



# Multi-level fiscal system in Bosnia and Herzegovina: evolution and coping with economic crisis

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## Abstract

*Fiscal federalism in Bosnia and Herzegovina is characterized by multi-level asymmetric architecture of government sector and a high degree of fiscal decentralization. Reform of indirect taxation has resulted in centralization of the major part of the revenues in B&H and induced a high degree of fiscal interdependence of governments. In the absence of national economic and fiscal goals and fiscal coordination required during the global economic crisis, strong autonomous activities of the Entities and District have been expressed. Uncoordinated and divergent responses to the crisis in addition to distorting the achieved degree of tax harmonization within B&H has led to a widening fiscal deficit and the rapid growth of borrowing at all levels of government. The aim of this paper is to propose a new model of fiscal coordination in B&H that would mitigate the negative effects of fiscal decentralization on macroeconomic management. The key hypothesis is that, in given political constraints, only a concept of fiscal federalism that includes comprehensive, institutionalized and obligatory fiscal coordination can ensure a coherent response to the crisis.*

*Keywords: intergovernmental fiscal relations, fiscal federalism, fiscal coordination*

## 1 INTRODUCTION

Expansion of the fiscal decentralization process in the world has prompted research on the effectiveness of macroeconomic management in fiscally decentralized countries. Opinions of economists concerning the impact of the fiscal decentralization process on the functioning of the macroeconomic system are divided. Starting from the three core functions of public finances, allocation, distribution and stabilization (Musgrave, 1959), Oates, creator of the theory of fiscal federalism, thinks that the optimum efficiency of the government sector can be ensured only by balancing the degree of centralization and decentralization of fiscal responsibilities between the central and local governments, where a fair distribution of income and economic stability can be provided by the central government, and the efficient use of resources by the local governments (Oates, 1972). Opponents of fiscal decentralization (Prud'homme, 1995) consider the excessive fiscal autonomy of lower levels of government a threat to the maintenance of macroeconomic stability and contrary to a reasonably guided macroeconomic policy (Tanzi, 2000). By contrast, proponents of a greater degree of fiscal decentralization believe that decentralized fiscal systems can contribute much more to macroeconomic policy management than is the case with centralized fiscal systems (Shah, 1997, 2005). However, they also suggest that it is necessary to establish an appropriate institutional framework for macroeconomic management and to adopt certain rules that will be required for all government levels. Comparative analysis of the effects of the fiscal decentralization process in the world done by Ebel and Yilmaz (2002), Bahl (2006) and Ter-Minassen (1997) showed that a different balance of power between central and local governments can threaten the macroeco-

conomic stability of complex countries. Theoreticians of the new theory of fiscal federalism, called “a second generation theory”, explain poor fiscal performance in some countries by the deviation from the principle of allocation of responsibility for expenditures and taxes and by the weak central government (Rodden, 2005). In conditions of strong regional governments fiscal coordination between governments becomes a critical issue of functioning fiscal federalism in complex countries. Weingast (2006) defined five conditions important for the successful functioning of fiscal federalism: (i) the hierarchy of government with clearly designated scope of authority, (ii) the autonomy of sub-national governments, (iii) single economic space, (iv) strong budgetary rules and (v) institutionalization of power. They believe that the successful functioning of fiscal federalism implies a balance between the autonomy of sub-national governments and the authority of the central one where each level achieves a comparative advantage. Fiscal federalism with strong budgetary rules contributes to strengthening government accountability for resources entrusted and to establishing fiscal discipline. Implementing fiscal authorities and rules should not be left to the discretionary decisions of the central government, but it is necessary to establish an institutional structure that will ensure smooth functioning of fiscal federalism. In that sense fiscal coordination between levels of government is seen as a key tool for running prudent fiscal management in complex countries that can bring the fiscal policy of middle levels of government in line with national fiscal goals.

Achieving efficiency of macroeconomic management in a decentralized fiscal system turned, during the global economic crisis, from being a matter of academic issues and case studies, into a serious problem faced by the governments of a large number of countries. The causes of the deterioration of fiscal positions in a number of countries can be found in the selected concept of fiscal decentralization and global tax reforms. The process of fiscal decentralization in the world undoubtedly led to an increase in the fiscal autonomy of lower levels of government. However, from the empirical research of Joumard and Kongsrud (2003) it can be concluded that the pace of delegating powers for expenditures was much faster than for taxing powers as a consequence of the trend towards revenue centralization and the introduction of value added tax (VAT). Bahl and Martinez-Vazquez (2006) point out the paradox of fiscal decentralization. Instead of increasing the fiscal autonomy of lower levels of government, ignorance of the rule that “finances follow expenditures” in the implementation of fiscal decentralization has increased the dependence of lower levels of government on the central government. The global economic crisis from 2008 exacerbated the problem of maintaining macroeconomic stability in complex countries. The tendency to centralize the most productive taxes and to increase the discretionary jurisdiction of the central government for vertical transfers to lower levels of government, on the one hand, and the delegation of responsibilities for expenditures to lower levels of government, especially those whose size and growth trends could threaten the fiscal position of the central

government, on the other hand, made lower levels of government vulnerable to serious budgetary shocks.

Analyses (Blöchliger, 2010a) showed that, before the crisis, the fiscal position of lower levels of government was more stable than that of the central government, which can be explained by the existence of strong fiscal rules for lower levels compared to the looser rules governing the central government. However, governments of lower levels were led into deficit by the global crisis due to the “scissor effect”, a sharp fall in revenues, in concert with constant or rising expenditures, especially social expenditures. In most European countries the “scissor effect” has led to a real decline of local budgets, the reduction being greater for local than central governments (Davey, 2011). Analysis of the crisis impact on the budgets of the world’s governments presented by Ter-Minassian and Fedelino (2010) shows that the strengths of expressing the effects on budgets of lower levels of government depend on, for example, the strength of the economy and employment in the region/local community, the structure of their own income, authority for expenditures that are cyclically sensitive and debt structure. Various manifestations of the crisis in different countries are the result of the crisis not having hit all governments at the same time, and of the differences in the administrative capacities of governments to agree and implement fiscal policies and intervention measures (Davey, 2011). Government’s response to the challenges of the crisis was largely determined by the degree of autonomy of the government in the area of revenue and expenditure, but also by possibilities of the central government to intervene. Interventions of the central government included various measures: insurance of additional transfers and credits, use of accumulated financial funds (“rainy day funds”), increase of loans or temporary relaxation of borrowing rules set for lower levels of government. According to OECD research, governments of lower levels have acted differently. Although most central governments of members opted for expansive fiscal policy, lower levels of government in half of the member states followed the fiscal policy of government while the other member states decided to cut expenses and increase revenues. The divergent fiscal policies in times of crisis demonstrated at different levels in the same country indicates the importance of the existence of intergovernmental fiscal coordination in order to insure a coherent government response to the economic crisis (Blöchliger, 2010a). Fiscal coordination between levels of government is seen as a key mechanism for efficient fiscal management in complex countries, aiming at bringing regional fiscal policies into line with national fiscal goals.

This literature review and the findings cited reveal that the negative effects of fiscal decentralization on the government fiscal position and the macroeconomic stability of a complex state are exacerbated in times of economic crisis. The importance of fiscal policy for macroeconomic management is more emphasized in Bosnia and Herzegovina than in other complex countries, not only because of the highly decentralized and asymmetric fiscal structure, but also because of the

limited possibilities of keeping an active monetary policy in terms of the existence of a Currency Board.

The aim of the paper is to present a model of fiscal coordination that would enable the fiscal consolidation of a multi-level and highly decentralized country such as B&H and ensure economic recovery and macroeconomic stability. Part two of the paper provides insights into the evolution of the complex fiscal structure of B&H from the Dayton Constitution to the present, analyzing the impact of the reform of indirect taxes on the taxing powers of sub-national governments and intergovernmental fiscal relations. The third part describes the quality of the fiscal system of B&H, focusing on the fiscal management and the established model of fiscal coordination, and analyses the levels of fiscal autonomy of the state and sub-national governments. Fiscal trends are presented in part four, and part five analyzes the fiscal position of B&H and its sub-national governments. The sixth part analyses the main drawbacks of the current loose model of fiscal coordination in B&H and presents an alternative model. The research should prove the hypothesis that only a binding, institutionalized and comprehensive fiscal coordination can contribute to fiscal consolidation and the economic recovery of the country.

