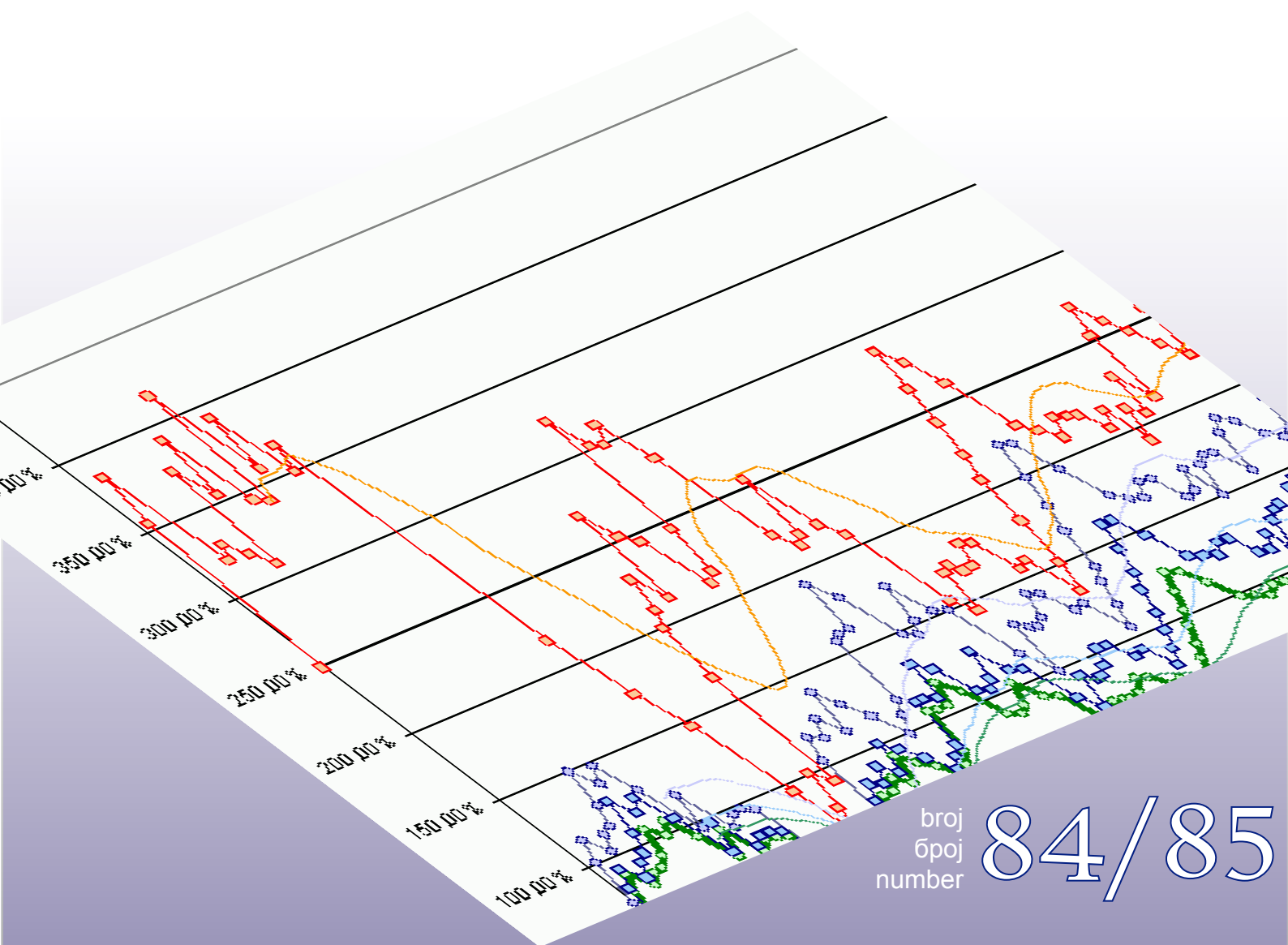




Macroeconomic Unit of the Governing Board of the Indirect Tax Authority

# *Oma Bilten*



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## With a double issue

Growth of 4,75% in net revenues of indirect taxes in July 2012 was not sufficient to compensate the decrease of revenues in the previous month (Chart 1). According to the ITA preliminary report on the collection of indirect taxes for seven months of 2012 it was collected 16 million KM less compared to the same period of 2011 or 0,16 % (Chart 2).

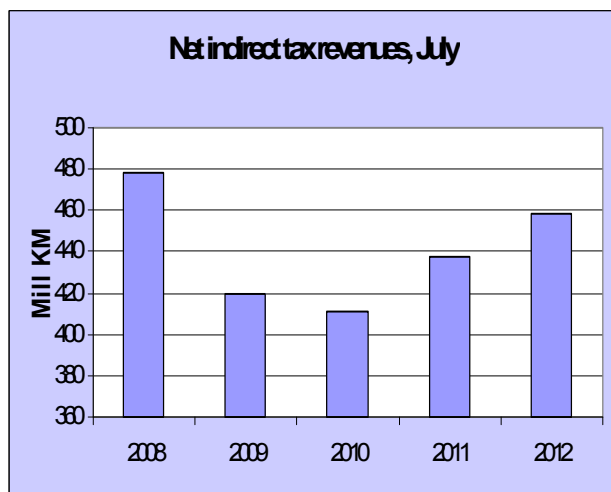


Chart 1

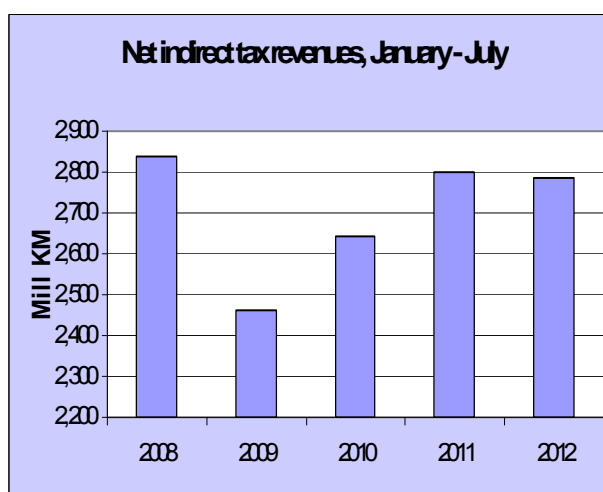


Chart 2

Besides negative trends in B&H economy which is reflected in the decline of production, consumption and employment, the efficiency of revenue collection, movements of tax debts and volume of tax and customs frauds affect tax collection as well. In addition to the analysis of indirect tax revenue for the period January – July 2012 in this double issue we also give a comprehensive overview of developments in the Global Summit of the World Customs Organization which was this year entirely devoted to the excise duties. The overview of measures taken over by the countries facing a severe loss of revenues from excise duties may be also useful for the operational work of the ITA to combat fraud but also for the collection of indirect taxes in general, given the growing importance of revenues from excise duties for the fiscal balance of B&H.

Dinka Antić, PhD  
Head of Unit

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## Collection of indirect taxes, January – July 2012

(Author: Dinka Antić, PhD)

### Total collection

According to the ITA preliminary report by types of revenue in July 2012 it was collected net revenue from indirect taxes 458,417 million KM or 4,75% more compared to the same month of 2011. It was collected 2,783 billion KM of net revenue for seven months. The increase in revenue in July was not enough to compensate for the decline in revenue in June so the cumulative collection for the period January – July 2012 decreased by 16 million KM or 0,6% compared to the same period of 2011 which is for 1,7 percentage points below the annual projections of the Unit (Chart 1).

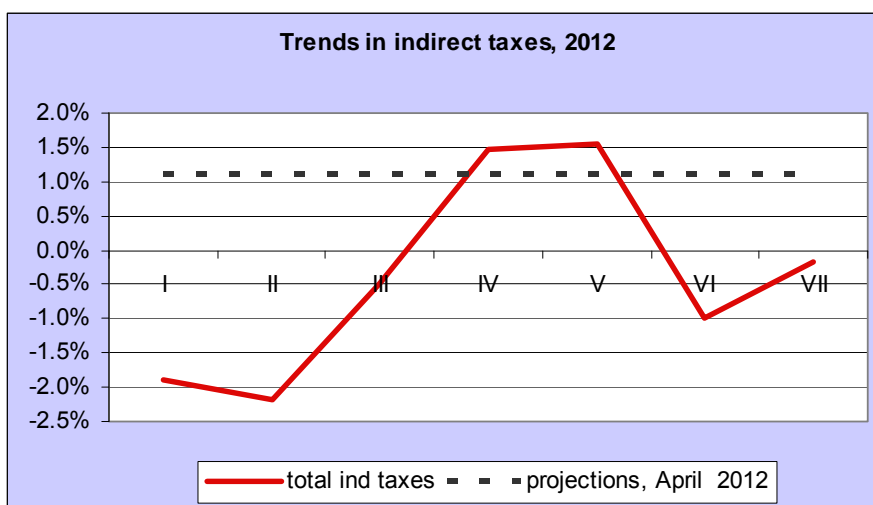


Chart 1

Sliding trend of indirect taxes can be noted from Chart 2 as well, which shows trend of the moving 12 month cumulative.

