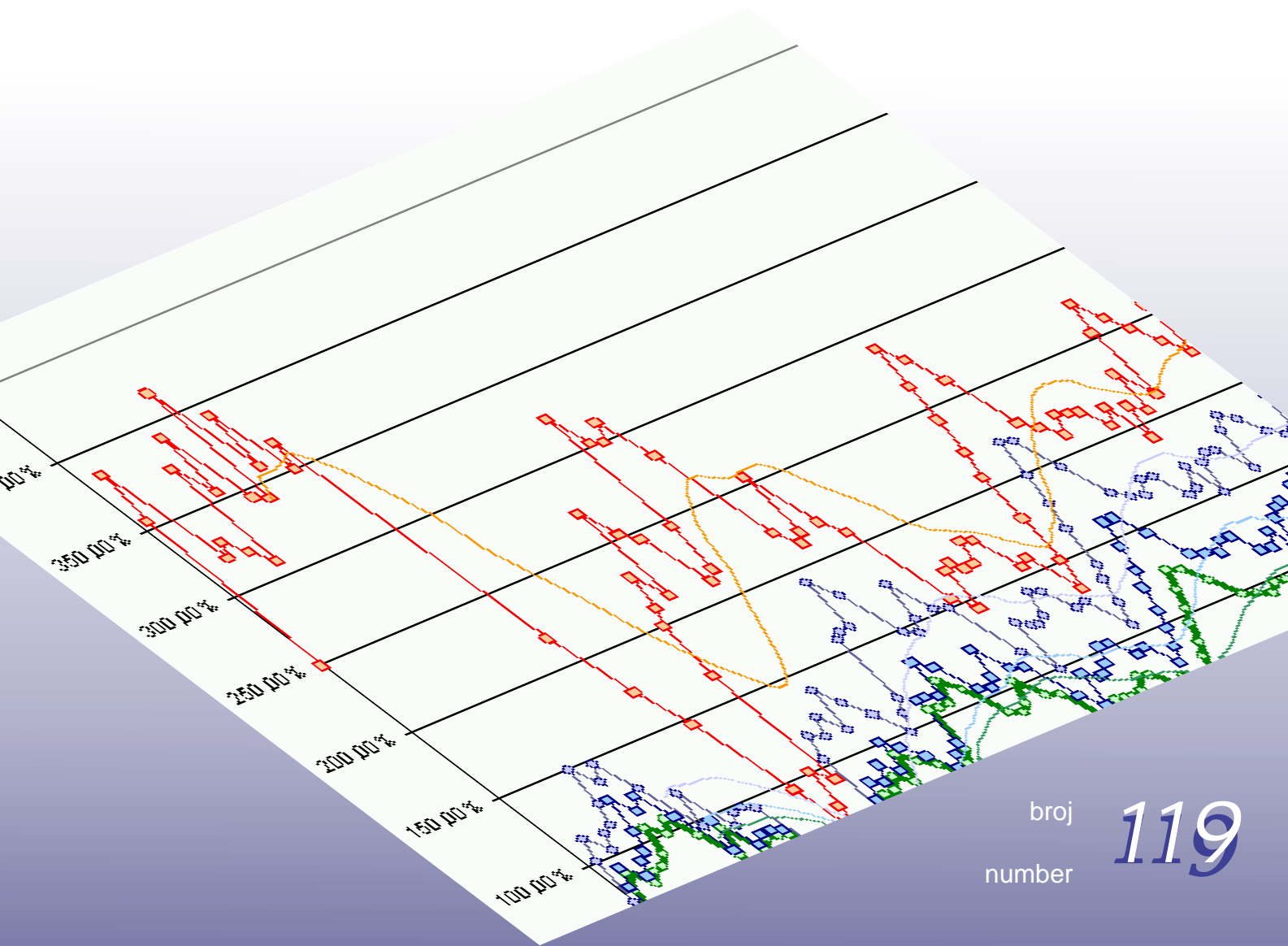




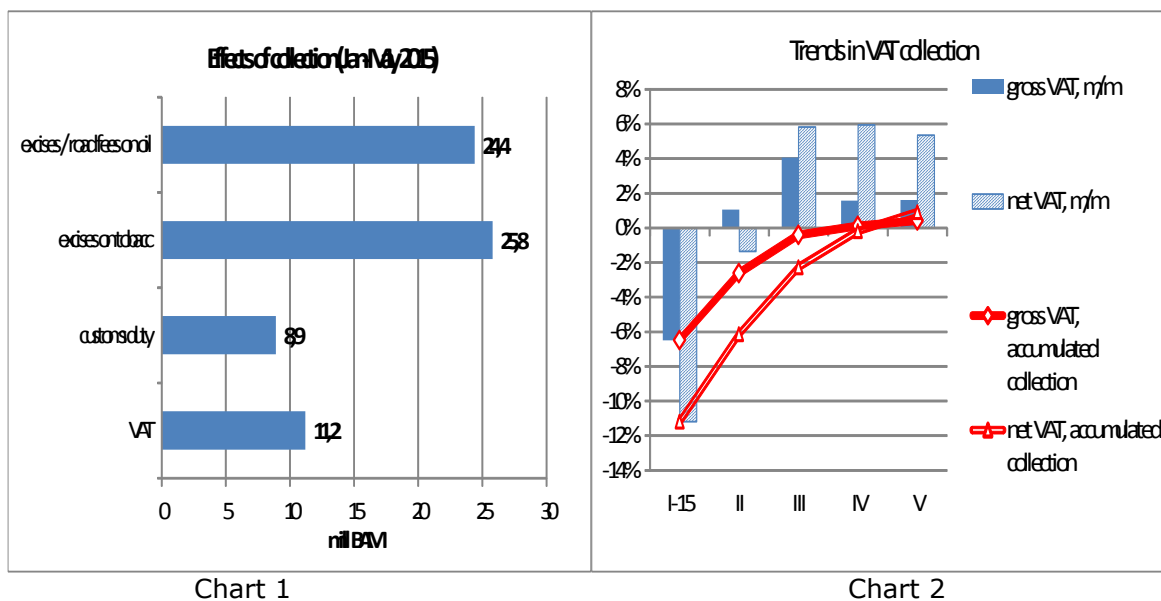
Oma Bilten



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With this issue

According to the ITA preliminary report the gross net collection of indirect taxes in May 2015 was by 5,5% higher than in the same month of 2014. As the payment of refunds at the same decreased by 7,9%, the growth in net revenue was 9%. Cumulative growth of gross collection amounted to 76 million BAM or 3,2% in the period January – May 2015. Cumulative refund payments were lower for 4,8 million BAM than in the same period of 2014, while net cumulative collection, ultimately, increased by 81,3 million BAM or 4,2%. At the five months level the growth was recorded in all main types of revenue and the highest was in excise duties (Chart 1).



Thanks to positive trends in gross collection and refunds at the level of five months the net VAT collection for the first time since the beginning of the year moved into the positive growth zone (Chart 2). Gross VAT for five months in 2015 grew at the rate of 0,4% and net 0,9%. In the period January – May 2015 VAT refunds decreased by 0,9%. The reasons for this were the reduction of refunds on the basis of international projects, the completion of a large part of investment in TPP Stanari and the maintenance of standard regime of VAT calculation for some companies that perform finishing operations (*lohn business*) in 2015. However, an increase in VAT refund payments could be expected in June and July as a result of export growth of 4,4% in May 2015.

Dinka Antić, PhD
Head of Unit

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Technical design: Sulejman Hasanović, IT expert
Reader/translator: Darija Komlenović, professor

Taxing tobacco in the EU in the period 2005-2014: trends in collection and consumption

(Author: Dinka Antić, PhD)

The paper aims to analyze implications of excise policy in Member States and at EU level in the period 2005-2014 based on the research of trends in consumption and revenues from excise duties on tobacco products in the European Union. From trends in the consumption of tobacco products it can be concluded that the policy which was based on the increasing excise burden on cigarettes while maintaining low excise duty on fine cut tobacco in most Member States led to distortions in the tobacco market and loss of excise revenues. The study presented in this paper confirmed the key hypothesis that the excise policy in Member States and at EU level cannot be effective without careful balancing the structure, amount and dynamics of increase in the tax burden on cigarettes and all products that may appear as their substitute.

1. INTRODUCTION

