insurance
Netherlands Antilles		F024:	Free Zones

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