



DOMESTIC RESOURCE MOBILIZATION

Case Study of Bosnia and Herzegovina, 2000-2016¹

Summary

The Dayton Accords defined the new institutional structure for present-day Bosnia and Herzegovina (BiH). It created two so-called entities, the Federation of BiH, predominantly populated by Bosniaks and Bosnian Croats, and Republika Srpska, populated by Bosnian Serbs, and a special district (Brčko), populated by the three main ethnic groups.

During the post-war period, both entities and Brčko worked to improve the fragmented, complex, distortionary, corruption-riddled, and costly tax system inherited from the former Yugoslav federation. The authorities replaced a complex, irksome sales tax with an efficient, broad-based value-added tax (VAT) collected by the new Indirect Taxation Authority. Other notable reforms included the introduction of new personal and corporate income taxes that treated taxpayers similarly in all jurisdictions, harmonization of excises with European Union (EU) standards, and replacement of trade taxes with domestic revenues.

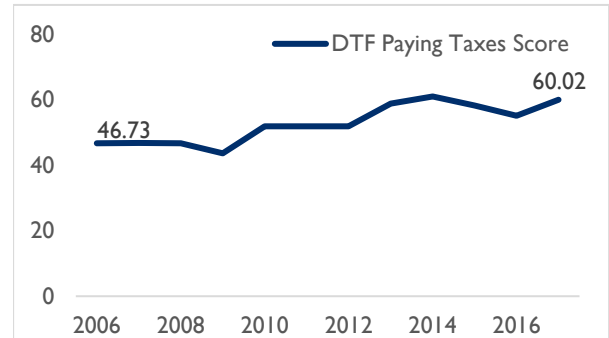
These reforms were complemented with substantial improvements in tax administration, including: a) the streamlining and automating major business processes; b) a new taxpayer registry and taxpayer identification number; c) creation of central processing centers; and d) improved system-wide data sharing thanks to a new high-speed, low-cost microwave-based data network.

The reforms enabled the BiH authorities to lower tax rates while maintaining or increasing revenues. These reforms also strengthened the business-enabling environment. Between 2006 and 2016, BiH's distance-to-frontier (DTF) score on the World Bank's *Paying Taxes* indicator rose from 46.7 to 60.0 percent.

The BiH case illustrates several basic lessons on improving domestic resource mobilization (DRM). First, it takes considerable investment and time (at least \$127 million from donors over 15 years) to make progress in post-conflict environments. Second, accession to the European Union (EU) is a powerful incentive. In BiH, it helped to motivate important VAT, excise, and customs reforms. Third, the structures established for donor coordination were critical to ensure that donors spoke with a single voice

Success in Mobilizing Revenue

Figure 1. BiH's Improved Performance on Paying Taxes, 2006-2017



Source: World Bank *Doing Business, 2006-2017*.

The success of BiH's tax system modernization efforts should be assessed not only on how much revenue has been collected, but also on *how* revenue mobilization affects people and the economy.

BiH moved from a fragmented, complex, distortionary, corruption-riddled, and costly system to one of much greater uniformity and predictability with a much lower compliance burden. The prior fractious polity and its atomized revenue systems made for a poor business environment in which it was difficult for businesses to operate throughout this rather small country.

From 2006 to 2017, the number of annual tax payments a typical company must make fell from 55 to 34.



Improvements in tax policies and regulations have strengthened the business-enabling environment. BiH's performance on the *Paying Taxes* category of the World Bank's *Doing Business* report demonstrates this progress. For instance, BiH's DTF score shows steady

¹ This briefing note was prepared by Janine Mans based on a full-length case study written by Mark Gallagher. The full case study is available at: https://pdf.usaid.gov/pdf_docs/PA00D5ST.pdf

improvement in the degree to which the country applied tax best practices from 2006 to 2017, rising from 46 to 60 percent. For example, the number of tax payments the typical company must make declined from 55 to 34 per year.

BiH has sustained adequate government revenue levels in the face of trade liberalization (Table 1). Average import duties declined over the past 15 years, from about 15 percent of revenue to only a negligible share today.² This decline in import duties resulted from a reduction in the average duty rate from 7.7 percent in 2006 to only 2.4 percent in 2015.

