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"A Common Indirect Tax System in BiH - Continuing Stalemate or a New Chapter in Sustainable Federalism in Bosnia and Herzegovina?"

Samra Šuškić-Bašić

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For the last ten years, **Samra Šuškić-Bašić** has been actively participating in key government reform initiatives focused on capacity development and strengthening governance arrangements in BiH. She worked for the U.S. Treasury Department for Technical Assistance in the initial stages of public budgeting and accounting reforms for the entity and State of BiH levels of government. In the period of her work with the U.S. Treasury she actively participated in the drafting of organic budget laws, treasury laws, public accounting laws and chart of accounts and accounting rulebooks for State and entity government, and also assisted in strengthening coordination and cooperation with lower level governments in BiH. Through her subsequent engagement with the USAID Public Sector Accounting Project she assisted in the implementation of treasury and accounting information systems in the cantons of the Federation of BiH. Since 2003 Ms. Šuškić-Bašić has either worked directly with or has provided training for executive and legislative bodies in BiH in the areas of policy analysis and development and institutional and sector-wide strategic planning. A large portion of these capacity building efforts have been geared towards strengthening governance arrangements and the cooperation between levels of government in BiH. Ms. Šuškić-Bašić holds a Bachelor of Science degree in Accounting cum laude from the University of Maryland University College and is currently completing her Masters of Science degree in Finance and Controlling with the Swiss Management Center based in Zug, Switzerland. She currently works as a consultant for the Sarajevo-based public sector consultancy firm Lucid Linx d.o.o. Ms. Šuškić-Bašić was born in Zenica, August 5th 1977 and currently resides in Sarajevo.

List of Abbreviations

BiH	Bosnia and Herzegovina
CoM	Council of Ministers of Bosnia and Herzegovina
EU	European Union
FBiH	Federation of Bosnia and Herzegovina
FC	Fiscal Council in Bosnia and Herzegovina
FPC	Financial Planning Council of Germany
FPI BiH Foreign	Policy Initiative of Bosnia and Herzegovina
GNP	Gross National Product
IMF	International Monetary Fond
ITA	Indirect Tax Authority of Bosnia and Herzegovina
PEIR	Public Expenditure Institutional Review of the World Bank
RS	Republika Srpska
RST	Retail Sales Tax
VAT	Value-added tax

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Executive Summary

During the period from 2004 to 2006, Bosnia and Herzegovina (BiH) made a significant step forward in its economic reforms by developing and establishing a single indirect taxation system, thus becoming one of 123 countries (Bird et al, 2001) around the world to adopt a value–added tax (VAT). This reform measure has brought about several key developments for BiH. For the budgets of the governments in BiH this has lead to a surge in tax revenues on almost all levels (albeit temporarily, according to International Monetary Fund estimates[1]). Institutionally, the introduction of VAT has lead to the merging of entity customs administrations into the Indirect Tax Authority (ITA), which is administered at the State of BiH level. But most importantly, VAT has introduced an independent source of financing for the State institutions of BiH which were, until then, dependent on contributions from entity level.

However, progress achieved thus far in this very important reform, as well as the in the overall system, risks being undermined. The current system for the allocation of indirect taxes between the State, entity and Brčko District governments is based on an assessment of relative proportion of final consumption, as reported by tax payers in tax returns. This basis for allocation and the way it is implemented in practice (via ad hoc decisions rather than standing regulations) is proving to be very problematic, and has resulted in constant political disputes, tensions and dissatisfactions.

This analysis points to the following problems that exist as a result of the current system for allocating revenues from indirect taxes:

1. **It creates more-than-usual uncertainty in budget revenue planning for entities and Brčko District;**
2. **It puts a great burden on the Indirect Tax Authority (ITA) to ensure the accuracy of information of taxes already being paid, rather than allowing it to focus on taxes that are due or on taxes not reported at all;**
3. **It can have adverse effects on the creation of a single economic space, the purpose for which it was initially established;**
4. **It further fragments the fiscal system in BiH;**
5. **It does not function as an instrument for ensuring fiscal balances and expenditure efficiency and effectiveness.**

Comparative analysis of the allocation of revenues from indirect taxes, mostly from value-added taxes (VAT), indicates that the decision to centralize the collection and regulation of indirect taxes in Bosnia and Herzegovina (BiH) is a sound one. However, many analysts argue that for those federations in which VAT revenues are shared between the federal and "lower" levels of government, the best approach is to apply a fixed formula which puts fiscal equalization considerations at the forefront of the allocation scheme. Likewise, the allocation scheme must be comprehensive, and include all levels of government that provide public goods and services and whose fiscal position can be affected by VAT, which has replaced the traditional retail sales tax, becoming the revenue of the federal government. Germany offers an example of one such comprehensive scheme in which the formulas for allocation aim to achieve an implicit fiscal equalization effect.

Another missing element in the fiscal system in BiH is the absence of transfers from the State level to "lower" level governments. Transfers are an intrinsic feature of all federal countries and are used as an instrument for alleviating the opposing pressures between efficiency and equality that decentralized decision-making creates. International best practice indicates that transfers conditioned around specific performance targets have the most positive effect on equality, but also on public expenditure effectiveness.

[1] Please see the IMF country Report No. 07/268; June 2007.

Earmarking a portion of revenues from indirect taxes as conditioned transfers to lower level governments for achieving greater public expenditure effectiveness is something that could be embedded in the indirect tax allocation system in BiH.

This analysis offers three options to remedy the current political tensions surrounding the allocation of revenues from indirect taxes, as well as to reform the system to make it a more purposeful instrument of federal cohesion. The ***first option*** presented in the analysis retains the current arrangements: but in essence, this option is not just a continuation of the status quo. Given that there is a political consensus on the need for change in the current allocation scheme, some remedial action will be taken. Most likely the coefficients will be "fixed", based on an assessment of recent trends in final consumption. This option is most acceptable at this moment, but should only be seen as an interim solution and the time during which it remains in place (a maximum of two consecutive fiscal years) should be used to find an alternative design of the allocation of indirect tax revenues in BiH.

The ***second option*** provides one possible alternative to the existing system. This option would require two substantive changes to the overall allocation system that would need to be reflected in respective legislation. Firstly, a similar allocation scheme as is currently used by the entities for allocation to lower level governments, based on objective criteria, would replace the current basis: i.e. relative portion of final consumption. Secondly, the Fiscal Council in BiH (FC), which would become the institutional forum in which discussion on allocation coefficients would be held, would, thus, have to be expanded to include representatives of cantons and municipalities.

The ***third option*** goes one step further and recommends in addition to establishing objective criteria for allocating revenues to all levels of governments earmarking a portion of these revenues for transfers to lower level government for financing programs in sectors deemed of importance for the entire country (such as education).

These programs would be designed and implemented by the respective levels of government, but the work of all those involved should be guided by a commonly agreed set of performance targets. Again, the FC would be responsible for reviewing the effects of the transfers and for renegotiating the conditionality pertaining to the making of transfers, and the State Ministry of Finance and Treasury would be responsible for monitoring the use of transfers.

The analysis concludes with a recommendation of the first option, which has the least impact on achievement of federal cohesion and expenditure effectiveness, but which fulfills the currently more important role of stabilizing intergovernmental relations and rebuilding trust in the indirect tax system. Nonetheless, the acceptance of this option should be undertaken with certain caveats:

- Fiscal equalization, horizontal and vertical, between all levels of government that provide public goods and services must be put at the forefront of the indirect tax-sharing system. In the near-term there must be complete abandonment of allocation based on relative portion of final consumption.
- The objective criteria agreed therein must be simple and transparent and based on uniform and reliable statistical information. As far as is possible, expenditure responsibilities must be taken into consideration when allocating revenues.
- The review of and proposals for revenue allocation coefficients must be left to the FC. The Managing Board of the ITA must, therefore, continue to be responsible for to assessing and advising on indirect taxation **policy** and to oversee the management and functioning of the ITA.
- The allocation arrangements for indirect taxes must be comprehensive, including cantons and municipalities. This will entail expanding the membership of the FC to include

selected members from cantons and municipalities. Associations of local governments should have the technical and organizational capacity to represent the interests of local governments.

- In terms of designing a system of intergovernmental output-based transfers, the State of BiH could go forth regardless of the destiny of the indirect tax revenue allocation scheme and design such a system from its existing budgetary resources for areas that it deems to be of national importance without having exclusive authority over them. The FC (in its expanded membership) needs to have a role in assessing and renegotiating the conditionality that will apply to these State-level transfers.

However, there are some major preconditions that precede any substantive and meaningful change, not only in this segment of intergovernmental fiscal relations in BiH, but in all aspects of governance in BiH. Firstly, in relation to the decision-making independence of sub-national governments, there must be "some consensus about the importance of national equity and efficiency objectives" (Boadway, 2007). The focus placed on these considerations in effect creates the fabric and form of society in general. Once these principles have been agreed, the federal, or in the BiH context the State level, must be given the instruments and authority to uphold these principles. Finally, there must be a degree of goodwill and willingness to engage in constructive dialogue and to assess all possible options and their implications. This paper and the arguments presented therein are based on the assumption that there are no issues regarding the existence of such goodwill, but only issues of how to channel it into wider and more constructive debates.

