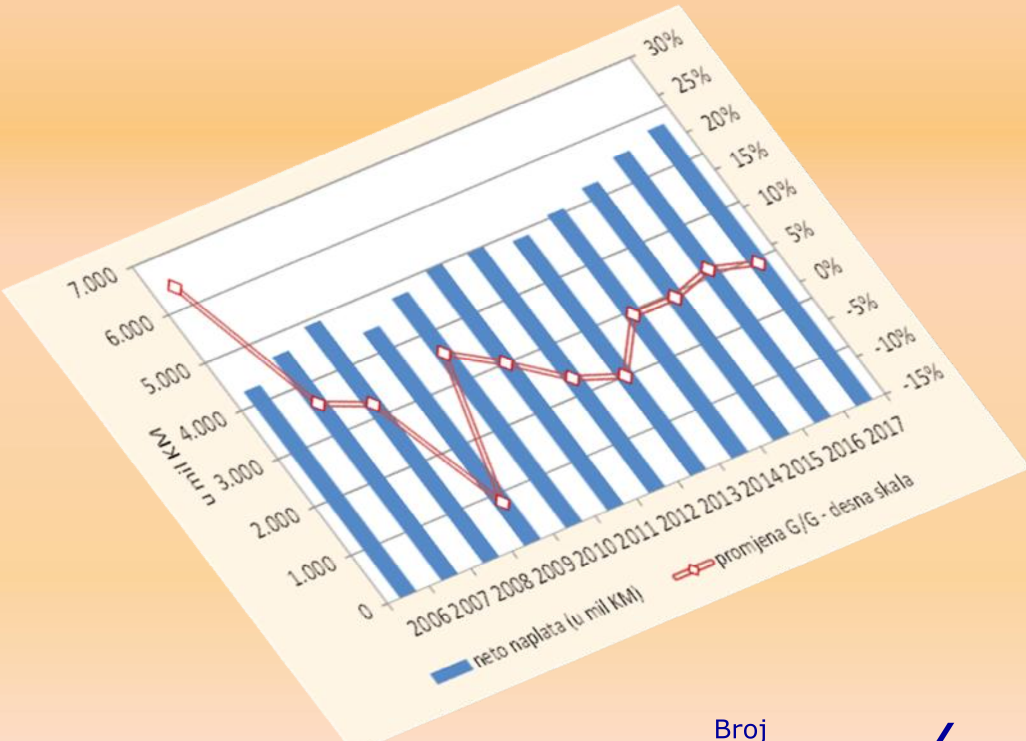
Bosna i Hercegovina
Odjeljenje za makroekonomsku analizu
Upravnog odbora Uprave za indirektno - neizravno oporezivanje

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

Macroeconomic Unit of the Governing Board of the Indirect Taxation Authority

# OMA Bilten

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## With this issue

In February 2018 there was an increase in excise tax revenues on oil derivatives of 3,5%. Bearing in mind expectations regarding changes to the Excise Law in B&H (effective from 1 of February 2018) a fairly high growth was achieved. However, three facts should be taken into account. Firstly, the collection of excise taxes on domestic oil derivatives is made on the basis of a report on quantities of derivatives placed on the market in the previous month. Consequently, the amount of excise taxes charged on domestic oil derivatives refers to turnover from January 2018, before the price rise on oil derivatives. Secondly, in anticipation of rising oil derivative prices from 1 of February 2018 there was an increase in derivative consumption by citizens and additional supplies were created. Third, the base for comparing the collection is not referential as it is very low. January and February 2017 were the months in which the lowest monthly derivative consumption was achieved in the whole previous year due to the jump in oil prices on the world market and then in oil derivative prices in B&H. (Chart 1).

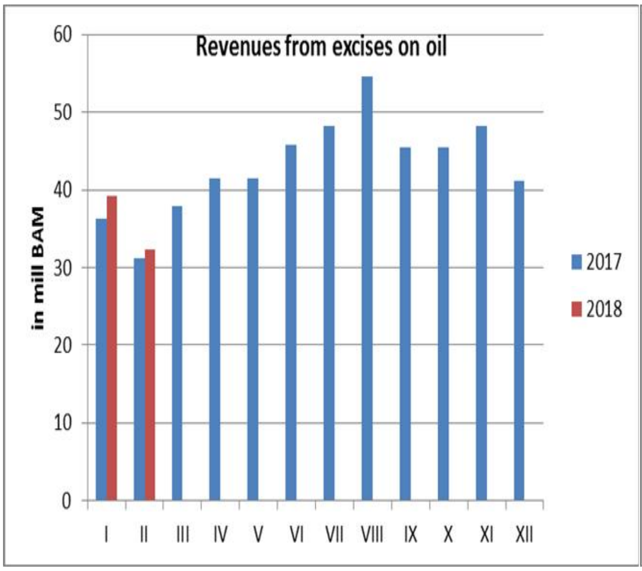


Chart 1

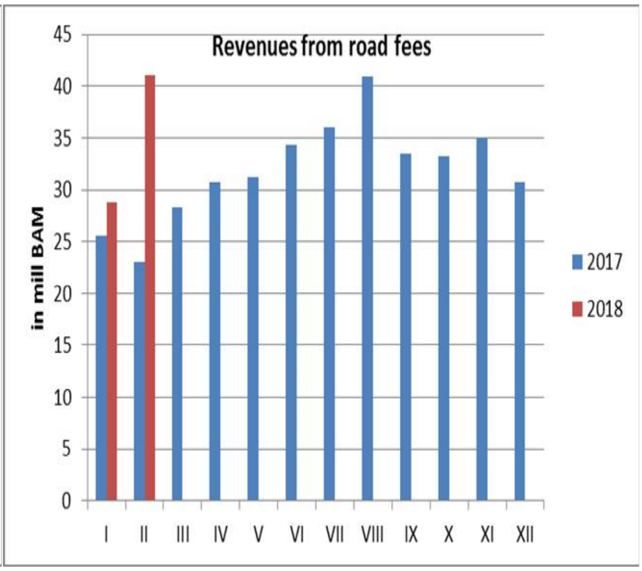


Chart 2

The revenue collection from tolls was expected to increase sharply due to the increase in the amount of dedicated tolls from 0,10 BAM/l to 0,25 BAM/l. However, as with excise revenues on oil derivatives, it is necessary to have certain reserves. Amounts for domestic derivatives are from January and the comparison base was the lowest in 2017. Chart 2 shows that the collection of the record amount of tolls in February 2018 was only slightly above the maximum monthly collection in 2017. It should be borne in mind that in 2017 a total of 0,25 BAM/l toll was charged (0,15 BAM/l for budget + dedicated of 0,10 BAM/l) and in February 2018 a total of 0,40 BAM/l tolls, i.e. 60% more than the last year. The impact of higher oil derivative prices due to the application of amendments to the Excise Law on oil consumption and thus on collection of revenues from excise taxes and tolls will be more accurate to look at in the coming months, when comparisons are made in relation to the much higher base from 2017.

Dinka Antić, PhD
Head of Unit

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

# Liberalization of Foreign Trade in B&H (2007-2017): implications and comparative analysis

(prepared by:Dinka Antić, PhD)

*Research has shown that all developing countries under pressure from the liberalization process of foreign trade are faced with the problem of maintaining the level of tax revenues in the situation of progressive reduction of customs revenues. Due to the extensibility and phase implementation the process of liberalization of foreign trade creates continuous pressure on fiscal authorities to compensate for the losses on customs duties by increasing the collection of other taxes. A comparative analysis of the effects of the liberalization of foreign trade in B&H has shown that B&H, albeit a small, economically weakly developed country, with complex constitutional and fiscal architecture, is an exception to most developing countries. Despite the fact that the majority of the trade liberalization process took place at the time of the last global crisis, B&H managed in every year to compensate entirely the loss in customs revenues as a consequence of the trade liberalization by the increase in taxation of tobacco and oil derivatives. As with most new Member States, excises and VAT are an alternative option to offset the loss of customs duties in the event of a further liberalization process of trade in B&H. However, the growth of indirect tax revenues in recent years is partly a consequence of B&H's regional tax competitiveness in the area of taxation of oil derivatives. The new excise tax policy on oil derivatives, which implies a rise in tax on derivatives, is expected to lead to a decline in consumption of non-residents and to endanger the expected collection of revenues from indirect taxes, reducing the chances of the continued liberation of trade with the EU as a revenue neutral reform.*

## 1. FOREIGN TRADE LIBERALIZATION PROCESS IN B&H

### 1.1. Phases of liberalization

Economic reforms that led to the strengthening of the market and the suppression of the grey economy, such as creating a unified economic space after the abolition of double taxation of inter-entity trade and taxation of imports on excise goods at the border, were completed by introducing VAT on 1 January 2006. Although revenue neutral replacement of the sales tax was planned, the introduction of VAT has been a successful economic reform that has resulted in an increase of indirect taxes of 26,1% compared to 2005 and thanks to which B&H achieved a consolidated fiscal surplus in 2006 and 2007 (Antić, 2009). However, one year after the implementation of VAT, B&H started the process of liberalization of foreign trade.