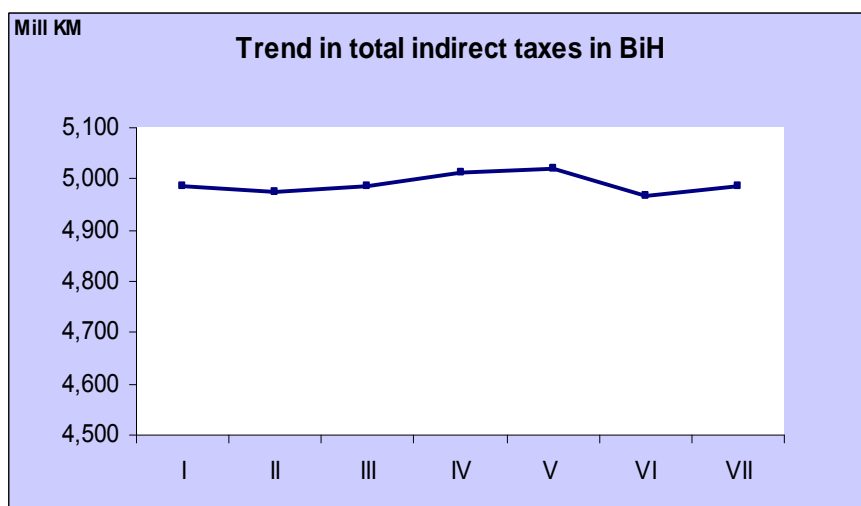


Chart 2

**Analysis by types of revenue**

*Customs*

After stabilization of customs revenue, which was the result of a five-year process of reducing imports of goods originating from the EU to duty free import, the last three quarters brought to 2011 the deterioration in the collection (Chart 3). The reasons for this are, among other things, the abolition of customs records of 1% from October 2011 and decrease of imports in 2012. As a whole, the collection of customs revenue in 2012 is within the annual projections of the Unit (Chart 4). Since October the collection of revenue on a monthly basis is expected to be stabilized due to the lower base of comparison from the last quarter of 2011.

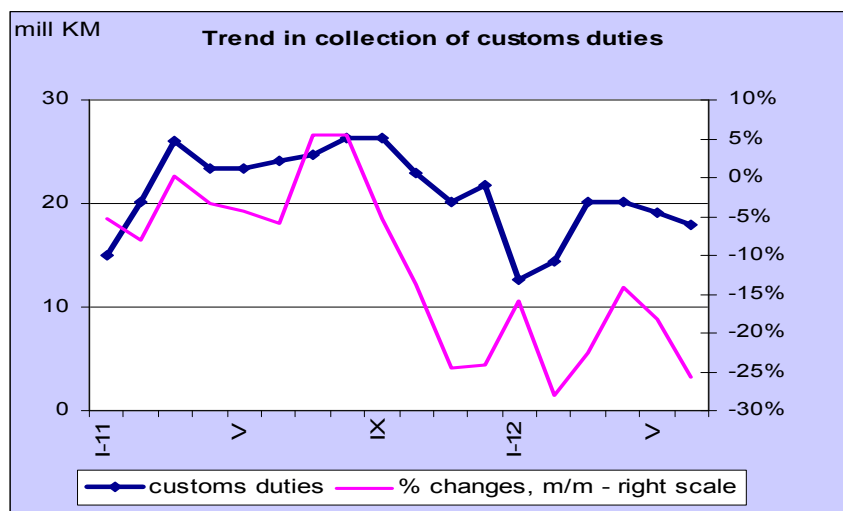


Chart 3

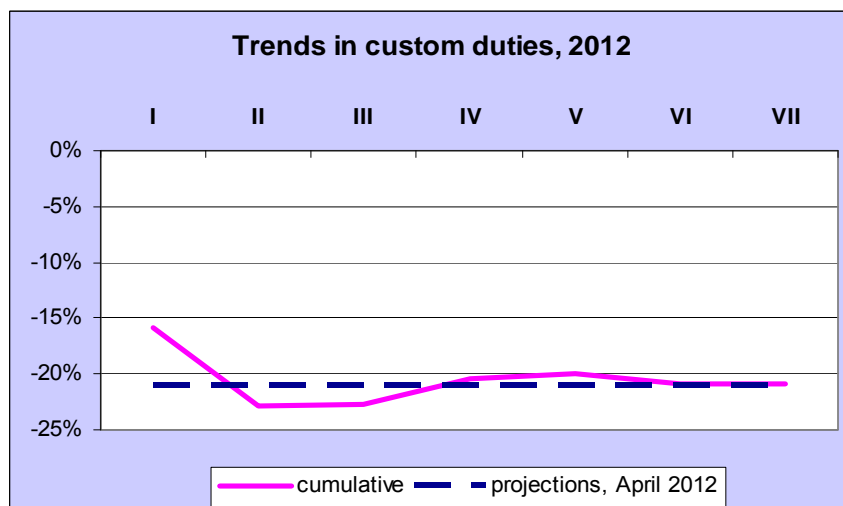


Chart 4

## VAT

Observing the basic groups of revenue from indirect taxes only revenue from VAT maintained at the level of the first half of 2011. That trend also continued in July (Chart 5) when there was a growth in net revenue of even 8,5%. The increase in VAT collection in July led to an increase in the cumulative collection for period January – July of 1,44%, which is for 0,6 percentage points above the annual projection of the Unit (Chart 6).

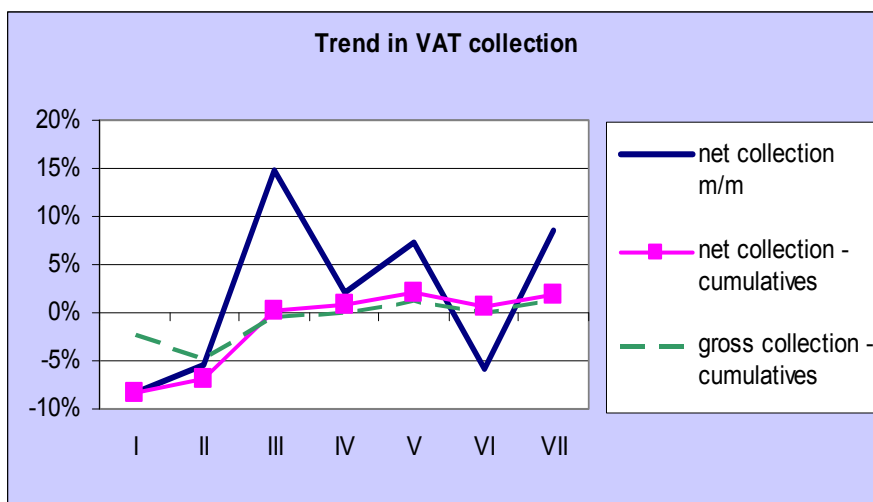


Chart 5

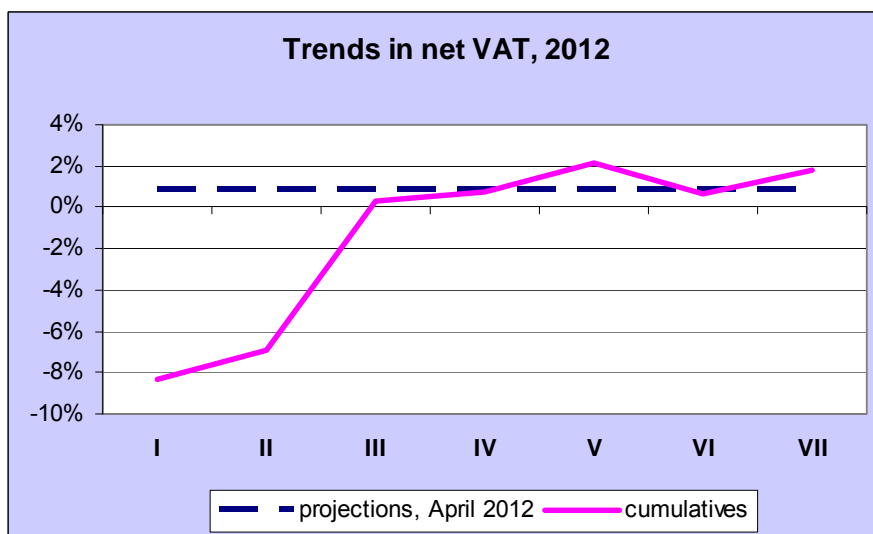


Chart 6

Given that most of unadjusted revenues are related to VAT it can be expected a higher growth in net VAT in the final report of the ITA. On the other hand, revenue collection from VAT since the outbreak of the global crisis is burdened by the growing refunds and debts on the basis of filed and unpaid VAT.