Table 1 - Aggregate Domestic Revenue Mobilization (% of GDP)

	2006	2010	2015
Tax revenues	21.69	19.70	19.98
<i>PIT (includes citizen+)</i>	1.44	1.03	1.80
<i>CIT</i>	0.66	1.32	1.21
<i>Excise</i>	4.29	4.63	4.51
<i>VAT</i>	15.08	14.66	15.21
Trade revenues	2.78	1.19	0.86
Non-tax revenues	1.52	0.05	0.12

Source: Macroeconomic Unit, ITA Governing Board

Key achievements in customs operations were to meet EU standards and to facilitate easier cross-border trade. For instance, the World Bank's *Doing Business* DTF score for Trading Across Borders, which measures the overall degree to which a country is applying best practices, shows considerable, steady improvement. From 2006 to 2017, BiH's score on the indicator rose from almost 67 percent to almost 92 percent. In addition, because of streamlining of customs and border practices, BiH was ranked 36th out of the 190 economies on this indicator.

How BiH Achieved These Results

Tax policy

Both entities and Brčko began the post-war period applying the tax laws carried over from Yugoslavia. Over the course of the 2000s, the two entities and Brčko undertook significant reforms that improved the efficiency and performance of the tax system.

One of the most impactful reforms was the introduction of the VAT in 2005. The VAT revenues exceeded the sales taxes collected by the entity and Brčko tax administrations at the time. BiH had several strong reasons to implement the VAT. First, its sales taxes were extremely burdensome, varied significantly between areas in the country, and were somewhat

distortionary. Second, because the VAT was trade-friendly, it offered the potential to promote the country's international competitiveness. Finally, BiH sought to meet the EU accession requirement to have a VAT that had a broad base, with very few exemptions or exclusions.

BiH also undertook significant reforms to its personal and corporate income taxes that now treat most taxpayers alike, regardless of where they operate in the country. In the Federation, the new personal income tax (PIT) developed with USAID assistance replaced about 70 different income taxes imposed by sub-Federation cantons. In the Republika Srpska, this new tax replaced seven so-called citizen taxes.

The Republika Srpska and the Federation enacted new corporate income tax (CIT) laws in 2007 and 2009 respectively that unified CIT tax rates nationwide. During the first full year of the new CIT in the Republika Srpska, which already had a low headline tax rate of 10 percent, revenues nearly doubled. The new CIT law was a bigger change for the Federation as it lowered its corporate tax rate from 30 percent to 10 percent, but also reduced many tax holidays. Despite the lower tax rate, CIT revenues for the Federation also nearly doubled the first year.

Tax administration

With the Dayton Accords, the entities and Brčko needed to build their new tax administrations from the ground up. By 2000, the Federation, Republika Srpska, and Brčko had set up basic tax administrations. During this early period, the governments enacted new tax administration legislation and implementing regulations to create the post-Yugoslav tax administrations.

The tax administrations, however, had neither the systems nor processes needed for effective and efficient tax administration. From 2001 through 2004, the tax administrations gradually reengineered and automated business processes to enhance the control, speed, and reliability of tax administration activities and facilitate taxpayer services. By 2005, the three tax administrations had solid, comprehensive information technology (IT) systems. Between 2002 and 2003, the three tax administrations also had developed a taxpayer identification number system, reregistered all known taxpayers with a new taxpayer identification number, and removed old, outdated, or fraudulent taxpayers from the registry. The number of taxpayers (companies and persons) rose threefold, despite the removal of fake registrations.

Central processing centers for the tax administrations of the Federation and Republika Srpska helped the tax

² Reliable, consistent data are not available for years before 2006.

administrations to know: a) who paid their taxes; b) whether payments were made on time; c) whether the right amount of tax was paid; d) who should be audited; and e) what supporting information was needed to conduct audits. These facilities also streamlined payments processes for taxpayers because now they could simply drop the return off, receive a stamped receipt, and leave. Earlier, a tax officer scrutinized each tax return at the tax office with the taxpayer. This process had caused very long queues and wait times.

In December 2003, the BiH Parliament adopted the Law on the Indirect Taxation System. This law established the Indirect Taxation Authority (ITA), a State-level semi-autonomous revenue authority responsible to a board of directors that today has more than 2,300 employees. Its purview includes customs and all indirect taxes for the entire country—including VAT, customs duties, and excises, including the so-called road tax. The ITA exercises considerable independence in its internal operations and human resource management and maintains strong budget independence.

The VAT took effect in January 2006, and revenues began flowing into the ITA within a month. The parties had fiercely debated how the VAT and other indirect tax revenues would be shared among the Republika Srpska, Federation, Brčko, and State budgets. By January 2005, they had agreed that all revenues collected by the ITA go directly into the single account opened in the Central Bank of Bosnia and Herzegovina. The legal framework requires that revenues be allocated on a pro rata basis among the entities and the State and remitted daily.