Introduction

During the period from 2004 to 2006 Bosnia and Herzegovina (BiH) made a significant step forward in its economic reforms by developing and establishing a single indirect taxation system, becoming one of 123 countries (Bird et al, 2001) around the world to adopt a value–added tax (VAT). This reform measure has brought about several key developments for BiH. Firstly, the "self-corrective" nature of VATs has enabled a boost in tax compliance, increasing the range of legal entities reporting on their business activities and paying taxes. Secondly, there has been a removal of tax from intermediate products, which is normally the case with retail sales taxes (RSTs), resulting in the expansion "of the tax base to include a wide range of services that, for the most part, were not subject to tax … thus (leading) to a considerable expansion in the range of consumption subject to tax" (Bird et al, 2001). For the budgets of the governments in BiH this has lead to a surge in tax revenues on almost all levels (albeit temporarily, according to the International Monetary Fund – IMF estimates[2]).

Institutionally, the introduction of the VAT has lead to the merging of entity customs administrations into the Indirect Tax Authority (ITA), which is administered by the State of BiH, thus centralizing the collection, recording and allocation of indirect taxes (which include VAT, excises and other import and export related surcharges). Most importantly, VAT has introduced an independent source of financing for the State institutions of BiH which were, until then, dependent on contributions from the entity levels.

However, progress achieved thus far in this very important reform, as well as in the overall system, risks being undermined. The current system of allocation of indirect taxes between the State, entity and Brčko District governments is based on an assessment of relative proportion of final consumption, as reported by tax payers in tax returns. This basis for allocation and the way it is implemented in practice (via ad hoc decisions rather than standing regulations) is proving to be very problematic for several reasons, and has resulted in constant political disputes, tensions and dissatisfactions.

During the Third Economic dialogues between the European Commission and BiH held in Sarajevo on 17th October 2007, the Chairman of the Managing Board of the ITA, Mr. Peter Nicoll, stressed this issue and stated that a permanent, or at least a more stable form of revenue allocation must be developed by the end of the year to avoid problems in year 3 in the implementation of the indirect tax system in BiH.[3] Interestingly enough, for many other federal states (or supra-federations, like the European Union) the introduction of VAT has also meant a "reshuffle" in revenue assignment and allocation between federal constituents (Bird et al, 2001). However, if one takes a broader perspective on this issue, the introduction of VAT, the centralization of indirect taxes and their assignment to the State level of BiH has, in fact, opened a new chapter in the development of sustainable federalism in BiH. Rather than just looking at the narrow short-term issue of how much "piece of the VAT cake" each level should get, the role of VAT, i.e. the indirect tax system, should be observed as an instrument for the forging of a more purposeful, rather than inadvertent, cohesion between each of the levels of government in BiH. The purpose of this paper is not to provide a "series" of potential formulae that could be used to substitute for the ones currently used to allocate indirect taxes in BiH. Developing proposals in those lines provide for a much wider and technically more robust analysis than could be done in the frame of the analysis presented in this paper.

This paper aims to present a wider debate on the arrangements of fiscal cohesion, partly by stressing the main areas of improvement in the current system, and partly by presenting relevant comparative experience of other federal countries in this area. In this latter respect it is difficult to devise a set of "best practices in fiscal federalism" given that there is no "golden

[2] Please see the IMF country Report No. 07/268; June 2007.

[3] Office for Macroeconomic Analysis, Bulletin, no.27, October 2007.

rule" of revenue allocation or intergovernmental fiscal relations and that each federation is a product of different historic, social and economic circumstances, and, thus, each is specific in its own right.

Circumstances currently at play in BiH might not be of sufficient maturity for some of the considerations offered in this paper to be politically acceptable at this moment. This might largely be due to the fact that the indirect tax system is still in its infancy and considerable time and effort still need to be invested in strengthening and developing it further. Likewise, the implementation of some of the options and recommendations requires that certain preconditions be met. However, the sustainability and further development of BiH depend on the ability of all relevant actors to broaden the debate on fiscal arrangements within BiH in general, and, more specifically, on the system for the allocation of indirect tax revenues. This debate, which should be part of a wider debate of pending constitutional amendments should not be driven exclusively by short-term political (or rather ethnic) considerations, but rather its ultimate objective should be a sustainable federalism based on principles of equity and solidarity, as well as common societal values and goals, which would diminish the risks of future destabilization of this country (either internally or externally driven).

If this paper makes even a small contribution towards such framing of public debate, at least in one aspect of intergovernmental fiscal relations, it would be considered a successful endeavor by its author.

The Indirect Taxation System in BiH

Institutional Arrangements

The reform of the indirect tax system in BiH has been a gradual process. Before the actual introduction of VAT on 1 January 2006, this significant reform aimed primarily at the implementation of article I.4 of Annex 4 of the General Framework Agreement (the Constitution of BiH), which established a single economic space in BiH, started during 2004, with the unification of customs administrations into the ITA and the shifting of customs policy to the State level (World Bank, 2007).

The ITA, which is based in Banja Luka, functions as an independent administrative body established in concurrence with relevant administrative laws and is regulated as the ***only*** body in BiH primarily responsible for "implementing legal regulations regarding indirect taxation and policies determined by the Council of Ministers at the proposal of the Board[4], as well as for the payment and allocation of indirect taxes on the territory of Bosnia and Herzegovina".[5]

The ITA establishes and maintains the tax accounting and reporting systems needed for monitoring indirect tax payments, tax arrears and for tax revenue allocation. Aside from the Central Office in Banja Luka the ITA has four regional offices (in Banja Luka, Mostar, Tuzla and Sarajevo) which are responsible for managing the customs offices and customs/border terminals within their territorial responsibility (see Figure 1). The location and authorities of these branches have been determined based on economic principles with the primary aim of ensuring an effective and efficient service to tax payers and "providing support to the functioning of a unique economic territory in Bosnia and Herzegovina".[6]

[4] Referring to the Managing Board of the Indirect Tax Authority.

[5] Article 4 of the Law on the Indirect Taxation System in Bosnia and Herzegovina ("Official Gazette of BiH", No. 44/03 and 52/04).

[6] Article 6 of the Law on the Indirect Taxation System in Bosnia and Herzegovina ("Official Gazette of BiH", No. 44/03 and 52/04).

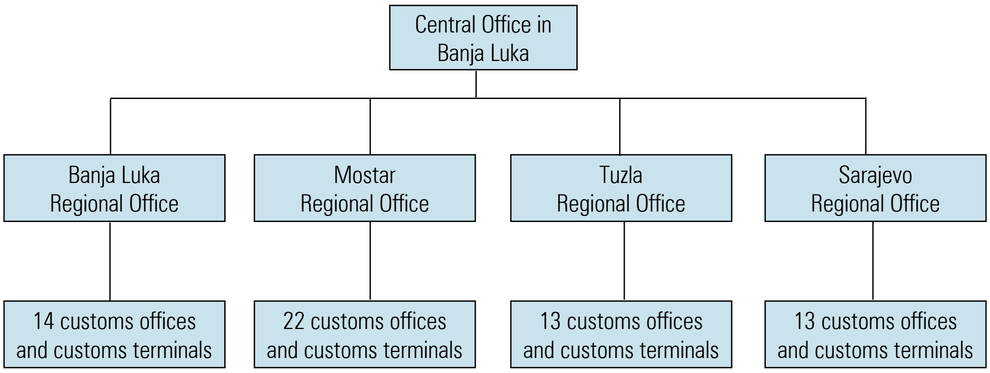


Figure 1:
Organizational Structure of the ITA of BiH

Although legally reporting to the Council of Ministers (CoM) on its activities, the ITA is governed by a cross-governmental Managing Board which is responsible for approving the ITA's budgets, internal operational rulebooks and, in general, overseeing the operations and functions of the ITA. However, the responsibilities of the Managing Board go beyond operational supervision of the ITA. The Managing Board also develops proposals concerning indirect taxation policy for consideration by the CoM and it is responsible for resolving disputes in decisions regarding the allocation of indirect tax revenues. The composition and major roles and responsibilities of the Managing Board are presented in Figure 2.

Figure 2:
Composition and responsibilities of the ITA Managing Board

3 experts for indirect taxation

Observers:
- Brčko District representative
- Central Bank representative
- Director of ITA

- Proposal for indirect taxation policy for approval by CoM
- Informing governments on budgetary implications of IT policy
- Resolving disputes on revenue allocation
- Defining strategic goals and performance monitoring of ITA
- Approving ITA work plans and budgets etc

Minister of Finance and Treasury of BiH

Minister of Finance of the FBiH

Minister of Finance of RS

Article 19 of the Law on the Indirect Taxation System in BiH[7] regulates that all decisions of the Managing Board must be made by consensus. The Chairman of the Managing Board is charged with determining whether consensus has been reached. When deciding on the allocation of indirect tax revenues, in the absence of a consensus, decisions are made by simple majority which must include the votes of all three ministers of finance.[8]

The organizational structure of the ITA is not bound by entity borders, which makes it a truly BiH-wide institution, existing to uphold the indirect taxation system in the entire country. On the other hand, the existence of a cross-entity Managing Board ensures that entity interests are not in any way contravened by the fact that the indirect taxes are in effect levied, administered and collected by the State of BiH level. However, currently, due to the allocation scheme described in the next section, the Managing Board of the ITA spends the smallest proportion of its time analyzing indirect taxation **policy** and recommending changes to it (World Bank, 2007).