In the last ten decade, tobacco market trends indicate that taxation policies of other tobacco products that may appear as substitutes to cigarettes can be of great importance for the creation of an effective excise policy. In recent years, the increasing substitution of cigarettes with fine cut tobacco has led to tobacco market distortions, the growth of the black market and illegal trade resulting in a drop in revenues from excise duties. It is evident that the substitution of cigarettes with fine cut tobacco becomes a factor which not only threatens the realization of set goals of fiscal and health policy but also derogates results achieved so far in combating tobacco consumption especially among vulnerable groups and the young.

The paper aims to explore the implications of the excise policy design in the EU and its Member States in the field of tobacco products within the period 2005-2014, focusing on the development of the convergence process of excise policy advocated by the EU and the increasing substitution of cigarettes with fine fine cut tobacco. Given that the research period coincides with the beginning of implementation of the new policy of excise duties on tobacco in B&H, the paper will give the score of achieved degree of harmonization with EU standards.

2. REVIEW OF LITERATURE

States turn to higher taxes in the first place to increase the flow of revenues. High capacity in excise duties on tobacco is the result of inelasticity of the tobacco demand, so that high income can be achieved even in a situation of price increases due to tax increases. According to analyses of the World Bank (1999) the growth of the tax burden of 10% on average brings the growth of tax revenues from cigarettes of 7%. The increase in the tax burden does not bring a proportionate increase in revenues due to income and substitution effects produced by taxes. Higher allocation for taxes inevitably leads to a reduction in consumption, and on the other hand consumers are trying to avoid the tax burden or reduce it in order to maintain the previous level of consumption. Excessive growth of taxes can produce the opposite effects on the growth of income if the tax burden exceeds the consumer' threshold of endurance, as Laffer curve shows. Further continuation of the increasing taxation policy leads to a serious erosion of revenues, growth of tax evasion and the expansion of the black market. Revenue growth is not also proportional due to the heterogeneity of consumers. The drop in consumption is higher in people with lower incomes, which leads to a smaller increase in revenues from excise duties. Based on researches of about 100 papers and studies in past fifty years it is concluded that most studies from countries with