Donor Support

International donors provided fairly comprehensive support to improve BiH's tax policy environment, and strengthen tax administration in the three entities and to establish the Indirect Tax Administration. The main donors involved with DRM in BiH include the EU; the U.S. government, both USAID and the U.S. Treasury; and the German government through its agency now known as the German Society for International Cooperation (GIZ).

EU tax assistance began immediately after hostilities ceased. The EU worked with the Office of the High Representative (OHR) and counterparts from entity and State governments to establish the Indirect Tax Commission (ITC). The ITC with support from the EU focused on establishing customs and excises operations first at the entity level. EU assistance also worked with the entity tax administrations in the area of sales tax collection and enforcement. Eventually, EU

assistance took the lead in developing VAT legislation, designing, setting up, and outfitting the ITA, and providing capacity-building assistance for the ITA.

USAID, the U.S. Treasury Office of Technical Assistance and the State Department all contributed to the reform process, with a focus on improving the institutional structures of the tax administrations of the two entities, including investment in new systems (including e-filing and e-payment) and communications technologies, the establishment of the centralized processing centers, and business process re-engineering. U.S. assistance also supported the harmonization of direct taxation, design and implementation of new property taxation, and development of a new system for supporting the migration of social security contributions (SSC) to the tax administrations.

Similar to the earlier ITC, the international community, in consultation with counterpart authorities in the entities, established the Direct Tax Commission (DTC) with the purpose of providing a single, coordinated voice on all matters related to direct tax reform. DTC membership included U.S. State Department, USAID, U.S. Treasury, the German Embassy, OHR, International Monetary Fund, and the World Bank. The DTC advocated, with great success, for reform and harmonization of personal and corporate income taxes, repeal of citizen taxes, reform of property taxation, and inter-entity cooperation.

Donor-assisted reforms helped establish operational tax systems that would support the "single economic space" concept. They helped to achieve and sustain adequate revenues to fund public services, even as trade liberalization reduced trade taxes to negligible levels. And, they did so while trimming back unnecessary burdens on business and society.

Overall, donors spent an estimated \$127 million to help build tax systems, and BiH has mobilized about \$35 billion (from 2006 to 2017) in total tax revenues (excluding payroll tax for social contributions).

Unfinished Business

One major area that will require significant improvement, however, is the SSC system.

In BiH, the SSC funds the social pension system, public health care, unemployment insurance, and child protection, as well as flood protection in Republika Srpska. Total SSC revenues come to about 15 percent of GDP, one of the highest rates in the world. SSC is a payroll tax imposed at 41.5 percent of salary in the Federation and 33.9 percent in the Republika Srpska, both rates near worldwide highs. Only France,

Germany, and a few other countries have higher SSC burdens.

These high SSC rates impose a large wedge between what employers pay for workers and what workers take home. The greater this wedge, the less inclined businesspersons will be to create new jobs, and the less inclined would-be workers are to accept jobs that leave them with little in their pockets. Considering the very low tax on capital (i.e., the ten percent CIT rate), businesses have more incentive to expand through capital-intensive rather than job-creating technologies. This may partially explain why formal sector jobs seem to be disappearing despite moderate economic growth.

Lessons Learned

The development of new tax agencies in BiH started with officials who had very little, if any, experience in tax and customs administration. They had little equipment, and had very little in terms of adequate office space, procedures, processes, and even leadership. We draw our lessons learned in light of this complex, post-conflict context.

Reform can take a long time. By early 2004, both BiH and international community leadership were well aware of the need to reform not only indirect but also direct taxation. Despite having developed a clear agenda, personal and corporate income tax reform took several years to come to fruition.

Indeed, although one team of USAID experts worked closely with counterparts to develop legislation and methods in 2005, it was not until 2006 when the first reform was enacted into law, and several more years before personal and corporate income taxes were reformed and harmonized throughout the country.

Accession to the EU was a powerful incentive.

There was and continues to be considerable opposition among some ethnic or political leaders to any moves toward creating a single economic space, but almost all BiH citizens and their leaders want greater freedom of movement, access to European markets, and access to assistance from the EU, which all remain limited as long as BiH remains outside of the EU. Unification of excises and customs and implementation of a VAT that meets EU standards are key points in this accession quest and bring the country together. Without the hope of eventual accession to the EU, these reforms might not have been feasible.

Donor coordination is crucial. For both direct and indirect tax reform, establishing the two commissions was key to both speaking with a single voice as well as ensuring that assistance and reforms all be appropriately coordinated. Without these two commissions at their respective times, gaining consensus for reform would have remained out of reach.

Figure 2. Timeline of Major Tax Reforms (2003-2016)