In the period January – July a slightly higher amount of refunds on indirect taxes was paid. However, analysis of the structure indicates an increase in refunds paid to taxpayers of 13,3 million KM or 3,02%. On the other hand, a reduction of refunds to international organizations and projects is evident. These trends have led to changes in the refund structure in favour of refunds

to taxpayers (Table 1). After several years of the strong growth of refunds to international projects and organizations there has been a decrease in the share of this refund category in total refunds but this group of refunds remains still significantly above the pre-crisis level of 2008. We note that the increase of other refunds from indirect taxes (excises, customs, road fees) of 2010 can be explained by the refunds of road fees payments to the taxpayers who are exempted from road fees by the new Law on Excise Duties (mines, railways and power plants) and due to a delay of making a decision on exempted quantities of diesel they subsequently exercised the right to a refund of paid road fee.

Table 1: Structure of refunds (I-VII) in %

	2008	2009	2010	2011	2012
Refund to taxpayers	95.1%	90.8%	88.8%	87.4%	89.4%
Refund to international projects and organizations	4.1%	8.4%	9.7%	10.7%	9.2%
Other refunds	0.8%	0.8%	1.5%	1.9%	1.4%

### Excise duties

Collection of excise duties in July 2012 was equal to the collection from July 2011 (Chart 7). Divergent trends were recorded in July. A strong increase of excise duties on cigarettes of 25% was not enough to compensate for a great decline of oil derivatives of 28%.

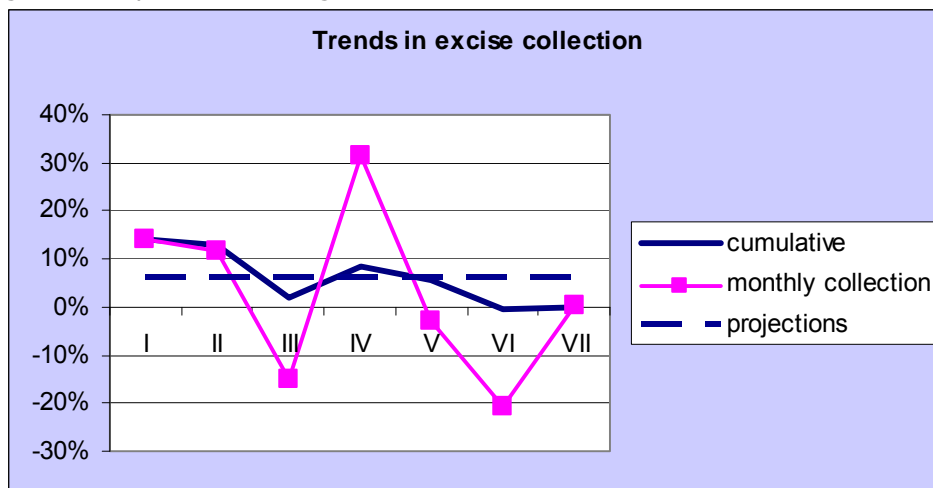


Chart 7

	VII 2012/ VII 2011	cumulative 2012/ 2011
Total tobacco	25,40%	4,98%
Tobacco imports	15,89%	6,39%
Tobacco domestic	50,39%	1,65%
Oil derivatives	-28,35%	-9,35%
Imported	-3,76%	-8,61%
Domestic	-46,67%	-10,30%
Coffee	15,21%	6,58%
alcohol, beer	5,84%	1,21%
Road fee, gross	2,58%	-2,76%

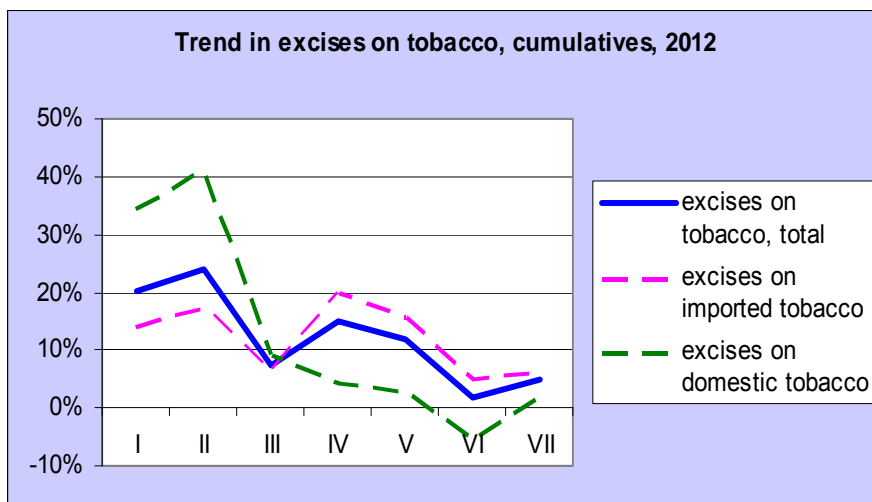


Chart 8

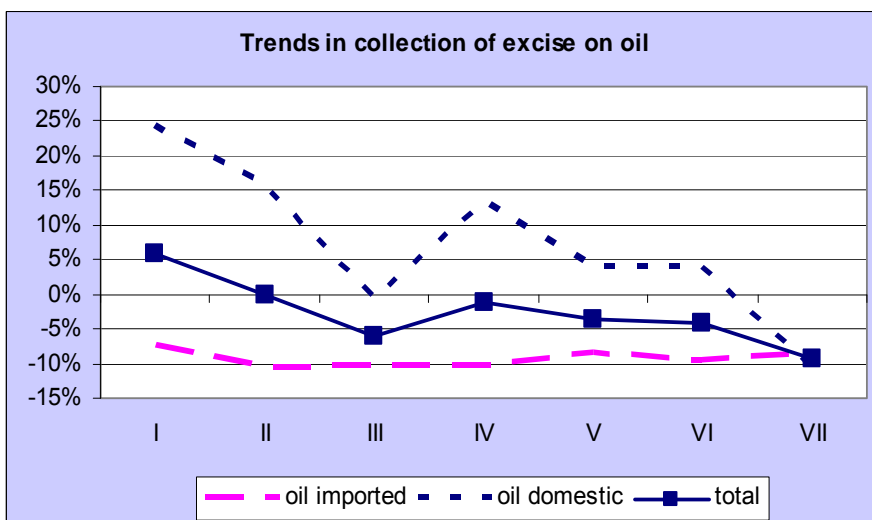


Chart 9

Comparison of collection of excise duties by product groups for seven months of 2012 with annual projections of the Unit indicates troublesome trends in oil derivatives. While projecting revenue for 2012 current negative trends in excise collection and road fees on derivatives that were a result of the economic crisis and differentiated derivative taxation on the volume and structure of derivative consumption were taken into account. However, the data indicate that current trends are far worse than pessimistic projections of the Unit. Although the collection of revenue from excise on cigarettes for seven months of 2012 is for 5% higher compared to the same period of 2011, it is still below the annual projections of the Unit. The reasons for this are significant fluctuations in the volume and structure of brands that are on the market as a result of fierce fighting between few companies from tobacco industry in the fight for taking over the cigarette market which is constantly decreasing by the continuous increase of excise duties. At the same time, despite the significant increase in prices and value of its total turnover, there was a decline in consumption and re-composition of overtaking from rising retail prices in favour of the state revenue and at the expense of profits. Current trends of other excise products correspond to projected revenue.

## Global Excise Summit – a letter from Brussels

(Author: Aleksandar Eskić, Macroeconomist in Unit)

### Introduction

At the beginning of July of 2012 Global Excise Summit was held in Brussels and is organized by the World Customs Organization and the International Tax and Investment Center. This event brought together over 160 representatives of customs and tax administrations, academic and business communities from over 60 countries worldwide. Summit was chaired by Mr. Mike Norgrove. The goal of the Summit was to discuss issues of customs and tax administration, activities aimed at fair and efficient collection of these revenues as well as modalities of cooperation between public and private sectors related to the upgrade and consistent compliance of tax and customs regulations.

Secretary General of the World Customs Organization Mr. Kunio Mikuriya in his opening comments encouraged the members to compliant private sector in accordance with the instruments for trade facilitation of the World Customs Organization. The conclusion is that the customs (and tax) administrations and private sector play a significant role in the fair and accurate collection of revenues and economic development. He pointed that the customs administrations are law enforcement and the World Customs Organization continues to support members in developing models of effective and efficient border control.

World Customs Organization is ready to support forums where tax administrations, customs administrations and the private sector would consider specific issues such as valuation of goods subject to trade, development and enforcement of relevant regulations and audit and control techniques to reduce the administrative burden in terms of customs duties, excise duties, VAT and income tax.

Excise duties remain an important component of government revenues. Therefore, it is important to have a transparent, predictable and balanced approach to making excise duties policy development, to improve the process of administering excise duties and provide real incentives for their full enforcement. There is a strong need for establishing and maintaining permanent control procedures in the field of excise duties at national level that would be an adjunct to an increased level of cooperation between customs authorities, tax authorities and other law enforcement agencies with the aim of protecting public revenues and identifying the risk of growth of illicit trade. Cross-border cooperation at the international level significantly improves the operational impact on the activities of law enforcement agencies and supports coordinated responses to the evasion of excise duties and illicit trade.