high incomes show price elasticity ranging between 0,25 and 0,5, with most of countries concentrating around 0,4 (Chaloupka et al., 2012). Cnossen (2006) lists Viscusi's overview of results from 41 researches on the effects of cigarette prices on demand, of which 31 apply to the USA and the rest to the UK. The demand elasticity ranged between -0,4 and -1,0 in the US, and in the UK between -0,1 and -0,8. The World Bank research (1999) showed that the demand elasticity for cigarettes is dependent on the level of development of the country. In developed countries with high incomes the average price increase of 10% per pack of cigarettes leads to a drop in consumption of 4%, while in developing countries that belong to the group with low and middle incomes a drop in consumption on average amounts to 8%.

Some studies have come to the conclusion that the elasticity of cigarettes varies according to the horizon of observation, income and age structure of consumers. Numerous studies over the last decade have shown that demand for cigarettes is price inelastic in the short term, while in the longer term it shows a greater degree of flexibility (Ramboll, 2014). Furthermore, demand for cigarettes is more elastic in people with low income. Analyses of the World Bank (1999) have shown that an increase in cigarette prices to a greater extent affects the poorer classes of consumers than richer because of low incomes, and the younger population, which has limited incomes. *Chaloupka et al.* (2002) cite studies in which it was found that the elasticity of demand for cigarettes of the young depends not only on their income, but also on the prices of other goods consumed by the young. Based on the analysis of trends in consumption of cigarettes and other goods among the young in the US at the time of a strong growth in the price of fuel, correlation between a decline in cigarette consumption and an increase in fuel prices can be seen. Explanation of analysts is that young people, when they find themselves in a situation where they must choose between cigarettes or to drive a car, prefer to choose a car and therefore fuel consumption.

Mentioned studies of behavior of young people indicate the importance of cross-elasticity of demand for design of policy of excise duties on tobacco. In conditions of the existence of cross-elasticity of goods, when buying one good depends not only on the price of the good, but also on the price of substitute or complementary goods, the state by its tax policy can provide a strong incentive for consumers to legally avoid paying high taxes, while at the same time they gain benefits from spending they had before the tax increase. This will derogate the expected goals of tax policy; produce distortions in the market and allocation of capital in terms of moving demand towards substitutes, as a result of tax measures, and not of the increase in efficiency in their production. A. Smith (1776) has pointed out the harmfulness of differentiated taxation of substitutes. Starting from the fact that the introduction of various excise duties on beer in England in his time led to harmful tax competition and increased tax revenue collection efforts at no visible fiscal effects, Smith argued for a tax system in which the substitutes will be subject to a single tax on consumption.

Empirical studies show that the main trigger for the occurrence of tax evasion in the last two decades was the policy of differentiated taxation of cigarettes and tobacco used for the rolling of cigarettes (so called RYO tobacco - *Roll-Your-Own tobacco*). Differentiated taxation of tobacco products has led to the migration of consumers from the market of cigarettes, products characterized by high prices, and consequently, higher taxes, towards the market of fine cut tobacco, cheaper product which is less taxed. Townsend (1998) cited the example of Norway, where an increase in cigarette taxes led to an increase in consumption of manually rolled cigarettes, and Egypt, which increasing taxes on cigarettes has led to an increase in demand for lower-taxed pipe tobacco (*shisha*). De Beyer and Yurekli (2000) point out that a similar thing happened in Indonesia, which increased taxes on white cigarettes but not on *kreteks*. Mentioned researches indicate that the negative effects of differentiation of excise taxes amplified in less developed countries with inefficient customs and tax administration, poor tax discipline, higher degree of corruption, weak control mechanisms and ineffective sanctions for tax frauds.

An extensive investigation of tax evasion for the European Commission, based on information collected from the customs services and the press, or by interviewing producers and consumers, found that about 13% of revenues from excise duties are lost annually in the EU due to illegal tobacco (Rambell, 2014). Unlike the EU, recent consequence studies of substitution of cigarettes for fine cut tobacco in B&H are performed based on actual statistical data on imports of cigarette-paper and norms of "homemade" cigarette production (Antić, 2014). The research has shown that the ratio of rolled cigarettes consumption and taxed cigarettes consumption from year to year increases dramatically. From negligible 3,6% in 2011, in 2012 it increased by 16% and in 2013 by even 33%. The author concludes that the potential consumption of cigarettes, if all consumers who roll cigarettes switch to taxed cigarettes, would still be lower than the total actual consumption (taxable and non-taxable), because one must take into account the limitation of disposable income for the purchase of tobacco and the price difference between cigarettes obtained by rolling and the cheapest taxable brand.

