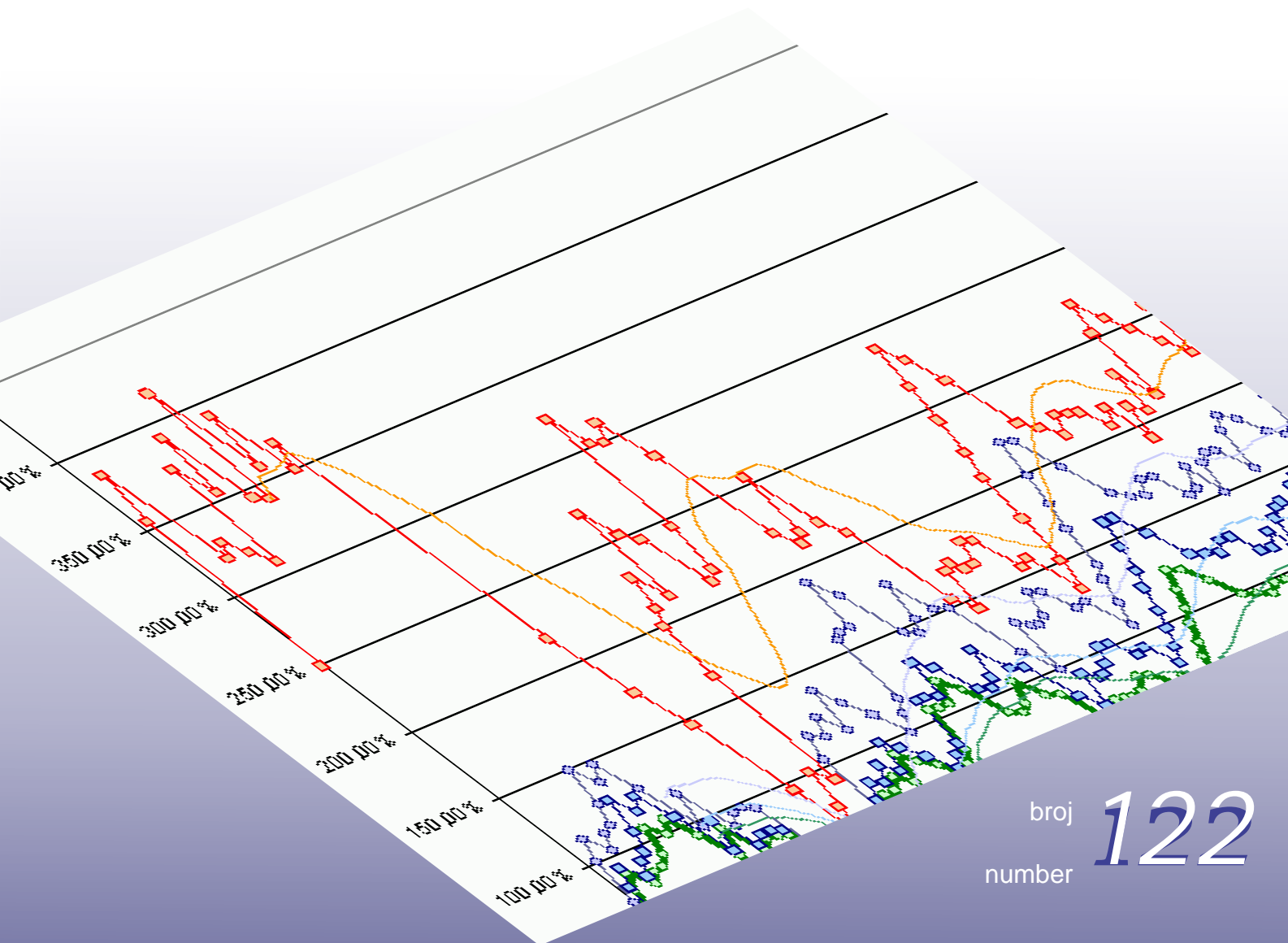


Bosna i Hercegovina
Odjeljenje za makroekonomsku analizu
Upravnog odbora Uprave za indirektno-
neizravno oporezivanje



Macroeconomic Unit of the Governing Board of the Indirect Tax Authority

Oma Bilten



broj **122**
number

Septembar 2015

Rujan 2015

2015

September 2015

With this issue

According to the preliminary report, it was collected 552,5 million KM gross revenues from indirect taxes on the Single Account of ITA in August 2015, which is 11,6 million KM less than in the same month of 2014. Since the payments of refunds increased by 4,2 million KM, the fall in net collection was slightly higher, 15,8 million KM or 3,3%, compared to a net collection in August 2014. The decrease in net collection has been recorded for the first time after six months of consecutive positive trends. Because of the cumulative effect of lower gross collection and larger refunds, the cumulative net surplus in 2015 was reduced to 143,8 million KM. However, negative trends in August still could not significantly jeopardize the current positive trends in collection of indirect taxes, which after eight months record a high growth of 4,4% compared to the same period of 2014 (Chart 1).