The trade liberalization process in B&H is being implemented in phases and stages (Chart 1). B&H has signed several international agreements in the area of free trade and cooperation of customs authorities. Of the bilateral agreements, which foresee the liberalization of foreign trade exchange, the most important is the Free Trade Agreement with Turkey. Multilateral trade liberalization corresponds to the regional structure of imports in B&H. In the first phase, which started in 2007, B&H joined the Central European Free Trade Agreement (CEFTA). The Agreement meant abolishing almost all customs duties in commodities exchange with the surrounding countries (Croatia, Serbia, Montenegro, Macedonia, Albania, Moldova). Second phase of liberalization, which began on 1 July 2008 with the application of the EU Stabilization and Association Agreement ("SAA"), implied the gradual introduction of imports of goods originating in the EU to customs duty free imports over a period of five years, but keeping customs duties on goods of strategic interest for B&H (agricultural products, etc). The third phase of foreign trade liberalization process partly affected the third countries as well. It was expected that the process of liberalization would produce direct losses of customs revenues, but also indirectly, through the increased substitution of imports from other countries, which remained burdened by customs duties, duty free imports from the EU and from the environment. However, the activation of the domestic oil refinery at the beginning of 2009 has led to a strong growth in oil imports from Russia, and consequently, revenues from customs duties, but also the so-called customs clearance[1], which had the same fiscal impact as customs duties. Customs clearance was previously abolished on imports on goods originating in the EU, while on imports on goods from third countries was abolished in the fourth quarter of 2011. The fourth phase of the liberalization process implied the abolition of customs duties and all other fiscal duties on imported goods of EU origin within the period of 3 years (2015-2017), as well as bilateral concessions between B&H and some EFTA members (Switzerland, Norway, Iceland, Liechtenstein). The fifth phase of the liberalization, which started on 1 February 2017, *de facto* represents the second stage of trade liberalization with the EU Member States and implies further abolition of customs duties on the basis of an adapted SAA.

Chart 1: Phases of foreign trade liberalization in B&H

| 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **CEFTA** | **EU, SAA** | | | **customs clearance** | | | | **EFTA** | | **EU, adaptation SAA** |

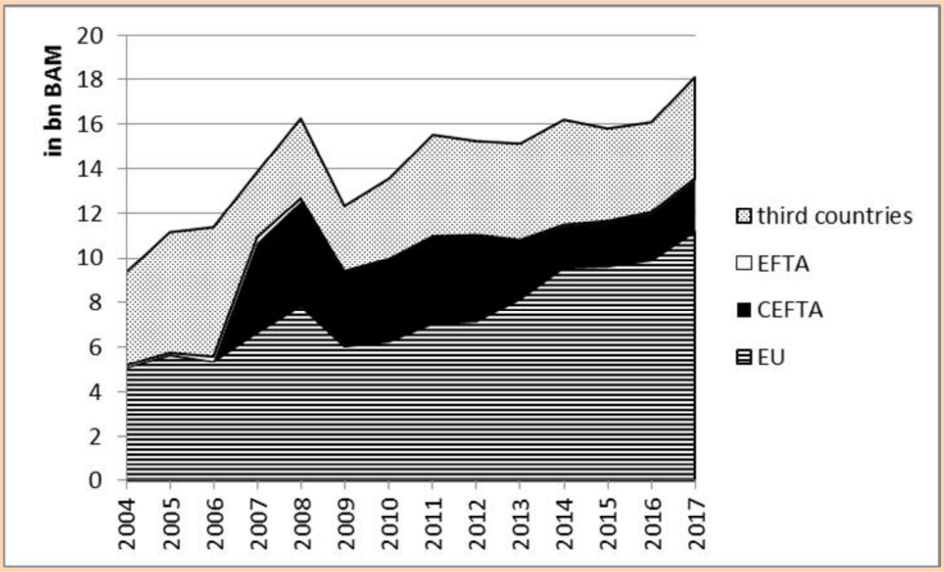
Source: Author's view.

### 1.2. Effects

The trade liberalization process has significantly influenced the scope and structure of B&H imports. Chart 2 shows a strong growth of imports from CEFTA Members in 2007 and the growth of imports from the EU in 2008. However, other important economic reforms occurred during the same period (reform of the indirect taxation system, introduction of VAT) which positively affected the integration of economic space in B&H and reduction of grey economy as well as the institutional reforms (integration of customs service and the establishment of the Indirect Taxation Authority of B&H) increasing the efficiency of collection of tax revenues and reducing tax evasion, both in imports and domestic goods traffic. In addition, fiscal surpluses achieved in 2006 and 2007 strongly stimulated private and public consumption and thus the import of goods for the final consumption. Finally, the growth of imports in B&H in 2008 (up to 43% compared to 2006) was influenced by external factors, price rising of energy products, raw materials and food on the world market. The emergence of the global economic crisis in the fourth quarter of 2008 has led to a drastic fall in imports to 2006 level. At times of crisis, liberalization of a large part of imports (up to 85%) was favored by companies in reducing the input costs for the amount of customs duty. Trade liberalization by SAA lasted until 2013. In the structure of imports, substitution of imports from third countries with duty free import from the EU and CEFTA was noticed (Chart 3). As of 1 July 2013 there was a reduction of imports from CEFTA countries and the growth of imports from the EU due to Croatia's entry into the EU. On the other hand, imports from third countries are also noticeably increased, initially due to the activation of domestic refinery and then due to the strong growth of imports from China and other Asian countries.

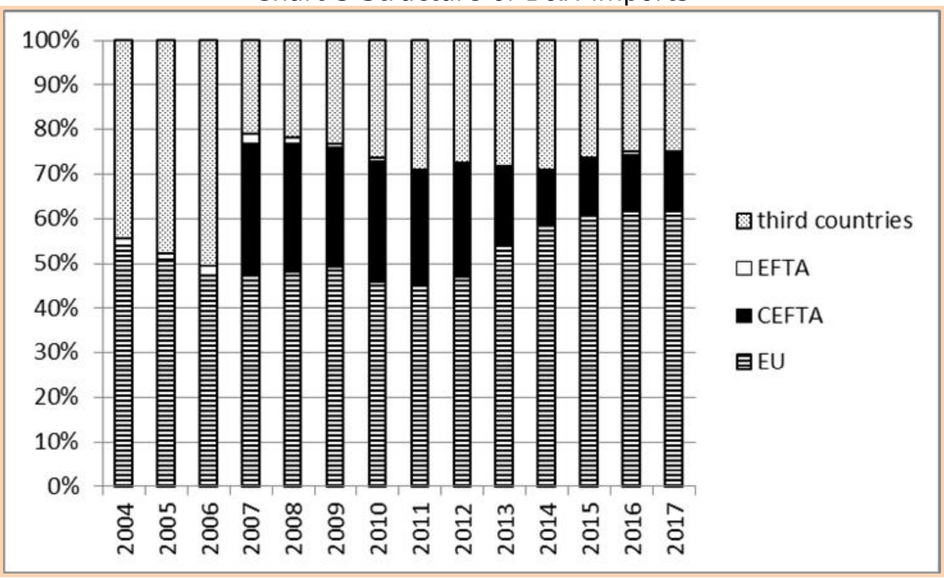
[1] Customs clearance was charged in the amount of 1% of the customs base.

Chart 2 B&H imports, trends




Source: Agency for Statistics B&H.