From the practice of Poland it can be concluded that the cigarette market can be stabilized by the adequate excise policy which will cover all the cigarette substitutes. Growth in retail cigarette prices, encouraged by the increase in excise duties, produced a strong migration of consumers towards rolled cigarettes. By increasing excise duties on fine cut tobacco Poland only managed to alleviate tax evasion, as consumers switched to the consumption of pipe tobacco which was taxed to a lesser extent compared to cigarettes and fine cut tobacco (WHO, 2011). From the example of Poland it can be concluded that there is always a danger that excise duties do not include, or at least not sufficiently, all potential substitutes. In terms of technological innovations that result in the rapid growth of the market, as is the case with e-cigarettes, it is necessary to precisely define different "borderline" tobacco products in order to avoid erroneous classification in non-taxable products, and expand the scope of taxation to raw tobacco, tobacco leaves, wastes, etc. (Ramboll, 2014).

Mentioned researches lead to the conclusion reached by A. Smith, that the most effective design of the excise policy would imply the application of a single rate. However, Cnossen (2006) is of the opinion that regarding a design of the excise policy one should take into account the cost aspect of the substitute production. Although cigarettes are the most important tobacco product on the market, there are also other products, such as cigars and cigarillos that are consumed by shortlisted consumers. Finally, fine cut tobacco, chewing tobacco, snuff or pipe tobacco is used for smoking. Different types of smoking tobacco are used for the personal production (rolling) of cigarettes. Basically it is lower quality processed products which are sold at lower prices, and it is logical that they are subject to lower tax rates. Cnossen (2006) believes that it is realistic that the excise duty per 1 kilo of fine cut tobacco should amount to 2/3 of the excise duty on cigarettes, expressed per 1 kilo of tobacco contained in cigarettes. Differences in taxation are necessary to reflect differences in the quality and costs between industrial production of cigarettes and tobacco wrapping.

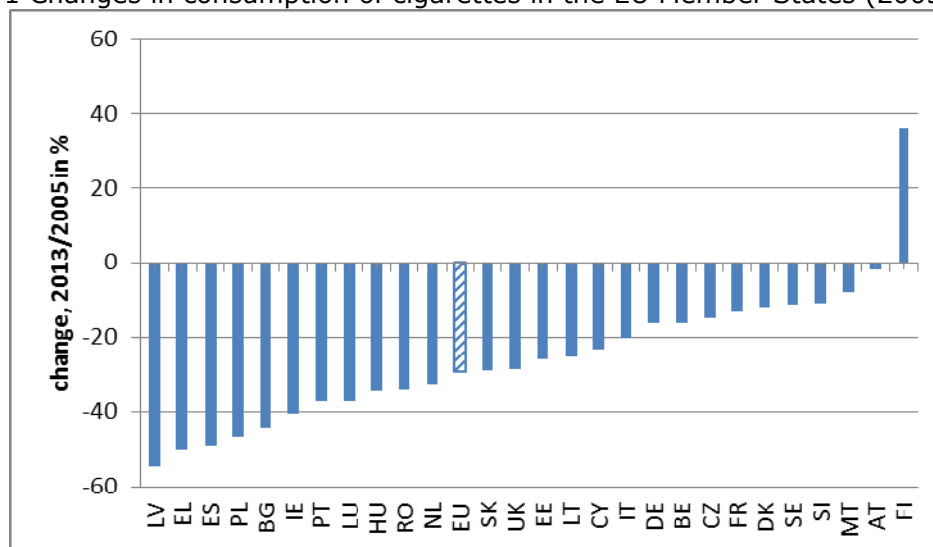
3. TRENDS IN REVENUES FROM EXCISE DUTIES ON TOBACCO (2008-2014)

Continuous increase in excise duties on cigarettes¹ in most Member States has, as expected, brought an increase in retail selling prices and, consequently, a strong reduction in cigarette consumption. Comparison of cigarette consumption in 2013 with the consumption in 2005 shows that a decrease in consumption is recorded in all Member States, and in some of them the consumption is halved. The increase in consumption of cigarettes in 2013 in Finland is a result of the accumulation of amounts of cigarettes before the increase in excise duties in 2014 (Chart 1).

¹ More: Antić D., „Policy of excise duties on tobacco in the EU in the period 2005-2014: evolution and process of convergence”, OMA bilten #114, January 2015, www.oma.uino.gov.ba.

Banja Luka: Bana Lazarevića, 78 000 Banja Luka, Tel/fax: +387 51 335 350, E-mail: oma@uino.gov.ba
Sarajevo: Đoke Mazalića 5, 71 000 Sarajevo, Tel:+387 33 279 553, Fax:+387 33 279 625, Web: www.oma.uino.gov.ba

Chart 1 Changes in consumption of cigarettes in the EU Member States (2005-2013)



Note: Consumption in Greece for 2013 relates to the period January – November.