## **2 FISCAL ARCHITECTURE OF BOSNIA AND HERZEGOVINA**

### **2.1 DAYTON COMPETENCES (1996-2004)**

Bosnia and Herzegovina (B&H) is a multi-level state in the political and in the fiscal sense. However, as compared to those in other multi-level states the political system in B&H has in a rather specific composition (see appendix, chart A1). It is composed of two entities, Federation B&H (FB&H), a highly decentralized entity consisting of three levels of government, the Republic of Srpska (RS), a highly centralized entity with two levels of government, and the District of Brčko (BD), which has a special status. FB&H consists of ten cantons. There are 80 municipalities in the FB&H and 63 municipalities in the RS. One of the attributes of B&H is a weak central government at the state level. According to the Dayton Constitution the state level was assigned only limited competences for expenditures, while full fiscal competences were assigned to the entities. The District of Brčko, established in 2001, had a certain level of fiscal autonomy in the field of direct and indirect taxation. From fiscal responsibilities under the Dayton Agreement only customs policy and determination of tariffs are within the exclusive jurisdiction of the State, while the tax policy, which includes the social contributions system, is entirely the responsibility of the Entities in terms of legislation, administration and revenue allocation. Although a set of state regulations regarding the single customs policy was adopted in 1997, the customs administrations of the Entities and Brčko District continued to exist until the beginning of the reform of indirect taxation system. Financing of the State level of administration was conducted through Entity grants from the Entity budgets in the ratio 2/3 FB&H: 1/3 RS. Sub-national governments, in FB&H the cantons, cities and municipalities, and in RS the cities and municipalities were funded from tax revenues collected by Entities.

The existence of autonomous customs and tax systems within B&H led to double internal taxation or non-taxation and a loss of public revenues.

## 2.2 IMPACT OF THE REFORM OF INDIRECT TAXES ON THE TAX STRUCTURE

The reform of indirect taxes started with an establishment of the inter-governmental Commission for Indirect Taxes under the supervision of the international community in the beginning of 2003. The first phase of that reform ended in December 2003 after the adoption of the Law on Indirect Taxation System in B&H by which the constitutional powers relating to the indirect taxation policy and the administration and collection of the sales tax, excises and customs duties were shifted from the two entities (FB&H and RS) and the District of Brčko to the state level. During the year 2004 the reform encompassed the final centralization of the customs administration and delegation of the responsibilities for indirect taxes (customs duties, sales tax and excises) from the Entities and District to the Indirect Tax Authority (ITA), the newly established State agency, and its Governing Board, in terms of administration and tax legislation. At the end of 2004 the new state laws on sales tax and excise duties were adopted, replacing the legislation of entities and Brčko District. On 1 January 2005 the ITA and its Single Account for the collection of indirect taxes became fully operational. In the final stage of the reform of indirect taxes (2006) the state sales tax was replaced by a value added tax (VAT).

After the tax jurisdiction re-composition of 2006 compared to the original jurisdiction of Dayton, direct taxes (income tax, profit, property, etc.) and social contributions remain under the exclusive jurisdiction of Entities and District. All levels of government can introduce a variety of administrative duties and nontax revenues. For the overview of the tax competences in B&H, see table 1.

Because of the centralization of revenues from indirect taxes, which are the dominant source of revenues for all levels of government, Entities were no longer in a position to finance the budget of B&H. It was necessary to create a new system of vertical distribution of indirect taxes in B&H to ensure the adequate funding of the institutions of B&H, Entities and District. Furthermore, given that the local government level had lost its own-source revenues transiting to the VAT, it was also necessary to establish a new system of vertical and horizontal distribution within Entities to ensure not only the financing of public needs in the Entities but also the balanced development of local communities.

TABLE 1

Tax competences in Bosnia and Herzegovina<sup>a</sup>

	B&H			BD			FB&H			RS				
	L	A	Ts	L	A	Ts	Entity	Cantons	Municip.	Entity	Municip.			
<b>Indirect taxes</b>														
VAT	L	A	Ts			Ts		Ts		Ts		Ts		
Customs duties	L	A	Ts			Ts		Ts		Ts		Ts		
Excises	L	A	Ts			Ts		Ts		Ts		Ts		
Road fees	L	A	Ts			Ts		Ts		Ts		Ts		
<b>Direct taxes</b>														
Profit tax <sup>b</sup>				L	A	Or	L	A	Ts		Ts	L	A	Or
Income tax <sup>c</sup>				L	A	Or	L	A			Ts	L	A	Ts
Property tax <sup>d</sup>				L	A	Or			L	A	Ts			Or
<b>Social contributions<sup>e</sup></b>														
Health insurance <sup>e</sup>				L	A	Or	L	A	Or			L	A	Or
Pension insurance							L	A	Or			L	A	Or
Unemployment insurance				L	A	Or	L	A	Or			L	A	Or
Children care												L	A	Or

*L* – legislation      *A* – tax administration      *Ts* – tax sharing      *Or* – own revenue

<sup>a</sup> For assignment of revenue (tax sharing or own revenue) new OECD test is applied (see OECD, 2009b).

<sup>b</sup> Profit tax in the FB&H is divided between Federal budget (100% tax on profit of companies, banks, insurance companies, electricity power industry, post, telecommunications, betting house) and cantons (tax on profit of other companies).

<sup>c</sup> Income tax in the RS is divided between the RS budget (75%) and municipalities (25%).

<sup>d</sup> Property tax, depending on cantonal legislation, is distributed entirely to municipalities in canton or it is divided with canton in a ratio prescribed by the cantonal constitutions/laws.

<sup>e</sup> Social contributions for employees in B&H institutions are paid into entity extra-budgetary funds. Social contributions for pension insurance for employees in District are paid into entity Pension Funds according to entity residence of employees.

### 2.3 DISTRIBUTION OF INDIRECT TAXES AT THE BOSNIA AND HERZEGOVINA LEVEL

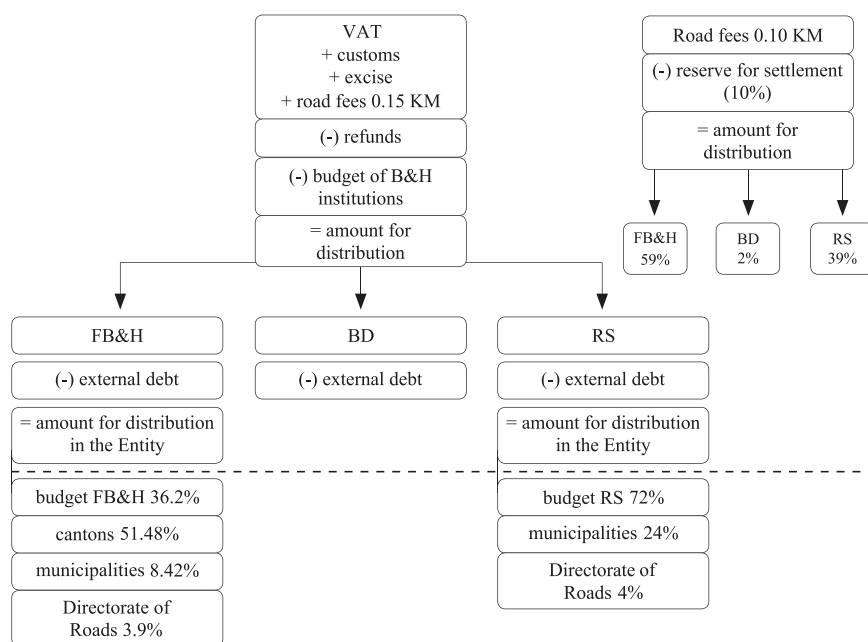
The system of financing levels of government in B&H from indirect taxes consists of two levels of distribution of indirect tax revenues. The first level of distribution is defined by the State Law on Indirect Taxation System in B&H and the second by the Entity regulations.

In accordance with statutory provisions, indirect taxes collected into the Single Account (SA) are allocated daily in the order established by the Law. The priority in the distribution of indirect tax revenues is the refund to the taxpayers. Budget of B&H institutions is financed mostly from indirect taxes with a smaller share of the State's own revenue (non-tax, grants, share profits of the Central Bank and others). An equal amount from the Single Account of the ITA is paid in to the B&H budget each day, according to the amount of the annual budget of B&H in-

stitutions. Finally, the remaining amount is shared between the Entities and Brčko District. External debt is deducted from the amount of the Entities prior to assigning, according to the dynamics set by the repayment schedule of the Ministry of Finance and Treasury B&H. The payment of external debt has the priority over other budget users. Servicing the external debt is the obligation of Entities but the State of B&H is a guarantee of payment obligations to international creditors. For this reason, the payment of external debt is realized from the part of indirect taxes belonged to Entities but the payment procedure itself is being conducted on behalf of the State by the Central Bank as a fiscal agent of B&H. After the payment of external debt the rest is transferred to Entities.