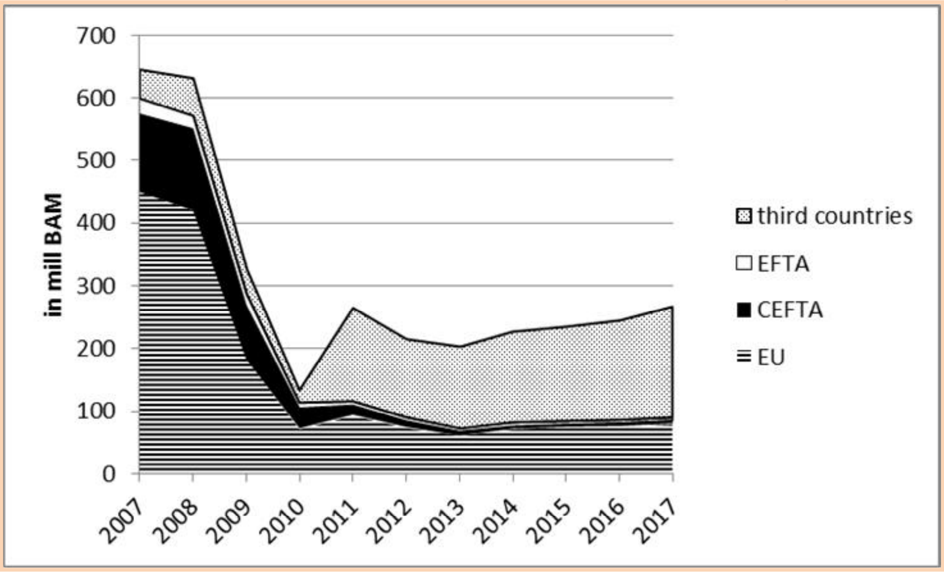
Chart 3 Structure of B&H imports




Source: Agency for Statistics B&H; Author's calculation

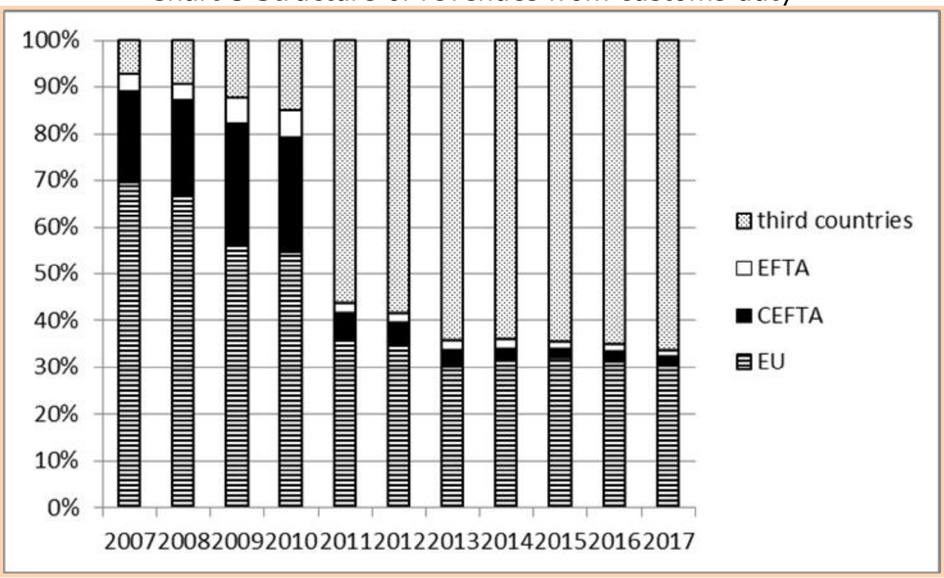
Chart 4 shows a sharp drop in revenues from customs duties in the first three years of foreign trade liberalization, which is strongly stimulated by the global economic crisis 2009-2010. Recovery of customs revenues recorded in 2011 as a result of the growth of imports from Russia and other third countries and as of the fourth quarter there was a gradual decrease in customs revenues caused by the abolition of customs clearance on imports of goods from third countries (Chart 5).

Chart 4 Collection of revenues from customs duty




Source: Indirect Taxation Authority.

Chart 5 Structure of revenues from customs duty

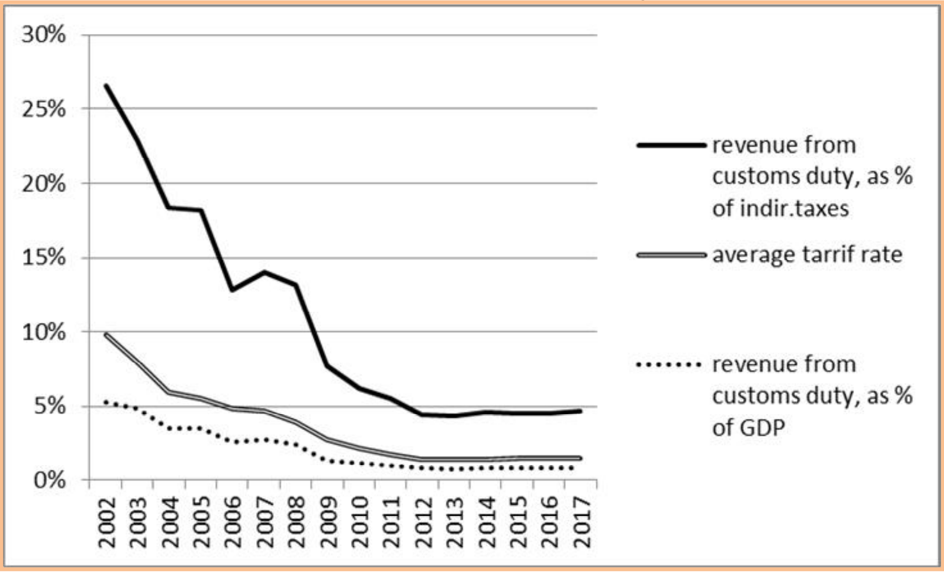



Source: Indirect Taxation Authority; Author's calculation.

Customs revenues have increased since 2014, mainly due to the growth in imports from China (for example investments in TPP Stanari) and other Asian countries and at the same time there is the growth in imports in part of goods originated in the EU remained under the customs regime. Trade liberalization has also led to dramatic changes in the structure of customs revenues. Chart 4 shows a cascading fall of revenues from customs duties from the EU, which was the largest in the first three years of the SAA implementation. While revenues from customs duties on goods originating the EU in 2007 accounted for 70% of total revenues from customs duties, in 2016 the share dropped to 30%. Minimum amounts of revenues from customs duties are charged on goods from CEFTA and EFTA countries, while 2/3 of customs duties are collected on imports from third countries (Chart 5).

The wide scope of trade liberalization in B&H had a drastic fall in the importance of customs revenues. The share of customs revenues, measured as % of GDP, fell from 2,8%, amounted in 2006, to only 0,8% of GDP in 2016 (Chart 5). However, in 2017, due to the unexpected rise in customs revenues, the share increased to 0,9% of GDP. A more drastic decline was recorded in relation to the collection of indirect taxes. Strong fall in customs duties charged, on the one hand, and strong growth of revenues from VAT, and then excise taxes, on the other hand, produced a sharp drop in the share of customs revenues in total indirect taxes from 12,9%, achieved in 2006, to 4,5% in 2016, i.e. 4,7% in 2017. The average customs duty rate in this period fell from 4,9% to 1,5% (Chart 6).

Chart 6 Indicators of trade liberalization process in B&H




Source: Imports – Foreign Trade Chamber of B&H (2002-2003)/Agency for Statistics of B&H; Indirect Taxation Authority (2004-2017); GDP projections (2017) – Directorate for Economic Planning , September 2017; Author's calculation

## 2. Comparative Analysis

### 2.1. Sample Countries for Analysis

Comparative analysis of the fiscal implications of the trade liberalization process in small countries in the EU/region requires a unique methodology and an analytical approach, first in terms of the definition of small country and country classification, and then with regard to analytical methods and tools. Due to the focus of analyses in comparative analyses of tax systems, two analytical approaches are possible, structural and horizontal (Antić, 2016). Structural approach implies the comparison of the tax system according to the structure, i.e. the importance of certain forms of taxation in the structure of tax revenue collected, while the horizontal comparison implies comparison of certain elements of a certain form of taxation in two or more countries (bases, rates, reliefs, etc.).

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For classifying countries in large and small ones, the World Bank uses the criterion of the population number, and accordingly, small countries are those with less than 1,5 million inhabitants[2]. The simplicity of this criterion does not meet the needs of deeper economic analysis, as there are small developed countries as well as large countries that are very poor. Crowards (2002) points out that the number of inhabitants is not a sufficient criterion, moreover the content

[2] www.worldbank.org

of the criteria has evolved over the last 50 years[3]. There have been several reasons – a rapid increase in the number of small countries devalued by the high-set population threshold, acceptance of special economic features characterized by small-scale groupings. When classifying 190 countries in the world Crowards (2002) used a combination of three criteria: the number of inhabitants, the country's land area size and the *per capita* income level to create a cluster of countries classified in micro-countries, small countries, medium-small countries medium-large countries and large countries. Starting from the criteria for each group B&H could be classified as medium-small country. However, due to the large differences between the countries it was not possible to create a single composite criterion for classifying countries. When researching the impact of European integrations on development of small countries, for the purpose of classifying EU Member States into small and large countries, Tomaš (2017) used the Kuznetz criterion according to which countries with up to 10 million inhabitants are small. According to this approach small Member States are: Bulgaria, Denmark, Estonia, Ireland, Croatia, Cyprus, Latvia, Lithuania, Luxembourg, Malta, Austria, Slovenia, Slovakia, Finland and Sweden.

Given that the unique definition of a small country does not exist, and that its content adjusts depending on a concrete research, a comparative analysis of the fiscal implications of trade liberalization in B&H has been made with respect to the EU Member States and surrounding countries similar to B&H. "Similarity" is defined by several criteria:

a. A Similar developmental path of economic and political system;
b. Great openness of economies;
c. The great importance of customs as a safeguard mechanism in foreign trade;
d. Similar tax structures dominated by indirect taxes;
e. Similar implementation of the liberalization process (dynamics and tempo);
f. Similar level of economic development before implementation of trade liberalization.

Starting from the above criteria, it was the simplest way to explore all the new EU Member States, and Serbia and Montenegro from the surrounding countries. Although the new EU Member States are heterogeneous, given the traditional classification criteria used by the World Bank and Crowards, there is similarity with B&H according to several mentioned criteria. All former SFRY and SSSR members meet the criteria a.-f., although some do not meet traditional criteria of the population number or surface (for example Poland, Romania, Bulgaria, Hungary, Serbia). On the other hand, Malta and Cyprus do not share the socialist heritage and the way to capitalism or CEFTA membership before joining to the EU, but according to traditional criteria they can be considered as small and open countries. Similarly, both countries along with other new members have gone through the same process of trade liberalization with the EU as the other new members, B&H, Serbia and Montenegro.