[7] Official Gazette of BiH, No. 44/03 and 52/04.

[8] As explained on the web site of the ITA of BiH, http://www.uino.gov.ba/b/O_nama/Upravni_odbor.html

Allocation of Indirect Taxes in BiH

The allocation of indirect taxes in BiH is regulated primarily by the Law on the Indirect Taxation System[9] and the Law on Payment to the Single Account and Revenue Allocation[10], as well as by a series of related ancillary regulations. Mostly due to opposing political interests, the fixed percentages for indirect tax allocation to the State, entity and Brčko District governments was never formally regulated. As a result, coefficients for allocation were left to be decided on an ad hoc basis during the meetings of the Managing Board of the ITA.

The overall allocation scheme is presented, in simplified form, in Figure 3 below.

Based on the assessment of final consumption as reported in tax returns, the Federation of BiH (FBiH) receives on average around 65% of indirect tax revenues that are eligible for allocation, the Republika Srpska (RS) around 32% and Brčko District the remaining 3%. The exact percentages of allocation, however, are never certain.

The amount of consumption varies not only between localities, but also between time periods (as is illustrated in Table 1).

[9] Official Gazette of BiH, No. 44/03 and 52/04.

[10] Official Gazette of BiH, No. 55/04.

[11] Through a Decree of the High Representative for BiH, the coefficient for Brčko District is fixed to 3.55, while the coefficients for the entities are to be calculated based on the relative proportion of final consumption in both entities. This Decree has been in place since 1 June 2007.

Table 1:
Allocation coefficients between levels of government in BiH for the period January - December 2007[11]

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Dec
FBiH	64,7967	65,05	65,05	65,05	65,05	64,88	64,58	64,58	64,58	64,58	64,58	64,58
RS	31,5142	31,57	31,57	31,57	31,57	31,57	31,87	31,87	31,87	31,87	31,87	31,87
Brčko District	3,6891	3,38	3,38	3,38	3,38	3,55	3,55	3,55	3,55	3,55	3,55	3,55

Source: Office for Macroeconomic Analysis, Bulletin no. 27, October 2007

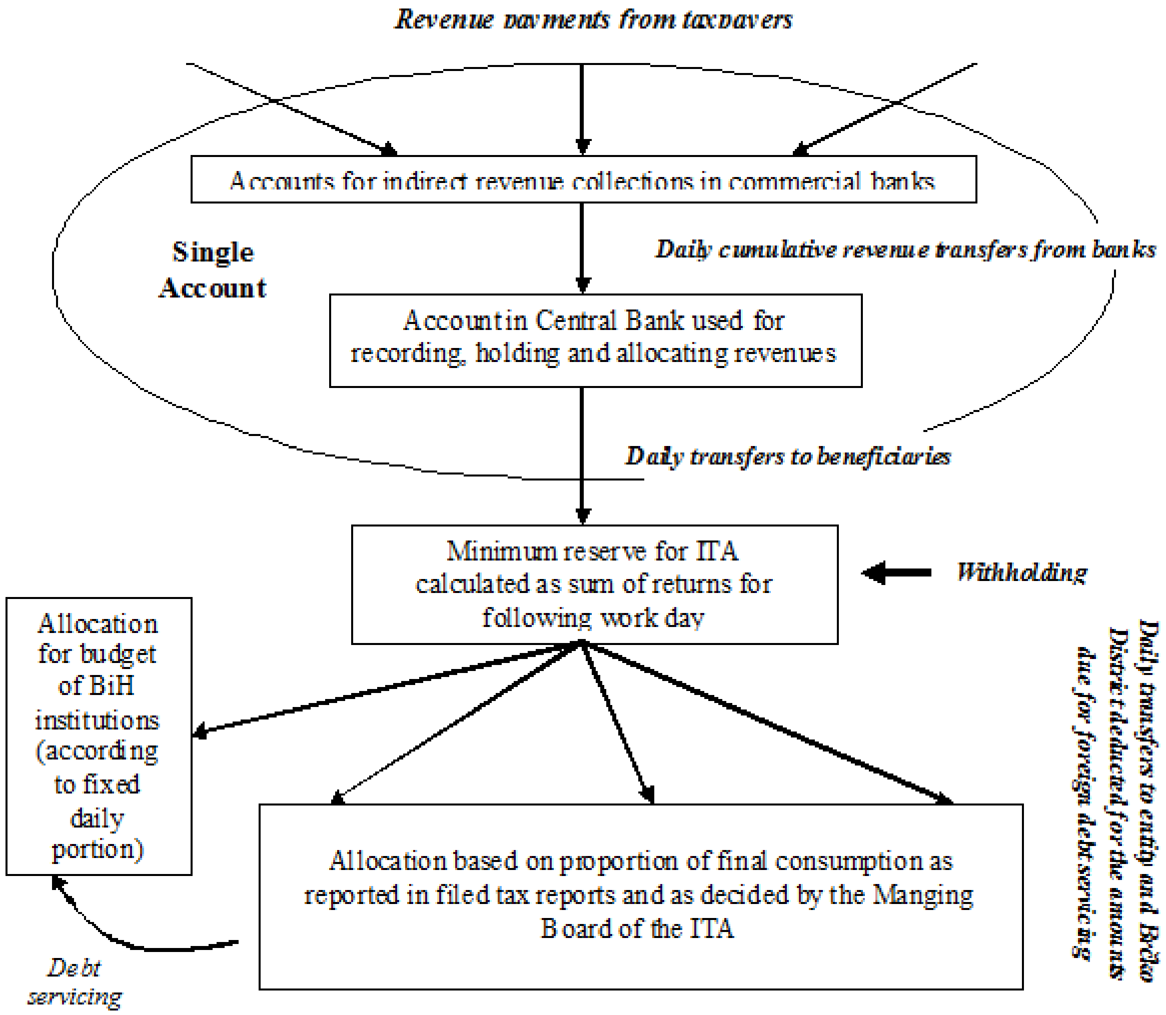


Figure 3:
System of allocation of indirect tax revenues in BiH

Given the large amounts of indirect taxes in question, even a difference of less than half a percentage point in the allocation coefficients during the year can mean up to hundreds of thousands of KM less (or more) of indirect tax revenues between two consecutive months. Bearing this in mind, it is no wonder that such heated debates arise around percentages and that so much scrutiny is undertaken of the information about 'final consumption' that is reported in tax returns. Based on all that has been said thus far about the indirect tax revenue allocation system, it is not difficult to see why the situation is increasingly unsatisfactory, and in some cases even the cause of contempt.

Aside from the obvious dissatisfaction with the amount of revenues that it allows to each of the recipients (which, in all honesty, will always exist in any tax revenue allocation system between levels of government), in terms of revenue planning, it puts the entities and Brčko District in a less favorable position than the State of BiH institutions. This is because the State institutions are able to estimate their revenue, on a daily basis, more accurately than is the case with other recipients.[12]

Secondly, it puts a great burden on the ITA to report promptly on returns made to tax payers (which are excluded from the revenue amounts subject to allocation), as well as revenue payments due. Likewise, given the basis of allocation, the ITA must ensure the accuracy of information from the tax returns in order to ensure the validity of tax allocations. As a result, much of the ITA's time and effort is dedicated to verifying the information on tax returns for taxes already paid, rather than ensuring enforcement of collection of taxes that are due, or tracking taxes that are not even reported.

[12] The proportion allocated daily to the State of BiH is according to Article 12 of the Law on Payment to the Single Account and Revenue Allocation (Official Gazette of BiH, No. 55/04) calculated as "the amount approved in the State of BiH budget for the current year multiplied by the coefficient derived when 1 is divided by the number of working days of the Indirect Tax Authority in the current year".

Another inadvertent effect of this allocation scheme is that each of the governments has a perverse incentive to ensure that spending (public or otherwise) is very much kept within its territorial "boundary" given this directly reflects on the amount of the allocation coefficients. This diminishes the positive role the indirect tax system is meant to have regarding the creation of a unified economic space through the unhindered flow of goods, people and capital. Given the high proportion of public spending in the overall GDP, each level of government also maintains an interest in increasing public spending in their localities since this contributes to the increase of the allocation coefficients.

Needless to say, the nitpicking that comes about as a result of this allocation scheme diminishes the policy role of the Managing Board of the ITA and is a source of high political tension. It places large administrative and accounting burdens on the ITA and diminishes overall trust in the system. Probably the most "problematic" aspect of the current scheme is that it prevents any of the levels of government to look further than the immediate needs of ensuring revenues for financing their budgets and towards a more holistic appraisal of the entire system. The current discussions of the issues disregard the very obvious fact that the system is fragmented; with lower level governments (namely cantons and municipalities) explicitly excluded from the allocation schemes.