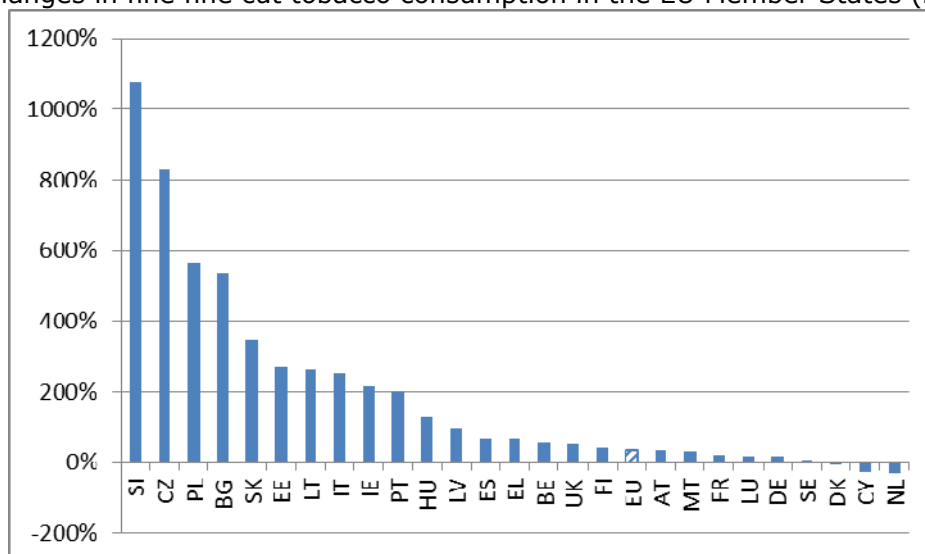
Source: European Commission; Author's calculation.

The increase in excise burden on cigarettes was not the only reason for the decline in cigarette consumption in the EU Member States. Another reason was inconsistent policy of taxation of tobacco products in the EU, which favored fine cut tobacco. Raising the minimum excise duty on cigarettes in the EU to 90 EUR/1.000 pieces, which was not accompanied by adequate increase of excise duty on fine cut tobacco, for consumers of most Member States represented the trigger for mass migration from the cigarette market to the fine cut tobacco market. Consumption of fine cut tobacco in some Member States in just a few years has doubled while Slovenia and Romania recorded enormous growth (Chart 2).

New trends have brought a new analytical approach in researches of tobacco market. Until a few years ago, analyses of tobacco market limited only to cigarette market as the share of other tobacco products was minor. After the emergence of a strong substitution of cigarettes for fine cut tobacco it is necessary to consider total trends in all tobacco products. Otherwise, without considering the overall trends, observing only the cigarette consumption could create the illusion that trends in the tobacco consumption were in line with the health policy goals.

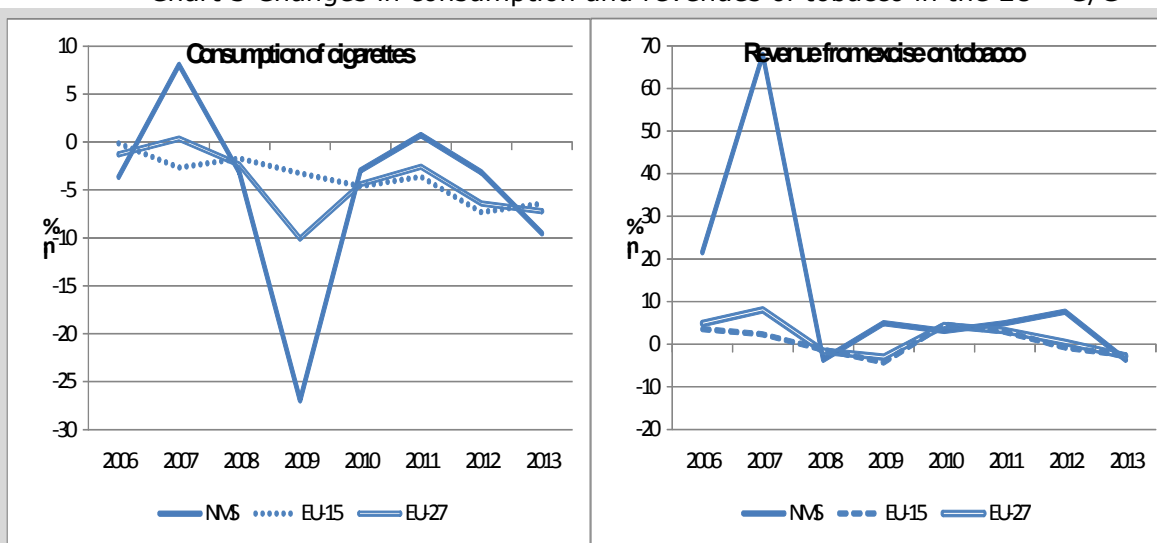
Growing excise burden on cigarettes in the EU to a certain moment brought the growth in revenues from excise duties but then a stronger decline in cigarette consumption offset the increase in excise duties and in some Member States it exceeded leading revenues into a negative growth zone.

Chart 2 Changes in fine cut tobacco consumption in the EU Member States (2008-2013)



Notes: ^a Consumption in Greece for 2013 relates to the period January – November.
^b Romania has been omitted due to enormous growth over 2000%.
 Source: European Commission; Author's calculation.