Starting from the research method of Cage and Gadenne (2016) a comparative analysis of fiscal implications of trade liberalization focuses on the analysis of tax structures in terms of defining the duration of the liberalization episode[4], the amount of fiscal cost and modalities of its compensation.

### 2.2. Fiscal cost

The fiscal cost[5], which is the loss of customs revenues due to the trade liberalization process, for the needs of the analysis is calculated in a double way, on an annual basis compared to the base

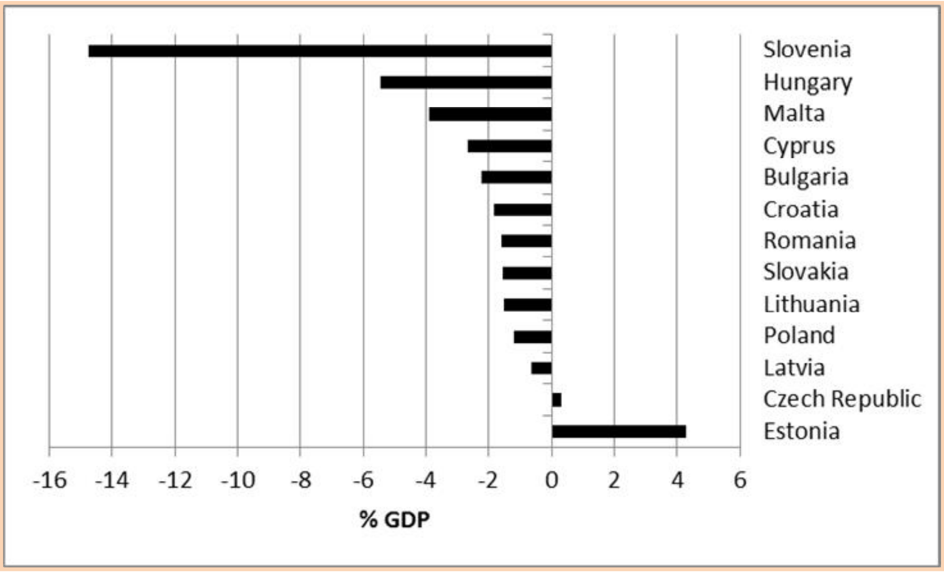
[3] In the 50s of the 20th century, the threshold for classification into small countries was 10-15 million inhabitants, in 70s up to 5 million, and in 90s 1-1,5 million ( Crowards, 2002).
[4] Cage and Gadenne (2016) analyzed trade liberalization in 130 countries in the period from 1792 to 2006. Given the long period of observation (1792-2006) the trade liberalization process was divided into episodes (time intervals), corresponding to the period of reduced tax revenues, measured as % of GDP. This methodology has identified 140 trade liberalization episodes in the world.
[5] Cage and Gadenne (2016) called this direct fall in tax revenues as fiscal cost of trade liberalization.

year (the year preceding the liberalization episode) and at the level of the episode, comparing the collection of customs in the last year of the liberalization episode compared to the year preceding the liberalization episode. Defining the liberalization episodes, which for the purpose of analysis represent a time interval for the evaluation of the effects, depends on the status of the country (Member, Candidate country) and moment of acquisition of that status.

The start of the liberalization episode for the seven new Member States is a moment of inclusion in the CEFTA[6] Agreement. This is followed by a period of gradual liberalization of trade with the EU as the first step towards adjusting to the EU economic system and the adoption of the *acquis,* which will last until the accession of the Member State to the EU[7].

Due to the different beginning of the liberalization episode, we calculated the fiscal cost at the level of the full interval, comparing the share of customs revenues measured as % of GDP at the end of the liberalization episode with the share of customs revenues measured as % of GDP with the year before the beginning of the liberalization episode. Slovenia endured the largest fiscal cost followed by Hungary and then Cyprus and Malta (Chart 7). These countries are extremely open economies[8]. The least affected are the Baltic countries, with Estonia also recording the growth of the share, which can be explained by the application of a different methodology of tax revenue classification[9].

Chart 7 Fiscal cost of trade liberalization in the new EU Member States




Source: EUROSTAT (2012); EUROSTAT (2017).

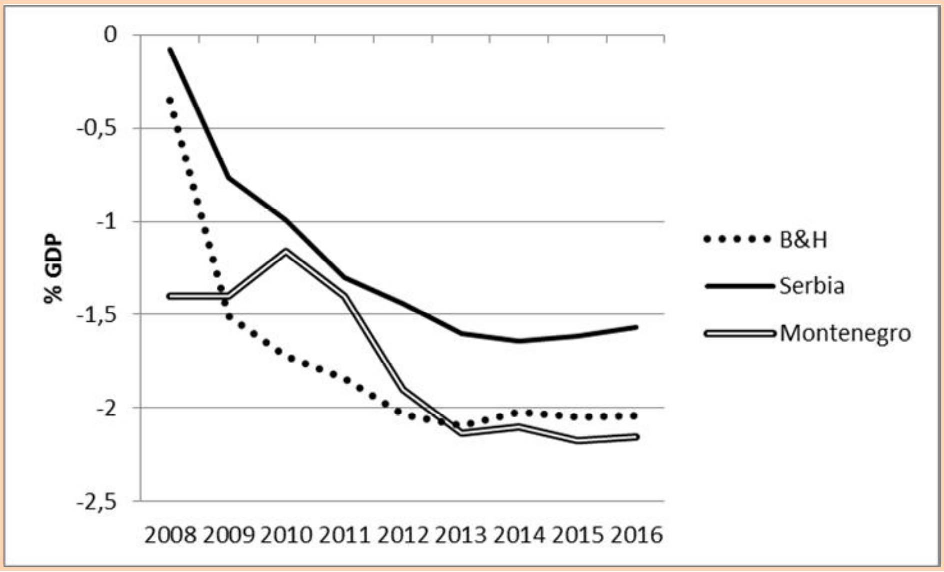
After entering the EU, the share of customs revenues in tax structures of Member States is minimal, and includes the collection of residual customs revenues and eventually EU's revenues

[6] Of the new Member countries Czech Republic, Hungary and Poland were in CEFTA Agreement since 1992, Slovenia since 1996, Romania since 1997, Bulgaria since 1998 and Croatia since 2002.
[7] Ten Members (Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia, Slovenia) joined the EU on 1 of May 2004, Bulgaria and Romania on 1 of January 2007 and Croatia on 1 of July 2013. The length of the analysis period depends on the available time data series.
[8] The volume of trade in Malta in 2016 amounted 270% of GDP, in Hungary 174%, Slovenia 148% and in Cyprus 124% of GDP. For comparison, the average volume of the EU trade in 2016 was 82% of EU GDP. Source: World Bank, www.worldbank.org
[9] The EU methodology recognizes the classification of taxes in the "customs duties and other taxes on imports, except VAT" category. Estonian data are assumed to include excise taxes on imports collected by the customs service, since the share of the excise category in the tax structure of Estonia is extremely low.

from the duties retained by Member States to finance the cost of the customs service[10]. The continuation of the EU liberalization process (for example the application of the CEFTA Agreement with Canada which entered into force on 21 of September 2017) at the world level will not have a direct impact on the budget of Members, but will indirectly increase requirements for greater separation of existing revenues (% VAT or % GDP).

For B&H and the countries around the trade liberalization episode begins with the entry into CEFTA Agreement (1 of January 2007), to which the five-year period of SAA implementation continues with or without the episode interruption[11]. Calculation of the fiscal cost is made by comparing the share of customs revenues, measured as % of GDP, on an annual basis for each year in the 2008-2010 period related to the share in the base 2007 year. It can be noticed that B&H was most and Serbia least affected by the process of liberalization in financial sense. Similarly, the strongest pace of liberalization was in B&H while the lowest was in Serbia (Chart 8). B&H has rapidly started into trade liberalization, *de facto* in just two years, and the scope of the goods was huge. On the other hand, Serbia has a better commodity exchange with the environment so the effects of liberalization with CEFTA are lower than in B&H. In addition, Serbia started implementing the SAA trade segment in 2010 which enable it to consolidate revenues after entering CEFTA and to amortize the first strike of the global economic crisis.

Chart 8 Fiscal cost of trade liberalization in B&H, Serbia and Montenegro




Source: B&H – B&H Indirect Taxation Authority, B&H Agency for Statistics, author's calculation; Serbia – Ministry of Finance of Serbia; Montenegro – Ministry of Finance of Montenegro.