The issue of their allocation of indirect taxes is thus left to be regulated in various different ways by their responsive "upper-level" governments. Fiscal equalization polices, therefore, are currently not at the forefront of the design of the indirect tax system allocation schemes.

The approaches taken by other federally constituted countries vary. However, most federations that do share similar centralized indirect taxes, namely VAT, with other levels of government, do so based on fixed coefficients, structured around fiscal equalization considerations that apply to all levels providing public goods and services. A comparative overview of VAT revenue allocation in the developed federal democracies is provided in the following section.

Comparative Perspectives on VAT Allocation

The decision to centralize the collection and administration of indirect taxes, most prominently VAT, in essence goes against conventional wisdom concerning tax assignment in decentralized countries or federations (Bird et al, 2001). Retail sales tax (RST), which has been supplanted by VAT in most countries, was more often than not the revenue of sub-national governments and usually not subject to tax sharing among different levels of government. This was also the case in BiH, with the RS, Brčko District and the cantons in the FBiH as the primary beneficiaries of the previous RST.

However, for most federations, such arrangements were no longer feasible under the new VAT taxation regime. Some of the reasons for this stems from the fact that levying VAT on more than one basis could have highly distorting economic and fiscal effects and likewise, make administration and compliance needlessly costly (Bird et al, 2001).

This is why VAT was mostly centralized in developed federations around the world with varying degrees and methods of revenue-sharing at sub-national levels of government (see Table 2).

It is only for large, territorially dispersed federations, such as Canada, that sub-national value-added taxation systems are considered sustainable taxation arrangements[14] (Bird et al, 2001). Nonetheless, for a country the size of BiH, the initial approach of centralizing indirect taxes (a majority relating to VAT) is a sound one. However, as explained in the previous section, the allocation criteria are proving to be very troublesome. It creates larger-than-usual uncertainties in financial and budgetary planning because it is dependent on negotiations during the fiscal year between key political actors. Likewise, as the European Union (EU) is also coming to realize in efforts to assign VAT revenues within the EU, if economic cohesion entails obliterating

[13] It must be borne in mind that for most of these countries VAT does not constitute a substantial portion of total tax revenues. For most of these countries the "largest" taxes, personal income and profit taxes, are usually exclusive revenues of the federal levels.

[14] However, it must be borne in mind that value-added tax has been difficult to implement in general in North America, with the U.S. failing to implement VAT taxes to this day (Bird et al, 2001).

Country	Is there a Federal VAT?	Is there sales tax on sub-national levels?	What is the type of sales tax in the sub-national governments (SNGs)?
Germany	Yes	No	SNGs share in VAT revenue
Austria	Yes	No	SNGs share in VAT revenue
Switzerland	Yes	No	None
Belgium	Yes	No	None
Australia	Yes	No	All VAT revenue goes to SNGs
Canada	Yes	Yes	Some have VATs, some have RSTs
United States	No	Yes	Most have RSTs

Table 2:
Sales tax in Federal Countries (Bird et al, 2001) [13]

borders within a particular economic space, it is extremely difficult to determine, in a transparent and fair way, points of destination-based final consumption for purposes of VAT allocation (Bird et al, 2001).

This is why "many have argued that the 'German solution' of a centralized VAT, with some of the revenues shared with the states on a formula basis, is probably the best approach" (Bird et al, 2001). With the unification of Germany the formula used for allocating VAT has changed, with the Federal government foregoing a larger potion of VAT than was the case before unification.

Furthermore, as of 2004, the Federal Government is committed to additional supplemental financing of the new Eastern Federal states in order to ensure that their standards fall into line with their older Western counterparts, at the same time alleviating some of the supplementary financing provided until then by the Western states. The fixed percentages used until 2004 to allocate VAT vertically are presented in Table 3.

Table 3:
Allocation of total VAT revenues in Germany in percentages and in order of allocation[15]

The amount in %	To Whom?	At what Stage of Allocation?	Rationale
5,63%	Federal Government	Up Front	Because of the contributions by Federal Government to the Statutory Pension Scheme
2,2%	Municipalities	Before further allocation to other levels	on a per capita basis (implying a strong implicit equalization effect) (Spahn, 1995)
50,4%[16]	Länder	After first two allocations	Same as previous
49,6%	Federal Government	After first two allocations	Same as previous

Under the same scheme, VAT was also allocated horizontally, with 25% of the share of the total VAT allocated to the Länder going up-front to those Länder in fiscally weaker positions. Disregarding at this time the specificities of the German allocation scheme and the exact percentages used in Germany for allocating VAT revenues, a key feature of this particular allocation scheme is its ***holistic approach to revenue allocation in order to achieve greater equalization.***

This is attested to by the plain fact that the allocation scheme guarantees a portion of VAT revenues to municipalities, regardless of the fact that municipalities are administratively responsible to the Länder. Therefore, fiscal equalization, both vertical and horizontal, is the key determinate of the allocation scheme. A holistic approach to fiscal equalization and, ultimately, to ensuring government spending efficiency and effectiveness is completely lacking in the current fiscal system of BiH, as is explained in the following section.

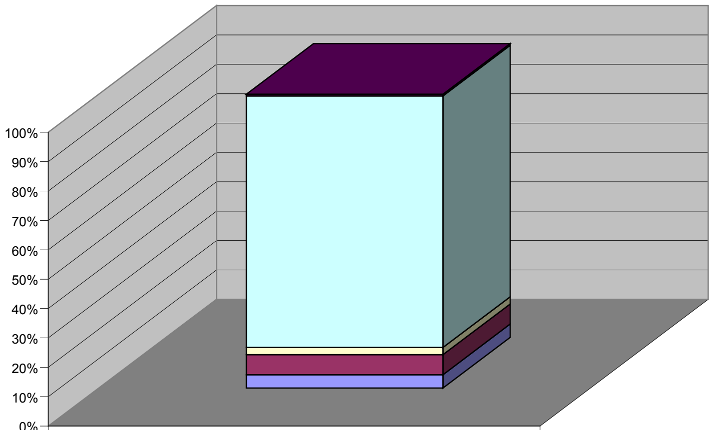
[15] Based on information compiled from the German Federal Ministry of Transport, Building and Urban Affairs and Spahn, 1995.

[16] These are the percentages for allocation to the Federal and Länder governments of amounts remaining after 5.63% and 2.2% have been deducted for Statutory Pension Schemes and to municipalities.

Fiscal Balances and Expenditure Efficiency and Effectiveness

Through Indirect Tax-Sharing Schemes

Of course fiscal relations cannot be observed solely through the prism of the indirect taxation system of BiH. Although indirect taxes are the only taxes shared between the State level, entities and Brčko District, there is further revenue sharing between the entities and their constituent units. However, as Figure 4 clearly demonstrates, the overwhelming majority of total tax revenues for all levels in BiH relates to indirect tax revenues.



	% of total tax revenues for first six months of 2007
Other taxes	0,59%
Indirect tax revenues	85,61%
Property tax	2,44%
Wage and labor tax	6,82%
Invidivdual income tax and company profit tax	4,53%

Figure 4:
Types of revenues as percentage of total tax revenues collected for first six months of 2007

Source: Office for Macroeconomic Analysis of the ITA

The same is true for each of the levels of government in BiH. For the cumulative tax revenues of FBiH, cantonal and Federation municipal budgets, 84.27%[17] include revenues from indirect taxes, while the same is true for 80.73% of cumulative tax revenues for the RS and its municipalities.[18] Therefore, given the high proportion these revenues represent in total tax revenues, as well as in overall revenues, the allocation scheme of indirect taxes ***throughout the whole of BiH*** is exceptionally important for sustaining vertical and horizontal fiscal balances.[19]

Primarily owing to significant donor input[20], the FBiH and the RS, have, as of 2006, introduced allocation schemes for indirect taxes that seem to address the high vertical and horizontal fiscal imbalances that existed in the tax sharing schemes prior to the implementation of the BiH-wide indirect tax system. Namely, "a Law on Public Revenue Allocation was adopted in the FBiH[21], as were changes to the Budget System Law in the RS[22] … [establishing] a new system of intergovernmental finance, which had the following effects:

- A higher share of revenue to local government;
- Introduction of equalization principles at both the local government and cantonal levels, significantly lowering the disparity in revenue per capita;
- A transparent, predictable and standardized system of revenue allocation to cantons and municipalities, with clear and objective criteria;
- Assurance that growth in revenue from the single account will be shared proportionately among all levels of government (each level has a specified share of single account revenue);
- Introduction of standardized sharing of wage tax revenue in FBiH; and
- Significant harmonization of the system for funding local governments". (GAP, 2006)

[17] Furthermore, based on information collected by the Ministry of Finance of the FBiH of revenue collected in the period January to August 2007, 95.37% of total tax revenues for the Federation level, 83.66% for the cantonal level and 55.55% for the municipal level relate to indirect taxes.

[18] Based on information of the Office for Macroeconomic Analysis (OMA) of the ITA of the tax revenues collected for the first six months of 2007.

