



“The Allocation of Indirect Tax Revenues - The Key to Fiscal Stabilization and Public Spending Efficiency”

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The Core Issues of the Indirect Tax Allocation System

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 and introducing a value-added tax (VAT). This significant reform effort achieved many positive steps, however the way in which the system for allocating revenues from indirect taxes has been established risk to further destabilize the already fragile fiscal relations in the country and seriously shake confidence in the indirect taxation system. There are several reasons for this:

(1) The current system creates more than usual uncertainty in revenue planning for entities and the Brčko District

- The basis for allocation is the relative portion of final consumption as reported by tax payers on tax returns for indirect taxes. This can vary significantly between territories and between time periods. 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 are still left to be decided on an ad hoc basis during the meetings of the Managing Board of the Indirect Tax Authority (ITA). 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. 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, once their budget has been approved, are able to estimate their revenue, on a daily basis, more accurately than is the case with other recipients.¹

(2) The current arrangements for allocation have adverse effects on the creation of a single economic space for which it was initially established

- 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.

(3) It further fragments the fiscal system in BiH

- The allocation system is not holistic, with cantonal and municipal governments explicitly excluded from State-level laws and institutional arrangements that currently govern the allocation arrangements. The allocation of revenues from indirect taxes to cantonal and municipal government is regulated by entity laws. This, coupled with the fact that revenues from indirect taxes are such a significant portion of “lower” level government budgets², leave these important providers

A “Policy Development Fellowship Program” has been launched by the Open Society Fund BiH in early 2004 with the aim to improve BiH policy research and dialogue and to contribute to the development of a sound policy-making culture based on informative and empirically grounded policy options. The program provides an opportunity for selected fellows to collaborate with the Open Society Fund in conducting policy research and writing a policy study with the support of mentors and trainers during the whole process. Thirty eight fellowships have been granted in three cycles since the starting of the Program. All policy studies are available at www.soros.org.ba

„Federalism may mobilize resources and growth through decentralization and competition among jurisdictions, but this potential is easily squandered where there is little or no interjurisdictional cooperation and fairness. Where federalism is understood to mean fiscal segregation and budget segmentation, existing regional inequities will persist and even become aggravated, social cohesion will remain illusory, and latent conflicts are likely to build-up further”
(Spahn, 2002 g.)

¹ 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”.

² For the cumulative tax revenues of FBiH, cantonal and Federation municipal budgets, 84.27% include revenues from indirect taxes, while the same is true for 80.73% of cumulative tax revenues for the RS and its municipalities. 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.

The arguments and statements presented in this policy brief are derived from a wider policy study entitled: "A Common Indirect Tax System in BiH - Continued Stalemate or a New Chapter in Sustainable Federalism in BiH? - An Analysis of the Issues Surrounding the Allocation of Revenues from Indirect Taxes"

of public goods and services very vulnerable to changes in allocation criteria that could adversely affect their abilities to finance their legally prescribed responsibilities. This fragmentation risks creating large fiscal imbalances, i.e. divergences in the levels of financing and spending, and inequities both vertically and horizontally between the levels of government in BiH.

(4) It does not function as an instrument for ensuring fiscal balances and expenditure efficiency and effectiveness

- All of the above prevent the indirect tax allocation scheme to function as an instrument of more purposeful fiscal equalization and of ensuring expenditure effectiveness and efficiency, and prevents debates surrounding the indirect allocation scheme to go beyond narrow interest of "how much VAT cake each level should be receiving". Furthermore, the allocation scheme puts great burden on the ITA to provide accurate information on final consumption reported in tax returns rather than focusing its efforts on those not reporting or paying taxes at all. Likewise, the current arrangement completely diminishes the policy role the Managing board of the ITA should have in relation to indirect taxes (for instance analyzing the effects of multiple rates or changes to single rates on overall fiscal system, economy and society).