Cooperation between customs / tax authorities with a legitimate business community raises the level of transparency and the security of supply chains of legitimate trade and supports the common interests of the public and legitimate private sector (and thus society in general) to curb illicit trade. Knowledge of the regime of functioning and governance of key industrial sectors are important elements in risk assessment and reporting process. Customs administration and the participants in supply chain should build relationships and exchange information aimed at improved understanding of domestic and international markets.

WCO encourages studies how different models of delivery channels, such as managing key account clients, affect the assurance of revenue at the best price for both the government and for taxpayers. The solutions include the use of information and communication technologies in support of customs and tax administrations that can raise the level of transparency, protect revenue and control of delivery channels. This may be of particular importance when one takes



into account the trend of dematerialization and digitization of documents and automated risk assessment systems.

### Principles of excise taxation

Excise duties should be broadly defined to include taxes on smoking, drinking, gambling, polluting (including energy consumption) and driving (cars namely)<sup>1</sup>. Excise duties are deliberately selective and discriminatory. Excise tax liabilities are often measured quantitatively and enforcement may be subject to physical control. The goal is to improve the excise taxation of market and broader social objectives, as well as economically justifiable resource allocation. By contrast, sales taxes including VAT tax consumption including all goods and services, unless there are specific exemptions. The goal of sales taxes is revenue and compliance is controlled through accounting checks.

Consumer sovereignty prescribes that rational and fully informed individuals should make their own decisions what to consume and what not, but external costs imposed on other people should be included. Internalization of external costs induces consumers or users to make optimal decisions from a sociological point of view. Ideally, excise duties should be equal to marginal cost of damage caused to other people what is possible if the relationship between these costs and consumption is linear. If costs rise disproportionately with the increase of consumption, then the average cost approach is the second-best solution. Supplementary regulation is used to control the costs of externalities.

In a perfect market for a homogeneous good there is no difference between specific and ad valorem duties, but markets are not perfect. Specific duties establishes a link with the costs of externalities, it is easily administered, and the problem of determining the valuation (transfer pricing) issues do not arise. Ad valorem duty is difficult to administer, discourages improvements in terms of quality and discriminate in favor of cheaper goods. In addition, specific duties should be indexed to inflation.

In general, excise duties should be increased to the level of costs of externalities, but not beyond that. In any case, there are two exceptions:

1. further increase is justified if consumers (for example young people) are not rational or fully informed about what they are doing
2. further increase is also justified if the marginal cost of collecting excise duties is less than the cost of collecting VAT

Traditionally, excise duties are desirable source of revenue because these goods are:

- widely consumed
- demand is inelastic
- there are few producers (except wine)
- there are no readily available substitutes in the short term
- administration and compliance costs are relatively low

In general, excise duties on luxury goods are not recommended because:

- taxable base is very small
- progressivity is negligible and should be promoted through the income tax (paid by the rich who buy luxury goods)
- administration (ad valorem tax) is problematic

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<sup>1</sup> Sijbren Cnossen, University of Maastricht (economics) and University in Rotterdam (law)  
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- legal or illegal importation is easy (cars, yachts and private planes are the main exceptions)

### Excise duty on tobacco products and illicit trade

It is proven that there is a strong link between the level of the tax burden and the illicit trade of excise products<sup>2</sup>. Illicit trade in tobacco products is especially serious problem and is a global phenomenon that covers all continents including countries with both high and low levels of income. According to some studies<sup>3</sup>, approximately 11% of global cigarette market is illicit resulting in loss of public revenue in the amount of approximately \$ 40 billion annually.

Illegal trade has significant negative impact on:

- loss of public revenue
- ***national security and growth of organized crime***
- erosion of respect for the rule of law
- financial loss of legitimate industry, trade and employment
- enhanced access to cheap and uncontrolled products which particularly has negative impact on health of consumers

There are two basic reasons for this:

- an excessive level of taxation that often results in a sharp decline in the affordability of cigarettes in terms of increased share of income needed to purchase the goods
- willingness of organized crime to complement the level of supply given the opportunity to gain huge profits from tax evasion

Even in countries that are traditionally considered as those with a high level of compliance with the rule of law, such as the United Kingdom, France, Germany, Italy, Japan, Canada and the U.S. faced with the increased share of illicit and illegal market up to 30%<sup>4</sup> due to increase in retail prices induced by increase of excise duties. Based on this experience it is well known the statement of the Prime Minister of Malaysia in late 2011 who opposed the additional tax pressures that would be reflected in the growth of the retail price of cigarettes when illegal market has already reached a level of 40%. Also, there is a statement by the Prime Minister of Singapore, who in late of 2006, after considering raising the tax burden on tobacco products, gave up because of the existing high level of smuggling which were already adversely affected on the revenues from taxation of these types of goods.

Statement of the Minister of Finance of the Republic of Ireland in late 2009, where the excise incidence on the most popular price category was 61.4%, was in line of opposing the direction of raising the level of burden on tobacco products on the grounds that this would lead to massive smuggling of cigarettes, while emphasizing his duties as a Minister of Finance to protect the tax base i.e. tobacco industry. At the same frame of it was a statement of the Minister of Finance of the Kingdom of Norway in early 2012, which emphasized that, apart from the obligation of providing revenue for the state, the purpose of excise burden on tobacco products is to limit consumption in order to avoid increasing of illicit cross-border trade and smuggling.

When intend to increase the tax burden on cigarettes, three key elements must be taken into account for successful implementation:

- *how the tax burden (through retail selling prices) affects the consumers affordability*

<sup>2</sup> Adrian Cooper, CEO of Oxford Economics

<sup>3</sup> Framework Convention Alliance, 2008

<sup>4</sup> Available data for the period 1998 - 2010

- *level of prices in neighboring countries*
- *total level of excise burden and proposed increase dynamics*

It should be borne in mind that illicit trade has negative impact on public revenues and the policies that aim to reduce smoking by increasing the accessibility to cheap cigarettes. There are three basic ways for illicit cigarettes arrive legally on the market:

- smuggling of genuine cigarettes
- smuggling of illegally manufactured cigarettes (illegally manufactured cigarettes so called night shifts and illegal factories)
- smuggling of cheap white cigarettes<sup>5</sup>

Below are presented the case study of Hungary and Romania in the fight against smuggling<sup>6</sup>. The main cause of the increase of illicit trade in these countries is rapid increase level of cigarette excise burden. In Hungary, the level of excise burden was:

*2000: 18,45 EUR*

*2005: 46,74 EUR*

*2008: 67,49 EUR*

*2010: 76,89 EUR*

while the retail selling price was increased on average by about 80% in the period 2000 - 2005. The increase in price was an incentive for smuggling. At the same time people quit smoking and the cigarette market shrank in its size. There was a reduction in trade of legitimate cigarettes by 30%. At the same time, demand for fine-cut tobacco is quadrupled. Illicit market share rose to 27% in 2005. Immediate intervention was imperative!

At that moment customs and tax authorities decided to mobilize resources and engage in the fight against smuggling through coordinated actions. Basic characteristics of this approach are:

- more staff at critical points
- more security elements on excise stamps
- improved legislation
- new working procedures
- deployment of devices such as X-ray on the road and rail crossings
- new system of motivation
- modernization of canine training to detect smuggling
- increased control on the green borders
- improved cooperation with police
- improved cooperation with other countries
- cooperation with the tobacco industry

As a result, the illicit market share was reduced to a level of 3.8% in 2012.

Romania had a bigger problem considering that the illicit market share was 36.2% in the first quarter of 2010. Approximately 85% of the cigarettes arrived over the green borders. Then the strategy was developed by the national customs and tax administration which was approved by the Minister of Finance and Minister of Internal Affairs as well.

Changes in laws and other regulations have allowed:

- confiscation of modified vehicles for smuggling
- limitation of imports from free trade zones
- changes of definition of smuggling

<sup>5</sup> European example of cheap white cigarettes is brand Jin Ling that is produced in Kalindrad, Russia and in Ukraine and Moldavia. Seizure of this brand ranged from one million packs in 2005 to 400 million packs in 2009. These cigarettes can only be found on street market that is under control of organized crime groups.