### CHART 1

#### *Distribution of indirect taxes in Bosnia and Herzegovina*



Source: Law on Indirect Taxation System in B&H (Official Gazette of B&H No. 96/09), Decision on temporary allocation of road fees earmarked for highways (Official Gazette of B&H No. 102/2009), Law on the Repartition of Public Revenues in the FB&H (Official Gazette of the FB&H No. 22/06 and 22/09), Law on Budgets (Official Gazette of the RS No. 121/12).

Distribution of revenue from indirect taxes is defined by the Law on Indirect Taxation System as follows: the share of the remaining amount transferred the Federation, Republic of Srpska and the District is determined by their share in final consumption revealed by value added tax returns. The coefficient of allocation of indirect taxes to Entities is calculated in such a way that the final consumption of FB&H (RS, BD) revealed by the VAT returns is put in relation with the final con-



sumption in B&H as reported on VAT returns. As of 1 July 2007 by the decision of the High Representative and in order to protect the fiscal autonomy of the District, the District share in the amount of indirect taxes allocated to Entities and the District, is fixed at minimum 3.55% and in nominal terms to 124 million KM. Since then only coefficients of allocation of indirect taxes to Entities are determined by the ITA Governing Board.

After the amount of indirect taxes to the Entities has been assigned, Entities in accordance with Entity legislation allocate the funds to the users of the distribution (Entity budget, cantons in FB&H, municipalities and cities, Directorate of Roads).

In the meantime, on 1 July 2009 amendments to the Law on Excise Duties imposed an additional road fee on oil derivatives, intended for financing the construction of the highway network and whose distribution to the Entities and District is done by special coefficients determined by the ITA Governing Board. The scheme of the distribution of indirect taxes is shown in chart 1 (above the line).

### 3 CHARACTERISTICS OF FISCAL SYSTEM IN BOSNIA AND HERZEGOVINA

#### 3.1 FISCAL MANAGEMENT

The main features of the fiscal system in B&H are the complexity of government levels, a high degree of decentralization of responsibilities for revenues and expenditures, a weak central government and the asymmetry in the structure of the Entity government, where one Entity is fiscally decentralized (FB&H) and the other one is centralized (RS). Given the broad fiscal sovereignty of Entities, fiscal federalism in B&H in the post-war period had the characteristics of dual federalism. The asymmetry of fiscal structure in B&H has been enhanced by the establishment of the District of Brčko and assigning it a considerable fiscal autonomy. On the other hand, the more favorable tax treatment of companies in the District in terms of lower sales tax rates in relation to Entities, led to tax competition among governments within B&H. The phase of competitive federalism brought fiscal expansion to the District as many companies especially the importers of oil derivatives transferred their headquarters to the District. Tax competition between Entities and the District has been ended by the centralization of indirect taxes at the state level. Reform of the indirect tax system has radically changed intergovernmental fiscal relations, contributing to a firmer connection of previously autonomous fiscal authorities. The high degree of fiscal interdependence of all levels of government, after the implementation of the reform of indirect taxation, raised the issue of fiscal coordination between the levels of government in B&H. On the other hand, the process of European integration requires that "B&H speaks with one voice" which, in the given political relations, means the coordination of levels of government not only in the fiscal sphere, but also in all economic, political and social issues which require the takeover and implementation of acquis. Therefore, B&H is entering a phase of cooperative federalism which its functioning based on

the cooperation of levels of government. In the given political circumstances, cooperative federalism is the only possible option on the way towards the EU, although some authors consider cooperative federalism “a joint decision-making trap” (Watts, 1998). Finally, the reform of indirect taxes has incorporated in the fiscal system of B&H executive federalism in the form of the ITA Governing Board. Executive federalism is a process in which intergovernmental relations are performed by the executive agencies of the federal government and regional government, at political and administrative levels (Boadway and Watts, 2000). The establishment of the ITA Governing Board means the transfer of jurisdiction from the Parliament to the body of executive power in the area of indirect taxes. Decision making by the finance ministers of B&H and Entities on the policy of indirect taxes under the ITA Governing Board represents a direct involvement of executive power in intergovernmental fiscal relations.

After the reform of indirect taxes it became necessary to establish fiscal coordination between levels of government in B&H. In the beginning (2005) governments established the Fiscal Council as a form of informal fiscal coordination. However, a strong growth of revenue from indirect taxes caused by the introduction of VAT has brought a significant surplus to all levels of government so governments did not recognize the need for fiscal coordination until the emergence of fiscal deficit in 2008. According to the Law on the Fiscal Council (Official Gazette of B&H, No. 63/08) a formal fiscal coordination was established but without any institutional capacity. The Fiscal Council has six members: the Chairman of the Council of Ministers and Prime Ministers of the Entities, as well as the Entity and State Ministers of Finance. The Governor of the Central Bank and a representative of the Brčko District Government are observers in the Fiscal Council. The Fiscal Council’s task is to coordinate fiscal policy in B&H to ensure macroeconomic stability and fiscal sustainability of the State, Entities and the District. It adopts a medium-term fiscal policy framework, which includes the fiscal goals of the State, Entities and the District, macroeconomic projections, projections of indirect taxes and their distribution in the following year and the proposed debt ceiling of B&H, Entities and the District. The fiscal goal is limited to the primary budget surplus/deficit. Decisions of the Fiscal Council are adopted by the majority of five votes, but majority must include at least one vote from each of the three constituent peoples. In case of lack of agreement on the fiscal framework, governments are required to submit a proposal for interim financing in the amount of the budget of the previous year. In the event of the budget being exceeded, the government that has violated the budgetary framework should transfer 10% of the excess of the budget at the expense of special purposes from which the repayment of internal debt of the government that violated the rules is financed.

The existing model of fiscal coordination has numerous functional and substantial weaknesses. Inclusion of Prime Ministers in the composition of the Fiscal Council reduces the effectiveness of the Council, which can affect the shift of the focus of

work from fiscal issues to political debates. Furthermore, the mechanism of voting, which includes elements of nationalism, can lead to a blockade of the work of the Fiscal Council in the event that one nation in the Council is represented by only one member. Fundamental weaknesses relate to the comprehensiveness of fiscal coordination and weakness of the sanctions mechanism. Unlike B&H and Entities, the District in the Fiscal Council has the role of an observer and has no right to decide but takes over the obligations and can be sanctioned as well as the Entities and State. Completely out of the coordination system remained the cantons and local communities, which together account for 28% of total tax revenue in B&H as well as other government and quasi-governmental units such as extra-budgetary funds. The fiscal goal is limited only to the primary budget surplus/deficit where capital expenditures and receipts are not taken into account. The fiscal goal excludes the surpluses/deficits of internationally funded projects. By defining fiscal goals in this way a large part of expenditure remains out of the control of the Fiscal Council which is the channel for “accounting gymnastics”, i.e. showing current expenditures within the capital that are not under control. The sanction involving extracting 10% of the excess in a separate account from which internal debts are financed (for example, old foreign currency savings, material and non-material war damage, etc.) can be seen as a form of forced savings of government, which in any case must at some point pay off the debt, rather than a penalty for violation of the agreed framework. The mechanism of sanctions does not include personal penalisation, as in some other countries (Ter-Minassian, 1997; Joumard and Kongsrud, 2003), which in the case of B&H could be more effective than introduced sanctions. This raises the question of the efficiency of sanctioning the B&H central government and the District government if it is known that internal debt is the Entity debt. Finally, the Council’s decisions, though legally established, are de facto not mandatory for the Presidency of B&H which proposes the budget of the institutions of B&H and Parliaments of B&H and Entities which adopt budgets so that the implementation of the Council’s decisions depends on the balance of power of the ruling political structures in the institutions that make decisions on budgets.

### 3.2 FISCAL AUTONOMY

To assess the quality of fiscal federalism in B&H it is important to look at the structure of the tax system. The tax structure in B&H is characterized by the historical legacy from the socialist system and the low level of economic development. The result of these two factors is the predominance of indirect taxes. The introduction of VAT has deepened the gap between indirect and direct taxes. Finally, integration processes (CEFTA, EU) have diminished the importance of customs duties, and increased the importance of excise duties. In general, all the listed factors have contributed to the increasing dominance of indirect taxes in the tax structure in B&H (table 2).

**TABLE 2**  
*Structure of revenues in Bosnia and Herzegovina, 2011*

	% GDP	% B&H revenues
<b>Indirect taxes</b>	<b>19.3</b>	<b>43.2</b>
VAT	12.1	28.2
Excises	4.9	11.3
Road fees	1.1	2.6
Customs	1.1	2.5
Other	0.1	0.2
<b>Direct taxes</b>	<b>3.5</b>	<b>8.1</b>
Profit tax	1.1	2.5
Income tax	2.0	4.7
Other direct taxes	0.4	0.9
<b>Social contributions</b>	<b>15.6</b>	<b>36.2</b>
<b>Non-tax revenue</b>	<b>5.1</b>	<b>11.8</b>
<b>Other (other revenue, transfers, grants)</b>	<b>0.2</b>	<b>0.7</b>

Source: Database of Macroeconomic Analysis Unit (MAU) of the ITA Governing Board.