Chart 3 Changes in consumption and revenues of tobacco in the EU – G/G



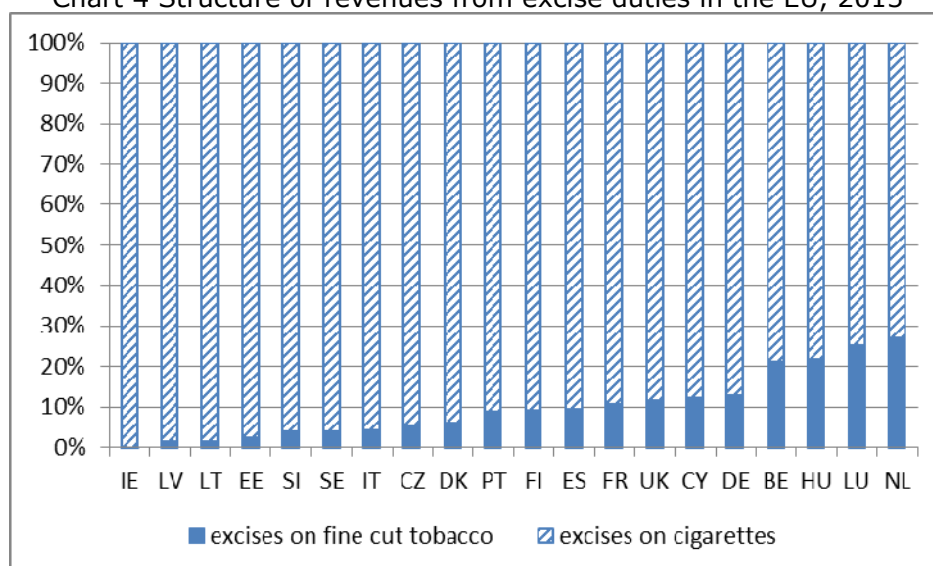
Source: European Commission (except for revenues in Romania in 2013 which were obtained from the Ministry of Public Finance of Romania); Author's calculation.

Overall, the consumption of cigarettes and revenue collection in the new Member States has been subject to strong fluctuations due to harmonization with the minimum excise duty of EUR 64, and in the last two years due to the growing substitution of cigarettes for fine cut tobacco. As expected, the increase in excise duties in the new Member States has brought enormous revenue growth in the first few years, and after stabilization of revenues there was a slowdown of the growth. On the other hand, cigarette consumption in the EU-15 has been continuously declining, but with no major fluctuations, while revenues fluctuated in the range from -5% to 5% (Chart 3). The extent of erosion in cigarette consumption and revenues is best shown by the comparison related to the base year 2005. Cigarette consumption in the EU-15 in 2013 was reduced to 70% of consumption in 2005. Revenues from excise duties on cigarettes were in the same period increased by 4% with a downward trend, although the excise burden on the price of cigarettes on

average increased by 47%. Although, due to higher weights, the trends in the EU-15 mainly determine trends in the EU-27 it is interesting to analyze the trends in the new Member States. Increase in the excise burden on cigarettes by an average of 133% for nine years of the harmonization process has brought a growth of excise revenues of 131%, whereas at the same time the consumption of cigarettes dropped to 63% of consumption from 2005. The results of the above analysis are confirmed by trends in Member States in the period 2011-2013 when the effects of substitution of cigarettes are mostly shown. Of 27 Member States, ten of them which carry 37% of revenues, in the last three years showed negative trends in the collection of revenues from excise duties on cigarettes. Of these ten Members, of which nine belong to the EU-15, four of Member States in all three years recorded a drop in revenues with the deterioration tendency, and others recorded a decline in revenues in the last two years. On the other hand, five new Member States recorded strong revenue growth; five recorded stable or moderate growth, while Romania recorded zero growth. Bearing in mind that excise duties are much higher in old Member States than in new Member States existing trends indicate negative sides of rapid growth in excise duties, which on the one hand, was not accompanied by adequate measures to prevent tax evasion and frauds, and on the other hand, by adequate tax policy of substitutes.

Reduction in cigarette consumption and increase in fine cut tobacco consumption, in addition to fiscal losses, led to changes in the structure of excise revenues (Chart 4).

Chart 4 Structure of revenues from excise duties in the EU, 2013



Source: European Commission; Author's calculation.

From an insignificant share in revenues in the last two years, the share of revenues from excise duties on fine cut tobacco is growing rapidly. This trend is the result of the cumulative effect of the nominal decrease in revenues from excise duties on cigarettes and nominal growth in excise duties on fine cut tobacco, which is the result of inconsistent excise policy on fine cut tobacco in the EU.

4. REDEFINING THE TAXATION POLICY OF OTHER TOBACCO PRODUCTS IN THE EU

Analysis of the policies and trends in consumption and revenues indicated large distortions in the market of cigarettes, which are the result of differentiated taxation of substitutes and poor mechanisms for the prevention of tax evasion. In addition to undermining the revenue collection the substitution of cigarettes for fine cut tobacco seriously jeopardizes the realization of the health policy objectives. Instead of being an instrument that would discourage tobacco consumption, the excise policy has not only enabled consumers with lower incomes to maintain the same volume of

tobacco consumption, but it has also encouraged them to buy cheaper and low quality tobacco. The unsustainability of the current situation suggests the need for urgent redefinition of the excise policy on fine cut tobacco and other cigarette substitutes. The harmonization of excise duties on cigarette substitutes should stop further growth of legal and illegal substitution in consumption of cigarettes and in the long term stabilize the cigarette market, in order to continue with the application of measures to discourage tobacco consumption.