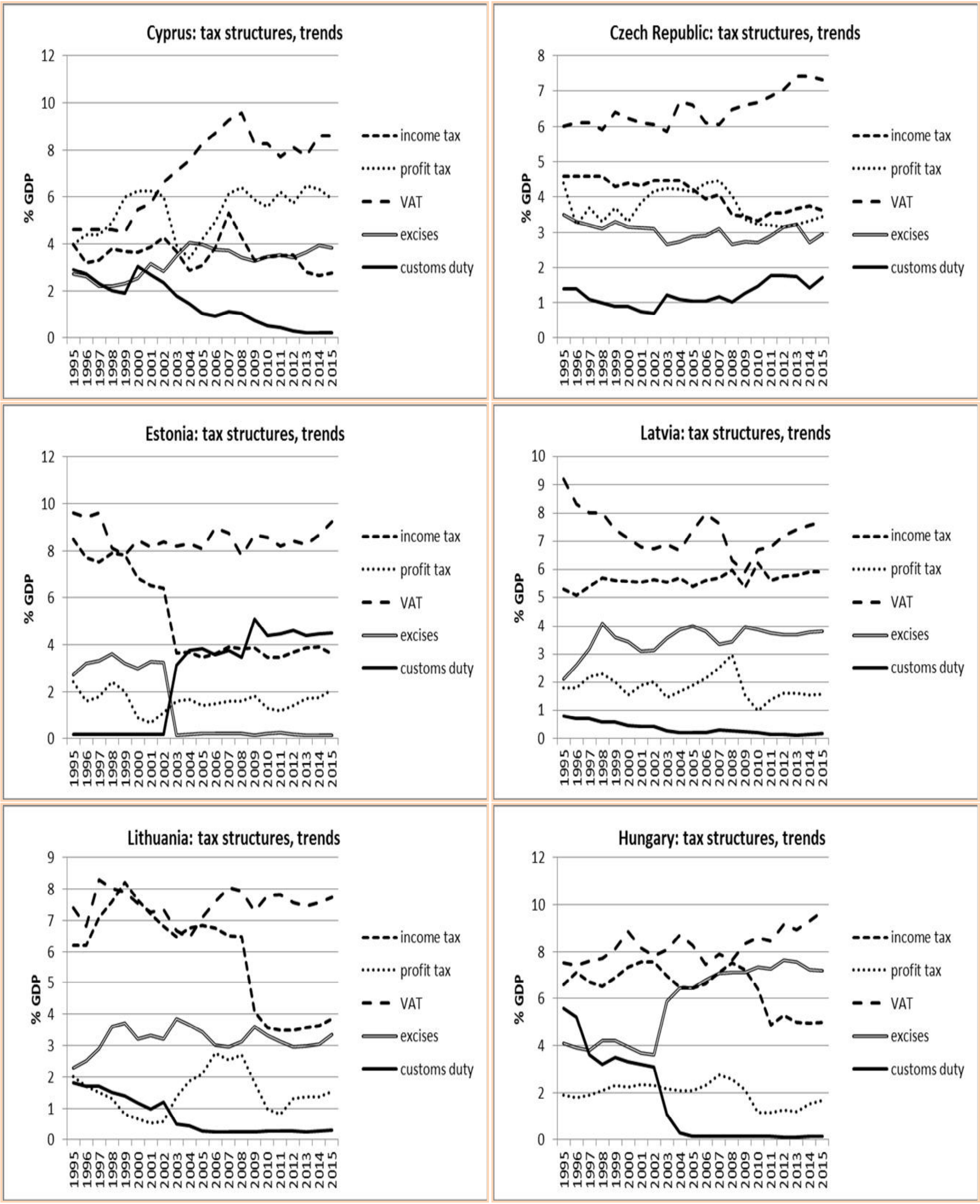
### 2.3. Fiscal Cost Reimbursement

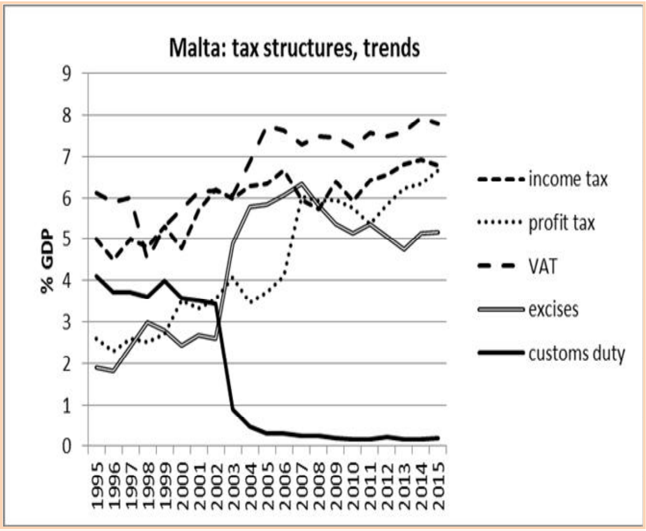
An overview of the effects of trade liberalization in the world has shown that countries, depending on their size and economic strength, have compensated for the loss from customs revenues in the process of liberalization by increasing domestic taxes (VAT, excise taxes, income tax, capital taxes, etc.).

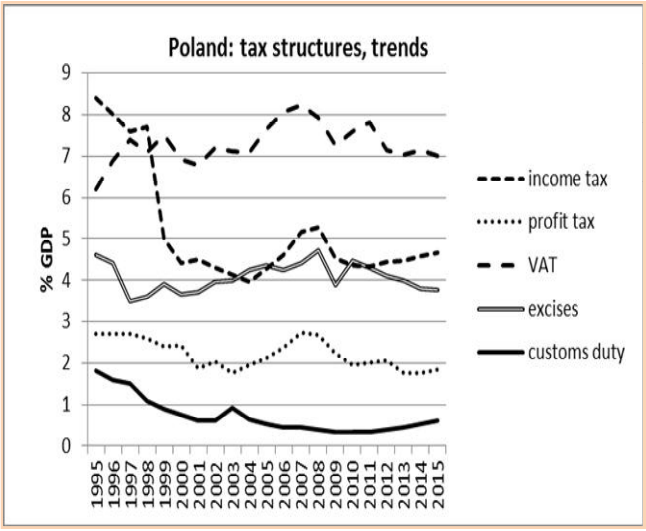
The tax structure best reflects the tax policy applied by the country in order to offset the revenue from customs duties lost by the liberalization of trade.

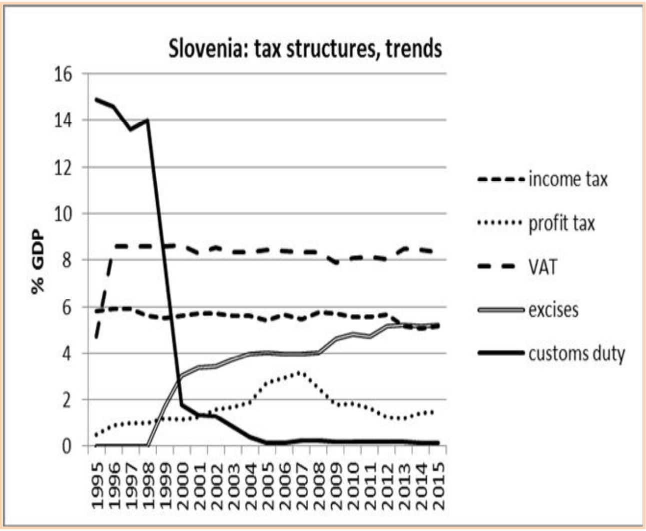
[10] The Member retains 25% of revenues from the EU customs duty charged for the cost of the customs service.
[11] Montenegro has started with the implementation of the SAA on 1 of January 2008, B&H on 1 of July 2008 and Serbia on 1 of February 2010.

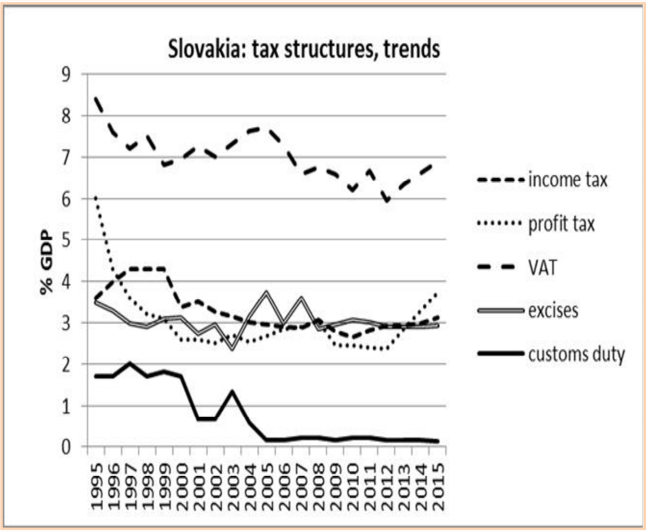
Chart 9: Tax structure of the new EU Member States