Measuring the degree of fiscal decentralization in B&H and in a sample of complex countries on the basis of the share of central government and government at lower levels in revenues (table 3) indicates the extremely weak fiscal autonomy at the state level (central government) and extremely strong fiscal position of middle level of government which consists of entities, cantons and the District (Antić, 2009).

**TABLE 3**  
*Revenue, as % of GDP, 2005*

	Austria	Belgium	B&H	Canada	Germany	USA	Spain	Switzerland
<b>Tax revenue</b>								
GG	27.7	30.4	25.3	29.0	21.9	18.8	21.4	22.4
CG	20.4	25.8	3.0	14.0	10.8	9.8	11.8	10.0
SNG	7.3	4.6	22.3	15.0	11.1	9.0	9.7	12.1
<b>Social contributions</b>								
GG	16.3	16.5	13.2	5.5	17.8	7.0	12.8	7.7
CG	15.4	15.1		4.5	17.1	6.8	12.7	7.7
SNG	1.0	1.4	13.2	1.0	0.8	0.2	0.1	
<b>Other revenue</b>								
GG	4.9	4.4	5.3	6.6	3.3	5.8	2.8	8.3
CG	2.4	2.8	0.6	1.2	0.6	0.5	1.5	1.6
SNG	2.5	1.6	4.7	5.4	2.6	5.3	1.2	6.6

GG – general government      CG – central government      SNG – sub-national governments

Source: Antić, 2009.

Comparison of the degree of fiscal decentralization in B&H with recent measurements made by the IMF for 63 countries based on a set of four indicators (Dziobek et al., 2011a), confirms the presented finding of an extremely weak central

government in B&H, which has less authority than any of the other countries, regardless of the category (European, unitary, federal), except for spending on staff salaries (table 4).

**TABLE 4**  
*Fiscal decentralization indicators, CG/GG<sup>a</sup>, 2008*

Indicators (in percent)	B&H	All countries <sup>b</sup>	Federal countries <sup>c</sup>	Unitary countries <sup>d</sup>	European countries
Revenues	8	47	72	90	84 <sup>e</sup>
Tax Effort <sup>g</sup>	7	48	76	91	87 <sup>e</sup>
Expenditures	7	35	62	81	73 <sup>f</sup>
Compensation of employees	18	12	37	73	59 <sup>f</sup>

<sup>a</sup> CG – central government (middle level) + national social security funds; GG – general government.

<sup>b</sup> Lowest ratio for 63 countries.

<sup>c</sup> Mean for 8 federal countries.

<sup>d</sup> Mean for 55 federal countries.

<sup>e</sup> Mean for 36 countries.

<sup>f</sup> Mean for 37 countries.

<sup>g</sup> Tax effort = tax revenue + social contributions.

Source: B&H – author's calculation based on MAU Database, ITA Governing Board; Other countries (Dziobek et al., 2011a).

Fiscal autonomy of local communities is very low considering that the share of revenue on which they decide entirely (non-tax revenue) or partially (tax on property) is low. In the analysis of fiscal autonomy it is not possible to apply the standard OECD synthetic typology (OECD, 2009a) to determine the degree of fiscal autonomy of lower levels, due to the fiscal interdependence of the government levels. If fiscal autonomy is measured by the discretionary indicator (Joumard and Kongsrud, 2003), which is calculated as percentage of tax revenues of lower level of government where the Government has 100% control over the rate and/or base, then we come to the interesting conclusion that the fiscal autonomy in B&H is quite low at all levels and that B&H institutions, as nucleus of the central government, do not have any discretionary power in making the tax laws (table 5).

**TABLE 5**  
*Discretion degree of sub-national governments, in %, 2006*

Discretion degree	Municip. RS	Budget RS	Municip. FB&H	Cantons	Budget FB&H	BD	Total degree
2006 <sup>a</sup>	0.47	18.84	3.78	5.07	5.23	17.78	15.43
2011 <sup>b</sup>	0.44	23.81	2.97	6.51	4.09	9.91	16.00

<sup>a</sup> Source: Antić, 2009.

<sup>b</sup> Source: Author's calculation based on MAU Database, ITA Governing Board.

The reform of indirect taxes in B&H has strengthened the single economic space but on the other hand, it has increased the interdependence of the government levels because of the centralization of indirect taxes, which are the main source of funding for all levels of government in B&H. However, compared with other complex countries, the process of the centralization of taxes in B&H was not accompanied by the centralization of authority for expenditures and by any strengthening of the central government. Besides the defence reform and the establishment of agencies and directorates necessary for European integration, all major responsibilities are assigned to Entities and cantons. Despite the centralization of legislation and administration in the area of indirect taxation, Entities retained a certain influence on the policy of indirect taxation through the representation on the ITA Governing Board. Entities in this specific body have the right of veto on changes of legislation related to indirect taxes that originally belong to Entities (taxation of goods and services, excise tax), while the State has the right of veto in decision-making on customs revenues that are within the exclusive jurisdiction of B&H. Furthermore, the fiscal autonomy of the District is protected by the Law, even though the District has no right to decide within the ITA Governing Board. The specific impact of State and Entities in the area of indirect taxes is reflected in the fact that without the consent of the ITA Governing Board any legislation in the field of indirect taxation cannot be passed in the Parliamentary Assembly of B&H. Despite a modest revenue share the decision-making capacity of B&H has been strengthened, because the level of B&H decides, through the ITA Governing Board, on the shares of Entities in indirect taxes. At the same time, Entities through the Entity voting in the House of Representatives in Parliament of B&H directly impact the budget of B&H institutions and thus on the height of part of the B&H budget funded from the ITA SA.

A general assessment is that due to the specific system of indirect tax distribution and the low share of direct taxes in B&H, all levels of government have quite weak fiscal autonomy, which implies a high degree of fiscal interdependence between levels of government and the need for fiscal coordination. In order to meet the specific situation in B&H, it will be necessary in OECD typology to add another criterion: degree of fiscal autonomy of government level in the group of revenue division (d.5), which would indicate revenue distribution with the consent of both levels of government.

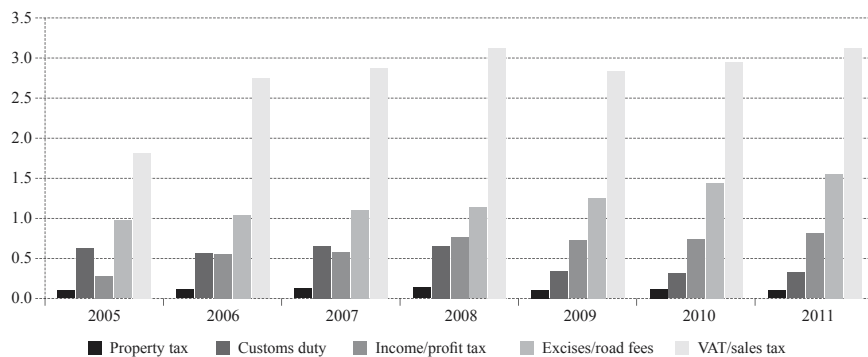
#### **4 FISCAL TRENDS IN BOSNIA AND HERZEGOVINA**

The complex structure of government in B&H has contributed to exaggeration of public services and administration in B&H, with the effect of duplication and overlapping of public services, loss of public sector efficiency and effectiveness. The relatively high level of public spending, measured by percentage of GDP, as a result of the complex political-territorial organization of B&H and the high degree of fiscal decentralization of B&H, also had an impact on the country's fiscal picture in the form of high tax burden. Besides these factors, trends of

consolidated revenue of general government of B&H in the period ever since the end of the war (1996) have been affected by the process and reforms in the fiscal and economic sphere. Systemic reforms that led to strengthening the market and reducing the gray economy, such as the creation of a single economic space after the abolition of double taxation of inter-entity trade and taxation of the imports of excise goods at the border, and then reform of the indirect taxation system, which was completed by the introduction of VAT, positively affected revenue growth in the period 2004-2008. Besides, the enormous price growth of energy products, raw materials and food on the world market during 2008 has led to a strong nominal growth in revenues from indirect taxes (customs, VAT) which are calculated ad valorem in the second and third quarters of 2008. On the other hand, there has been a significant loss of the customs revenue because of accession to joining CEFTA (2006) and the signing of the Stabilization and Association Agreement with the EU (since 1 July 2008) (chart 2).

## CHART 2

*Collection of taxes (in billions KM)*



Source: Indirect Taxation Authority: MAU Database, ITA Governing Board.