<sup>6</sup> Janos Nagy, former director general of Hungarian Customs and Finance Guard  
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- changes of definition of tax fraud
- provision of information by banks
- acceleration of court proceedings
- cooperation with tobacco industry
- dog training<sup>7</sup>
- purchase of new equipment and 38 dog teams
- reorganization of customs administration in July 2011 (reducing the number of employees from 4568 to 3159)
- international cooperation (neighboring countries, the European Union - exchange of information, coordination of inspections, joint actions)
- establishment of central database of seized cigarettes in cooperation with the police
- establishment of a training center for mobile teams and canine teams in Giurgiu
- purchase of new vehicles and communications devices for 10 mobile teams
- establishment of task forces made up of customs and police officials in the fight against smuggling
- establishment of a joint intelligence unit made up of customs and police officials
- establishment of intelligence units
- efficient detection of fiscal fraud through better monitoring, assessment and risk management

Revenues from excise duties on cigarettes increased from 1.35 billion Euros to 1.70 billion Euros (an increase of around 350 million Euros in a year) while the share of illicit cigarette market in Romania decreased from 36.2% in the first quarter of 2010 to 13.4% in the last quarter of 2011.

### **Excise duty on alcohol and illicit trade**

Illicit production of alcohol is carried out by organized criminal groups that have enough resources, and are organized like a real business organization, often well-connected and also hamper operations of legitimate manufacturers that do business in a highly corrupt environment. Among the main dangers of uncontrolled production of alcohol and alcoholic beverages are increased risk to human health and the distortion of the reputation of legitimate manufacturers of alcohol and alcoholic beverages.

Legal forms of illicit trade include cross-border trade and purchasing for others (in accordance with binding rules). Illegal forms of illicit trade are procurement from outside for non-taxable sales in the country, organized smuggling and evasion of taxes and other duties on a large scale. The controls are essential in order to detect and prevent the illicit trade activities and also facilitate the free movement of legitimate goods. Reduced level of income for the purchase of alcoholic beverages is an incentive for the illicit production and sale of alcohol. Also, a large difference in tax burden comparing with neighboring countries is a powerful incentive for smuggling.

An example that follows show enormous difference in the level of the minimum excise duty on beer (12 degrees per Plato or 4.8% ABV in Euros per hectoliter on April 1<sup>st</sup>, 2012)<sup>8</sup>:

France (13.2) - United Kingdom (108.9)  
Denmark (41) - Sweden (87.9) - Finland (143.5)

Lack of government resources results in:

<sup>7</sup> JTI has donated 30 000 Euros for dog training

<sup>8</sup> SABMiller

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- inadequate enforcement of laws
- focus on seizures and quick successes
- do not tackle investigation of routes of criminal groups

### Excise duty on mineral oil and illicit trade

Below are presented the case of United Kingdom and Republic of Ireland in regard to the taxation of fuel. Revenues from taxation of mineral oil products have a significant share in total public revenues. In the UK they amount to over 27 billion pounds a year which is double the revenue from taxation of tobacco products and alcoholic beverages.

Some derivatives are taxed at a lower rate when used for specific purposes such as agriculture, boats, planes, trains, construction. These fuels are marked in order to prevent them being used as a road fuel.

The tax differential creates opportunities for organized groups and businesses to use more sophisticated methods to avoid taxes.

There is a great potential for these types of frauds to continue to grow due to:

- fuel prices increase
- economic downturn
- additional pressures on the industry
- increased availability of formulas of this kind on the Internet

It is estimated that the revenue loss due to fraud with fuel is about 750 million pounds a year. In addition, there is a huge cost of environmental pollution. Fuel as well as tobacco and alcohol, is another commodity that lends itself to tax evasion. It takes continuous improvement of detection techniques and the purpose of its usage. Trial on enhanced marker in North Ireland is scheduled for October 2012th year.

Republic of Ireland has launched a Project mineral oil. The reasons for launching this comprehensive Project are numerous, among which has been stressed:

- a significant loss of revenue due to illicit activities with fuel
- problems with markers
- the recently observed phenomena of stretching petrol, which led to the suspension of sales
- increased number of cases falling fuel quality
- increase the number of pop-up stations
- increased concern of legitimate traders
- media attention

Nowadays, traders of auto-fuel currently require Revenue license to trade with derivatives of mineral oil. This will enhance controlling access to market through extension of licensing regime for traders of marker gas oil (diesel and heating oil). Introduction of mandatory return of information on oil movements by all licensed traders to support supply chain analysis is also news. All licenses are to be renewed annually from July 1<sup>st</sup>, 2013. License conditions include the adequacy of premises, safe access for Revenue officials and accurate meters on pumps. The legislation related to the types of mandatory accounting documents and information it must contain is revised. It is mandatory monthly submission of data on trade by licensed traders through on-line applications. This system is to be effective from the beginning of next year.

Mandatory information that all warehouse keepers, distributors and gas stations and forecourt retailers need to provide are:

- Opening balance by product type
- Closing balance by product type
- Each inward movement by product type, date, quantity, invoice, customer quoting license number or VAT number
- Each inward movement by product type, date, quantity, invoice, supplier quoting license number or VAT number

### **Usage of technology aimed at tackling illicit trade**

Traditional tax stamps serve as a proof of paid duties. They are usually used for marking of tobacco products and alcoholic beverages. The main weaknesses are that they can be counterfeited within just a few weeks. However, security elements are improving, increasing production costs being borne by registered taxpayers. Theft of tax stamps is possible which stands as a challenge to the security aspects and influences the overall cost.

Some other solutions for marking are possible that involve the use of ink and laser. Many of these service providers are actively lobbying to ensure that the use of tax stamps is gradually decreasing. The main weakness is that it would represent a significant cost for large domestic producers. At the same time, the position of small manufacturers and importers would be endangered because a new solution of that kind requires extra time and money. In particular this applies to beer producers where they have large quantities in terms of number of packages with low unit price. As a result, brands that are consumed in small amounts as well as small importers would become uneconomic.

If take tobacco industry as an example it can be noticed a significant share of illicit trade. Globally speaking share of counterfeit is 30%. This represents a violation of intellectual property as well. It raises the potential risk of loss of consumer confidence and a huge loss of revenue for government. A possible solution is to harmonize standards of a particular industry at the international level. The unique marking of each carton of 200 cigarettes, a digital code with information about time and place of origin as well as information about the brand and the country for which the product is intended to be made should be made available for customs and tax officials in real-time.

The fact is that the information held by the business sector (taxpayers) can be useful in the fight against illicit production and smuggling, such as: information and trends of specific market segments, information on production and consumption, information on raw materials and suppliers, as well as arrangements of transport and transporters. Presented solutions vary depending on whether it had intended to solve the problem of counterfeit, tax evasion or smuggling. When the counterfeit is in focus proposed solutions involve the use of authentication of covert and overt identifiers in order to determine whether it is original or a counterfeit. When tax evasion is in focus proposed solution is tax verification in terms of monitor and control of quantity of manufactured products in order to verify accuracy of due duties and paid duties. An instrument that would support the above goals is a digital identification and tax verification (DTV). Positive sides of this solution is that it provides results at a low cost so that all manufacturers can use it, provides control over production by the authorities as well as authentication by all participants in the supply chain. As for the smuggling, model of track and trace of products is suggested in order to provide control over its movement through the supply chain. In any case, a key factor in reducing the illicit trade of any legitimate product is securing supply chain.

## Conclusion

In times of crisis there is a need to do more and achieve better results with less available resources. What seems to be the imperative for customs and tax authorities are:

- to provide timely responses to the global financial crisis and its impact on revenue collection from excise
- to be ready for the role of customs administrations in the 21 century to ensure their prompt, efficient and predictable border control of goods and people
- to comply with the Framework Convention on Tobacco Control by the World Health Organization
- to secure global supply chain from criminal threats
- to respond to the challenges on budgets and resources of the public sector

International cooperation is also an important instrument in the fight against illegal trade and production. One initiative by OECD is of great importance named "Oslo dialogue" that represents comprehensive approach of government in the fight against financial crime, including tax offences and financial fraud. Tax offences, commercial fraud, smuggling, money laundering and other illicit financial crimes threaten the strategic, political and economic interests of countries. Oslo dialogue was launched at the first Forum on Tax and Crime held in Oslo in March 2011 to encourage greater cooperation in combating all forms of financial crime. It brings together representatives from the ministries of justice and finance, tax administrations, law enforcement agencies, anti-money laundering authorities, anti-corruption authorities and financial regulators.

Three main pillars are:

- effective domestic cooperation between tax, regulatory and law enforcement agencies is vital
- addressing financial crime in a globalized world requires a global response, including cooperation and sharing of information between countries
- countering financial crimes requires knowledge of strategic and practical investigation techniques

Second Forum on Tax and Crime was held in Rome in June 2012 which was attended by over 250 delegates from 60 jurisdictions, including international organizations such IMF, World Bank, UN organizations and the private sector.

Leaders of the G20 countries also welcome efforts to enhance inter-agency cooperation in order to tackle illicit flows including the outcomes of the Rome meeting of the Oslo dialogue.

Bosnia and Herzegovina should be a part of such international initiatives while encouraging cooperation and effective share of information between domestic government institutions that could effectively end the illicit trade. Otherwise, the rule of law could be undermined, and direct damage could be born legitimate industry, government institutions as well as all users of social security funds that would not receive services at a satisfactory level of quality. It can be seen in the example of other countries that has been shown that success can not be absent if political consensus is achieved, establish appropriate organization supported by adequate legislation and tackling illicit trade set as a top priority. It should not be forgotten that design of excise policy is actually the first prerequisite whose effects are to be continuously monitored. Any inconsistency in this area can cause problems with devastating consequences for economic and social system. Above all, the end results are really the only measure of success in this case.