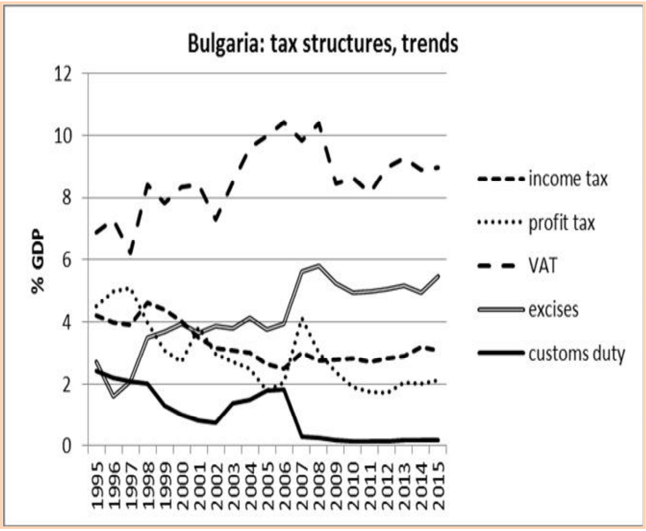


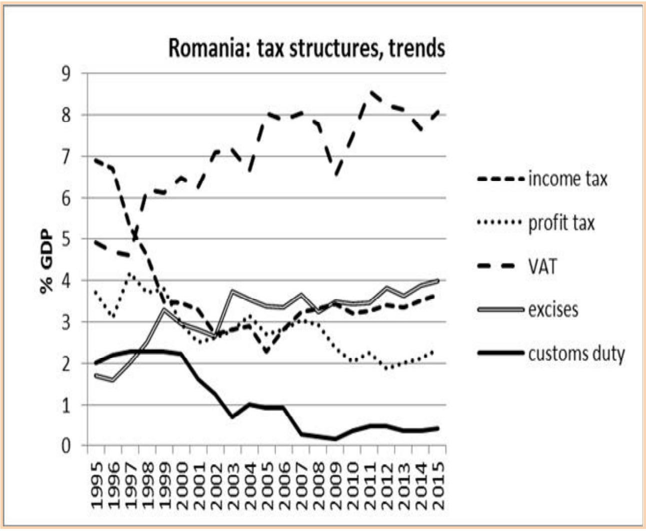

Malta: tax structures, trends
% GDP
income tax
profit tax
VAT
excises
customs duty


Poland: tax structures, trends
% GDP
income tax
profit tax
VAT
excises
customs duty


Slovenia: tax structures, trends
% GDP
income tax
profit tax
VAT
excises
customs duty


Slovakia: tax structures, trends
% GDP
income tax
profit tax
VAT
excises
customs duty

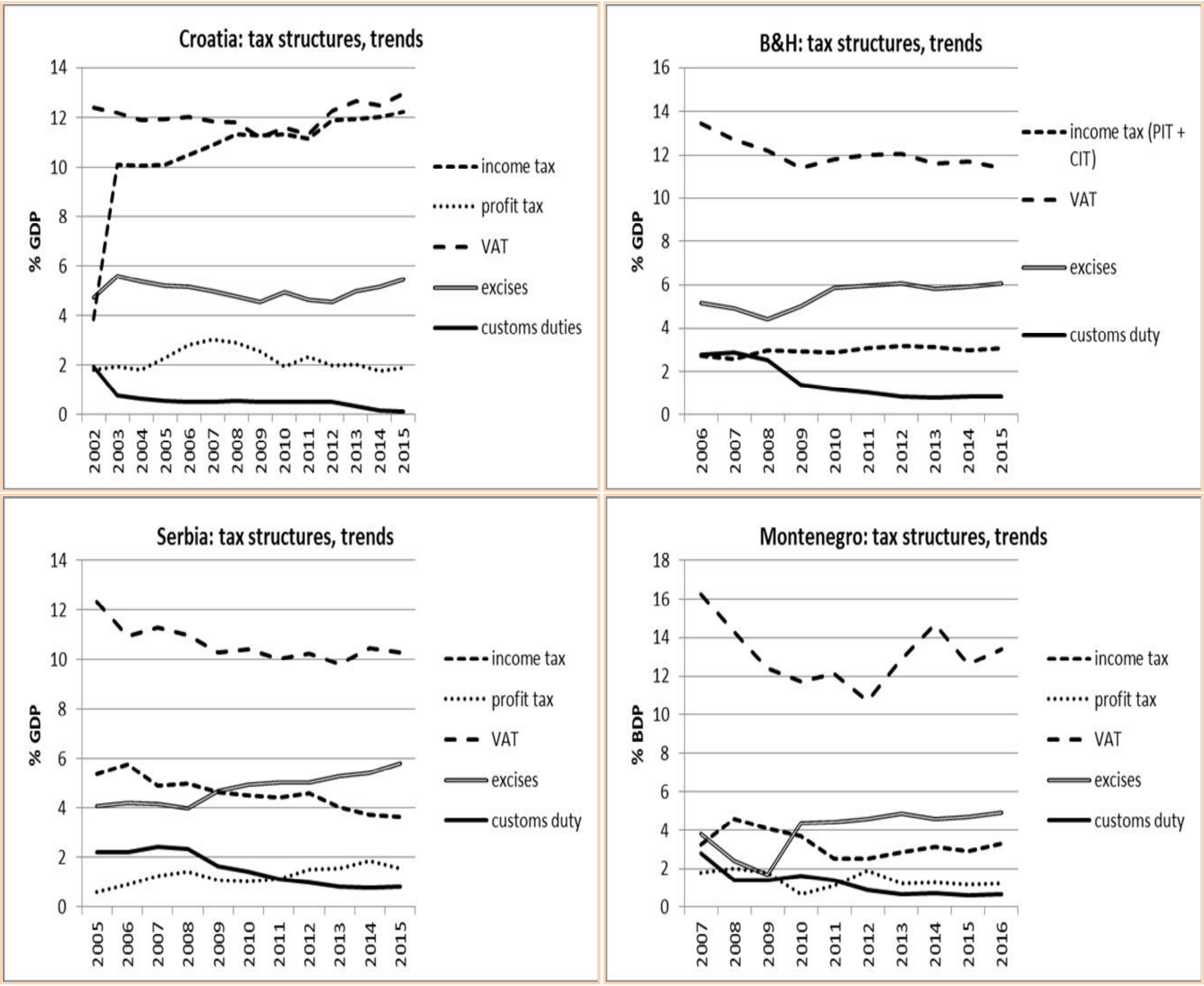

Bulgaria: tax structures, trends
% GDP
income tax
profit tax
VAT
excises
customs duty


Romania: tax structures, trends
% GDP
income tax
profit tax
VAT
excises
customs duty

The analysis of trends in tax structures of Members suggests that ten new Members compensate the loss of customs revenues before entering the EU by increased excise taxes and nine out of the increased VAT revenue. Czech Republic, Slovenia, Hungary and Lithuania have increased their profit tax to neutralize the loss of customs duties and Latvia increased the income tax. Malta is specific because in the period of trade liberalization due to the implementation of the SAA with the EU increased all major types of taxes.

A similar approach to the analysis can also be applied to Croatia. Croatia's tax structure suggests that customs revenues losses were largely offset by progressive income tax, which included the rate scale with very high marginal rates and, in part, the growth in profit tax (Chart 10).

Chart 10 Tax structures of countires in region




Source: Croatia - EUROSTAT (2016); B&H – B&H Indirect Taxation Authority; reports of the ITA GB Macroeconomic Analysis Unit, B&H Agency for Statistics, author's calculation; Serbia – Ministry of Finance of Serbia; Montenegro – Ministry of Finance of Montenegro; author's calculation.

Unlike other countries, B&H has limited possibilities for tax measures to be implemented. The main constraints of conducting a comprehensive tax policy in B&H are as follows: (i) decentralized fiscal architecture with a specific indirect taxation system, in which competences are divided between B&H and Entities for direct and indirect taxes; (ii) a tax structure dominated by indirect taxes and (iii) a process of euro integration that assumes that tax policy measures introduced by fiscal authorities in the area of indirect taxes must be aligned with minimum EU standards at the moment of adoption or gradually harmonized over a certain time horizon (Antić, 2017). In such a constellation of fiscal competences the main focus of the reform is aimed at balancing taxes within the group of indirect taxes, while complex political relations and poor fiscal coordination prevent the implementation of reforms such as tax shifting or fiscal devaluation, which require balancing between indirect taxes, on one hand, and direct taxes and social contributions, on the other. Having in mind the above-mentioned limitations of conducting comprehensive tax policy in B&H, the possibility of reimbursing customs revenue losses should be sought in the context of indirect taxes.

The tax structure of B&H shows that excise taxes were the main source for reimbursement of revenues from customs duties. Excises increased the share in the tax structure for 2 p.p. of GDP. There is a descending downward trend in VAT as a result of the application of exemptions in the country (IPA funds) and the growth of VAT refund payments on the basis of international projects, which at the beginning of liberalization amounted to 0,1% of GDP and in 2017 0,3% of GDP. The second factor is the reduced collection efficiency due to the accumulation of debts, which at the beginning of liberalization amounted to 0,1% of GDP and in 2017 1,3 % of GDP[12].

Similar to B&H, Serbia has compensated its fall in customs revenues by increasing excise taxes. There is a noticeable drop in the share of VAT, as a result of the spread of reduced rates, and a drop in direct taxes. Reimbursement of customs revenues with excise taxes in Montenegro exceeds 3 p.p. of GDP. The tax structure indicates strong oscillations in VAT collection and the growing trend in the collection of income tax. Total taxes, including social contributions, have a growing trend in recent years.