The fact that the beginning of five-year implementation of the phase reduction of customs duties on imports from the EU coincided with the beginning of the crisis greatly complicates the process of fiscal consolidation. The introduction of additional road fees from the price of oil derivatives as of 1 July 2007, and the continued increase of excise rates on tobacco products in accordance with the minimum standards of the EU since 2009 were not enough to neutralize negative effects of the crisis on the level of consumption and economic activity in the country. The specific fiscal architecture of B&H and decision-making within the ITA Governing Board determined the range of fiscal measures undertaken by the authorities in the area of indirect taxes after 2008. There were no changes in the area of VAT because the proposed measures were divergent, depending on the economic and political interests of the Entities (for instance, FB&H advocated the standard rate increase and RS the introduction of differentiated rates), so the single VAT rate of



17% has remained. The same situation occurred with RS initiatives for the introduction of “blue diesel” while FB&H advocated refunds to the farmers from the budget. The only consensus was reached with the gradual increase of excise taxes on cigarettes in line with the EU minimum rate. Some positive effects on revenues from customs duties are expected in 2013 after Croatia joins the EU.

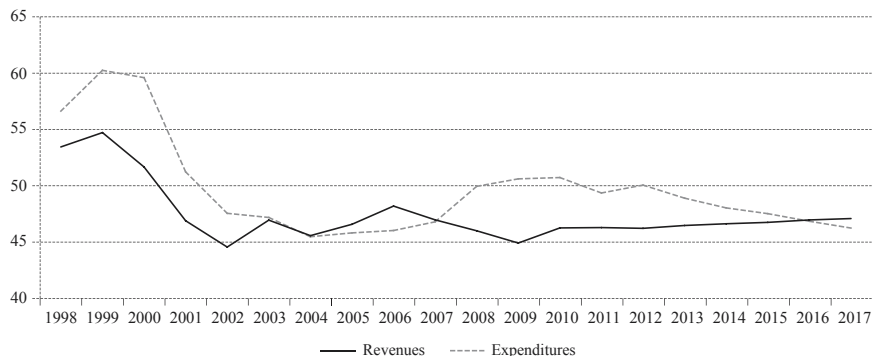
Given the limitations of changes in the policy of indirect taxes, the Entities and Brčko District have focused on changes to direct taxes (income tax, profit tax, and property tax). The reform of direct taxes has included, *inter alia*, the introduction of a global (synthetic) model of income taxation, aligning profit taxation with international practice, reform of taxing property in RS and Brčko (abolishing inheritance and gift tax, introduction of a property register and using market value for the tax base), using modern IT platform, procedures and technique, establishment of single registers of taxpayers, etc. The mentioned reform has resulted in some degree of internal harmonization of direct taxes in B&H and the elimination of double internal taxation.

Reforms in the sphere of direct taxes implemented by the Entity governments in the period 2006-2009 occurred during the crisis and were unable to achieve the expected results (chart 2). The income tax rate in FB&H has been increased from 5% to 10%, while the profit tax rate was reduced from 30% to 10%. RS has changed the income tax rate several times and finally, in 2011, it was increased from 8% to 10%. In 2011 taxation of income and profit in the District was harmonized with Entities although there are differences in exemptions, deductions and allowances. For example, in FB&H and the District there is a personal deduction while it was abolished in RS as of 2011. During 2012 RS and Brčko District introduced profit tax exemptions for investing in production and hiring new workers. The effects of these measures on government budgets and economies are unpredictable because the poor political climate in B&H discourages foreign investors. On the other hand, financing the local level in RS is uncertain because of the comprehensive property tax reform in RS, which started in 2012.

Growth in revenue from indirect taxes in 2006 and 2007 launched a spiral of expenses of a complex administrative apparatus and social benefits at all levels of government (chart 3). Obligations created under collective agreements and laws on social rights quickly melted fiscal surpluses from 2006 and 2007. Because of the rigidity of wages and social benefits that are regulated by Entity laws, governments were not able to respond quickly to the revenue decline caused by the economic crisis and implementation of the Stabilization and Association Agreement with the EU. Stand-by arrangement with the International Monetary Fund from 2009 (IMF, 2010a) was only partially carried out, since the government had no power to enforce a savings program due to political aims.



**CHART 3**  
*Trends in revenues and expenditures as % of GDP*



Source: IMF, *World Economic Outlook Database*, 16 July 2012.

Rising expenses combined with a revenue decline in B&H in 2009 led to a fiscal deficit of 5.7% of GDP which, due to a moderate increase in revenue from indirect taxes and decrease of expenditures, undertaken in accordance with the commitments from the stand-by arrangement with the International Monetary Fund, amounted to 4.5% of GDP in 2010 and 3.1% of GDP in 2011. Fiscal deficit in Entities were financed by the receipts from privatization (RS) and by new borrowings (FB&H, RS) under unfavorable conditions. The consequence of this policy was the increase of total public debt from 31% of GDP in 2008 to 43% of GDP in 2011. The IMF estimates that B&H may not get out from the negative zone before 2016.

## **5 FISCAL POSITION OF GOVERNMENTS IN BOSNIA AND HERZEGOVINA DURING THE GLOBAL ECONOMIC CRISIS**

### **5.1 FACTORS AFFECTING THE BUDGETS OF GOVERNMENT LEVELS IN BOSNIA AND HERZEGOVINA**

Under the influence of divergent processes in global public finance – the centralization of revenue and processes of decentralization of expenditures – today, many of the factors listed are beyond the scope of measures of local and regional government, which reduces the possibility of effective and efficient response to the economic crisis. A similar process has affected the governments in B&H. The reduction of the fiscal sovereignty of the Entities and Brčko District and the increase the interdependence of government heightened the vulnerability of the budgetary positions of the sub-national governments in relation to fluctuations in revenues caused by the global crisis. Sub-national governments do not have instruments that can affect the major part of the source of revenue for financing. Indirect taxes, the most powerful lever, have been moved to the State level. The complexity of the procedure for amendments to regulations in the field of indirect taxes prevents rapid response of government to fiscal shocks. On the other hand, the vertical

system of indirect tax distribution is very complex, because it involves all levels of government, external debt and indirect tax refunds.

The fiscal position of sub-national governments is indirectly influenced by factors derived from the model of the distribution of indirect taxes (see chart 1). The first factor affecting the distribution is the level of indirect tax refunds. Given that refunds are the Achilles heel of the VAT system in each country, the increase of refunds due to VAT frauds directly decreases transfers of indirect taxes to the levels of government. Furthermore, the increase of the B&H budget decreases transfers to levels of governments and vice versa. Due to the failure to adopt the B&H budget during 2011, the share of B&H institutions was kept at the level of 2006, which allowed the overflow of revenue from indirect taxes to the Entities and the District.

The model of allocation of indirect tax revenues based on the final consumption introduces purely economic criteria in the revenue allocation. The established interdependence of governments is reflected in the fiscal position so that a relative increase in final consumption in one Entity, which is the result of more favorable economic developments in that Entity, leads to a reduction in the share of indirect taxes in the other Entity and vice versa. As consequence, in the preparation of budget frameworks governments cannot accurately predict shares in indirect taxes, which makes it hard to draft the projection of the budget of lower government levels and in general makes the negotiating process for the budget framework of the general government of B&H very unreliable and uncertain.

Another problem is the process of adopting allocation coefficients. According to current regulations the ITA Governing Board should determine allocation coefficients between the Entities quarterly. Should there be a failure to adopt the decision, coefficients from the previous quarter have to be applied. The regulations also provide for the first temporary settlement for six months of the current year and second temporary settlement for the previous year. After the external audit final settlement between the Entities is performed. So far, it has often happened that the Governing Board cannot reach an agreement and so the old coefficients are applied. As the deviations of the actual coefficients from those applied are larger, the calculated amounts of the settlements are larger as well. Settlements are unpredictable because they are subject to political agreements. They are always carried out with a large time lag; in the event of the accumulation of high amounts of annual settlements, this will endanger the fiscal position of the Entity that needs to return funds to the other Entity.

## 5.2 ANALYTICAL APPROACH

In order to illustrate in the best way the changes in the fiscal position of sub-national governments in B&H after the outbreak of the global economic and financial crisis, a comparison of fiscal reports of government levels for pre-crisis 2008 and

2011 by the major items of revenues and expenditures has been made. Analysis of the fiscal structure in B&H can be carried out horizontally, by decomposition of the consolidated fiscal balance of the general government to the central governments but also it can be done vertically, by decomposition of fiscal reports of government levels within the Entities (see appendix, chart A2).