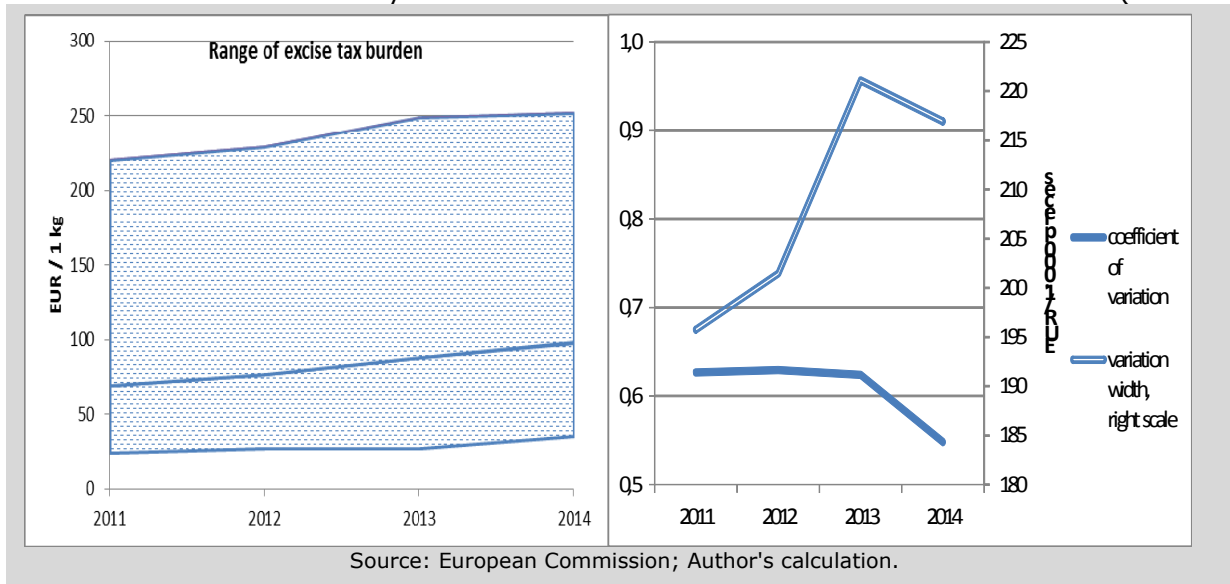
For many years the taxation of other tobacco products (cigars, cigarillos, fine cut tobacco, other smoking tobacco) was considered as residual segment of the taxation policy of tobacco due to a minor share in revenues and tobacco market. According to EU directives other tobacco products can be subject to only *ad valorem* excise or to only specific excise or a combination of *ad valorem* and specific excise. When the single market has been establishing, the taxation of fine cut tobacco in the amount of 30% of the retail selling price including taxes or EUR 20/kg was stipulated. Rates of excise duties on fine cut tobacco have not been changed until 2001. In the period 2001-2004 the rate was increased from EUR 24/kg to EUR 32/kg. The following increase was recorded in 2011 (EUR 40/kg), and then in 2013 (EUR 47/kg). Other smoking tobacco is currently taxed with EUR 22/kg or 20% of the retail selling price.

Analysis of the taxation policy of fine cut tobacco in the previous years indicates a significant increase in the excise burden on fine cut tobacco in EU Member States. Basically, the increase in the excise burden is achieved by (i) increasing the existing specific excise duty, (ii) introduction of the specific excise duty and a drastic reduction of the *ad valorem* excise duty or (iii) in Member States with a mixture of excise duties by the increase in the specific excise and reduction of the *ad valorem* excise.

In 2011 in six Member States fine cut tobacco was subject to only *ad valorem* excise and in 2014 in only three, out of which two have in the meantime increased the rate, while Hungary kept the same rate of the *ad valorem* excise duty, provided that the effect of the increase in the excise burden was achieved by increasing the VAT rate. The number of Member States that have only the specific excise duty was in the period 2011-2014 doubled, from 7 to 15 (including Croatia), and the number of Member States that have a mixture of the *ad valorem* and the specific excise duty was reduced from 14 to 10. Contrary to trends in the EU, Slovenia insignificantly increased the specific excise duty but as of 1 of July 2014 it has introduced the *ad valorem* as well, which ultimately led to strong growth in the excise burden.