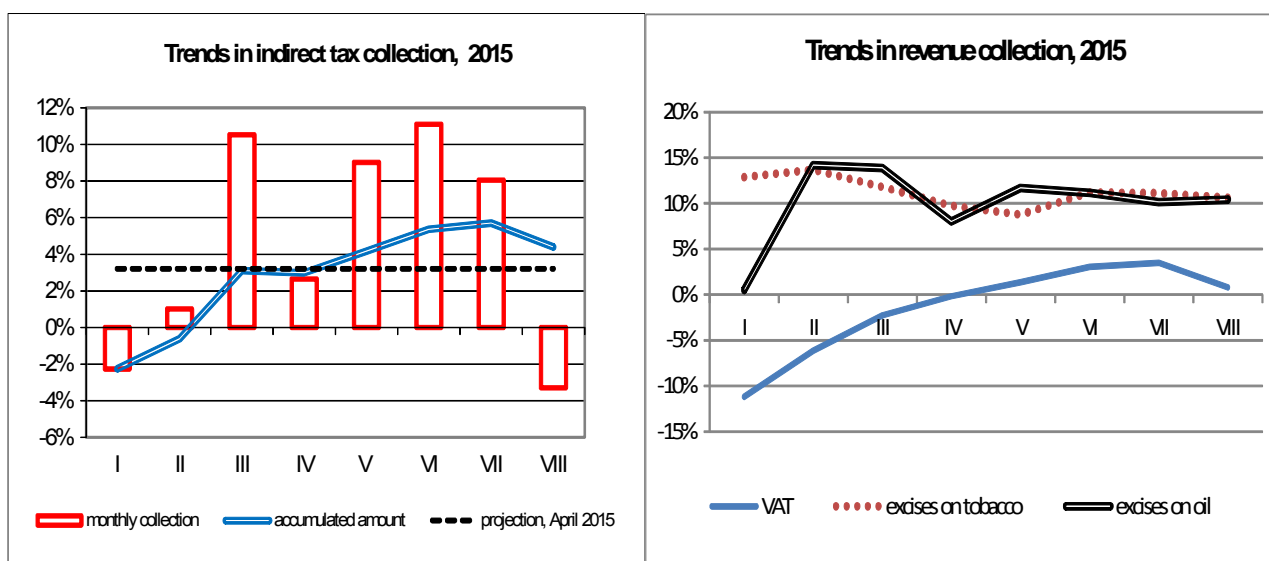


Chart 2 shows the trends in cumulative collection of certain types of indirect taxes which, given their dominant share in total revenues from indirect taxes, also dictate current trends in 2015. The most stable growth for eight months of 2015 was recorded in revenues from excises on tobacco. Excises on oil derivatives were unstable only in January 2015, while in other months their growth has been high and stable. Positive growth in cumulative net VAT collection has appeared only since May, with the slowdown in July, and the fall in August. However, since the greatest part of the unadjusted 23 million KM of revenues relates to VAT, after the final adjustment for August, the decline in VAT could be much lower. The charts show a great coincidence of trends of total revenue and of VAT, and the extent to which revenues from VAT determine the trend of the total collection.

Dinka Antić, PhD
Head of Unit

Table of contents:

Excise policy in B&H in the light of the EU trends in taxation of tobacco	2
Consolidated reports	9

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

Excise policy in B&H in the light of the EU trends in taxation of tobacco

(Author: Dinka Antić, PhD)