It should be noted that according to the IMF methodology the general government of B&H consists of the central government and local governments (IMF, 2005). The central government includes budget institutions (B&H institutions, budget of FB&H, ten cantons in FB&H, budget of RS and Brčko District), extra-budgetary institutions of the Entities and the District and extra-budgetary social funds in the Entities and the District (see appendix, chart A3). The local level includes 80 municipalities in FB&H and 63 municipalities in RS. Reporting according to IMF format includes also fiscal operations of the Entity Directorates for Roads financed from indirect taxes, then revenue and expenditures of international projects. Official reports of governments in B&H do not usually include Directorates for Roads and international projects, and, given their great importance to international projects that finance the reconstruction in B&H, this resulted in significant differences between the government and IMF reports in terms of fiscal deficit, around 2% of GDP at present.

### 5.3 GENERAL GOVERNMENT OF BOSNIA AND HERZEGOVINA

In general, the largest share in collected revenues and expenditures of the general government of B&H (table 6) goes to the Federation of B&H, as a result of the economic development and population growth. GDP of FB&H accounts for two thirds of the GDP of the State. Similarly, FB&H has twice the population of RS, which results in social benefits and transfers. In addition, the complex federal structure of FB&H has resulted in high administrative expenses. The share of capital expenditures in the RS is higher than in the FB&H. This is the result of divergent economic trends in Entities in recent years, as well as the different tax policy and policy of investment and privatization of strategic state-owned companies. The process of privatization of the telecom in the RS, just before the outbreak of the crisis, has brought significant resources that RS invested in the private companies, housing and infrastructure and partly covered the deficit in the extra-budgetary funds and public corporations (for example, railways). On the other hand, the share of direct taxes is almost the same, except that the tax burden increased in RS in the last three years. Similarly, reforms in the system of social contributions in Entities brought the increase in the tax burden and also the increase of the proportion of RS due to the increase of rate and expansion of the base.

**TABLE 6**  
Share of governments, % of revenue and expenditure

	2008				2011			
	B&H	BD	FB&H	RS	B&H	BD	FB&H	RS
<b>Total revenue</b>	<b>8.0</b>	<b>2.2</b>	<b>60.0</b>	<b>29.9</b>	<b>7.6</b>	<b>2.1</b>	<b>57.7</b>	<b>32.6</b>
Indirect taxes	13.8	3.2	55.4	27.6	14.3	3.2	53.5	29.0
Direct taxes	0.0	1.9	56.3	41.8	0.0	1.9	51.5	46.7
Tax on profits	0.0	3.2	48.9	47.8	0.0	2.1	49.7	48.2
Tax on income	0.0	1.4	57.1	41.4	0.0	1.9	49.8	48.4
Other direct taxes	0.0	0.6	68.1	31.3	0.0	1.2	66.3	32.5
Social contributions	0.0	0.6	69.2	30.2	0.0	0.8	65.5	33.7
Non-tax revenue	7.1	3.3	57.7	31.8	10.6	2.2	54.0	33.2
<b>Total expenditure</b>	<b>7.2</b>	<b>1.7</b>	<b>62.3</b>	<b>28.8</b>	<b>7.8</b>	<b>1.9</b>	<b>57.8</b>	<b>32.5</b>
Expense	7.2	1.8	62.4	28.7	8.0	1.8	58.9	31.3
Wages and compensation	18.2	2.3	53.5	25.9	19.5	2.4	50.2	28.0
Use for goods and services	7.8	3.4	59.9	28.8	8.7	3.7	72.3	15.4
Grants, subsidies	0.9	0.8	63.5	44.0	0.9	0.8	63.5	44.0
Interest	0.2	0.0	50.3	49.4	0.2	0.3	59.1	40.5
Other expense	7.2	0.0	59.7	33.1	2.6	1.7	69.2	26.4
Net acquisition of nonfinancial assets	9.3	6.1	41.1	43.5	4.4	2.8	33.0	59.8

Source: MAU Database, ITA Governing Board.

#### 5.4 CONSOLIDATED CENTRAL GOVERNMENTS

Vertical analysis of the fiscal position of governments in B&H is based on the decomposition of the government sector to the constitutional system: the institutions of B&H, Brčko District, consolidated FB&H (FB&H budget, cantons, municipalities and cities and extra-budgetary funds) and consolidated RS (RS budget, municipalities and cities and extra-budgetary funds). Analysis of revenue structure of the government levels in B&H (table 7) shows similar shares of indirect taxes in the Entities, except in the case of the institutions of B&H and Brčko District.

**TABLE 7**  
Consolidated central governments revenue, as % of revenue, 2011

	Institutions of B&H	BD	Consol. FB&H	Consol. RS
Indirect taxes	81.2	65.5	40.1	38.4
Direct taxes	0.0	7.2	7.2	11.6
Tax on profits	0.0	2.5	2.2	3.8
Tax on income	0.0	4.2	4.0	6.9
Other direct taxes	0.0	0.5	1.0	0.9
Social contributions	0.0	14.4	41.1	37.4
Non-tax revenue	16.5	12.5	11.1	12.0
Other (other revenue, transfers, grants)	2.2	0.3	0.6	0.6
Total	100.0	100.0	100.0	100.0

Note: All users of indirect tax distribution in B&H are included except for Directorates for Roads.

Source: Reports of MAU, ITA Governing Board, [www.oma.uino.gov.ba](http://www.oma.uino.gov.ba).

Since the Federation of B&H is a fiscally complex structure as well, it is interesting to analyze the distribution of revenues by levels of government within the FB&H (table 8). It is obvious that the budgets of FB&H and cantons are mainly sensitive to an increase of indirect taxes while cantons are the most sensitive to the movements of direct taxes. The main incomes of the local communities in FB&H are the non-tax revenues and property tax.

**TABLE 8**

*Consolidated FB&H revenue per level of government, as % of revenue, 2011*

Type of revenue	Budget FB&H	Cantons	Municipalities
Direct taxes	10.0	65.7	24.3
Taxes on income and profits	12.0	73.6	14.4
Taxes on income of individuals	0.0	77.4	22.6
Taxes on profits of companies	0.0	99.9	0.1
Other income taxes	100.0	0.0	0.0
Taxes on payroll and workforce	0.0	70.6	29.4
Taxes on property	0.0	16.2	83.8
Indirect taxes (including road fees)	42.2	50.4	7.5
Other taxes	1.8	67.7	30.6
Non-tax revenue	29.2	33.9	31.6

*Source: MAU Database, ITA Governing Board.*

Analysing the fiscal position of consolidated Entity governments in 2011 compared to 2008 (see appendix, table A1) we see a trend of the revenue decrease in FB&H and revenue increase in RS, measured as a share of GDP, as a result of tax reforms in Entities and the growth of coefficient of indirect tax distribution in favour of RS. Fiscal consolidation, imposed by the IMF under the stand-by arrangement from 2009 (IMF, 2010a) has brought expenditure cutting in FB&H, mainly in the item of social benefits and transfers to sub-national governments. In contrast, there was an increase in expenditures in RS induced by the financing from the telecom privatisation receipts.

### 5.5 SUB-NATIONAL GOVERNMENTS IN ENTITIES

Analysis of the fiscal position of sub-national governments in 2011 compared to 2008 is based on fiscal reports for each level of government (the Entity budgets, cantons in FB&H, municipalities and cities). Comprehensive analysis of the local governments finance in the European countries during the crisis (Davey, 2011) shows that revenues were more volatile at the upper levels of sub-national governments than at the local level. However, the data from both Entities in B&H shows the opposite trend. From consolidated reports (see appendix, table A2) we can note a negative trend in the nominal revenue reduction in cantons and municipalities of FB&H in relation to the budget of the Federation, in which revenue was increased. Revenues of cantons and municipalities are lower than in 2008 due to a reduction of income tax. The local level in FB&H is further affected by a significant reduction of property taxes, although it is a specific tax (according to the

area of the property) and by the reduction of subsidies and transfers received from the Federation and cantons. The drop of intergovernmental grants to sub-national governments was higher than decrease of own tax revenues, which is in the line with the conclusion of the OECD analysis that intergovernmental grants were more volatile than own tax revenues (Blöchliger, 2010a).

The federal level has significantly reduced expenditures, which, together with the increased revenues, has reduced the fiscal deficit. The expenditure reduction is evident in cantons as well, but in a smaller proportion. The expenditure structure analysis indicates that the reduction has been made in grants, subsidies and transfers to sub-national governments and to capital expenditures. On the other hand, wages at the level of FB&H and cantons have not been cut and material expenses have been reduced to a lesser extent. It is interesting that the local level has increased wage expenditures at the expense of the social benefits that are the responsibility of local communities.