## Tax revenues of cantons and municipalities in FB&H

(Prepared by: Aleksandra Regoje, macroeconomist in the Unit)

### Introduction

Revenues of cantons and municipalities have a significant share in the revenues of Federation B&H. According to MAU report which includes Budget of FB&H, cantons, municipalities and funds, the share of cantons and municipalities in tax revenues (including contributions) is about one-third. If we exclude extra-budgetary funds, than that proportion reaches over 60%.

The following describes the dynamics of tax revenues in municipalities and cantons in FB&H in the past few years, and their importance for the financing of these levels. The most important factors affecting their collection are first described in order to understand the dynamics of these revenues.

### Conditionality of tax revenues

There are a lot of factors that affect taxes collected in a country. Some of them are economic development, regulation of tax systems, organization of tax administration, level of gray economy, population, openness of the economy, and there are many others.

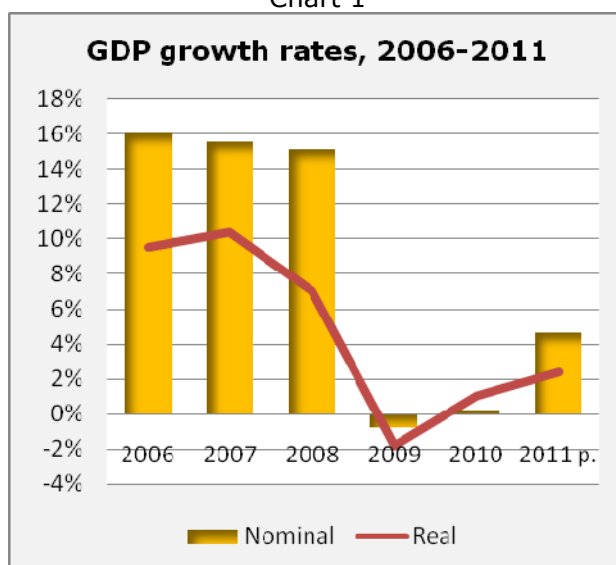
The main factors that have impacted the change in the amount of tax revenues in FB&H and the cantons and municipalities in the recent period will be described here. Among the most important we can include the following:

- Economic trends,
- Tax reforms,
- Distribution of revenues.

#### *Economic trends*

Level of tax rates has a strong impact on economic growth and development, while on the other hand the rate of economic growth largely determines the amount of tax revenue. Dynamics of gross domestic product (GDP) is among the main determinants of tax revenue. Higher GDP brings a broader tax base and revenues, and vice versa.

Chart 1



Source: DEP, Annual report 2011, April 2012

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Chart 1 shows the movements of GDP (nominal and real growth rates) in Bosnia and Herzegovina in the last six years (DEP). After strong economic growth in the period 2006-2008, it is recorded in 2009 the decrease in nominal and real gross domestic product. The real growth begins again in 2010, but very modest, amounting to 1%. It is estimated that it amounted 2,4% in 2011.

### *Tax reforms*

The introduction of VAT in 2006 brought a strong growth of indirect taxes at all levels in B&H. The reforms in the area of indirect taxation have also been implemented after 2006, which, among others, had an impact on the budgets of municipalities and cantons in FB&H. It should be noted that provisions of the Stabilization and Association Agreement which entered into force as of 1st July 2008 brought a sharp drop in customs revenue, especially in 2009. The new Law on Excise Taxes entered into force in July 2009. The provisions relating to the road fee and tobacco positively influenced the dynamics of indirect taxes.

Reforms in the system of direct taxation were carried out in 2008 and 2009. New Law on Profit Tax (1st January 2008) prescribed reducing rate from 30% to 10%. Personal income tax (1st January 2009) replaced wage tax and a number of taxes related to taxation of citizens.

### *The methodology of revenue distribution*

Regarding the allocation of indirect taxes, the budgets of all levels in the FB&H, and so the cantons and municipalities, have been impacted by the following factors:

- (a) The share of B&H Institutions in revenue distribution,
- (b) Allocation coefficients for FB&H,
- (c) Amount of repayment of FB&H foreign debt.

(a) When distributing the net revenues from the ITA Single Account (SA), it is first allocated the share for financing B&H institutions. A higher proportion of B&H institutions means less revenue for other levels, and vice versa. The share of B&H Institutions has been growing in the period from 2006 to 2009. In 2010 it declined compared to 2009. In 2011 it was kept at the level of the previous year. In 2007 and 2008 the rate of growth for the Institutions of Bosnia and Herzegovina roughly corresponded to the rate of growth of indirect taxes collected on the SA. On the other hand, in 2009 and 2010 these rates were significantly different. In 2009 the share of the B&H institutions grew, and the collection of revenues to SA decreased. In 2010 the opposite situation occurred, SA revenues grew and share of B&H Institutions decreased. Temporary financing of the B&H Institutions had been in force during entire 2011, so the amount of distributed funds remained the same as in the year before, and revenue collected on the SA increased.

(b) After distribution of funds to finance the B&H Institutions, the rest of indirect taxes are shared to entities and Brcko District according to coefficients calculated on the basis of the share in final consumption. The growth of allocation coefficient means a higher rate of growth of revenues allocated to a given entity from the total allocated revenues, and vice versa.

(c) The level of foreign debt repayment in Federation has a similar effect on distribution as the share of funds for B&H Institutions. The strong growth rates of debt repayment amounts were recorded in the period 2009-2011.

In addition to these, we should bear in mind the other, so to speak technical, factors which influenced the dynamics of distribution from SA, like the suspension of refunds to taxpayers who are not predominant exporters in 2006, then the rate of allocation for reserves, settlements between the entities etc.

For the further observation of indirect taxes distribution at the level of FB&H, as well as the distribution of other revenues, it is important to mention the Law on the Repartition of Public Revenues in the FB&H adopted in 2006, which regulates revenue repartition in budgets of FB&H, cantons, municipalities and road funds. Its main goal is the introduction of transparent and predictable system of distribution, and it also brought the elements of horizontal fiscal equalization.<sup>9</sup>

### **The structure of cantonal and municipal revenues**

After consideration of the factors affecting the dynamics of tax revenues of municipalities and cantons in the Federation, it will be interesting to see how they have actually been moving. The total amounts in all cantons and municipalities, as well as the individual in every canton, will be observed.

Firstly we should pay attention to the importance of tax revenue in the financial resources of municipalities and cantons, especially the revenue from indirect taxes. Chart 2 shows the share of tax revenue in the sum of tax and non-tax revenue in the cantons, municipalities (by cantons) and collectively (municipalities of the canton and canton). It can be seen that this share is more significant in the case of cantons than in municipalities, ranging between 83% and 94%. In the case of municipalities, this share ranges from 32,4% in municipalities of Sarajevo to 72,6% in municipalities of Bosnia-Podrinje Canton.<sup>10</sup> When comparing one should bear in mind the provision of the Law on the Repartition of Public Revenues in the FB&H (Article 24) according to which indirect taxes from a single account which belong to the municipalities of Sarajevo are allocated to Sarajevo Canton, then distributed afterwards to the local governments, according to cantonal laws and regulations. It is therefore more correct to observe these indicators collectively, by gathering revenues of all municipalities of the canton and cantonal revenue. Due to the significant weighting of cantonal revenue in this sum, the range of shares calculated in this way, doesn't significantly differ from the above indicators for the cantons, ranging from 72% to 90%.

The share of indirect taxes in tax revenue of cantons and municipalities is also important. A weighted average amounts 81% for cantons and 62,6% for municipalities. If we want to look at the individual shares by cantons (chart 3), it is again more correct to analyze the aggregate data (municipalities of the canton plus corresponding canton), because of the above-mentioned specific way of distribution the indirect taxes in the Sarajevo Canton. Aggregate individual shares of indirect taxes in tax revenue range from 70,9% in the Sarajevo Canton to 89,1% in Bosnian Podrinje Canton, and weighted average amounts 78,1%.

<sup>9</sup> More about distribution system and fiscal equalization in FB&H could be found in Bulletins No 52/53 and 56

<sup>10</sup> Those shares are lower in total revenues (including grants and transfers).