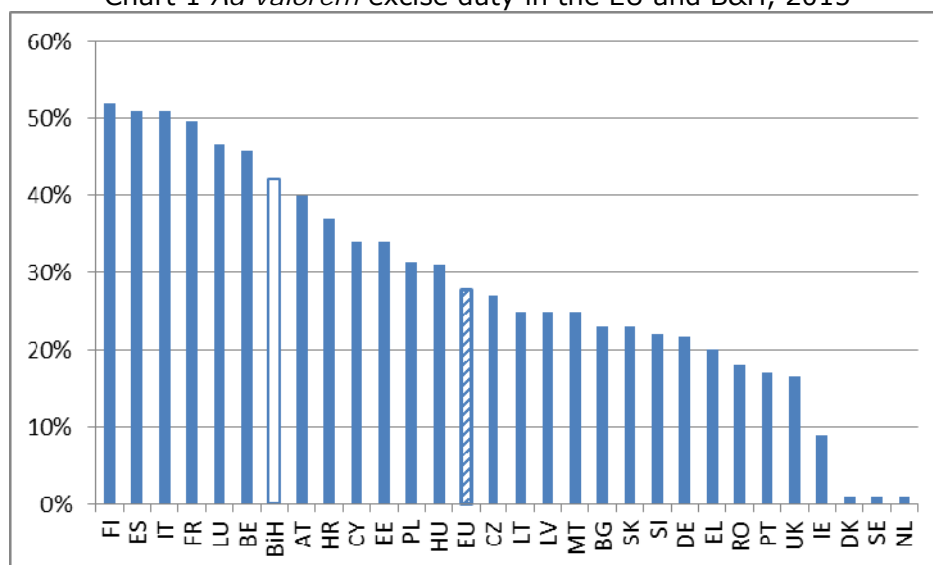
POLICY AND TRENDS

In mid 2009 B&H has started with the harmonization process of tobacco product taxation with the minimum EU standards. The process included the retention of the *ad valorem* excise rate on all tobacco products in the amount of 42% of the retail selling price and the introduction of 0,15 KM/pack of the specific excise duty on cigarettes. Another new element is the introduction of the category of minimum excise duty on all cigarettes which binds to the category "the most popular price of cigarettes" as the reference brand for the application of the minimum rate of excise duties. Finally, the Law provides for the gradual annual increase in the specific excise duty on cigarettes from a minimum of 0,15KM/pack until it reaches the minimum excise in the amount of 126 KM/1.000 pieces of cigarettes (or EUR 64/1.000 pieces). Other tobacco products (cigars, cigarillos, fine cut tobacco, etc) have been subjected to only *ad valorem* excise of 42% on the retail selling price with taxes included.

The introduction of the specific excise duty brought vertiginous growth in revenues and modest decline in consumption of cigarettes. However, the growing gap in the tax burden on cigarettes and fine cut tobacco has led to a severe decline in cigarette consumption due to the substitution of cigarettes for branded and non-branded fine cut tobacco and, consequently, to the appearance of the black market and tax evasion (Antić, 2014). Amendments to the Law on Excise Duties, which entered into force on 1 of August 2014, have primary been aimed at preventing a reduction in revenues and suppressing the black market of rolled cigarettes. Minimum pace of increase in the specific excise duty in the amount of 0,15KM/pack per year is maintained, but the Governing Board of the ITA may decide to increase the amount. Reference threshold for harmonization of the excise burden on cigarettes is increased to the level of EUR 90 /1.000 pieces of cigarettes.

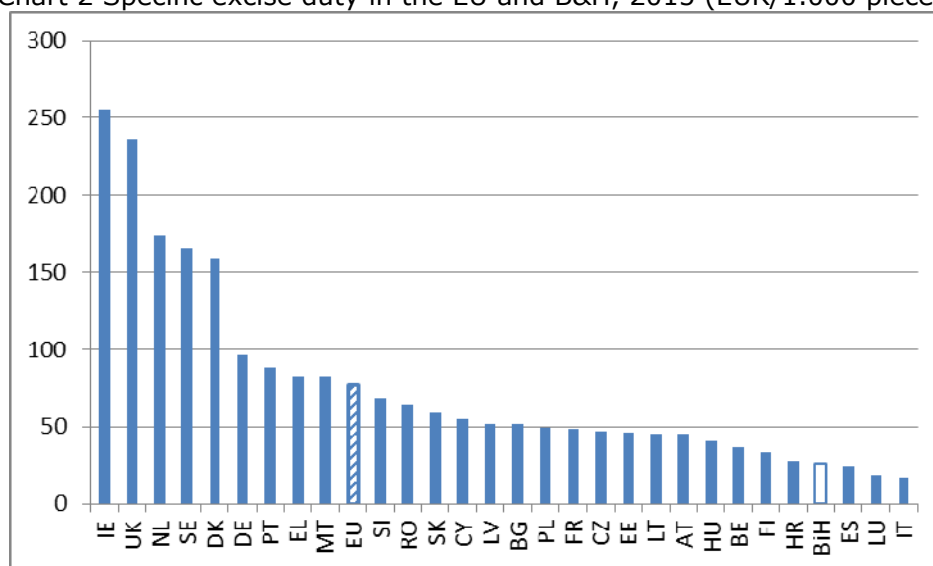
The new excise policy in B&H in the field of taxation of tobacco products means more new elements. Instead of the concept of the most popular price category of cigarettes a minimum excise duty on cigarettes shall be determined on the basis of the concept of the weighted average retail selling price of cigarettes. Bearing in mind that in the last four years the most popular price categories of cigarettes implied the cheapest brands the minimum excise duty on cigarettes, which was so far determined based on the concept of the most popular price category of cigarettes, has lost its meaning. By amendments to the Law the concept of the EU for determining the minimum excise duty on cigarettes is taken, which implies the calculation based on the weighted average retail selling price of cigarettes. Unlike the EU, the weighted average retail selling price of cigarettes in B&H is determined by October 31 of the current year for the following year. This shift has resulted in the different period for the calculation, which in the case of B&H does not coincide with the calendar/fiscal year but covers the first half of the current year and the second half of the previous year. The amendments stipulate that the minimum excise duty on cigarettes may not be less than 60% of the said base.