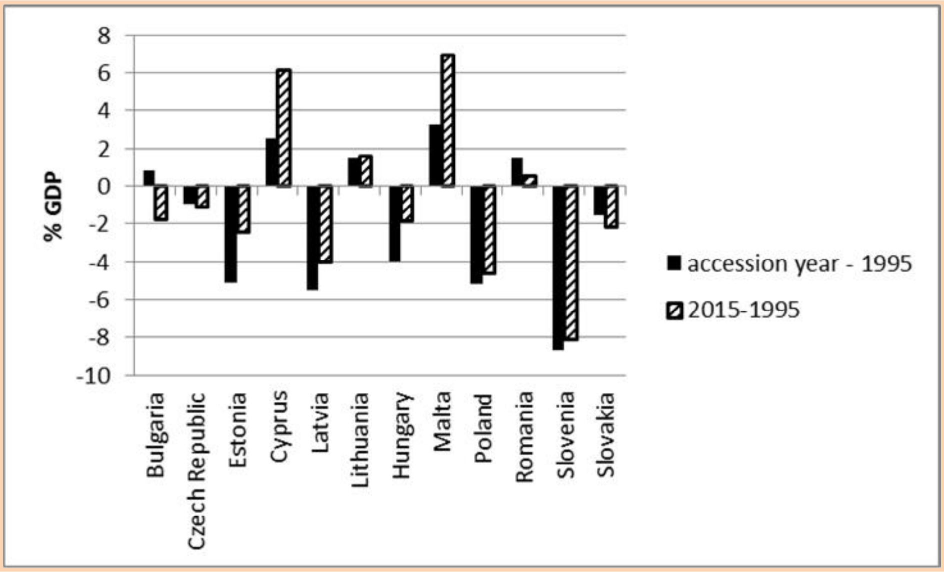
### 2.4. Tax burden

The trade liberalization of new EU Member states has produced different effects. If the effects of the measure differ in the amount of tax burden in the year of entry into the EU compared to the beginning of the liberalization period[13] it can be concluded that six Member States increased tax burden and six decreased (Chart 11).

The highest growth of tax burden has Malta, which has increased all major types of taxes (VAT, excise taxes, profit and income tax) and then Cyprus, Lithuania and Romania. The comparative analysis of the tax burden in 2015 compared to 1995 shows a strong trend of tax growth in Malta and Cyprus and Lithuania which can be explained by fiscal consolidation after the global economic crisis. Slovakia, then Latvia, Estonia, Poland and Hungary had the largest tax burden falling in the year of entry into the EU. The minimum drop was recorded in the Czech Republic and Slovenia. Most of the mentioned Member States in the period after joining the EU slightly increased their taxes. It can be concluded that some new Member States have also used the EU membership preparation period for tax breaks of citizens and companies, regardless of the fact that a significant part of revenues due to the abolition of customs duties in the EU exchange was lost during that period.

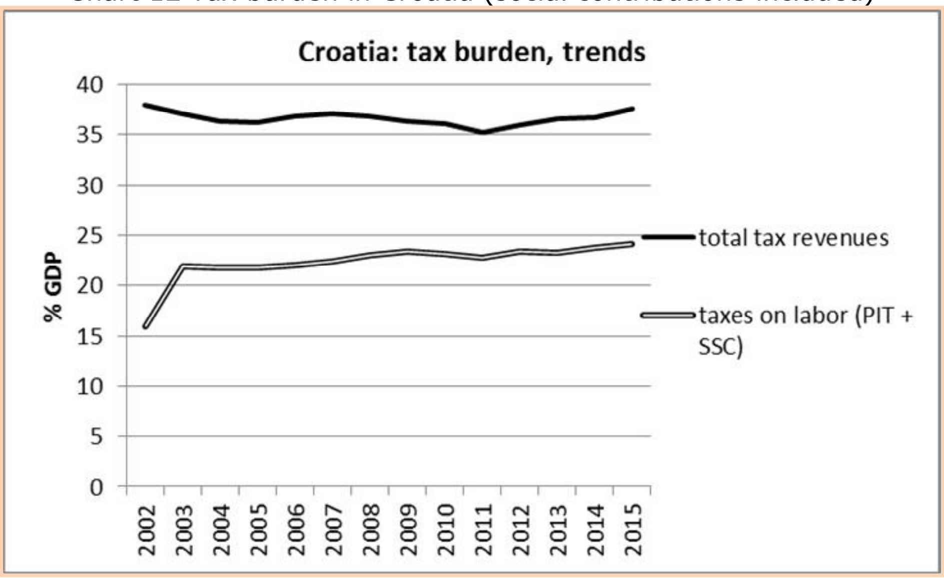
[12] Cumulative indicator OECD showing the trend of debt.
[13] EU statistics for new Member States go back to 1995 so it can be assumed that this is the year in which European integration processes are started.

Chart 11 Effects of trade liberalization in new EU Member States




Source: EUROSTAT (2016); author's calculation.

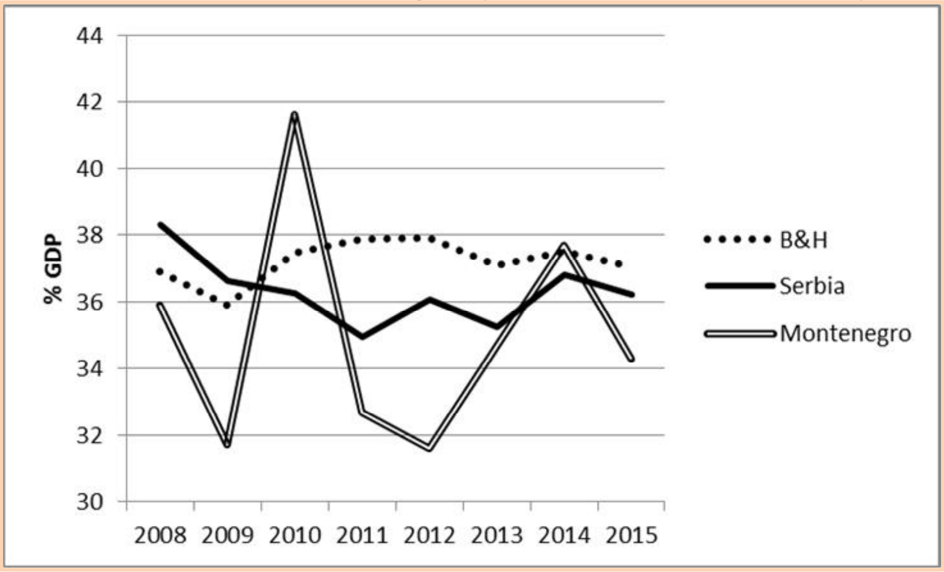
Chart 12 Tax burden in Croatia (social contributions included)




Source: EUROSTAT (2016).

Although the process of phase liberalization of trade with the EU ended in 2007 until the end of the observed period, Croatia failed to reach the level of tax burden from 2002 (Chart 12). One of the significant factors is the impact of the global economic crisis, which has led to a fall in VAT revenues. Unlike B&H, the process of harmonization of excise rates with the minimum EU standards has not only resulted in the growth of excise revenues but there has also been a decline that was repaired in 2015. The losses of the remaining customs revenues that have become EU revenues after Croatia's accession to the EU have been compensated by increasing the VAT rate and restricting the scope of reduced rates of VAT only to goods and services covered by Council Directive 2006/112/EC.

Chart 13 Tax burden in region (social contributions included)



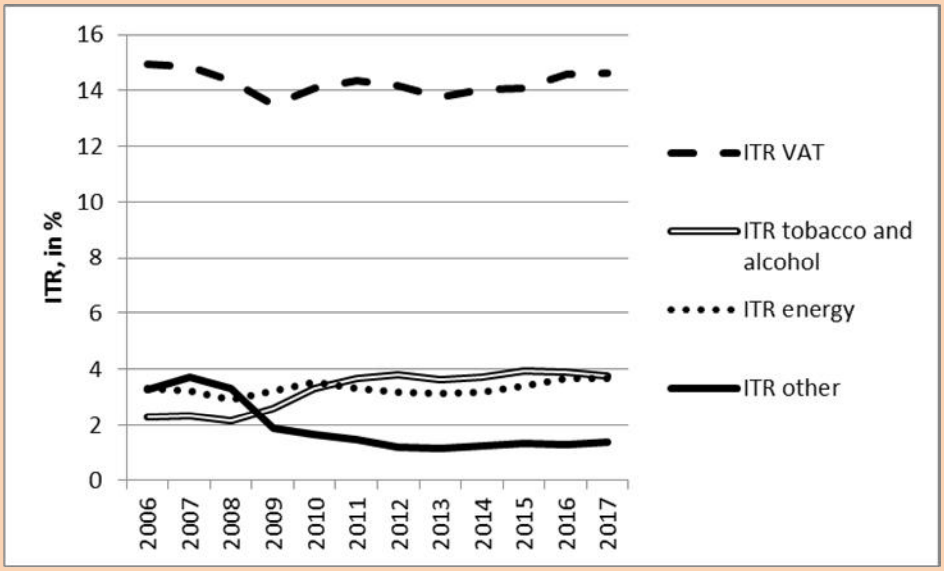

Source: B&H – B&H Indirect Taxation Auhtority, B&H Agency for Statistics, author's calculation; Serbia – Ministry of Finance of Serbia; Montenegro – Ministry of Finance of Montenegro.