Comparative Experiences in Federal States

Revenue assignment and allocation is a very sensitive issue in any federal or decentralized setting, therefore in that regard BiH is no exception. However, it is of paramount importance in ensuring all providers of public goods and services on each of the levels have the capacities

to perform their functions. This means ensuring that funding levels are in balance with public spending responsibilities. In that regard, the approaches taken by other federally constituted countries vary in regards to the issue of indirect tax, namely VAT, allocation (see Table 1). Based on the experience of other federal countries, for a country the size of BiH the initial approach of centralizing indirect taxes (a majority relating to VAT) was a sound one. However, the basis used for allocating indirect taxes in BiH, namely relative portion of final consumption is not commonly used among those federations that share indirect, namely VAT taxes, with sub-national levels of government. As the European Union is also coming to realize in efforts to assign VAT revenues within the EU, if economic cohesion entails obliterating borders within a particular economic space, determining points of destination-based final consumption for purposes of VAT allocation is extremely difficult to do in a transparent and fair way (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 fixed formula basis is probably the best approach" (Bird et al, 2001). In the case of Germany the legal framework for allocating VAT revenues encompasses all levels of government, including municipalities. Furthermore, the coefficients for allocation are determined on a fixed percentage basis that takes into consideration factors such as population sizes, public spending responsibilities and degree of economic development of regions to ensure revenue amounts are adequate. Therefore, fiscal equalization, both vertical and horizontal, is put at the forefront of determining the VAT allocation scheme. Currently the fiscal system in BiH neither has an allocation scheme for indirect taxes that put fiscal equalization at the forefront if its design nor is it holistic in its design. Furthermore, the State of BiH has no instruments by which it can ensure consistency in the quality of public services nor ways to ensure national objectives derived from the BiH Constitution can be effectively implemented³. In all federal states, irregardless of their form, the central, i.e. federal government naturally assumes such a role, even to the most limited degrees.

³ Such as for instance objectives relating to the quality of education that is a precondition for the free flow of work labor in the country. The policy study on which this brief is based gives an overview of the extent of some of the issues facing the education sector in BiH, which require highly coordinates action on each of the levels followed by the adequate financing of such initiatives.

Table 1:
Sales tax in Federal Countries
(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

*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.



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%	Länder	After first two allocations	Same as previous
49.6%	Federal Government	After first two allocations	Same as previous

Table 2: Allocation of total VAT revenues in Germany until 2004 in percentages and in order of allocation

Options for Improvement

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 Council of Ministers, 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 comparable fiscal standing needed for providing their legally determined responsibilities), 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 and a natural continuation of the reforms implemented thus far in establishing the indirect tax system in BiH.

The benefit that currently exists is that there need be no risks of State “dominance”, as there is nominal consensus for the establishment of coordination mechanisms (namely, the Fiscal Council in BiH) that can provide “an intergovern-

mental forum to achieve consensus on the standard of equalization and objectives”, considered a key positive trait in the design of intergovernmental fiscal relations (Boadway et al, 2007). Taking into consideration the previously stated, the options put forth in summary in the table below are structured with the aim of eliminating the current weaknesses within the current allocation system of indirect tax revenues.

Option 1: Retaining current arrangements of indirect-tax revenue allocation

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.

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 and regulated through State level regulations. Secondly, the FC in BiH would assume the role of periodically assessing and deciding on allocation criteria and, thus, 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.⁴

⁴ 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).



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.

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 pre-determined 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 revenues from indirect taxes be "earmarked" for transfers to lower level governments 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.).⁵

All federal governments use intergovernmental transfer systems to alleviate the tensions within all federations between, on the one hand, the efficiency that is broadly believed to be derived from decentralizing decision-making and, on the other hand, 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" that are usually under the responsibility of sub-national governments to deliver against, but of federal governments to uphold. (Boadway, 2007.g.).

⁵ Although the mentioned policy study uses the example of education, any area deemed of national importance could be incorporated into the system.

Final Recommendations

Bearing in mind the very volatile political circumstances currently pertaining in BiH, 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.

Therefore, immediate agreement must be made regarding fixed coefficients of relative portion of final consumption by the members of the Managing Board of the ITA. However, this should be seen as temporary solution and the following needs to be changed in the overall system of allocation of indirect tax revenues:

- 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.