B&H is at the top of Europe according to the amount of the *ad valorem* excise duty of 42% because only five Member States have a higher rate (Chart 1). However, it should be noted that only a few years ago the situation was quite different, so in 2008 eleven Member States had a higher rate of the *ad valorem* excise duty than B&H.

Chart 1 *Ad valorem* excise duty in the EU and B&H, 2015

Source: European Commission, 1.1.2015.; Author's calculation.

Chart 2 Specific excise duty in the EU and B&H, 2015 (EUR/1.000 pieces)



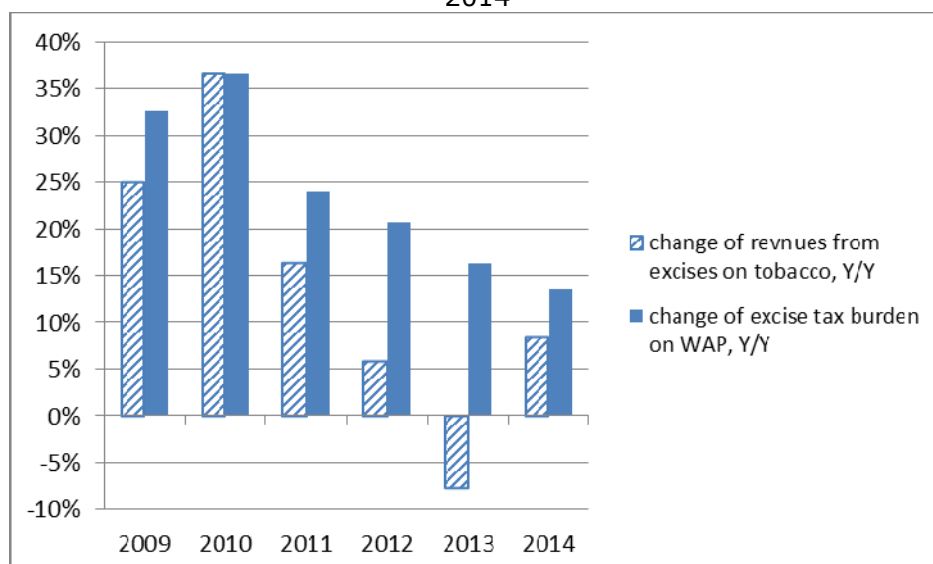
Source: European Commission, 1.1.2015.; Author's calculation.

Regarding the amount of the specific excise duty, besides the continuous increase for many years, B&H has not advanced much in relation to EU Member States. Only two EU Member States (Luxembourg and Italia) have lower rates of the specific excise duty than B&H (Chart 2). The latest increase in the specific excise duty will not significantly move B&H to higher place given that at the same time EU Member States increase rates in order to comply with the EU minimum excise duty.