19 Based on OMA information this is 71.69% of total BiH-wide revenues reported by the OMA for first six months of 2007. Based on information of the Ministry of Finance of the FBiH for the first eight months of 2007 this is 68.62% of total reported revenues for the FBiH.

20 Namely the USAID and Sida funded Governance Accountability Project of BiH.

21 Official Gazette of the FBiH No. 22/06.

22 Official Gazette of the RS No. 34/06.

Box 1: Indirect tax-sharing schemes for lower level governments in the FBiH and the RS

According to the Law on Allocation of Public Revenues in the FBiH[23] the Government of the FBiH used "for the first time a formula for the distribution of revenues to lower level government" (Dervišević, 2006). The revenues from indirect taxes that are allocated in total to the FBiH level are further distributed in the following manner:

-- 36,2 % to the FBiH level;
-- 51,48 % to the cantonal level;
-- 8,42 % to the municipal level;
-- 3,9 % for the Directorate for Roads.

Five types of criteria (weights) are used for the horizontal allocation between cantons and municipalities:

a) size of territory (6% weight for cantons, 5% for municipalities),
b) size of population (57% weight for cantons, 68% for municipalities),
c) number of pupils enrolled in elementary schools (24% weight for cantons, 20% for municipalities),
d) number of pupils enrolled in secondary schools (applicable only for cantonal levels, 13% weight)
e) index of development (applicable only for municipalities, 7% weight) which "measures the factor of fiscal capacity of municipalities" and is "calculated as the portion of collected sales and profit tax for a certain municipality in 2005 in comparison to the FBiH average for these taxes" (Dervišević, 2006).

The Law on the Amendments to the Budget System Law of the RS[24] allocates vertically the total revenues allocated to the RS from the single account of the ITA according to the following percentages:

-- 73,5 % to the RS level;
-- 23,0% to the cities and municipalities;
-- 3,5 % to Public Enterprise "RS Roads";

Horizontal allocation between cities and municipalities is carried out based on the following criteria:

a) 75% based on the size of population;
b) 3% based on size of territory,
c) 15% based on number of pupils enrolled in secondary schools;
d) 5% based on the number of pupils in elementary schools.

For the FBiH, the current tax-sharing scheme for indirect taxes offer the possibility for an increase in the portion of indirect taxes over a certain period for those municipalities and cantons that historically have had the smallest share of the former RST (Dervišević, 2006). The same is true for municipalities in the RS.[25]

Changes introduced in the allocation schemes of indirect taxes resulting from the introduction of VAT have, for the first time, presented the concept of objective criteria in intergovernmental revenue allocation. However, there have been some concerns that the allocation criteria used have not fully taken into consideration the expenditure responsibilities of the cantonal and/or municipal governments, which raises questions as to the extent to which fiscal equalization has been achieved. Another major issue that has arisen in the use of objective criteria is the unreliability of statistical data. Both entities relied on the statistics provided by their respective statistical agencies. However, overall statistical data gathering is fragmented and statistical

[23] Official Gazette of the FBiH No. 22/06

[24] Official Gazette of the RS No. 34/06

[25] Please see the Decision of the Government of RS on the allocation of indirect taxes to individual municipalities made in June 2007. (Official Gazette of the RS, No. 56/07).

methodologies differ. Without reliable statistics, the coefficients being used can be subjected to dispute, again leaving the allocation system subject to ad hoc, unsystematic negotiations between the levels of government.

However, given the derivative basis used previously for allocating RST (particularly in the FBiH) (Dervišević, 2006), the changes introduced have contributed towards the widening of perspectives on fiscal policy by using revenue sharing, based on objective criteria, to achieve greater fiscal equalization, either vertical or horizontal. That in itself is a very positive step forward, as it increasingly makes policy makers on each of the levels aware that decisions regarding taxation, revenue assignment and allocation, and consequently, expenditure assignment cannot be made in isolation and that fiscal decisions and systems in one part of the country can have effects (positive and negative) on other parts. Another concrete result of this increasing awareness has been the initiative aimed towards creating a Fiscal Council in BiH discussed below.

Through Inter-governmental Transfers

However, the advantages of well-designed and structured inter-governmental transfers not only in closing fiscal gaps, but also in the achievement of wider national objectives are yet to be recognized and these should be developed as instruments of fiscal policy and fiscal cohesion. For all forms of government, transfers are a key feature of government finances, amounting to as much as "60 percent of sub national expenditures in developing countries and transitions economies and about a third of such expenditures in member countries of the OECD" (Shah, 2007).

For federations, transfers are considered an "intrinsic feature" (Boadway, 2007) of intergovernmental fiscal relations. This is primary due to the inherent tensions within all federations between, on one hand, the efficiency that is broadly believed to be derived from decentralizing decision-making and, on the other, achieving overarching national objectives "including equality of economic outcomes, equality of opportunity, and economic security, versions of which are often found in a nation's constitution" and that is usually the responsibility of sub-national government to deliver, but for federal governments to uphold (Boadway, 2007). Transfers are one of the policy instruments federal governments usually use to alleviate these tensions (Boadway, 2007).

In that regard, despite its high level of decentralization (one might even argue an extreme level in some cases); BiH does not function as a functional federation. This is simply attested to by the fact that the State of BiH does not provide any forms of transfers to lower level governments. Furthermore, the State of BiH does not have any means of securing any forms of cohesion within the country (legislative, fiscal or otherwise).

A prime reason for this is the "hybrid nature" of the Bosnian-and-Herzegovinan "federation" (FPI BiH, 2007) (see Figure 5)

It is obvious from the table above that BiH is neither a dual nor a cooperative federation, but rather a combination of both, making the overall governance structure of BiH highly unstable and extremely inefficient (FPI BiH, 2007). This is reflected in the indirect taxation system. The fact that it was centralized and assigned to the State level of government is in line with experiences of other federal countries (as explained earlier), however if BiH were more of a cooperative federation the allocation of indirect taxes would have been done on a more holistic basis, taking into account the fiscal capacities of all levels of government providing public goods and services and using assessments based on solid and unified statistical data. On the other hand, if BiH were more of a dual system none of the indirect tax revenues would be shared with other levels, leaving the resulting fiscal gaps in the lower levels to be resolved through transfers from the State level.

	Separate legislation for federal and sub national governments	Strong representation of sub national governments in federal legislature	Little or no harmonization on tax bases and tax rates, decentralized tax administration	Fiscal redistribution between federal and sub national levels
Dual federal system with coordinate responsibilities[26]	Yes	No	Yes	No (or very limited)
Cooperative federal system with shared responsibilities[27]	No, federal level regulates sub national level implements	Yes	No	Yes
BiH "federal" system	Yes	Yes	Only indirect taxes shared	No

Adapted from "Governance Structures in BiH: Capacity, Ownership, EU Integration, functioning State", FPI BiH

Figure 5:
Governance arrangements in BiH against "ideal" types of federal systems

However, transfers in federal governments, aside from equalizing "the fiscal capacities of regional governments to provide comparable levels of public services", also often serve as an "incentive for [sub national governments] to design their programs in a way that reflects national norms of efficiency and equity, and encourages them to harmonize their policies" (Boadway, 2007).

Due to this complex array of purposes transfers can be of various types. The main types and their characteristics are described in Table 4 below.

[26] An example of this type of federal system in Europe is Switzerland.

[27] The German federation comes closest to being an example of this type.

Types of transfers	**Main characteristics**
General-purpose transfers (non-conditional)	Provided as general budget support with the intent of preserving local autonomy and enhancing inter-jurisdictional equity
Block transfers	Lie somewhere between general-purpose and specific-purpose transfers. Aimed at providing broad support to a general area (for instance education) but leaving recipients to decide specific areas of spending
Specific-purpose transfers (conditional)	Conditioned transfers designed to provide incentives to recipient governments to undertake specific programs or activities
Non-matching transfers	Recipients do not need to match level of funding as long as transfers used for intended purposes
Matching transfers	A specified percentage of targeted expenditure is met by financing from the recipient government
Close-ended	Grantor matches recipient funds up to specified limit
Open-ended	Grantor matches what ever level of resources the recipient provides

Table 4:
General characteristics of the main types of transfers (Shah, 2007)

As stated previously no transfers, either conditional or non-conditional, are made from the State to entity or lower levels of government. The use of transfers in entities toward lower level governments (cantons and municipalities) are primarily regulated through annual budget execution laws and, in effect, are not established as an integral part of overall intergovernmental fiscal relations. Therefore, the effects of these transfers in terms of fiscal equalization would need to be systematically assessed and designed according to these assessments.

Divergences in expenditure efficiency and effectiveness attest to the failure of transfers from entities to lower level governments to introduce improvements in this area of public expenditure management, as explained through the example of the education sector outlined in the next sub-section.