Compared with 2008, RS has accomplished the nominal revenue increase at the level of government budget on the basis of direct tax growth, the growth in the share of indirect tax distribution and completed settlements for 2009-2011 (see appendix, table A3). However, municipalities have less revenue due to reduced transfers of indirect taxes, decrease of property tax and non-tax revenue. The increase in social contribution rates, abolition of personal allowance for income tax and the introduction of fiscal cash registers in RS, which was initiated in 2008, led to the closure of many small businesses, which reduced both the tax and the non-tax revenue of the RS budget and local communities.

In 2011, the fiscal position of the RS budget improved due to revenue growth and expenditure decrease, while the fiscal deficit of local level was reduced. Fiscal consolidation in RS brought a significant reduction in the RS budget expenditures. Expenditure reduction has been carried out on material expenditures, grants and social transfers, while expenses for salaries and capital expenditures were increased. Local communities have retained their wage expenditures at the same level, while at the same time they reduced grants and social transfers as well as capital expenditures.

## **6 THE CRISIS AS IMPETUS FOR REFORMING OF THE CONCEPT OF FISCAL COORDINATION IN BOSNIA AND HERZEGOVINA**

The time from the occurrence of the crisis to date has shown up the stated weaknesses of existing system of fiscal coordination in B&H. Autonomous reforms of direct taxation implemented by Entities have jeopardized employment, foreign investments and achieved a level of internal tax harmonization. A weak central government at the State level and a loose fiscal coordination within the Fiscal Council could not affect the policy of wages and social benefits in the Entities and at the local level or prevent increasing disharmony in Entity tax policies. The po-

litical turbulences in the country have prevented the Fiscal Council from determining the state's share of indirect taxes in B&H and adopting the fiscal goals and medium-term fiscal framework of B&H for the period 2011-2014, which is why the institutions of B&H were on temporary funding through whole 2011 while the entities created their budgets autonomously. The budget crisis culminated at the beginning of 2012 when the failure to adopt the budget of the B&H institutions for 2012 led to a freeze on foreign debt payments although there were funds from the allocation of indirect taxes set aside for that purpose. However, in order to meet the requirements for obtaining financial assistance from the EU, the IMF and the World Bank, the Fiscal Council succeeded in May 2012 in reaching an agreement on medium-term allocations of indirect taxes for the budget of B&H institutions and global fiscal framework of the general government of B&H for the period 2012-2015.

Growth of debt and the slow recovery of the economy, on the one hand, and divergent fiscal measures adopted during 2012, with uncertain effects, without cutting current expenditures, could, in terms of the existing loose and casual fiscal coordination, very often initiated and urged by International Community, deepen the fiscal deficit of sub-national governments in B&H still further. Moreover, having given up on the implementation of the single debt ceiling in B&H from 18% of total revenue in the summer of 2012, the RS Government has tied the debt ceiling to GDP, creating extra space for borrowing in this entity. In conditions of the increase of borrowing and low credit rating the authorities reached a new arrangement with the IMF of 410 million EUR in September 2012. The main obligations under a new stand-by agreement include, inter alia, cutting wages and social benefits and subsidies, better targeted social policies, establishing a more effective fiscal coordination and medium-term fiscal planning, removing blockages in the distribution of indirect taxes and funding the B&H budget and external debt (IMF, 2012). The obligations imposed on B&H are promising for the citizens from the standpoint of reducing government spending, strengthening the State position in fiscal relations and implementing the long expected reforms of expenditure policies. It should finally relax the fiscal position of sub-national governments, while ensuring an efficient and equitable system of social benefits in B&H. However, due to the announcement of more rigorous requirements for the payment of the next IMF tranche, the agreement reached within the Fiscal Council from May 2012 could be questionable.

Failures of the Fiscal Council to ensure, in the past four years, a coordinated fiscal response to the global economic crisis indicate the need for a serious reform of the current concept of fiscal coordination. In principle, the reformed model of fiscal coordination in B&H should be at the same time politically sustainable, economically efficient and able to anticipate obligations of B&H in the EU accession process. Since B&H is, due to specific political and fiscal relations, more similar to the EU than it is to other complex countries, the reformed model should be based



on the concept of harmonization and coordination supported by the EU member states (Šimović, 2007), i.e. on the cooperative fiscal federalism. However, unlike other complex countries in the EU with a developed democracy and a high level of fiscal responsibilities, in which governments respect the obligations arising from the national fiscal agreement even though fiscal coordination is not required (European Commission, 2012), political agreement is not enough for the governments in B&H and they must be obliged by the law to respect fiscal targets and frameworks. In order for decisions of the Fiscal Council to be binding on the Presidency and Parliaments, in terms of budgetary frameworks, the institutionalization of the Fiscal Council is required as a form of executive federalism which would include the mechanism of decision making similar to existing voting mechanism of the Governing Board of the ITA. Adoption of fiscal target and budgetary framework should be preceded by discussion that would necessarily involve the budget committees of the B&H Parliaments and Entities, most cantons, associations of local communities and the biggest extra-budgetary funds. Reform of the concept of fiscal coordination in B&H should also include redefining the fiscal target in terms of its determination related to consolidated income and expenditure (current and capital) of all levels of administration, including deficits in international projects, operations of local communities, state-owned development banks and corporations that are generously financed from the budget (for example railways), and prescribing the uniform debt ceiling of borrowing for B&H and entities. Automation of current distribution of indirect taxes without the intervention of the ITA GB would substantially relax the work of the Fiscal Council and make the budget projections of lower level governments more reliable. Finally, the effectiveness of fiscal coordination cannot be achieved without fiscal discipline at all levels of government, effective monitoring of fiscal operations and sanctions for non-compliance with the fiscal framework for collectives and responsible individuals in governments.

## 7 CONCLUSION

The crisis has confirmed the opinions of theoreticians that the distribution of the main responsibilities between levels of administration in complex countries, advocated by the theory of fiscal federalism, is incapable of preventing a negative impact of fiscal decentralization on macroeconomic management. It is necessary to introduce fiscal coordination as an institutional glue to harmonize budgets and fiscal operations of all levels of government with national fiscal targets.

The analyse of the fiscal system in B&H, its performance and response to the crisis has pointed out the main drawbacks of the complex and highly decentralized fiscal system in B&H. Autonomous and uncoordinated actions of Entities in time of economic crisis worsened the fiscal position of B&H. The current model of loose fiscal coordination, based on political agreement of Entities, usually induced by the international community, has elicited only temporary compliance from the governments. The divergent functioning of the fiscal system in B&H that plunged



the country into indebtedness, jeopardizing the prospects of economic recovery, has raised the need to design an alternative model of fiscal coordination that would harmonise Entity fiscal policy with national fiscal goals.

The hypothesis of this paper was that only comprehensive, institutionalized and binding fiscal coordination between levels of government can ensure a coherent response of B&H to the challenges of the economic crisis.

Taking into account the complex fiscal setting and serious political constraints, it is necessary to establish a multi-tier system of fiscal coordination, involving all interested parties in the process of negotiating budgetary frameworks and national fiscal targets.

Request for institutionalization of fiscal coordination means that the Fiscal Council should be transformed from a political body to the main fiscal institution deciding on overall national fiscal policy.

An alternative model of fiscal coordination should meet two requirements in order to be feasible: it should reconcile a high degree of fiscal autonomy of the Entities and a need for better macroeconomic management of the state government. In order to meet those requirements a new model of fiscal coordination in B&H should take into consideration the characteristics of the cooperative and executive fiscal federalism. However, the cooperation between the State and Entities, established within the Fiscal Council, is necessary but not sufficient for adherence of the governments to the national fiscal goals. Unlike other complex countries, in which the federal government is responsible for fiscal coordination and monitoring of fiscal operations of lower levels, the state level in B&H is not powerful enough to run fiscal coordination. Bearing in mind that without extensive modification of the constitutional system it is not possible to delegate to the state additional fiscal responsibilities for macroeconomic policy it is necessary to incorporate executive fiscal federalism into intergovernmental fiscal relations in B&H, similarly to the model applied in the indirect taxation system. Therefore it is necessary to assign the Fiscal Council executive fiscal powers regarding the setting of the national fiscal targets, fiscal rules and a budgetary framework binding on all levels of governments and their parliaments. It would help not only in fiscal consolidation and economic performance but also in a reduction of the political tensions in the country and faster fulfilment of obligations in the EU integration process.