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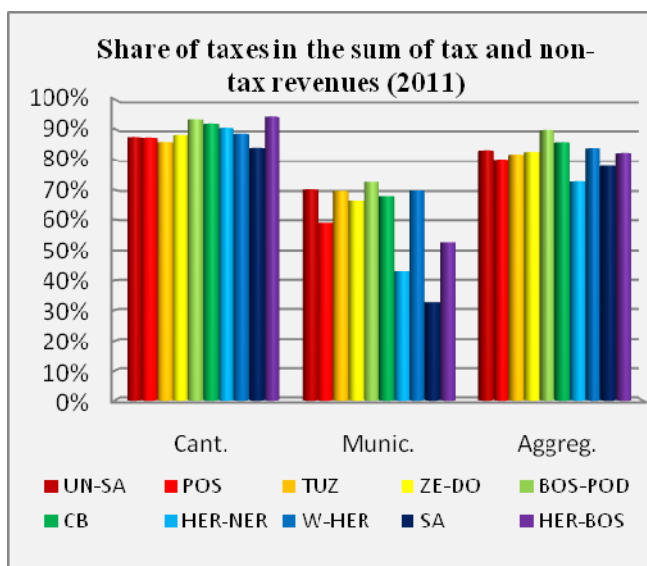


Chart 2

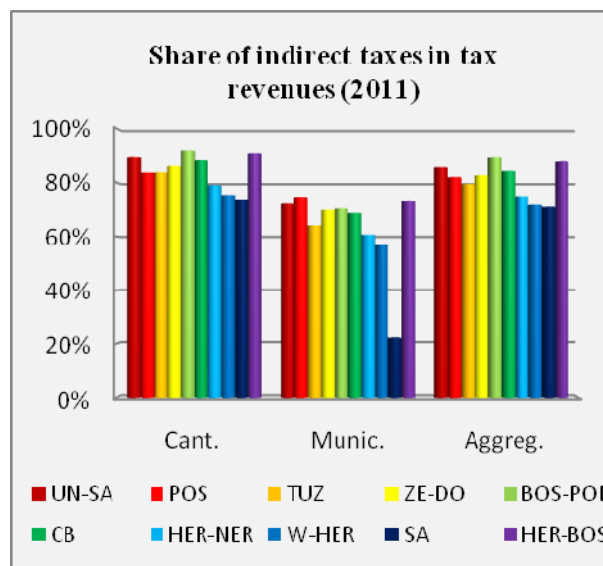


Chart 3

**The latest trends in tax revenues of cantons and municipalities**

The following two charts show the dynamics of direct, indirect (including payment of arrears, according to the regulations until 2006) and total taxes in cantons and municipalities in FB&H over the past three years.

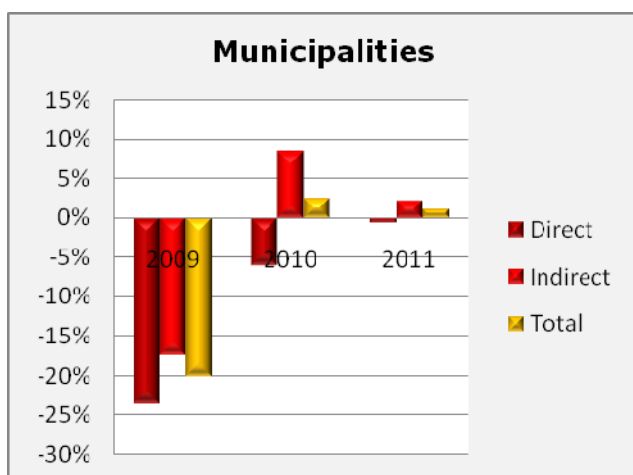


Chart 4

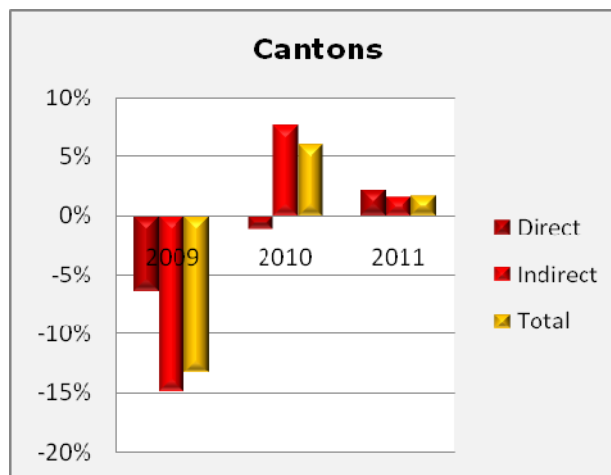


Chart 5

What they have in common is a decrease of both in 2009. In 2010 direct taxes fall again in both, cantons and municipalities, while the indirect grow. Modest growth rates of all are recorded, except for municipal direct taxes (slight decline), in 2011. The following chart shows which municipalities had a positive and which negative growth rates of direct taxes in 2011.

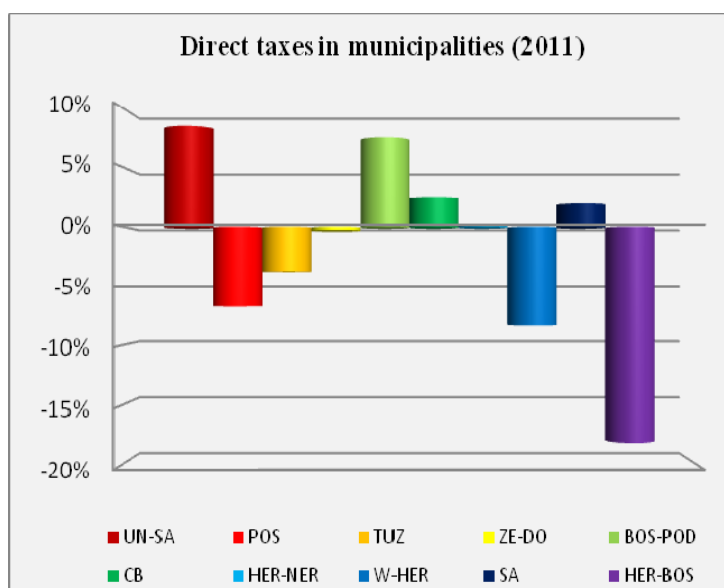


Chart 6

The dynamics of indirect, direct and total taxes cumulative for the cantons and municipalities is shown in chart 7. The decrease in total tax revenue was 14,5% in 2009, while growth rates of 5,4% and 1,6% were recorded in 2010 and 2011 respectively. In the year 2010, the total tax revenue growth was achieved thanks to the strong growth in revenue from indirect taxes, which mitigate the effects of direct tax decline. Modest growth rates of both were recorded in 2011.

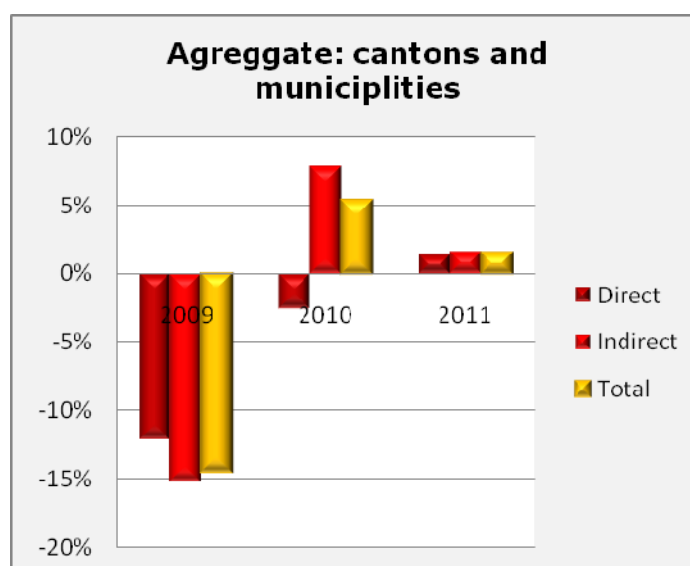


Chart 7

If we look at the dynamics of total tax revenues (direct and indirect) by the individual cantons, we can see that in 2009 a decrease of municipal taxes in each canton was recorded, as well as the fall in tax revenues in all ten cantons.

The situation is not so uniform in 2010. Municipal taxes fell in the three cantons (Tuzla Canton, West Herzegovina and Sarajevo), and in other increased, while the cantonal taxes increased in all cantons.

In 2011 municipal taxes decreased in three cantons (Tuzla Canton, West Herzegovina and Herzegovina), in one they were stagnant (the Herzegovina-Neretva), and grew in the others. The cantonal tax revenues have fallen only in the Posavina Canton.

### Conclusion

As well as the aggregate tax revenues of all levels in B&H, tax revenues of municipalities and cantons in FB&H fell sharply in 2009, and increased in 2010 and 2011, at a slightly lower rate in the latest year. Many factors caused this dynamic, and the most important were macroeconomic trends and tax reforms, which have influenced the movement of all tax revenues at the state level.

When it comes to the dynamics of tax revenues at the level of Federation B&H it is emphasized the impact of the following factors: the reform of direct taxes in FB&H and distribution of funds from SA (share of B&H institutions, the distribution coefficients).