Issues of Expenditure Efficiency and Effectiveness

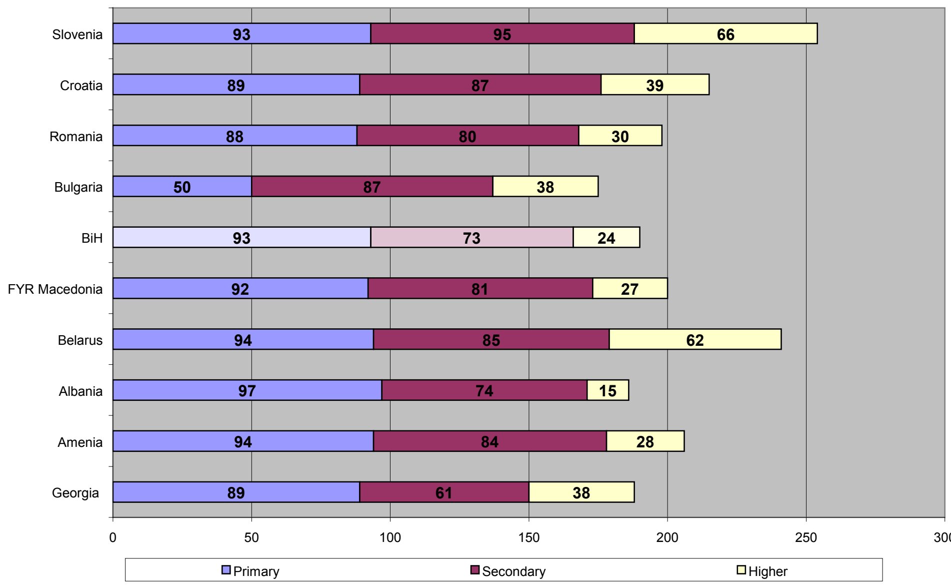
Thanks in part to the allocation schemes from sub-national government to lower level governments as discussed above, but primarily due to very tight fiscal constraints, fiscal balances between and within each of the levels of government have, for the time being, been achieved. The question remains however-to what extent is public spending efficient and effective? The World Bank in its Public Expenditure and Institutional Review (PEIR) of September 2006 concluded that "at current levels, government expenditures are a full 5 percent of GDP higher than in countries with similar levels of income per capita and 4 percent higher than average of the countries in Southeast Europe (SEE) [however] outcomes of government spending … tend to be substantially poorer". In fact, the primary "drain on public resources" comes not so much from the "higher than optimal levels of government spending" but from highly ineffective and inefficient public spending (World Bank, 2006).

An example of this can be seen in the education sector[28], where several key deficiencies have been noted by the World Bank, some of which are reiterated in the key points below:

- "Given funding levels, education performance is unacceptably poor, characterized by low coverage and inadequate educational achievement;
- Secondary and higher education coverage is low compared to other countries (see Figure 6)
- The private costs of schooling constrain school attendance for poor children; and
- Exacerbating coverage issues, student performance in a number of areas is substandard, while geographical differences are substantial … reflect(ed) in part by differences in income and government outlays on education [between various levels of government] (Table 5)".

[28] For the newest National Development Strategy for BiH focus will be put on the strategic importance of a smaller number of assessed sectors. The education sector will most likely be assessed of high strategic importance for sustainable long-term economic growth.

Figure 6:
Education Coverage by Countries Expressed in Net Enrollment Ratios[29]



[29] The percentage of the population in the normal age group for each level of education that is actually enrolled at each age-appropriate level of schooling.

Source: World Bank, Public Expenditure and Institutional Review (World Bank, 2006)

If standards of education in relation to enrollment ratios and educational performance are to be achieved, all efforts, including those explicitly recommended by the World Bank in its PEIR, will require not only political will, but coordinated efforts between each of the levels of government.

Table 5:
Percentage of primary students with below minimum standard in mathematics assessment by region 2003 - 2004

	20-30%	30-40%	40-50%	Slightly over 50%
Tuzla			x	
Central Bosnia				x
Mostar	x			
Una Sana				x
Zenica			x	
West Herceg.	x			
Sarajevo	x			
Canton 10			x	
Posavina			x	
Gorazde			x	
Brcko			x	
RS		x		
FBiH (average)			x	
Total	**3**	**1**	**7**	**2**

Adapted from the "Public Expenditure and Institutional Review" (World Bank, 2006)

Currently there are no BiH-wide driven programs aimed at addressing some of the weaknesses identified in the education system in BiH that require joint and coordinated action. Furthermore, the brunt of reform effort in the education sector rests on those levels of governments that provide educational services (RS and cantonal government for secondary and higher education, and municipal governments for primary education). Furthermore, even if joint programs were to exist, in order to secure adequate funding, the implementation of these programs would depend on the commitment of executive bodies on each of the levels.

The current system of indirect taxation does not address, from a legal standpoint, the allocation of revenues below entity and Brčko District levels. Additionally, the Managing Board of the ITA has been explicitly excluded from deciding or even discussing the allocation of indirect taxes to sub-entity levels. By its nature this body does not deal with expenditure issues at all. However, a new coordination body is envisaged that will take on a more prominent role in fiscal harmonization for BiH - the Fiscal Council (FC) in BiH, which should have a role in influencing effective government spending. The roles, responsibilities and composition of the FC are described in more detail in the following sub-section.

Institutional Arrangements for Intergovernmental Fiscal Relations

The FC in BiH was tentatively introduced during 2005, mainly at the behest of the IMF which was concerned about the lack of formal or institutional mechanisms for the coordination of fiscal policy in BiH, particularly in relation to the size and scope of government spending across levels of government in BiH. There was a brief period of success in holding consecutive meetings of the FC in BiH, and even in the implementation in practice of the recommendations of its meetings (most notably during 2005). Unfortunately, the change of government in the RS and the 2006 elections brought about a complete halt to the workings of the FC in BiH and to initiatives to set it up as a legal entity and to determine its role.

However, during the recent Economic Dialogues held between the European Commission and BiH, discussions concerning the FC have been revived and it seems that a general consensus on the legal framework defining the role and responsibilities of the Council has been reached. An agreed Law on the Fiscal Council in BiH has been put into legislative procedure toward the CoM and there is a wide-spread agreement that the Law will be adopted in the coming months. The role and responsibilities of the FC as regulated in the draft Law are described in Box 2[30].

[30] Article 5 of the Draft Law on the Fiscal Council in Bosni and Hercegovina.

Box 2: Role and Responsibilities of the Fiscal Council in BiH

1. Coordination of fiscal policy in BiH;
2. Adopting the proposal of the three-year "Global Framework of Fiscal Balance and Policy in BiH", containing proposed fiscal objectives for BiH, entity and Brčko District budgets, proposal of indirect tax macroeconomic projections for total indirect taxes and their allocation; and an upper debt limit for BiH, entity and Brčko District budgets;
3. Adopting proposal of short-term and long-term macroeconomic projections;
4. Monitoring the implementation of determined objectives and criteria in the execution and adoption of budgets;
5. Achieving complete coordination of activities in accordance with agreed budget calendars for State, entity and Brčko District governments,
6. Proposing priority measures for enhancing public sector financial management in BiH;
7. Adopting all acts necessary for the proper functioning of the Fiscal Council, as well as its budget.

The FC in BiH is comprised of representatives of the State and the two entities (this time around it is the prime ministers and ministers of finance, with the Governor of the Central Bank and President of Brčko District Government acting as observers). It is assumed that coordination with lower levels of government (cantons and municipalities) will be carried out by the competent "upper-level" government.[31] If fiscal equalization considerations were to be put at the forefront of the indirect tax allocation scheme, the FC in BiH should be the forum in which this scheme would be monitored and assessed. In the light of that, the FC in BiH would need to expand its membership to include representatives from cantons and municipalities. There are several arguments for this.

Firstly, indirect taxes comprise a high proportion of the overall amount of tax revenues within cantonal and municipal budgets. This results in a high dependence of cantonal and municipal fiscal positions on such revenue. This ultimately impacts on the quality of public service delivery in this particular revenue source. Fiscal balance can only be achieved, therefore, if there is a holistic and common set of criteria of revenue allocation encompassing all levels of public service delivery in BiH.

Given that indirect taxes are exclusive revenues of the State of BiH (regardless of the executive and legislative arrangements of the State in general and the specific institutional arrangements for the indirect taxation system in particular) the State should have some role in ensuring that objectives of fiscal equalization and equity and quality in public service delivery are met. At the very least, this could be enacted through the representation of cantonal and municipal ("lower") level governments in State-level forums, established for the purpose of negotiating measures to ensure fiscal policy and balance, i.e. arrangements for indirect taxation allocation.

Direct representation of sub-national and local level governments in institutionalized fiscal policy coordination mechanisms exist in other decentralized and federal countries. Within an overall fiscal framework, this is one way in which the interests of sub-national governments can be secured. However, "impartiality" of a fiscal system can be achieved through other types of institutional arrangements (see Box 3).

[31] There is even general discussion about creating a similar institutional arrangement on the FBiH level to ensure greater fiscal harmonization between FBiH and cantonal levels. Whether this would include municipal representation is not known.

