

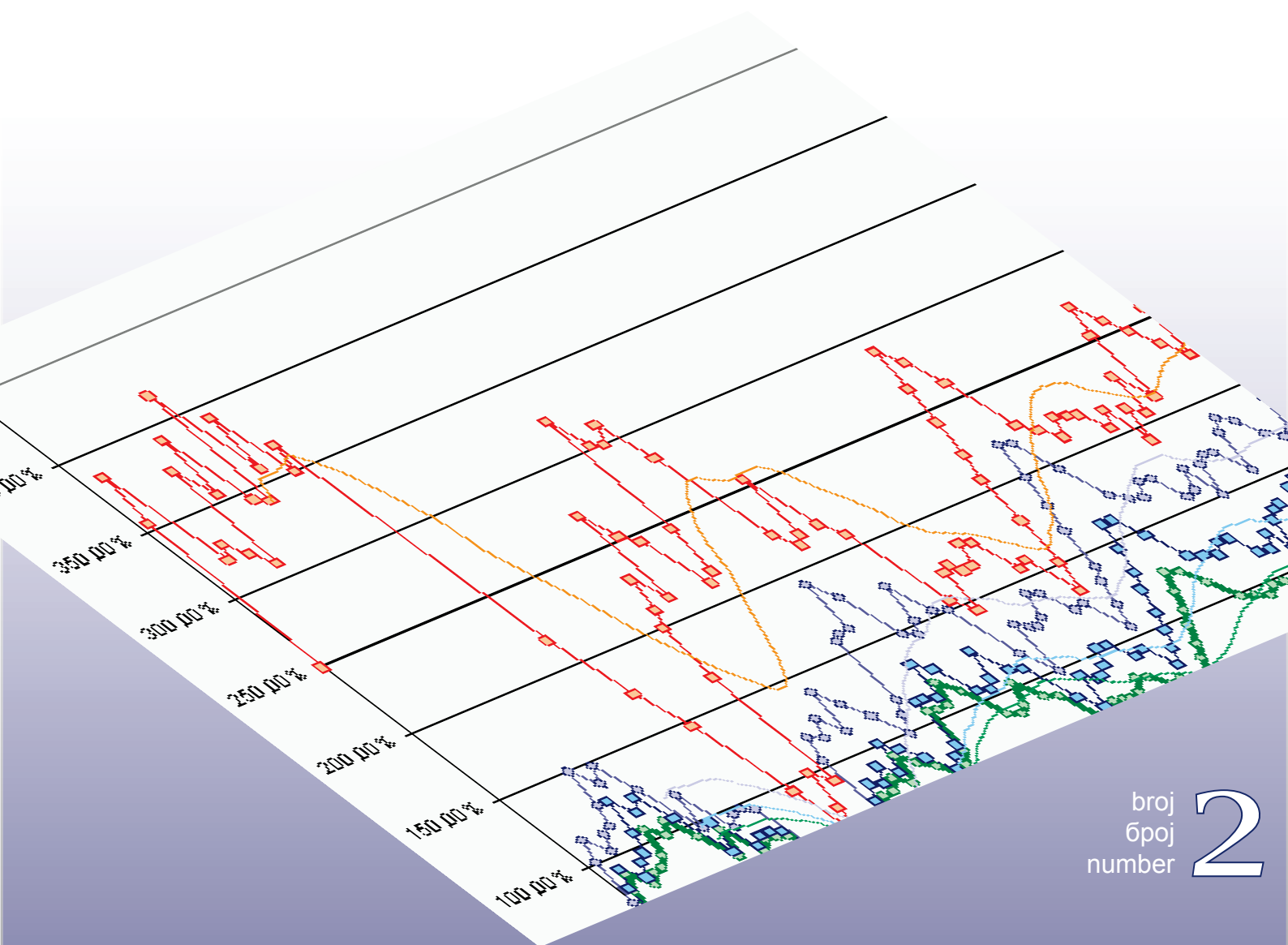
Bosna i Hercegovina
Odjeljenje za makroekonomsku analizu
Upravnog odbora Uprave za indirektno-
neizravno oporezivanje



Босна и Херцеговина
Одјељење за макроекономску анализу
Управног одбора Управе за индиректно
опорезивање

Macroeconomic Unit of the Governing Board of the Indirect Tax Authority

Oma Bilten



broj
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number

2

• Septembar 2005 • Rujan 2005 • Септембар 2005 • September 2005 •

With this issue...