Due to the fact that the process of liberalization in B&H, Serbia and Montenegro is overlapped with the effects of the global economic crisis, it is not possible to determine when the liberalization episode is over. However, if the completion of the episode is the same level of the tax burden as at the beginning of the liberalization, it can be concluded that B&H has, despite the effects of the crisis, quickly compensated for the loss of customs revenues, regardless of the five-year period of the SAA application. On the other hand, Serbia and Montenegro have completed the liberalization episode in 2014 after the end of the SAA (Chart 13).

## 3. Is it possible to continue the process of trade liberalization in B&H?

The European path of B&H will in the foreseeable future require complete liberalization of imports of goods originating in the EU and at the final stage also the harmonization of foreign trade policy in relation to third countries with the EU policy. Regardless of the fact that the share of revenues from customs duties in revenues is low, significant reduction in revenues from customs duties can endanger the financing of government budgets of all levels in B&H. Given that the measurement of the tax burden as a percentage of GDP represents a statistical macro indicator used to assess the tax burden in the past in order to look at the causes of changes in the tax burden on consumption in B&H, it is necessary to analyze implicit tax rates – ITR, by which according to the methodology of the EU the real (effective) average tax burden on the tax bases or activities is measured. For the purposes of the analysis ITR on consumption is divided into four sub-categories: VAT, energy (excises+toll), tobacco and alcohol (excises) and other. Revenues from customs duties are included in the sub-category "other". Chart 14 shows that the tax burden on consumption in B&H is declining despite the fact that in B&H the VAT system is with single rate and broad base which, by definition, needs to be more efficient than the VAT system in the EU Member States with lower rates and zero rate. Analyses show that it is a result of tax evasion, the VAT debt growth, the growth of VAT exemptions on the use of IPA funds, the growth of VAT refunds to international projects and the fall of revenue collection efficiency (Antić, 2014). Only in the last two years there has been a rise in the tax burden, which is still below the initial values. Also, a significant share in the reduction of consumption taxation has the liberalization of trade. By analyzing the components of the implicit rate on consumption it is also possible to analyze the indirect effects of liberalization on the tax burden of consumption, given that customs duties and excise taxes are included in the base for calculating VAT.

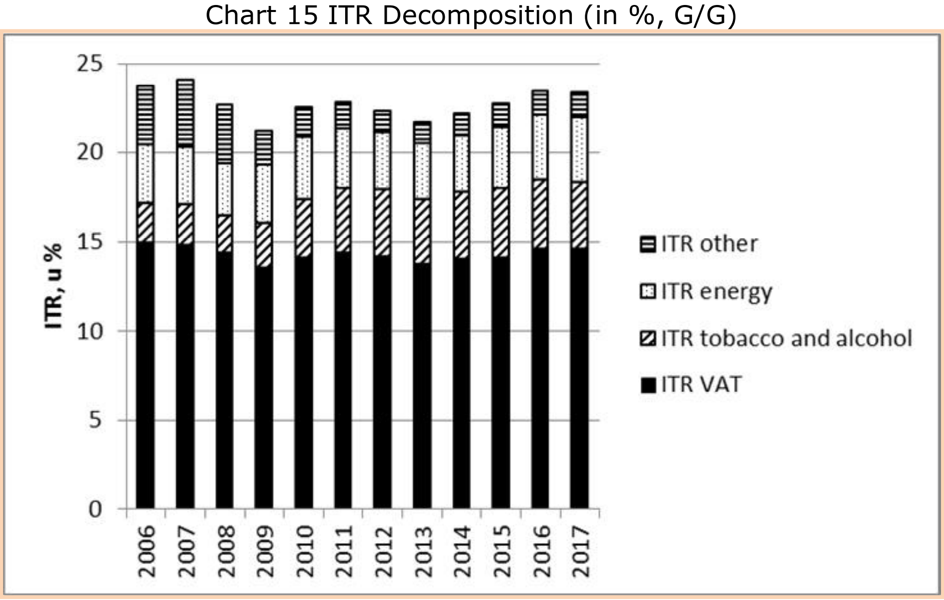
Chart 14 Implicit tax rate (ITR)




Source: GDP – B&H Agency for Statistics; revenues – Indirect Taxation Authority (2004-2017); Consumption estimates (2017) – Directorate for Economic Planning, September 2017; author's calculation.

Over the last two years the VAT tax burden has increased but it is still below the burden of the first few years after the introduction of VAT. Similarly, in the last two years there is a slowdown in the growth trend of the tax burden on excise taxes on tobacco and alcohol, and the growth of the burden on energy products. There is a noticeable weakening of the negative ITR related to other revenues (customs duties) as the five-year liberalization process of foreign trade with the EU ended and the growth in the last two years as the result of the growth of imports from third countries (Chart 15). It can be concluded that the growth of the tax burden, caused by the growth in excise revenues, could compensate for the fall in revenues caused by the liberalization of trade in the period 2007-2013, in addition to the economic crisis.

Chart 15 ITR Decomposition (in %, G/G)




Izvor Source: GDP – B&H Agency for Statistics; revenues – Indirect Taxation Authority (2004-2017); Consumption estimates (2017) – Directorate for Economic Planning, September 2017; author's calculation.

Tax evasion on the tobacco products market, due to the continued growth in retail prices since 2009 due to the harmonization of excise taxes on cigarettes with minimum EU standards, brings less and less effects in the form of additional revenues, and in 2013 a negative growth as well. The weakening of the tax reform effects over the last three years has been offset by the strong growth of excise revenues on oil derivatives[14], which are largely the result of the growth of non-residents' demand in border and transit traffic due to the tax competitiveness of B&H in the VAT and excise tax sector compared to countries in the environment resulting in the lowest prices of oil derivatives. Growth of demand for derivatives has also led to an increase in demand for tobacco products and other consumer goods in the border area, resulting in unexpected increase in revenues from excise taxes on tobacco in midd-2017 and excise taxes and tolls on oil derivatives as well as VAT.

The data on the effects of the application of the adapted SAA on revenues suggest that the losses in the exchange with Croatia are neutralized entirely by the increase in the collection of customs duties on the remaining imports from other Member States still in the customs regime. In 2017, despite all expectations and estimates of relevant domestic and international institutions, customs revenue growth of 8,4% was realized, which represent an increase of 20,1 million BAM compared to 2016 (MAU, 2018). According to projections of indirect tax revenues in the period 2018-2020 (MAU, 2017) the share of customs revenues collected on imports from the EU is planned to be 0,3% of GDP of B&H, while total customs duties make 0,9% of GDP[15]. Given that according to projections with unchanged indirect tax policy an annual net effect of 0,6% of GDP growth is expected, the abolition of customs duties on imports from the EU would have halved the expected effects. Under conditions of slow economic growth, additional excise revenues on oil derivatives can be a solid source for implementing the next phases of B&H trade liberalization with the EU and the rest of the world if B&H retains the tax attractive position of the country in the environment. However, the increase in tax burden of derivatives from 1 of February 2018 has reduced the tax competitiveness of B&H, which could have a negative impact on the excise revenue collection. Since the regional tax competitiveness is concerned, significant factors of revenue growth are tax policies implemented by the countries in the environment. The eventual increase of oil derivative taxes in the surrounding countries could neutralize the negative impact of the increase of taxes on oil derivatives in B&H. However, bearing in mind price turbulences in the oil world market and uncertainty of oil price trends, it can be concluded that it would be largely unreliable to plan to continue the liberalization of trade in B&H, with the reliance on compensation for the loss of customs revenue from excises on oil derivatives.

## 4. Conclusion

In B&H's case it can be concluded that the negative effects of the liberalization of customs duties on indirect tax revenues can be also successfully neutralized by well-coordinated tax reforms in small countries with a complex political and fiscal structure. The liberalization process in B&H was preceded by a major economic reform which meant replacing the sales tax with a generous VAT. This has created a solid revenue base for the most important phases of the trade liberalization process in B&H, with the surrounding countries and EU Member States. In the wake of the global economic crisis, B&H has also begun the reform of cigarette taxation in line with EU standards, and losses from customs duties are compensated by additional revenues from excise taxes on tobacco. In this way, trade liberalization with the EU, as a prerequisite for B&H's integration into the process of European integration, also acted as catalyst for incorporating EU taxation standards into B&H legislation. The rising trend of VAT refunds and debts as well as tax evasion on the tobacco and oil derivative market, due to differentiated taxation, led to erosion of VAT base and revenue loss, exhausting opportunities to continue the liberalization process. Possibility of reimbursing future losses of customs revenues after the increase of oil derivative tax on 1 of

[14] Collection of excise taxes on oil derivatives in 2016 was by 20% higher than the collection in 2014. Source: ITA.

[15] Source: ITA data (revenues), Directorate for Economic Planning (BDP), author's calculation.

February 2018 is questionable. Bearing this in mind, under the conditions of modest growth of the economy, income and consumption, the continuation of the liberalization of foreign trade with EU Members which expects B&H in the forthcoming phases of European integration process largely depends on the future VAT policy, as the main alternative source of revenue. An important factor of the revenue growth is also the efficiency of tax administration and control institutions of central and middle level of government in B&H in combating tax frauds and market distortions caused by differentiated indirect tax policy.

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