

**ASSESSMENT OF THE EFFECTS OF CROATIA'S ACCESSION ON
THE REVENUE FROM INDIRECT TAXES**

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PREFACE

In the past six years on B&H stage there was a process of accelerated liberalization of B&H imports. CEFTA Agreement envisages the abolition of customs duties in mutual trade in goods between B&H and the Western Balkan countries. Since 2008 the Stabilization and Association Agreement of B&H with the EU has been in force by which the import of most of goods from the EU was brought down to a duty-free basis for a period of five years. These two processes, along with a decrease in imports due to the economic crisis and the abolition of customs records in October 2011, led to a drastic reduction in customs revenue. Although the Agreement with the EU included the majority of imported products, however, after a five year transitional period, customs duties will be kept to the products that are important to the B&H economy. Joining the Republic of Croatia to the EU as of 1 of July 2013 instead of zero rates, rates that apply to all EU members will be applied on these products. Croatia's accession to the EU will bring significant changes in the customs regime for the import of goods from Croatia since the Agreement with the EU agreed on retention of customs duties on imports of certain goods in B&H from the EU.

Despite the low share of customs in indirect taxes the assessment of the effects of introducing customs to the import of goods from Croatia can be significant in a fiscal sense. Fiscal authorities at all levels of government are, delaying expenditure reforms, more and more focused on the collection of public revenue. A complex fiscal structure in B&H in which all levels of government to a large extent depend on the collection of indirect taxes further increases the pressure of government in terms of overtaking of government levels from the ITA Single Account. In this situation, every, and even the smallest, increase in revenue from indirect taxes becomes significant not only for the restoration of fiscal bad debts, but also for the relaxation of intergovernmental fiscal relations within B&H.

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I. IMPORTANCE OF CUSTOMS REVENUE FOR FISCAL POSITION OF B&H

In the past ten years the importance of customs revenue is largely reduced. Customs revenues are from 675 million KM in 2002 reduced to 265 million KM in 2011 (Chart 1). This was mainly contributed by the simultaneous action of two processes: process of liberalization of foreign trade of B&H and reform of indirect taxes.

VAT was introduced by the reform of indirect tax system in 2006. VAT, which is much more generous tax in relation to sales tax, brought a reduction in the share of customs revenue in indirect taxes. The process of liberalization of trade, through the implementation of the Free Trade Agreement with Turkey, the CEFTA¹ Agreement and later through the Agreement² with the EU, brought a drastic decline in customs revenues, so that the share of customs revenues in the total revenues from indirect taxes dropped from 26% in 2002 to 6% in 2010. The share of customs in the revenue from indirect taxes was further reduced to 5,5% by the abolition of customs records of 1% to the imports from CEFTA members and third countries in the fourth quarter of 2011. A strong liberalization of imports has led to a drastic reduction of average customs rate from 9,8% in 2002 to 1,77% in 2011, while the customs burden, measured in % of GDP, fell from 5,26% to 0,93% of GDP. It is expected that the lowest share of customs will be reached in 2013, given that in this year the five-year abolition of customs duties to certain products originating in the EU is to be ended³. As of 2013 it is expected a slight increase in customs revenue in line with the growth of imports of goods on which customs duty is calculated (Chart 1).