As the day „D“ is approaching – implementation of new way of taxation with value added tax – there is more and more discussions on VAT effects on prices and social status of population. In this issue MAU prepared article on VAT effects on prices comparing it with sales tax system and effects of VAT effects on prices in neighboring countries – Croatia and Serbia.

One of MAU objectives is creation of monthly consolidated reports on revenues and expenditures for all levels of administration in BiH. Main topic of this issue is institutional set up of fiscal consolidation in the country, system of responsibility and competencies. As part of this, we presented proposal of coordination system for budget cycle of all levels in BiH.

From this issue and on, the Unit will publish consolidated reports for state and entity governments on monthly basis. In accordance with dynamics of receiving data from Finance ministries, this issue contains consolidated reports for the first eight months of this year.

Due to the fact that revenues collected to the ITA single account are significant for fiscal sustainability and budget planning for all levels in BiH, we will present you flow of revenues in the ITA single account, as part of our regular section in the bulletin.

mr.sc. Dinka Antić
Head of unit – supervisor

Current events!**Agreement on the Fiscal Council has been conformed**

Session of the Fiscal Council took place on September 12th, 2005 in Banja Luka and the agreement on establishment of the Fiscal Council was conformed.

The agreement determines composition of the Council, defined competencies, ways to act in accordance with decisions of the Council, voting and decision making mechanism.

According to the Agreement, voting members of the Council shall be: Chairman of BIH Council of Ministers, Prime ministers of entities, Finance ministers of BiH and entities. Central Bank governor and mayor of Brčko District shall have status of observers holding right to participate in discussions and proposals for the agenda.

This Agreement is key step towards making the Law on Fiscal Council and important condition for signing new stand by arrangement with the IMF mission in October in Washington.

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In focus: Effect VAT on prices

Author: Ognjen Đukić, macroeconomist in the Unit

IMF has evaluated VAT rate of 16% as revenue neutral, i.e. the rate bringing same amount of revenues as under the sales tax system. Such tax rate should also be price neutral. Following this, applying tax rate of 17 % will increase prices in the average amount a bit less than 1%. We should bear in mind two things:

- Psychological effect on average price level by VAT introduction
- Changes in relative prices.

1. Psychological effect on average price level by VAT introduction

Psychological effect on price level by introducing VAT brings potential efforts in raising prices for products and services above real need and under the justification of VAT introduction. Such trends have been experienced by other countries in their reform of tax systems and in introducing new currencies (experience of European countries in introduction of EURO, when sellers tried to justify price increases with the reform).

Correction of these rises in the market is usually slow. However, there are often examples of rigidity in some price increases. Although VAT, due to its neutrality, will influence average price increase for less than 1 %, we still cannot exclude significant price increase in the beginning period after the VAT introduction.

2. Changes in relative prices

The VAT introduction will shift relative prices ratio. Prices of products taxed with rate zero in the current sales tax system will undoubtedly increase by VAT introduction as well as great number of products and services that are taxed by 10%.

On the other hand, products taxed with a rate of 20% will be relieved, which will give a chance to sellers to reduce prices. Whether these increases and decreases will be in proportion with new tax burdens and relieves depends on a strategy of individual market players and their decision how to react to new conditions. It is important to mention that products and services from group 0% to 10% would not be burdened automatically with 17% and 7%. Sellers of products from the group 0% were exempt from paying the sales tax on these products.