Box 3: Fiscal Coordination in Decentralized and Federal Countries

Germany

The 1969 Budget System Law of Germany established a Financial Planning Council (FPC) because of "a lack of legally-binding opportunities to influence the budgetary policy of the Länder", and is primarily responsible for providing "recommendations for coordinating the budget and financial planning of the Federation, the Länder, the municipalities and the association of municipalities". With the acceptance of the Maastricht Criteria by Germany "the role of the FPC was strengthened … to submit recommendation for fiscal discipline, in particular a common expenditure policy". In order to influence budgetary decision-making the FPC meets in the spring and autumn. Its members include:

-- The Federal Minister of Finance, acting as Chair,
-- The Federal Minister of Economics and Labor,
-- The Länder ministries responsible for finance
-- 4 representatives of municipalities and the association of municipalities (appointed by the Bundesrat); and
-- Representative of the Deutschebank as guest.

(Lübke, 2005)

Australia

Since its constitutional establishment as a federation at the beginning of the 20th century, the federal government of Australia has over time, mostly in response to adverse political, economic and social circumstances, "overtaken" large portions of revenues of its six States. At the peak of dissatisfaction over fiscal arrangements that was becoming increasingly unfavorable, if not unbearable for the States during the 1930s (for instance, the State of Western Australia passed a referendum on secession), an "independent Commonwealth Transfers Commission was established to review states' claims for special assistance and make recommendations" (Spahn et al, 1995). The primary role of the Commonwealth Transfers Commission is to administer general purpose equalization transfers to the States based on a very comprehensive and complex equalization system.

It is an independent body comprised of five experts, non-affiliated to any of the levels of government, usually academics, retired civil servants, and very rarely former politicians. These members are appointed by the federal Government and formally responsible to the Parliament through the Ministry of Finance. However, it is expected to work very closely with the State Treasuries in designing the equalization system. Special purpose transfers, which are also important to the overall fiscal system is administered by the Ministry of Finance exclusively.

(Boex et al, 2004)

South Africa

The abolishment of apartheid in South Africa "harmonized the structure of the public sector" and divided expenditure responsibilities between three "spheres" of government, national, provincial and local. Although provinces account for 60% of public expenditure and 70% of public sector employment, revenues are highly centralized making the provinces and local spheres of government dependent on transfers. The Financial Fiscal Commission was established as an independent advisory body to the national and provincial legislatures on matters of financial and fiscal matters, including the issue of division of "national fiscal resources". It currently has nine members (reduced from the previous number of 22 Commissioners), and is serviced by a professional staff of some 20 people.

Five of the members are selected from a list compiled in accordance with national law with consultations with the Premiers (for three members) and organized local governments (for the other two members). It has a Chairman and Deputy Chairman, and two other independent members. It is meant to function as an independent body to balance relations with the three spheres of government, but is obliged to work closely with decision-making institutions of the national government which have the ultimate say in the allocation of revenues.

(Boex et al, 2004)

Of course, comparisons of any kind must be undertaken carefully, given that institutional arrangements, such as those described above, are highly dependent on historic, political and social circumstances within the countries. However, what can be said for certain is that, regardless of their form of functioning or of which instruments are used for cohesion, in all federations, the central government or centrally-led coordination mechanisms play a significant role in closing fiscal gaps, as well as in ensuring a minimum of common standards in public service delivery and effectiveness.

There is a very simple reason for this. Although federations score highly in efficiency compared to more centrally administered countries, these scores do not similarly apply when it comes to issues of equity. Devolved decision-making causes federations to become prone to inequalities in public service coverage and provision, and in many cases, the most vulnerable groups within any society (for example, single mothers) are more disenfranchised than similar groups in more centralized or unitary states (Watts, 1999).

Despite the institutional arrangement of the indirect tax system in BiH and despite the fact that indirect taxes are shared between the levels of government (i.e. directly between the State, entities and Brčko District, and indirectly to the other levels of governments, namely cantons and municipalities) indirect taxes collected by the ITA can be considered ***exclusive*** revenues of the State of BiH, as the CoM, i.e. the State level, is de facto and de jure ***politically responsible*** for raising this particular source of revenue (Bird et al, 2001).

Therefore, ensuring fiscal equilibrium (in the sense that all levels have the comparable fiscal standing needed to deliver the legally mandated public goods and services of each of them), and simultaneously ensuring the effectiveness of their spending (particular for areas of strategic importance for overall economic growth, such as education) should be a natural role that the State of BiH should assume. This would lead to a natural continuation of the reforms implemented thus far in establishing the indirect tax system in BiH.

The benefit that will exist is that there need be no risk of State "dominance", as strong coordination mechanisms will exist (namely, the Fiscal Council of BiH) that can provide "an intergovernmental forum to achieve consensus on the standard of equalization and objectives", considered a key positive trait in the design of intergovernmental fiscal relations (Shah, 2007).

With that overarching goal in mind, the options outlined in the following section are structured with the aim of eliminating the current weaknesses within the current allocation system of indirect tax revenues, yet building upon some of the potential strengths of the overall fiscal system in BiH. They are then assessed in general terms for their acceptability, feasibility and potential impact on the improvement of the overall fiscal system.

Options for Improvement

The options outlined below are structured primarily for the purpose of expanding the discussion on enhancement of the allocation system of indirect tax revenues as a precondition for stabilized fiscal relations. These options are presented in summary in Table 6 below and explained in the remainder of this section.

Table 6:
Summary overview of options for improvement

<table>
<tr><th>Options</th><th>Benefits</th><th>Risks</th></tr>
<tr><td><u>Option 1:</u> Retaining current arrangements of indirect-tax revenue allocation</td><td>• Status quo in essence retained, subject to political agreement of “fixed” coefficients
• Allows time for strengthening current indirect taxation system without introducing major changes
• Acceptable only if viewed as an interim solution, pending further changes</td><td>• Allocation decisions made without recognition of full impact on all governmental levels of public-service delivery
• Makes overall fiscal system still highly fragmented, thus limiting the impact of the indirect taxation system on the creation of a single economic space</td></tr>
<tr><td colspan="3"><u>Implementation Considerations:</u>
• Agree on acceptable fixed coefficients based on historic trends relating to final consumption, but only as an interim solution (valid for one to maximum two fiscal years)
• Use this time to allow FC, with technical support of the State Ministry of Finance and Treasury, in cooperation with all other relevant stakeholders, to devise a set of simple objective criteria which would consider comprehensive vertical and horizontal fiscal equalization, in line with expenditure responsibilities of each of the levels</td></tr>
<tr><td><u>Option 2:</u> Arrangements based on horizontal and vertical fiscal equalization considerations</td><td>• Current tax-sharing schemes for sub-entity levels embedded in State-level law, making “unilateral” and unequal changes more difficult
• Fiscal equalization considerations truly at forefront of allocation design as debate would be expanded to more than four key actors thus limiting needless politicization
• Managing Board of ITA “freed” to focus discussions on issues of indirect tax policy, whereas equalization criteria become subject of FC discussions</td><td>• System could be undermined and fiscal equalization not achieved without reliable and unified statistics
• Expenditure effectiveness issues still lost from the “radar”, as freedom left to governments to decide on how to spend funds
• No monitoring of country-wide expenditure effectiveness for expenditure programs of high national priority (like education)</td></tr>
<tr><td colspan="3"><u>Implementation Considerations:</u>
• Requires complete abandonment of the principle of relative proportion of final consumption as the basis for indirect tax allocations, replacing it with principle of objective criteria
• The FC in BiH assumes role deciding on changes needed to indirect tax allocation coefficients based on assessment of implications it has on fiscal positions of all governments in BiH.
• Requires reliable statistics, compiled through the application of uniform methodologies; requires agreement as to what basis to use for sizes of population in the absence of robust census data
• Effective expenditure policy coordination through FC in BiH could neutralize risks of ineffective and untargeted government spending; however, requires FC to engage in discussions beyond budget ceilings and fiscal targets
• The FC should be expanded to include cantonal and municipal representatives. Representatives of cantons and municipalities that are members of the FC must truly represent their constituents and have technical capacities to engage in discussions</td></tr>
<tr><td><u>Option 3:</u> Arrangements based on fiscal equalization and public expenditure performance considerations</td><td>• Portion of funding for State-wide agreed educational performance targets provided
• Discussions on indirect-tax revenue allocation shift from necessary inputs to desired outcomes of government funding</td><td>• If educational reform programs not designed and monitored properly, could just additionally secure funding for ineffective educational programs and could inadvertently increase government spending
• Lack of proper coordination could lead to duplication of financing (both from State transfers as well as through “regular” budgets)</td></tr>
<tr><td colspan="3"><u>Implementation Considerations:</u>
• Discussions on design of transfer systems between State and other levels of government in BiH should be done through the FC in BiH
• State Ministry of Finance and Treasury must have capacity to monitor the use of transfers and have means to assess whether targets are being met
• Requires comprehensive consultation with ministries of education and other implementers of the reform programs</td></tr>
</table>

Option 1: Retaining current arrangements

In essence, this option is not simply the status quo. Given that there is political consensus on the need for change in the current allocation scheme of indirect tax revenues, some remedial action will be taken. Most likely the coefficients will be "fixed", based on an assessment of recent trends in final consumption. However, the need for an immediate resolution will mean that the allocation system will not fundamentally change. The basis of allocation will still be the relative portion of final consumption and this could adversely affect the free flow of goods and services within BiH, as well as contributing, inadvertently, towards an increase in government spending. Thus, the allocation of indirect taxes will fail to bring about more purposeful cohesion within BiH, and will rather contribute to its continued fragmentation and imbalance.