CHART A1

Bosnia and Herzegovina, political structure

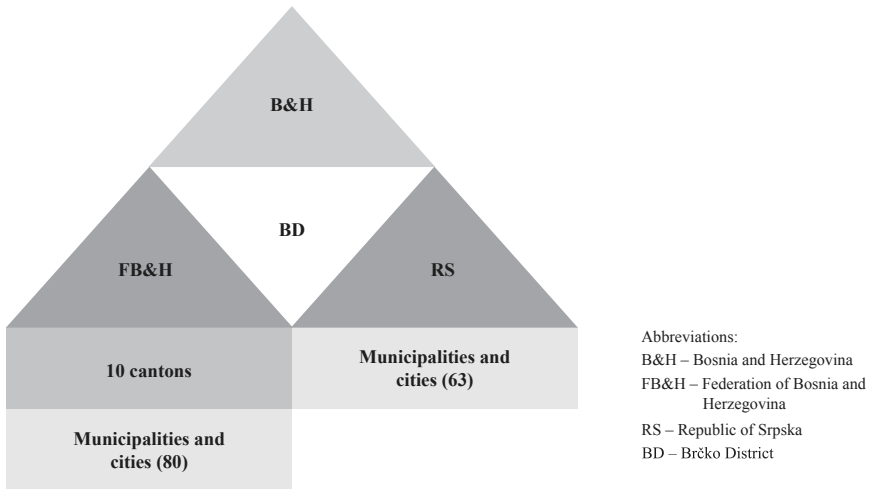
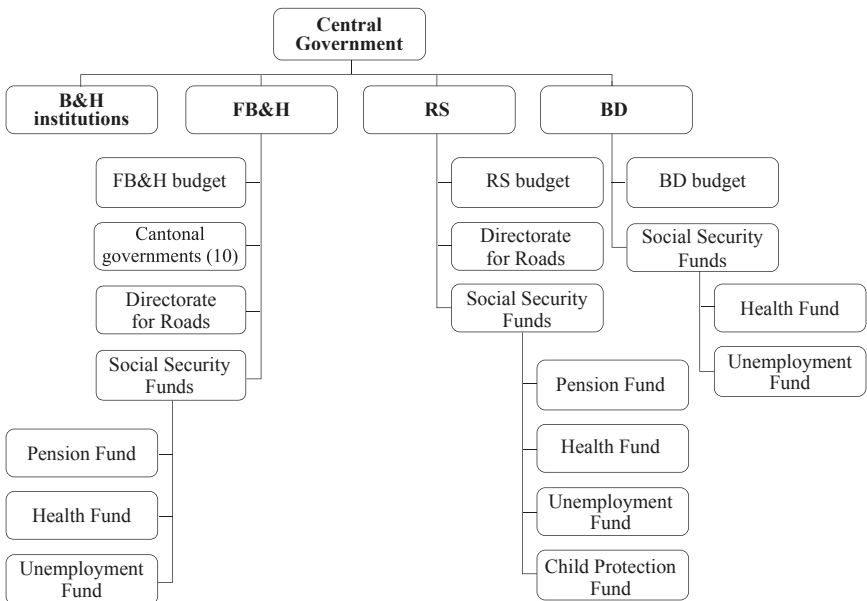


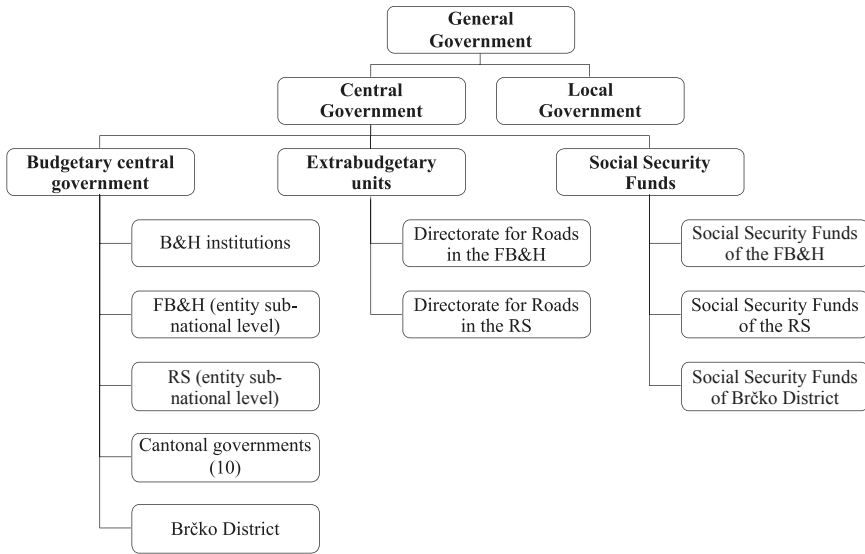
CHART A2

Bosnia and Herzegovina, levels of central government



Note: Presentation based on IMF GFS analytical approach.

Source: IMF, 2005.



Source: IMF, 2005.

TABLE A1  
Consolidated entity governments as % of GDP

	2008		2011	
	FB&H	RS	FB&H	RS
<b>Revenue</b>	26.5	13.2	24.8	14.1
Indirect taxes	10.9	5.5	10.0	5.4
Direct taxes	2.1	1.6	1.8	1.6
Profits tax	0.5	0.5	0.5	0.5
Income tax	1.2	0.8	1.0	1.0
Property tax	0.5	0.2	0.2	0.1
Social contributions	10.1	4.4	10.2	5.3
Non-tax revenue	2.9	1.6	2.7	1.7
Other	0.3	0.1	0.1	0.1
<b>Expenditure</b>	27.9	13.7	25.6	14.4
Current expenditures	26.7	12.3	25.0	13.3
Wages and compensation	6.5	3.1	6.4	3.6
Use of goods and services	5.6	2.7	5.8	1.2
Grants	14.0	6.0	11.2	7.7
Interest payments and other compensations	0.3	0.3	0.4	0.3
Other expenses	0.3	0.2	1.2	0.8
Net acquisition of nonfinancial assets	1.3	1.3	0.6	1.1
Gross operating balance	-0.2	0.9	-0.2	0.8
Net lending/borrowing	-1.4	-0.5	-0.8	-0.3

Source: MAU Database, ITA Governing Board.

**TABLE A2**  
*Sub-national governments in FB&H as % of GDP*

	2008			2011		
	Budget FB&H	Cantons	Municipalities	Budget FB&H	Cantons	Municipalities
<b>Revenue</b>	5.4	8.3	3.1	5.2	7.4	2.5
Indirect taxes	4.4	5.7	0.8	4.2	5.0	0.7
Direct taxes	0.2	1.3	0.7	0.2	1.2	0.4
Income tax	0.1	0.3	0.1	0.2	0.4	0.0
Profits tax	0.0	0.9	0.2	0.0	0.8	0.2
Property tax	0.0	0.1	0.4	0.0	0.0	0.2
Non-tax revenue	0.8	1.0	1.0	0.8	0.9	0.9
Other	0.0	0.3	0.6	0.0	0.2	0.4
<b>Expenditure</b>	6.2	8.7	3.2	5.3	7.5	2.6
Current expense	5.8	8.2	2.7	5.3	7.3	2.2
Wages and compensation	1.0	4.5	0.7	0.9	4.5	0.7
Use of goods and services	0.3	1.0	0.5	0.3	0.9	0.5
Grants	4.3	2.7	1.3	3.6	1.5	0.5
Interest payments and other compensation	0.3	0.0	0.0	0.3	0.0	0.0
Other expenses	0.0	0.0	0.2	0.2	0.4	0.4
Net acquisition of nonfinancial assets	0.3	0.4	0.5	0.1	0.2	0.4
Gross operating balance	-0.4	0.1	0.4	-0.1	0.1	0.3
Net lending/borrowing	-0.8	-0.4	-0.1	-0.1	-0.1	-0.1

Source: MAU Database, ITA Governing Board.

**TABLE A3**  
*Sub-national governments in RS as % of GDP*

	2008		2011	
	Budget RS	Municipalities	Budget RS	Municipalities
<b>Revenue</b>	6.3	2.6	6.3	2.1
Indirect taxes	4.2	1.3	4.2	1.2
Direct taxes	1.3	0.3	1.3	0.3
Profits tax	0.5	0.0	0.5	0.0
Income tax	0.7	0.2	0.7	0.2
Property tax	0.1	0.1	0.1	0.1
Non-tax revenue	0.9	0.7	0.7	0.6
Other	0.0	0.2	0.0	0.0
<b>Expenditure</b>	6.2	2.9	5.5	2.2
Current expense	5.9	1.9	5.0	1.7
Wages and compensation	2.4	0.6	2.7	0.7
Use of goods and services	0.5	0.6	0.4	0.5
Grants	2.7	0.6	1.5	0.2
Interest payments and other compensation	0.3	0.0	0.2	0.1
Other expense	0.2	0.0	0.3	0.3
Net acquisition of nonfinancial assets	0.2	1.1	0.5	0.5
Gross operating balance	0.4	0.7	1.3	0.4
Net lending/borrowing	0.1	-0.3	0.8	-0.1

Source: MAU Database, ITA Governing Board.

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