However, they had to include sales tax paid for certain purchases (for example office furniture, fuel, cars, telephone services, heating, electricity etc.) as well as the sales tax paid by their suppliers that was transferred to their expenses.

With the VAT introduction, a sale of such products will be additionally burdened with 17% on output but sellers will be able to deduct full input tax, so their purchases will contain less tax than earlier. In this sense, it is difficult to determine new price burdens for this product group, as it is almost impossible to estimate single amounts of cascaded transfer of sales tax.

Social effects

After the VAT introduction, it is inevitable to expect rise in price of great number of basic products and services that currently fall under the rate of 0% and 10%. Although the additional tax burden for sellers is under 17% and 7%, greater rises in prices of some products are possible. The law on VAT has foreseen some social relieves through the exemption of some activities and services from VAT payment (such as medical services, health protection services, social insurance, education etc.).

Relatively high threshold of 50.000 KM for compulsory registration provides a tax relief to owners of small companies and shops. However, the VAT introduction must be followed by social program that targets social groups who will be the most affected by this reform.

This includes the groups whose household budgets contain high percentage of these products and services – socially vulnerable. This way of assistance is considered being more efficient than the introduction of low tax rates for basic products and services since tax rate reduction as a relief is applied on richer levels of society in proportion to their consumption of products and services. A great task of creation of social assistance program is to find good criteria for recognition of targeted groups and success depends on that.

In conducting such tax reform there is a possibility of creating, according to the experience of a number of European countries, control body whose task would be to follow movements of prices for products and services (focusing on basic ones) and citizens would be able to report on significant rises in prices. In this way, we create good awareness and basis for making good decision on method to resolve above mentioned price/social problems.

Review of VAT effects on prices in Croatia and Serbia

(prepared by: Dinka Antić, Head of Unit - Supervisor)

In a bit more than three months VAT will be introduced in Bosnia and Herzegovina. The public expects the new way of taxation at a standard rate of 17% to cause a sudden price increase for basic products and services, which would impinge in particular on socially weaker parts of the population. It is therefore useful to examine the price effects experienced by neighboring countries that have recently introduced VAT.

Croatia introduced VAT on January 1st, 1998, at a standard rate of 22% for all goods and services. The Croatian experience is interesting because a long period of time has elapsed since the introduction of VAT, so the effects on prices can be observed over the longer run. The analysis of economic reactions and of attitudes of traders in conducting business under a VAT over time reveals that most of the traders did not increase their margins in response to the new tax.

Some kept prices unchanged lowering their margins to remain competitive while others used the introduction of VAT as an excuse to increase their margins. However, after the first moderate price shock, the free market would limit price increases, which can be seen from Table 1. It shows the price index by groups of products and services during a period of one year (December 31st, 1998) after VAT had been introduced while only one single VAT rate of 22% was in place:

(31.12.1997.=100)			
Food products and drinks	103,5	Meat and meat products	101,9
Food-total			103,2
Clothing and shoes	90,8	Technical goods and furniture	94,1
Personal services and transportation	105,6	Medications and food for children	112,4
Utility services	114,2		
Total			103,5

Table 1. Price index by groups of products and services during a period of one year after VAT introduction