On the other hand, given the lack of uniform, reliable statistics, and other instrumental means of ensuring parity of cantonal and municipal interests, this option is acceptable as it allows for tensions to be alleviated and thus encourages trust in the indirect taxation system to be restored. However, these benefits will only be felt if this is seen as an interim solution and if the period in which it remains in place (a maximum of two consecutive fiscal years) is used to find an alternative design of the allocation of indirect tax revenues in BiH, such as the ones described below. The FC, with the technical support of the State Ministry of Finance and Treasury, must have the leading role in proposing alternative solutions.

Option 2: Arrangements based on horizontal and vertical fiscal equalization considerations

This option would require two substantive changes to the overall allocation system that would need to be reflected in respective legislative change. Firstly, a similar allocation scheme, based on objective criteria, such as is now used by the entities for allocation to lower level governments, would replace the current basis of relative portion of final consumption. This would alleviate the burdens now placed on the ITA and allow it to focus its efforts more on further development of the indirect taxation system and on tax enforcement. As coefficients would be based on considerations of fiscal equalization, their implications and adjustments could be discussed within the FC in BiH, leaving the Managing Board of the ITA truly to assume its role of advising the CoM of BiH on indirect taxation **policy** (such as the implications of introducing more than one rate of VAT, or the effects of changes to current single rate and similar).

Secondly, the FC in BiH would have to be expanded to include representatives of cantons and municipalities. They could be appointed by the respective entity legislatures, based on the recommendations of the associations of local self-governments. However, associations must truly act as advocates of cantonal and municipal governments and must have the technical capacities to be able to engage actively in the discussions of the FC and to act on its collective best interest. This requires substantive change within the existing associations, in terms of capacity and, potentially, organization.[32]

Reliable and uniform statistical information is paramount to the design of objective criteria for allocation. Although it is highly advisable to keep the criterion used in fiscal equalization as simple as possible (Shah, 2007), in the case of BiH the exact figures, even for a statistic such as the population size by region, are unknown. However, difficult though statistical issues may be, they can be overcome if there is clarity on the desired objectives aiming to be achieved by the revenue allocation system.

[32] In many developed decentralized and federal countries (such as the Netherlands, Germany and others) "most types of institutional intergovernmental arrangements somehow include local government associations as an institutional partner". This is not without certain key requirements; namely that "(a) the local government associations have the institutional and technical capacity to engage in policy analyses and informed policy dialogues with central government counterparts, and (b) the local government associations are sufficiently representative to be able to credibly speak on behalf of all local governments" (Boex et al, 2004) Hopefully, in the BiH context, the latter would, be considered through the unification of existing local government associations.

Option 3: Arrangements based on fiscal equalization and performance considerations

It is common for federal countries to use both revenue-sharing and transfers in order to achieve fiscal equalization, as well as to secure the achievement of objectives deemed of national significance. Analysis of intergovernmental fiscal transfers in other countries indicate that output-based transfers, i.e. transfers conditioned against the accomplishment of predetermined performance targets, are the most effective forms of transfers (Shah, 2007). The reason for this is that, by this arrangement, funding for achieving national objectives is provided for, whilst retaining the flexibility for sub-national governments to design spending programs.

A similar scheme could be incorporated within the indirect taxation allocation arrangement in BiH. Objective criteria could be used for allocating revenues between levels of government, (similar to the system described under option 2), with the addition that a portion of the indirect taxes be "earmarked" for transfers to lower level government in order to finance educational reform programs designed to achieve set performance targets (such as an increase in net enrollment ratios for secondary and higher education; a decrease in the percentage of primary students with below minimum standards in mathematics assessments etc.).[33]

The question of how to meet these targets would be a matter for the responsible governments (entity, Brčko District and cantonal) to decide for themselves.

Any conditioned intergovernmental transfers arrangement must be periodically assessed and renegotiated, but most importantly it must be monitored carefully for compliance and effectiveness. The State Ministry of Finance and Treasury must assume this monitoring role. The FC in BiH can be responsible for reviewing the effects of the transfers and for renegotiating the conditions pertaining to them. However, it is equally important for the recipient government to be able to trace their budget expenditures to the performance targets, requiring of them to use more sophisticated tools for the planning and execution of their budgets.

Again, all the above might be difficult, but not impossible, to put in place and implement. Consultations with ministries of education and educational institutions would provide insight into the performance standards that could realistically be set, and the actions that would be needed to achieve them. Care must be taken not to design a transfer system that could inadvertently support ineffective educational programs or which would lead to duplication of funding (i.e. from State transfers and "regular" budgets). This is why monitoring and assessment are very important.

33 Although this analysis uses the example of education, any area deemed of national importance could be incorporated into the system.

Final Recommendations

If the options described above were to be assessed broadly for their **acceptability** (i.e. will the change be accepted?), **feasibility** (how difficult is it, in the medium-term, to implement change?) and **potential impact** (to what extent will cohesion and expenditure effectiveness be achieved?) the assessment would yield results as presented in Table 7.

Table 7:
Assessment of options

	Acceptability	Feasibility	Potential impact
Option 1	High	High	Low
Option 2	High (particularly among cantonal and municipal governments)	Moderate (requires certain preconditions)	Moderate
Option 3	Low	Low	High (if properly designed)

Option 1 is the most acceptable and the easiest to implement, but to the detriment of fiscal balance and expenditure effectiveness. Option 2 is more politically acceptable and can be implemented with greater impact if certain preconditions are met. Establishing an intergovernmental output-based transfer system within the indirect tax allocation scheme will require more time and effort, but will yield potentially the greatest impact (if properly designed). It also requires that the State Ministry of Finance and Treasury assume a more distinct role in monitoring the use of transfers and supporting the FC in its role of assessing the overall system.
However, despite this assessment and bearing in mind the very volatile political circumstances currently pertaining in BiH, the greatest benefit that can be achieved at this moment is full implementation of the "status quo" option (i.e. option 1). Stabilization of intergovernmental relations, primarily between State, entity and Brčko District and the rebuilding of trust in the indirect tax system are absolutely imperative at this time.

Nonetheless, the acceptance of this option should be made with certain caveats:

- Fiscal equalization, horizontal and vertical, between all levels of government that provide public goods and services, must be put at the forefront of the indirect tax-sharing system. In the near-term, there must be complete abandonment of allocation based on relative portion of final consumption.
- The objective criteria agreed must be simple and transparent and based on uniform and reliable statistical information. As far as is possible, the expenditure responsibilities of each of the levels of government must be taken into consideration when allocating revenues.
- The review of and proposals for revenue allocation coefficients thus established must be left to the FC. The Managing Board of the ITA must, therefore, be left to assess and advise on indirect taxation **policy** and to oversee the management and functioning of the ITA.
- The allocation arrangements of indirect taxes must be comprehensive enough to include cantons and municipalities. This entails expanding the membership of the FC to include selected members from cantons and municipalities. Associations of local governments should have the technical and organizational capacity to represent the interests of local governments.
- In terms of designing a system of intergovernmental output-based transfers, the State of BiH could go forth regardless of the destiny of the indirect tax revenue allocation scheme

and design such a system from its existing budgetary resources for areas that it deems of national importance but over which it has no exclusive authority. The FC (in its expanded membership) needs to have a role in assessing and renegotiating the conditionality of these State-level transfers.

However, there are some major preconditions that need to precede any substantive and meaningful change, not only in this segment of intergovernmental fiscal relations in BiH, but in all aspects of governance in BiH. In fact, these are necessary preconditions for any federal setting (Boadway, 2007). Firstly, there must be "some consensus about the importance of national equity and efficiency objectives" (Boadway, 2007) in relation to the decision-making independence of sub-national governments. The focus placed on these considerations, in effect, creates the fabric and form of society in general. Once these principles have been agreed, the federal, or in the BiH context, the State level, must be given the instruments and authority to uphold these principles.

The strength of the State institutions depends on the value the society places on issues of equity and national (or, in the BiH context, inter-national) solidarity. Just as it is imperative to give an equal institutionalized "voice" to cantons and municipalities in issues of intergovernmental relations, the State of BiH must be given its "voice" as well. The strength of this voice depends on the strength placed on the value of equity and solidarity. There is no "European requirement" in this aspect. It is a judgment call that the political decision-makers and the citizens who vote and support them will have to make, and one that will shape this society for future generations.

Finally, there must be a degree of goodwill and willingness to engage in constructive dialogue and to assess all possible options and their implications. Unfortunately, unlike the arrangements that are negotiated between federal constituents via constitutions, laws, agreements etc., where there is always room for valid disagreements and nuances in approaches, there are no nuances when it comes to the questions of goodwill and willingness for dialogue. They either exist or they do not. Collectively, as citizens and inhabitants of this country, we either want this country to succeed as a progressive society or we do not. This paper and the arguments presented therein are based on the assumption that there are no issues regarding the existence of such goodwill, but only issues of how to channel it into wider and more constructive debates.

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