The introduction of the specific excise duty in middle of 2009 and continuous increase in the first years led to a decrease in consumption within expected scope (4% - 8% annually). Already in 2012 a decline in consumption of taxed cigarettes has exceeded 12% and in 2013 20%. In general, for a period of five years the cigarette consumption in B&H is reduced by more than 40%. These trends, however, cannot be taken as real due to the strong growth of the black market of fine cut tobacco in recent years when there was a huge increase in consumption of fine cut

tobacco by 700%. Erosion of consumption of cigarettes over the expected affected the revenues as well. For the first years of harmonization of excise duties B&H recorded enormous growth in revenues which began to slow in 2012, and in 2013 revenues from excise duties fell by 7,8%. It can be concluded that in terms of threshold of consumer's endurance from Laffer's curve the year 2013 was obviously a turning point, and tax evasion reached the peak (Chart 3).

Chart 3 Effects of growth in excises on revenues from excise duties in B&H in the period 2008-2014

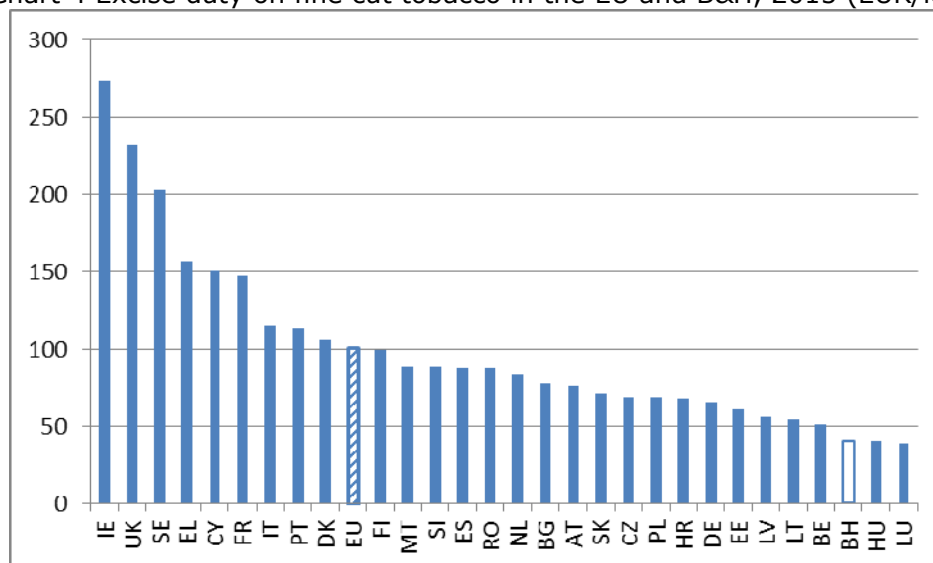


Source: Author's calculation.

Negative trends in revenue collection and the rapidly decline in taxable consumption of cigarettes, with the growing consumption of fine cut tobacco, mainly non-branded, required a different approach to the taxation of fine cut tobacco in B&H. In order to stop the growth of the black market and erosion of revenues it was necessary to discourage the consumption of fine cut tobacco by increasing excise duties. Instead of the *ad valorem* excise duty of 42% from the retail selling price with taxes included, a specific excise duty on fine cut tobacco was introduced as of 1 August 2014. The continuation of the harmonization process of excises on cigarettes with the minimum excise duty in the EU will inevitably lead to an increase in the minimum excise duty on cigarettes. To avoid re-widening the gap between the taxation of cigarettes and fine cut tobacco it was prescribed that the excise duty on fine cut tobacco can amount to minimum 80% of the minimum excise duty on cigarettes expressed for 1.000 pieces.

Introducing the specific excise duty on fine cut tobacco has tripled the excise burden on 1kg of fine cut tobacco since 1 August 2014, from an average 25KM it was increased to 78KM/kg (EUR 39,90 for 1 kg). The ITA GB decision determined the excise duty on smoking tobacco in 2015 in the amount of 80 KM/kg (or EUR 40,90 for 1 kg). However, even this drastic increase has not significantly shifted B&H in relation to the EU average and other Member States (Chart 4). Since EU directives allow a different approach to the taxation of fine cut tobacco, diversity of policies of the EU Member States is not surprising.

Chart 4 Excise duty on fine cut tobacco in the EU and B&H, 2015 (EUR/kg)



Source: European Commission, 1.1.2015.; Author's calculation.