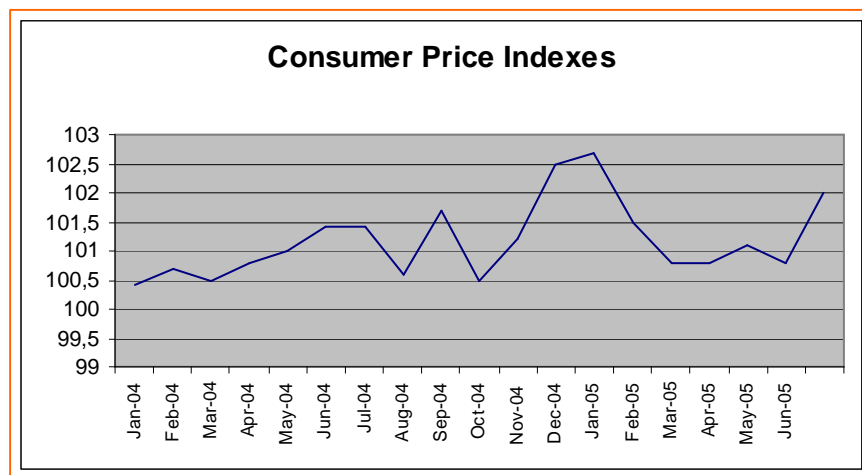
Source: Trade Chamber of Croatia

A standard rate of 22% was in effect until November 1st, 1999, when Croatia introduced a zero VAT rate on bread, milk, books and medications at first, while later extending the list of zero-rated goods and services. An analysis of consumer prices after the introduction of differentiated VAT rates shows that retail prices fell only insignificantly and that most traders had kept their prices unchanged arguing that some cost items (energy, utilities, etc.) had become more expensive in the meantime. Moreover, the introduction of differentiated rates opened a door for tax evasion, and it weakened

Croatia's position in the negotiations with the European Union because a zero rate is not in accordance with the *Acquis*, the legal and institutional heritage of the Union. It is expected that Croatia will abolish the zero VAT rate in due course and harmonise its Law on VAT with the Sixth VAT Directive of the EC.

Serbia introduced VAT on January 1st, 2005, at a standard rate of 18%, and a reduced rate of 8% on food stuff, medications, newspapers, etc. The experience of Serbia is important for reviewing VAT effects in the short run. According to data from the Serbian Ministry of Finance, the increase in prices during the first two months of 2005 was followed by a decrease in March. The development of retail prices before and after the

introduction of VAT is shown in Chart 1:



The general increase of retail prices in March 2005 compared to December 2004 was 5,1%.

This was mainly due to price increases of services and industrial non-food products (2/3 of total retail prices).

Chart 1. Development of retail prices before and after VAT introduction

Source: Serbian Tax Administration

The increase of retail prices in March 2005 (0,8%) slowed down significantly compared with the two preceding months (2,7% and 1,8% respectively). Moreover one should bear in mind that the increase of retail prices in the first quarter of 2005 was not only a result of introducing VAT, but also due to a general price increase of utility services in Serbia and the price increase of crude oil at world markets.

Topic of this issue: Fiscal consolidation

Author: Ognjen Djukic, macroeconomist in the Unit

Purpose

The purpose of fiscal consolidation is to obtain complete and aggregate data on fiscal operations of the government sector. These data represent necessary information for the management of fiscal policy, with the aim of maintaining macroeconomic stability and sustainable development.

Consolidation of fiscal data allows us to: assess the total budget balance of the government sector and analyze its changes; assess the share and the burden of the government sector in an economy; analyze the structure of public revenues and expenditures, their dynamics and developments of public debt etc.

The collected data, its analysis and consolidation represent a basis for coordinating fiscal policies at different levels of government. Fiscal coordination allows us to avoid many negative effects of partial planning and management of fiscal policies, such as the inability to assess the budget deficit and the total burden placed on an economy, the emergence of tax competition, and a lack of appropriate fiscal policy adjusted to the economic situation in a country etc.

Fiscal Council

The BiH Council of Ministers, and the governments of the Federation of BiH and the Republic of Srpska have formed a Fiscal Council (FC) as the body for coordinating fiscal policies in BiH.

It was agreed for the FC to make decisions on:

- limitations in terms of consolidated revenues and expenditures and their allocation to the BiH, the RS, the Federation of Bosnia and Herzegovina, and the Brcko District,
- the consolidated primary balance for the following fiscal year and for the following period of two years,
- the levels of total domestic and external borrowing and guaranties, and the allocation of external borrowing and guaranties to the budgets of the BiH, FBiH, RS, BD, and lower levels of government,
- the allocation of revenues from the Single Account of the Indirect Tax Administration.