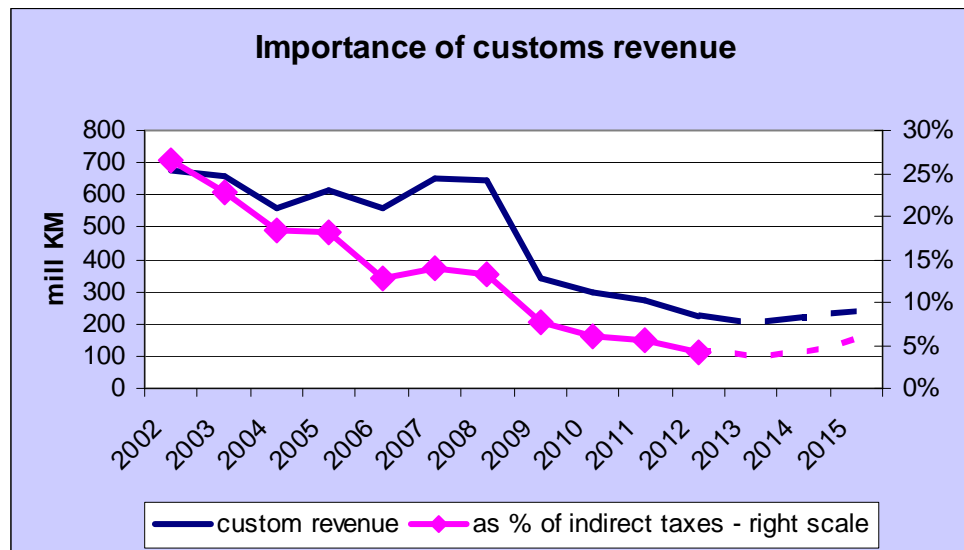


Chart 1

Croatia is one of the most important trading partners of B&H. Imports of products originating in Croatia make 14,3% of total imports of B&H. Nearly 30% of that will be subject to the change of customs regime from 1 July 2013. On the other hand, the process of import liberalization led to a reduction of Croatia's share in the customs revenue from 14% to 3%. However, at the same time the

¹ Foreign Trade Chamber of B&H, 'Agreement on Amendment of and Accession to the Central European Free Trade Agreement (CEFTA 2006), Sarajevo, April 2007. More: www.cefta2006.com

² 'The Stabilization and Association Agreement between European Communities and their Member States, on one side, and Bosnia and Herzegovina, on the other side', „Official Gazette of B&H – International Treaties“, No. 10, 13.11.2008.

³ Projections of the Macroeconomic Analysis Unit of the ITA GB, April 2012.

share of other income that is levied on import is increased, in the first place excise duty on cigarettes and derivatives, which has only slightly reduced Croatia's share in total revenue that is payable on import, despite the liberalization of customs regime, from 26,7% to 24,9% compared to 2007.

II. METHODOLOGICAL APPROACH

2.1. Analytical approach

Goods originating in Croatia, whose customs regime changes from 1 of January 2013, in order to analyze the effects on the collection of indirect taxes, are divided into two groups: tobacco products and other goods. This division is necessary because of the different tax treatment of tobacco products in relation to other goods, which are also reflected in the methodology of calculating the effects of the introduction of customs duties. On the one hand, tobacco products are taxed by *ad valorem* customs duty and *ad valorem* and specific excise duty. Furthermore, unlike other goods, estimates of tobacco products must take into account the effects of changes in excise tax policy in the observed period 2013-2014. On the other hand, other goods can be taxed by both *ad valorem* and specific customs duty, and some of them are subject to quantitative restrictions on import.

In the final phase a recapitulation of effects obtained for each group of products (tobacco, other) will be done. Applying the same scenario in both groups of products enables the collection of obtained results and the development of the uniform recapitulation of the effect evaluation.

2.2. Inputs

Analytical foundation for the analysis of implications of Croatia's accession to the EU on revenues from indirect taxes includes three sets of data:

- Tariff classifications and customs rates on imports of goods originating in the EU from 1 of January 2013;
- Data on issued excise stamps for cigarettes from the first half of 2012 are the reference data for tobacco products;
- Data on imports of goods from Croatia in 2011 are taken for other products⁴.

Data on imports of tobacco products from 2011 are not the reference for the analysis of tobacco products due to changes in excise policy in 2012 which led to a reduction in the amount of cigarettes on the market, as a result of increasing the tax burden. The analysis used data on imports of goods originating from Croatia whose customs treatment is changed after the release of Croatia from CEFTA Agreement and the EU accession. In this sense customs rates are taken for certain goods (*ad valorem* and specific), with an indication of the existence of quantitative import restrictions (quotes).