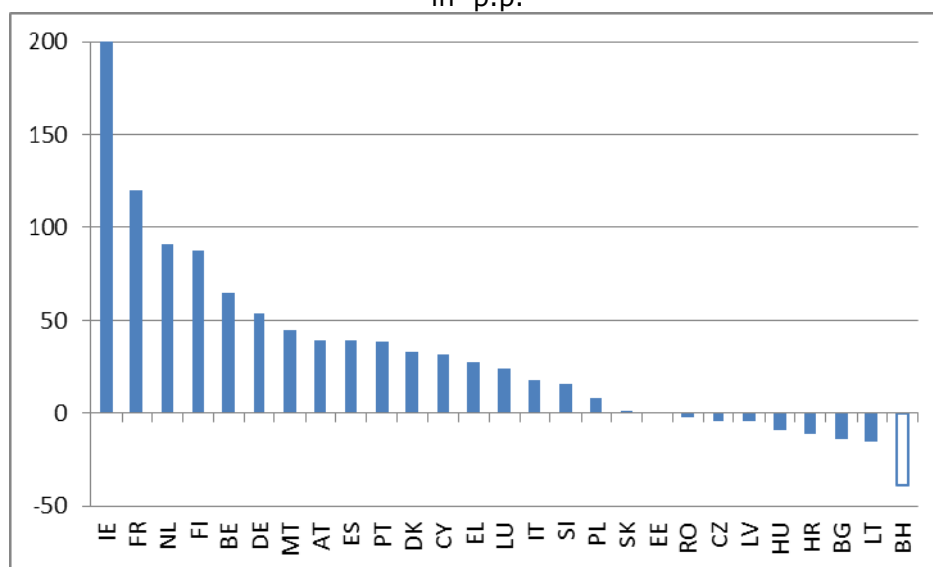
In the analysis of the excise burden in Member States one must bear in mind a different approach to taxation. This means that data for Member States which have the specific excise duty show the exact burden on 1 kg of fine cut tobacco, regardless of the various retail selling prices of different brands. For Member States that have the *ad valorem* excise duty the amount of excise duty is calculated by applying the rate of the *ad valorem* excise duty on the average weighted price of fine cut tobacco expressed for 1 kg. Thereat, the average weighted price reflects the structure of the tobacco market in terms of prices, quality, packaging and the share of each brand. For Member States that have a combination of the *ad valorem* and specific excise duty, the amount of the total excise burden is calculated by adding the specific excise duty (contained in 1 kg of any tobacco classified as fine cut tobacco) and excise duty obtained by applying the *ad valorem* excise duty on the weighted average price of fine cut tobacco expressed for 1 kg. In the case of Member States which have the *ad valorem* excise duty it should be borne in mind the impact of demand on the tax burden. If the market structure shifts toward cheaper brands it will automatically change the weighted average price and thus the amount of the *ad valorem* excise duty on fine cut tobacco.

Mentioned news in the excise policy in B&H entirely represents a significant shift in harmonizing excise policy on tobacco products with minimum EU standards. In relation to the standards, B&H has even made a step further as it prescribed the same level of excise duty on cut and other types of smoking tobacco which is not the case in the EU. Other tobacco for smoking shall be considered to include remnants of tobacco leaves and side products from tobacco processing or from manufacturing of tobacco products. By equating the excise duties on all substitutes of cigarettes B&H is trying to reduce the space for the expansion of legal evasion by substituting fine cut tobacco for other types of tobacco for smoking. However, because of the specific fiscal structure in which the level of B&H is responsible for the excise policy, and an intermediate level of government (Entities) for the control of the market, the expected effects of the new excise policy may be reduced or neutralized by inefficient political and operational measures aimed at combating tax evasion, illegal imports of tobacco and illegal production of cigarettes in the country.