Assuming the responsibility

Bosnia and Herzegovina thus far has not had a domestic institution responsible for fiscal consolidation at all government levels.¹ As one of the preconditions for the next tranche of the stand-by arrangement, the IMF requires a monthly consolidation of fiscal data by the Macroeconomic Analysis Unit (MAU). One other requirement put forward by the IMF is the drafting of the Law on the Fiscal Council of BiH.²

One of the priority tasks for the MAU is to start publishing consolidated fiscal data for all levels of government, including cantons, municipalities and extra-budgetary funds, which amount to 189 budget units in total. The monthly reporting of these data will create, among other things, the possibility of monitoring the execution of agreed fiscal envelopes by all governments and to timely identify unforeseen deviations.

Budget cycle

We can divide a budget cycle of a country into basic phases: collection of fiscal data, analysis and drafting of a budget plan; preparation of a budget proposal; consideration, debate and adoption of a budget; execution of the budget and reporting; budget audit.

In Bosnia and Herzegovina the dynamics of this cycle has been defined by the budget calendars at the entity level. With the establishment of the Fiscal Council it becomes necessary to adjust these calendars with the following basic steps (see Graph 1):

1. Production of macroeconomic framework

The Economic Planning and Policy Unit (EPPU), in cooperation with MAU, produces a macroeconomic framework of BiH for the following year. The FC considers and adopts the macroeconomic framework.

2. Revenue projections

On the basis of the adopted macro framework, MAU projects public revenues for the following year. Projections are being made in close cooperation with the entity ministries of finance, especially the projections of revenues under entities' responsibility. The goal of this step is to identify, on the basis of the adopted macroeconomic framework, revenue trends and foreseeable structural changes, and to come to the most realistic estimates of the individual revenue groups for the following year.

3. Production of fiscal framework

The FC agrees on comprehensive limitations of public spending, the targeted primary fiscal balance and its sharing among the state government, the entity governments and BD for the following year, on domestic and external borrowing and its allocation as well as on the allocation of revenues from the Single Account of Indirect Tax Administration.

¹ Please note that the Central Bank of BiH consolidates the budgets of entity and cantonal governments, funds and Brcko at a quarterly and annual level.

² In accordance with that, a working group for drafting the Law on Fiscal Council of BiH was formed. It is chaired by the Minister for Treasury and Finance of BiH.