The dynamics of tax revenue at the lower levels (cantons, municipalities) depend on the all above mentioned factors, as well as on the collection of direct taxes by the cantons, and the indicators on which the distribution methodology of indirect taxes, prescribed by the Law on the Repartition of Public Revenues in the FB&H, is based upon (population, size, number of students, development etc). This law entered into force in 2006, and prescribed the allocation of different revenue to individual levels in the FB&H, and gradually introduction of the formula for allocation of indirect taxes in the FB&H with the elements of horizontal fiscal equalization.

## Consolidated reports

(Author: Aleksandra Regoje)

### Table 1 (Consolidated report: B&H institutions, entities, 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 institutions of Bosnia and Herzegovina,
- revenues and expenditures of the budget of the Federation of Bosnia and Herzegovina,
- revenues and expenditures of the budget of the Republika Srpska.\*

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

### Tables 2 and 4 (Consolidated report: Central 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 and cantons,
- revenues and expenditures of the budget of the Republika Srpska\*,
- revenues and expenditures of the budget of Brčko District.

### Table 3 (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, municipalities and funds,
- revenues and expenditures of the budget of the Republika Srpska\*, municipalities and funds,
- revenues and expenditures of the budget of Brčko District and funds.

\*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 some foreign project implementation units established by ministries)

**Consolidated report: SA, B&H Institutions, entities, 2012**

	I	II	II	IV	V	VI	I-VI
Revenue	418,2	402,4	532,5	503,1	501,9	540,0	2.898,1
Taxes	382,4	357,6	455,6	440,0	460,7	441,1	2.537,5
Direct taxes	23,4	27,8	58,3	40,5	34,4	28,9	213,3
Taxes on income, profits and capital gains	22,8	27,1	57,3	39,6	33,4	27,9	208,1
Taxes on property	0,6	0,7	1,0	0,9	1,0	1,0	5,2
Indirect taxes (net)	358,8	329,8	397,1	399,5	426,2	412,0	2.323,4
VAT	217,9	210,1	264,0	252,3	267,4	260,0	1.471,7
Excises	105,9	85,2	91,1	102,9	114,4	109,2	608,7
Road fee	21,2	19,0	20,6	22,7	23,9	23,5	130,8
Customs	12,6	14,5	20,1	20,1	19,1	18,0	104,4
Other indirect taxes	1,2	1,0	1,3	1,5	1,4	1,4	7,8
Other taxes	0,2	0,1	0,1	0,0	0,1	0,2	0,8
Social security contributions	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Foreign grants	1,8	1,1	0,6	1,1	0,4	7,2	12,1
Other (non-tax) revenue	33,8	43,2	77,0	61,9	40,8	90,8	347,4
Transfers from other general government units	0,2	0,5	-0,7	0,1	0,0	0,9	1,1

	I	II	II	IV	V	VI	I-VI
Expenditure	421,0	386,8	457,0	480,2	456,3	485,9	2.687,3
Expense	416,5	382,3	453,2	475,3	450,4	467,1	2.644,8
Compensation of employees	130,4	131,5	133,0	133,6	129,2	129,6	787,3
Use of goods and services	13,3	17,2	26,2	29,4	27,7	30,6	144,4
Social benefits	51,5	52,7	65,1	55,1	45,3	57,7	327,4
Interest	5,0	5,8	19,2	8,5	14,3	27,4	80,2
Interest payments to non-residents	4,2	4,4	9,7	7,3	9,8	20,6	56,0
Interest payments to residents other than general government	0,8	1,4	9,6	1,2	4,5	6,8	24,3
Subsidies	2,2	2,4	4,0	13,8	6,1	8,4	37,0
Grants (to non-residents)	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Transfers to other general government units	40,9	39,9	40,0	51,1	47,6	50,9	270,3
Transfers from SA (BD, cantons, municip, funds, road funds)	162,9	128,7	169,4	172,2	173,1	152,8	959,1
Other expense	10,2	4,0	-3,6	11,7	7,2	9,7	39,1
Net acquisition of nonfinancial assets	4,6	4,5	3,8	5,0	5,9	18,8	42,6
Acquisition of nonfinancial assets	4,7	4,9	4,3	5,3	6,2	20,6	46,0
Disposal of nonfinancial assets	0,1	0,4	0,5	0,3	0,3	1,8	3,4
Gross/Net operating balance (revenue minus expense)	1,8	20,1	79,3	27,8	51,5	72,9	253,3
Net lending /borrowing (revenue minus expenditures)	-2,8	15,6	75,5	22,8	45,6	54,1	210,8
Net financing = (Minus) Net lending /borrowing	2,8	-15,6	-75,5	-22,8	-45,6	-54,1	-210,8

Table 1





**Consolidated report: Central Government, I-VI 2012**

	Q1	Q2	Total
<b>Revenue</b>	<b>1.326,4</b>	<b>1.533,1</b>	<b>2.859,6</b>
Taxes	1.122,0	1.274,0	2.396,0
Direct taxes	189,1	194,5	383,6
Taxes on income, profits and capital gains	180,1	184,6	364,7
Taxes on payroll and workforce	2,4	4,5	6,9
Taxes on property	6,6	5,4	12,0
Indirect taxes	931,4	1.078,2	2.009,6
Other taxes	1,5	1,2	2,7
Social security contributions	0,0	0,0	0,0
Foreign grants	3,7	9,3	13,1
Other (non-tax) revenue	200,3	249,3	449,6
Transfers from other general government units	0,4	0,5	0,9
<b>Expenditure</b>	<b>1.242,6</b>	<b>1.418,4</b>	<b>2.660,9</b>
Expense	1.226,3	1.376,3	2.602,5
Compensation of employees	684,0	683,6	1.367,6
Use of goods and services	98,1	143,7	241,7
Social benefits	217,2	216,1	433,3
Interest	31,6	51,8	83,4
Interest payments to non-residents	18,8	38,5	57,2
Interest payments to residents other than g. government	12,8	13,3	26,2
Subsidies	27,0	46,8	73,8
Grants (to non-residents)	0,0	2,1	2,1
Transfers to other general government units	127,8	159,8	287,6
Other expense	40,5	72,5	113,0
Net acquisition of nonfinancial assets	16,3	42,1	58,4
Acquisition of nonfinancial assets	17,9	45,1	62,9
Disposal of nonfinancial assets	1,5	3,0	4,5
<b>Gross/Net operating balance (revenue minus expense)</b>	<b>100,2</b>	<b>156,9</b>	<b>257,0</b>
<b>Net lending /borrowing (revenue minus expenditures)</b>	<b>83,9</b>	<b>114,8</b>	<b>198,6</b>
<b>Net financing = (Minus) Net lending /borrowing</b>	<b>-83,9</b>	<b>-114,8</b>	<b>-198,6</b>

Table 2

**Consolidated report: General Government, 2011 (final data)**

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	2011
<b>Revenue</b>	<b>11.180,1</b>
Taxes	5.747,8
Direct taxes	903,7
Taxes on income, profits and capital gains	794,0
Taxes on payroll and workforce	13,9
Taxes on property	95,8
Indirect taxes	4.828,0
Other taxes	16,2
Social security contributions	4.050,3
Foreign grants	38,3
Other (non-tax) revenue	1.322,2
Transfers from other general government units	21,5
<b>Expenditure</b>	<b>11.493,0</b>
Expense	11.002,9
Compensation of employees	3.328,7
Use of goods and services	2.067,6
Social benefits	4.333,3
Interest	164,4
Subsidies	428,2
Grants (to non-residents)	0,0
Transfers	217,8
Other expense	462,9
Net acquisition of nonfinancial assets	490,1
Acquisition of nonfinancial assets	531,4
Disposal of nonfinancial assets	41,3
<b>Gross/Net operating balance (revenue minus expense)</b>	<b>177,2</b>
<b>Net lending /borrowing (revenue minus expenditures)</b>	<b>-312,9</b>
<b>Net financing = (Minus) Net lending /borrowing</b>	<b>312,9</b>

Table 3

### Consolidated report: Central Government, 2011 (final data)

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	2011
<b>Revenue</b>	<b>5.983,4</b>
Taxes	5.050,9
Direct taxes	709,3
Taxes on income, profits and capital gains	677,2
Taxes on payroll and workforce	9,8
Taxes on property	22,3
Indirect taxes	4.330,5
Other taxes	11,1
Social security contributions	0,0
Foreign grants	29,4
Other (non-tax) revenue	887,2
Transfers from other general government units	15,9
<b>Expenditure</b>	<b>6.228,5</b>
Expense	6.020,5
Compensation of employees	2.847,5
Use of goods and services	679,4
Social benefits	1.032,4
Interest	137,9
Subsidies	376,8
Grants (to non-residents)	0,0
Transfers	701,6
Other expense	244,9
Net acquisition of nonfinancial assets	208,0
Acquisition of nonfinancial assets	228,6
Disposal of nonfinancial assets	20,5
<b>Gross/Net operating balance (revenue minus expense)</b>	<b>-37,1</b>
<b>Net lending /borrowing (revenue minus expenditures)</b>	<b>-245,1</b>
<b>Net financing = (Minus) Net lending /borrowing</b>	<b>245,1</b>

Table 4