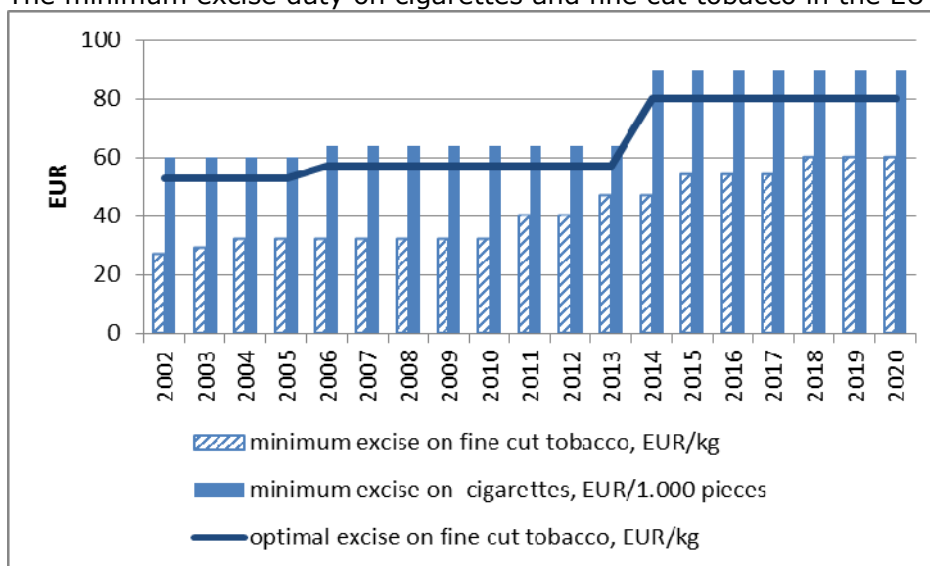
On the whole, the policy of increasing excise duties on fine cut tobacco in the last four years has led to the growth of the average excise burden on fine cut tobacco in the EU by 40% (Chart 5). In the period 2010-2013 inconsistent policies of Member States led to the growth of the variation width. Only the last measures for the consolidation of the excise policy in 2014 resulted in a greater convergence of excise rates that reflected in the decrease of variation coefficient and variation width narrowing.

Chart 5 Measures of variability of the excise burden on fine cut tobacco in the EU-27 (2011-2014)



Although the policy of minimum excise duty on fine cut tobacco has in the past few years based on strong growth in excise duties, parallel increase in the minimum excise duty on cigarettes to a certain extent from the start derogates the expected success of this policy. Even the planned increase in excise rates on fine cut tobacco by 2020 will not significantly reach the level of Crossen's optimal excise burden on fine cut tobacco of 2/3 of the excise burden on cigarettes, measured for 1 kg of tobacco contained in cigarettes (Chart 6).

Chart 6 The minimum excise duty on cigarettes and fine cut tobacco in the EU by 2020.



It can be expected that a strong tax pressure on fine cut tobacco consumption in the following years will discourage the consumption of fine cut tobacco. However, given the experience of Poland and some other countries outside the EU it is necessary to consider the taxation of other substitutes such as pipe tobacco and other types of smoking tobacco. At the moment there is a huge gap between the taxation of fine cut tobacco and other tobacco, which will be in the following years even higher due to further increase in excise duties on fine cut tobacco. In addition,

economists warn of a need for a more precise definition of tobacco products, which entails the proper positioning of excise rates, particularly for raw tobacco. Finally, the rapidly growing market of e-cigarettes is a serious warning to the EU and Member States that in the coming years a stronger substitution of cigarettes for e-cigarettes can be expected. Currently, only in two Member States, Belgium and Luxembourg e-cigarettes are taxed if they contain tobacco extract (Ramboll, 2014).

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Consolidated reports

(Author: Aleksandra Regoje)

Table 1 (Consolidated report: General Government)

Preliminary consolidated report includes:

- revenues and expenditures of the budget of Institutions of Bosnia and Herzegovina,
- revenues and expenditures of the budget of the Federation of Bosnia and Herzegovina, cantons, cantonal directorates for roads, municipalities and funds in FB&H,
- revenues and expenditures of the budget of the Republika Srpska*, directorates for roads/highways, municipalities and funds,
- revenues and expenditures of the budget of Brčko District and funds in BD

**Includes: (A) Budget of the Republic and extra-budgetary funds recorded in Treasury General Ledger of the RS, (B) total foreign debt for the projects realized through municipalities and companies, and (C) Budget users who have their own bank accounts (including foreign project implementation units established by ministries)*

Consolidated report: General Government B&H, I-III 2015

(in million BAM)	Q1
Revenue	2.726,1
Taxes	1.420,0
Direct taxes	243,1
Taxes on income, profits and capital gains	209,9
Taxes on payroll and workforce	3,4
Taxes on property	29,8
Indirect taxes	1.148,0
Other taxes	28,9
Social security contributions	1.000,8
Grants	13,3
Foreign grants	11,3
Transfers	1,9
Other (non-tax) revenue	292,0
Expenditure	2.592,2
Expense	2.548,9
Compensation of employees	818,2
Use of goods and services	473,2
Social benefits	1.100,1
Interest	47,7
Interest payments to non-residents	25,3
Interest payments to residents	22,4
Subsidies	33,2
Grants, transfers	13,7
Other expense	62,8
Net acquisition of nonfinancial assets	43,3
Acquisition of nonfinancial assets	52,6
Disposal of nonfinancial assets	9,3
Gross/Net operating balance (revenue minus expense)	177,2
Net lending /borrowing (revenue minus expenditures)	133,9
Net financing = (Minus) Net lending /borrowing	-133,9

Table 1