4. Budget proposals

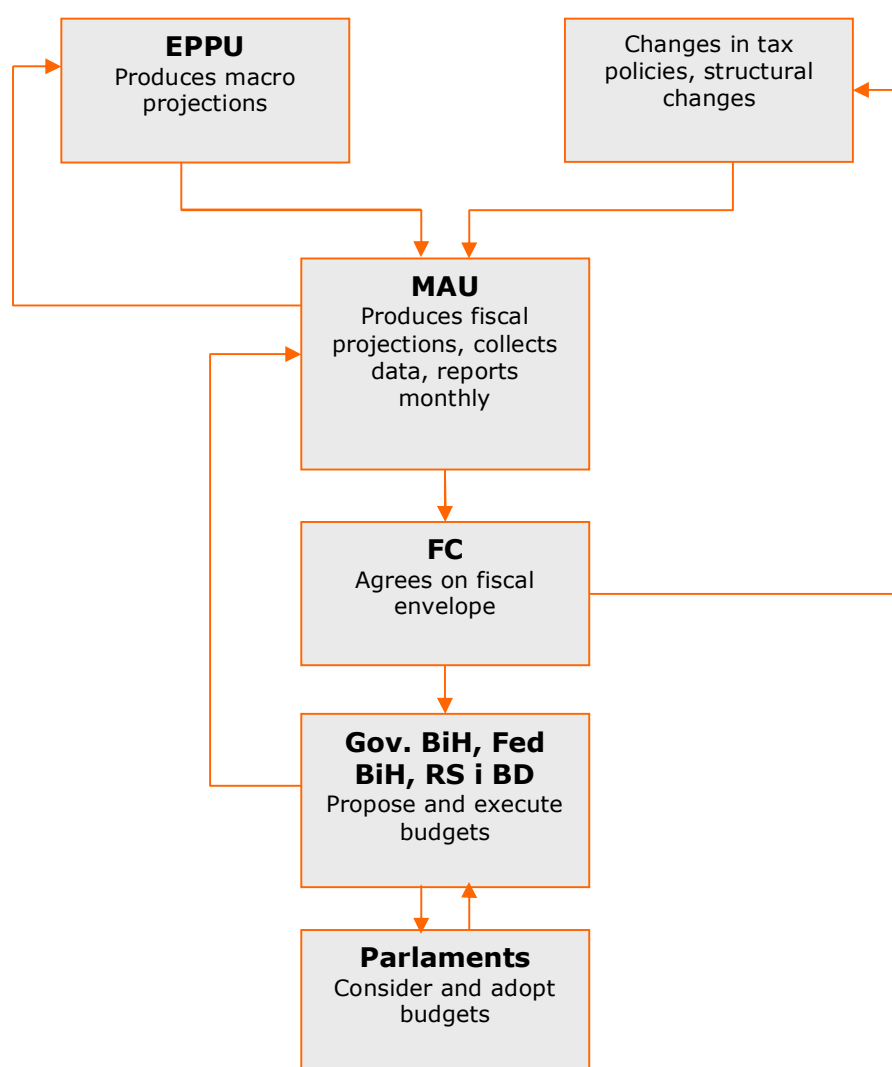
State government, entity governments and BD draft budget proposals. The governments must be obliged to implement what their representatives had agreed within the FC. Therefore, it is necessary for final budget proposals, submitted to the state and entity parliaments, to remain within the limitations of the agreed fiscal framework.

5. Parliaments

Parliaments of the above mentioned governments consider and adopt budgets.

6. Monitoring of execution

The MAU enters the adopted budgets into its database. Through a system of monthly reporting from all government levels, MAU collects data and monitors the execution of budgets. The monthly reporting of these data gives an insight to all interested parties into the execution of individual budget balances against the agreed fiscal framework. These data are further being used for preparing the macroeconomic framework for the following year (step number 1).



Graph 1. Simulation of proposed budget cycle after the establishment of the Fiscal Council