EXCISE HARMONIZATION PROCESS

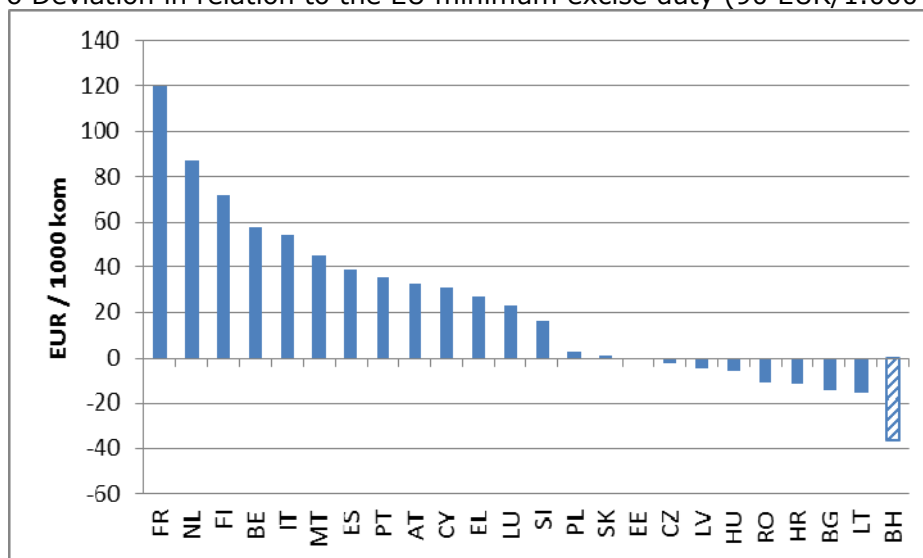
Minimum standards of cigarette taxation in the EU include two standards, the relative – the share of excise duties in the weighted average price of 60% and an absolute – the minimum excise duty in the amount of EUR 90 for 1.000 pieces. As regards the criterion „60%“, review on Chart 5 shows that B&H is currently leading¹.

Chart 5 Deviation of Member States of the EU and B&H in relation to the criterion „60%“ in 2015, in p.p.



Source: European Commission, 1.1.2015.; Author's calculation.

Chart 6 Deviation in relation to the EU minimum excise duty (90 EUR/1.000 pieces)

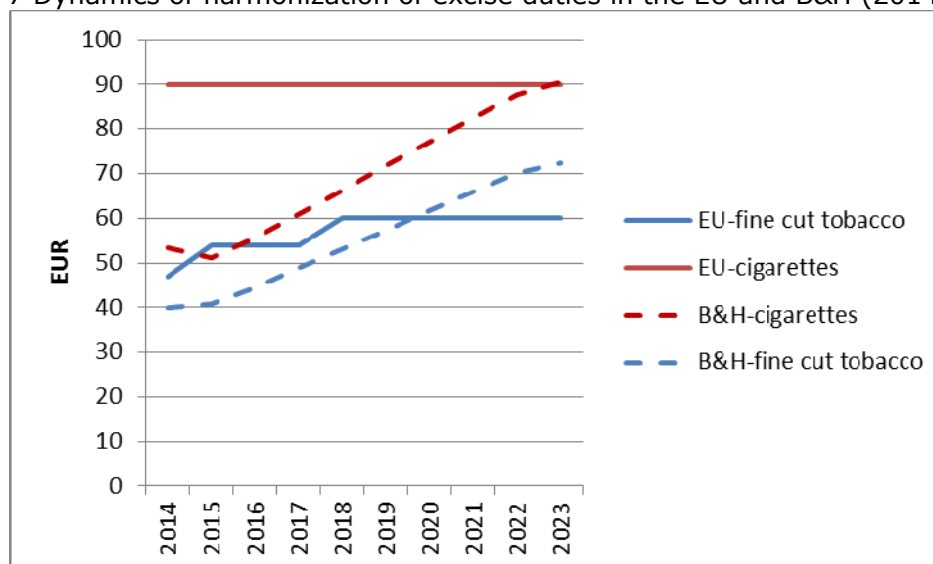


Source: European Commission, 1.1.2015.; Author's calculation.

¹ Note: calculation of the deviation for B&H for 2015 is based on assumption of full pass of the excise increase in 2015 on to customer.

Deviation of the minimum excise duty in B&H in relation to the EU minimum excise duty in 2015 amounts to 38,9 EUR / 1.000 pieces, i.e. 0,77 EUR / pack. From a review of the Chart 6 it can be seen that seven EU Member States have not yet reached the EU minimum excise duty. The reason for this is a transitional period for the harmonization that is approved in Bulgaria, Estonia, Latvia, Hungary, Poland and Romania until 31 December 2017. The same period for compliance is given to Croatia.

Chart 7 Dynamics of harmonization of excise duties in the EU and B&H (2014-2020)



Source: Author's calculation.

If in the coming years there is no change in the amount of the *ad valorem* excise duty and the pace of annual increase in the specific excise duty, the EU minimum excise duty on cigarettes will be reached in 2023 and standards of fine cut tobacco taxation in 2020 (Chart 7).