Monthly Consolidated Reports January– August 2005

Prepared by: Aleksandra Regoje, research worker assistant in the Unit

	2005												mil KM				
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	kv1	kv2	kv3	kv4	total
Current Revenue	168,8	174,2	220,9	213,5	242,3	363,9	269,4	281,0					563,9	819,8	550,4		1934,1
Taxes	160,6	160,3	202,8	202,8	225,3	233,7	221,7	261,0					523,7	661,8	482,8		1668,2
Indirect taxes	146,7	140,8	173,5	188,5	209,4	212,2	206,8	246,7					461,0	610,1	453,5		1524,7
Customs duties	31,8	36,1	45,8	48,1	52,7	53,7	49,7	55,9					113,7	154,5	105,6		373,7
Sales Tax	50,6	46,1	58,8	62,4	71,5	70,0	72,1	84,5					155,6	203,9	156,5		516,0
Excises	54,8	49,0	56,4	64,5	70,6	72,1	69,3	87,3					160,2	207,2	156,6		524,0
Railroad tax	9,3	9,3	12,1	13,1	14,2	15,5	15,4	18,7					30,7	42,8	34,0		107,5
Direct taxes	13,8	19,5	29,3	14,3	15,8	21,5	14,9	14,4					62,7	51,6	29,3		143,6
Non-tax income	8,1	13,9	18,1	10,7	17,0	130,2	33,1	19,9					40,1	157,8	53,0		250,9
Grants, gifts	0,1				0,1	0,1	14,6	0,1					0,1	0,2	14,7		15,0
Current expenditures	124,9	195,3	217,2	218,1	228,0	287,8	198,8	237,7					537,3	734,0	436,5		1707,8
Consumption expenditures	30,9	54,8	71,7	64,0	62,2	94,9	41,1	59,3					157,4	221,1	100,4		478,9
Non-wage labor costs	25,2	45,6	62,4	53,9	53,4	85,2	32,6	52,1					133,1	192,5	84,6		410,2
Compensations	1,7	10,9	13,1	13,2	13,2	29,3	2,9	14,4					25,7	55,8	17,3		98,8
Purchases of goods and services	5,8	9,2	9,3	10,1	8,8	9,7	8,5	7,3					24,3	28,6	15,8		68,7
Grants	31,9	58,1	59,9	60,5	57,7	99,1	66,1	60,7					149,9	217,3	126,8		494,0
Transfers to households	7,9	37,8	35,7	38,9	36,5	78,3	39,5	37,4					81,5	153,7	77,0		312,1
Transfers to organizations/institutions	20,1	15,4	19,0	14,1	16,7	13,8	14,4	13,1					54,4	44,5			
Subsidies	3,9	4,9	5,2	7,6	4,5	6,9	12,2	10,2					14,0	19,1	22,4		55,5
of which: Public enterprises																	
Interest payments	0,1	0,1	0,0	0,1	0,0	0,0	0,4	4,3					0,1	0,1	4,7		5,0
Other outlays	6,2	7,1	10,8	11,5	9,9	10,7	10,7	8,5					24,1	32,1	19,3		75,4
Transfers from Single Account	44,2	45,1	60,9	64,3	62,5	69,0	66,8	81,4					150,2	195,8	148,1		494,2
BiH Budget	18,6	19,6	23,5	20,6	20,6	21,5	20,6	22,5					61,7	62,6	43,1		167,3
FbiH/cantons, Road Directorate	16,8	15,4	25,0	27,9	27,4	32,8	32,0	37,9					57,1	88,1	69,9		215,1
RS / municipalities, cities, Road	5,8	6,1	7,4	10,2	8,3	8,2	7,8	13,0					19,3	26,6	20,9		66,8
Brčko	3,1	4,0	5,1	5,7	6,2	6,5	6,3	7,7					12,2	18,4	14,0		44,6
Amortization of debt																	
of which: foreign debt	10,5	24,8	12,7	16,3	34,7	12,4	12,7	22,4					47,9	63,4	35,0		146,4
Transfers to higher levels of authority	0,2	4,4	0,3	0,1	0,1	0,3							4,9	0,5			5,4
Transfers to Municipalities	0,9	0,9	0,9	1,3	0,9	1,5	0,9	1,1					2,7	3,7	2,1		8,4
Government Savings (1 - 2)	43,9	-21,1	3,7	-4,6	14,3	76,2	70,7	43,3					26,5	85,8	114,0		226,4
Capital outlays	1,6	3,5	1,9	1,7	2,4	33,3	15,3	3,3					6,9	37,4	18,5		62,9
Government surplus/deficit (3-4)	42,4	-24,6	1,8	-6,4	11,9	42,9	55,4	40,0					19,6	48,4	95,4		163,4

Table 2. Monthly consolidated Reports January - August

Notes to Report:

1. The consolidated report includes:
 - revenues from indirect taxes collected by the Indirect Tax Authority on the Single Account,
 - transfers from the ITA Single Account for external debt servicing,
 - transfers from the ITA Single Account for financing Brčko District, cantons, municipalities and Road Directorates,
 - revenues of the budget of Bosnia and Herzegovina from the ITA Single Account,
 - revenues and expenditures of the budget of the Federation of Bosnia and Herzegovina,
 - revenues and expenditures of the budget of the Republika Srpska.
2. Figures on revenues and expenditures of the Federation of Bosnia and Herzegovina and the Republika Srpska are not fully reconciled due to different accounting methods.
3. Once monthly figures on own revenues and expenditures of the budget of Bosnia and Herzegovina are available the Unit will publish a corrected report for the same period.

ITA Single Account!