CONCLUSION

Regarding the evaluation of pace and degree of harmonization of the excise policy in B&H with the EU standards from the analysis it can be concluded that it is necessary to redefine policies of excise duties. First, in terms of the structure of rates (*ad valorem* and specific) the focus of taxation of cigarettes should be moved from the *ad valorem* to the specific excise duty. Secondly, it is necessary to redefine the methodology of calculation of the weighted average price of cigarettes and harmonize it with the EU standards. On the one hand, it will lead to the situation that the minimum excise duty on cigarettes will get full meaning of protective excise duty for the revenue collection, and on the other hand, the policy of fine cut tobacco taxation will be placed on a more realistic basis in relation to the minimum excise duty on cigarettes.

Analysis of trends in tobacco taxation in the EU and B&H confirmed the hypothesis about the importance of cross-elasticity of goods that are substitutes or complementary goods for creating the excise policy. Excise policy in the EU for many years was based only on a unilateral increase of excise duties on cigarettes in order to discourage the consumption. However, data on the significant reduction in cigarette consumption are only an illusion due to growing trends of fine cut tobacco consumption. The high degree of the substitution of cigarettes for fine cut tobacco has led to major disruptions in the tobacco market and growth of the black market, so that a significant portion of tobacco consumption remains entirely untaxed or at best taxed at significantly lower

excise rates. Data on the erosion of revenues in the last two years show that the substitution was not revenue neutral and that further increase in fine cut tobacco consumption at the expense of cigarette consumption would seriously jeopardize the financing of the budget of Member States and health funds. Since the fine cut tobacco which is in the market is mainly of lower quality compared to tobacco used for cigarette production the continuation of trends in tobacco market would seriously undermine current achievements to the results of a strategy to reduce smoking, especially among social vulnerable groups and young population, which are more prone to substitution. The fact that in addition to cigarettes one may use other types of tobacco for smoking as well as e-cigarettes which are less taxed than fine cut tobacco requires a qualitatively new approach to the creation of the EU excise policy which will with high excise rates on substitutes discourage their consumption. In terms of tobacco taxation policy B&H has covered all substitutes of fine cut tobacco by the amendments to the Law. It was only remained to harmonize the methodology of calculating the basis for determining the minimum excise duty on cigarettes and excise duty on tobacco in line with EU standards.

Consolidated reports

(Author: Aleksandra Regoje)

Table 1 (Consolidated report: General Government and SA)

The preliminary consolidated report includes

- revenues from indirect taxes collected by the Indirect Tax Authority on the Single Account,
- transfers from the ITA Single Account,
- 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

Report doesn't include unadjusted revenues collected on ITA SA.

**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)*

Preliminary report: General Government and SA, I-VI 2015

<i>(in million KM)</i>	Q1	Q2	Total
Revenue	2.741,7	3.022,4	5.764,1
Taxes	1.437,4	1.579,1	3.016,5
Direct taxes	243,1	272,6	515,7
Taxes on income, profits and capital gains	209,9	236,7	446,6
Taxes on payroll and workforce	3,4	2,7	6,1
Taxes on property	29,8	33,3	63,1
Indirect taxes (net)	1.165,4	1.302,1	2.467,5
VAT	726,2	798,5	1.524,7
Excises	310,8	360,7	671,4
Road fee	66,7	79,2	145,9
Customs	57,7	59,1	116,8
Other indirect taxes	4,0	4,7	8,6
Other taxes	28,9	4,5	33,4
Social security contributions	1.000,8	1.069,8	2.070,6
Grants	11,4	10,0	21,4
Foreign grants	11,3	7,4	18,7
Transfers	0,1	2,6	2,8
Other (non-tax) revenue	292,0	363,5	655,5
Expenditure	2.620,0	2.842,3	5.462,3
Expense	2.576,7	2.733,4	5.310,2
Compensation of employees	818,2	824,5	1.642,6
Use of goods and services	473,2	494,6	967,8
Social benefits	1.100,1	1.157,2	2.257,3
Interest	47,7	72,0	119,7
Interest payments to non-residents	25,3	31,4	56,7
Interest payments to residents	22,4	40,6	63,0
Subsidies	33,2	53,5	86,7
Grants, transfers (incl. transfers from SA**)	41,5	38,5	80,1
Other expense	62,8	93,2	156,0
Net acquisition of nonfinancial assets	43,2	108,9	152,1
Acquisition of nonfinancial assets	52,6	122,8	175,4
Disposal of nonfinancial assets	9,4	13,9	23,2
Gross/Net operating balance (revenue minus expense)	164,9	289,0	453,9
Net lending /borrowing (revenue minus expenditures)	121,7	180,1	301,8

** transfers from SA include unconsolidated transfers to PC Roads of FB&H and PC Motorways FB&H

Table 1