In August 2005 there was significant increase in revenues collect to the ITA single account. Highest increase is noted in collection of excise and sales tax on imported and domestic excisable products while customs and other revenues.

Total amount of revenues collected in August compared to July 2005 has increased for 20%.

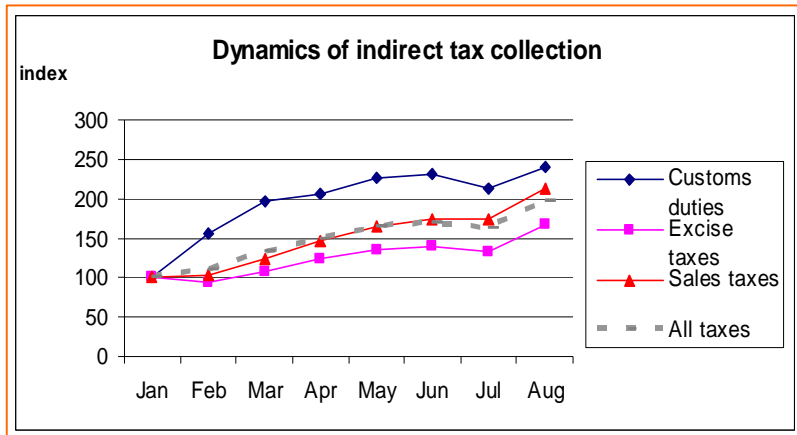


Chart 3. Dynamics of indirect tax collection

Trend of collection for most important groups of revenues and total of indirect taxes collected by ITA are shown in the charts 3 and 4:

As of January 1st 2005, ITA is the only institution in BiH authorized to collect indirect taxes: customs duties, excise, sales tax on excisable products and road tolls.

According to the dynamic plan of revenue collection, it's foreseen that ITA will collect approx. 2 billion KM in indirect taxes to the single account in 2005.

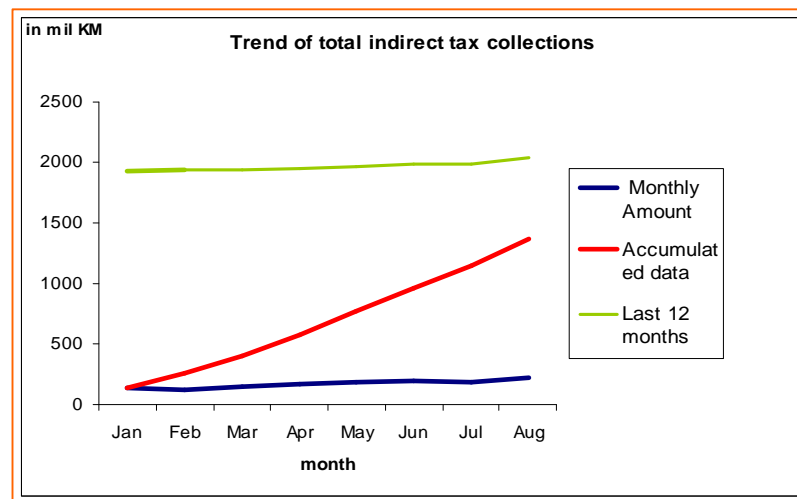


Chart 4. Trend of total indirect tax collections

Education programs: Global economic environment

According to the announcement and provided schedule, the lectures of Prof. Paul Bernd Spahn have started in the premises of ITA Regional Centre Sarajevo, as part of course „Global economic environment“.



Picture 1. Course in Global economic environment

Course is based on the program for masters degree organized by Duke University (USA) and Goethe Business School from Frankfurt. Participants will get certificates upon completion of the course. Additional information on course can be found on <http://www.cit.ba/PBSPAHN/radovi.htm>.

Prof. Spahn is professor at the University of Frankfurt, IMF expert and world known expert in the field of macroeconomics and fiscal policy.

Prof. Spahn has been appointed by the ITA Governing Board to set up MAU and Fiscal Council.