In terms of the choice of the year which should be the starting point for the analysis, the year of 2011 has been selected. There are three reasons. The first reason is of the methodological nature. Since the analysis of effects is to be done at the end of the third quarter of 2012, current available data on imports are insufficient to assess the effects. The second reason is related to the date of Croatia's accession to the EU, which also means the date of changes in customs regime of imports from Croatia. Changes of customs rates in the middle of the calendar year will be reflected in indirect tax revenues in

⁴ Source: Inputs from database of the Foreign Trade Chamber of B&H

the second part of 2013 so that the effects will be divided in two years, second half of 2013 and first half of 2014. For this reason it is necessary to have a valid set of data on imports for the second half of the year which will be the basis for the calculation of effects for 2013. Third, scope and structure of imports in 2012, especially in the first quarter of 2012, were influenced by special circumstances (snow storms in B&H), which made the data on imports as unrepresentative in relation to the normal structure of imports. Finally, data on imports of goods from 2011 can be used without the dynamic adjustment since the previous current trends in imports in 2012 show that the import for ten months of 2012 was only for 0,5% higher than imports in the same period of 2011.

2.3. Scenarios

The natural reaction of taxpayers when introducing a tax is attempting to eliminate or at least mitigate the new burden. Regarding the introduction of tariffs on certain goods from Croatia, the importers/manufacturers have several options. One option would be moving the production to B&H. The realization of this option *would* create new jobs and growth of employment in B&H, with an increase of tax (direct taxes and social contributions) and non-tax revenues. Any moving of the business, either by acquisition of existing companies or by establishment of new ones, requires a significant financial investment in equipment, infrastructure and training of workers, as well as time to start the production. On the other hand, reducing the production of particular goods in Croatia would have adverse consequences for Croatia, because of layoffs, but also for the company itself. Because of moving the production to Bosnia, usage of existing capacities in Croatia would be suboptimal, which would lead to the increase of the unit prices of products, due to fixed costs and financial expenses if the facilities are financed by the loan. Given that after joining the EU, Croatia will face strong competition from other states, the increase in prices of Croatian products would reduce their competitiveness on both the EU and the domestic market. The negative effects of this option are also increased by the fact that Croatian accession occurs at the time of economic crisis, falling consumption and insolvency of companies. It can be concluded that the option of moving production has many negative consequences for the Croatian manufacturers, which still exceed the losses due to the introduction of customs duties, unless the company already has established operations in B&H in a certain extent. Since the moving the production from Croatia to B&H and other CEFTA countries could be an option for only a small number of producers from Croatia who have well-established business in B&H, it is necessary to consider other, more certain options. We have made two basic scenarios in several varieties.

A. Scenario of shifting customs backwards – refers to a situation that producers/importers of goods from Croatia bear customs duty on the burden of their own profit and margins or they shift it to their suppliers. This second option is possible for large companies (for example large manufacturers, large shopping centers) which have the ability to dictate the terms of procurement. In the situation when companies in both B&H and Croatia face problems in maintaining liquidity and a decline in purchasing power of citizens it is unlikely that the financing customs duties at the expense of profit and margin could be a longer-term business strategy of manufacturers/importers of goods from Croatia, but only an option for the first few months after 1 of July 2013 in order to retain the customers. This option becomes even more attractive if it is combined with the stockpiling of goods prior to 1 of July 2013. In this sense two varieties of this scenario are developed.

- **Variety „7+1+4“** means putting one-month additional supplies before 1 of July 2013 and one-month bearing customs duty at the expense of their own profit and margin. Full shifting customs duties and additional taxes on retail price are limited to the last third of 2013 i.e. first two thirds of 2014.

- **Variety „8+2+2“** means putting two-month additional supplies before 1 of July 2013 and bi-monthly bearing customs duties at the expense of their own profit and margin.

B. Scenario of shifting customs duties to the customer – is the situation of shifting customs duties and additional excise taxes and VAT on the retail price. Basic scenario „B“ means shifting customs duties to the customer from 1 of July 2013. Given the expected reaction of importers towards mitigating the initial impact of customs duties, two variants of this scenario are developed:

- **Variety „7+5“** means putting one-month additional supplies before 1 of July 2013 so that customs duties are applied on imports during last five months in 2013. Considering this fact, fiscal effects in 2014 spread out over the first seven months of 2014.
- **Variety „8+4“** means putting two-month additional supplies before 1 of July 2013 thus limiting the expressing of fiscal effects to the last third of 2013 i.e. first two thirds of 2014.

Table 1: Dynamics and intensity of spreading the fiscal effects of introducing customs duties in 2013

scenario	2013											
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
A. shifting customs duty backwards												
“7+1+4”												
“8+2+2”												
B. shifting customs duty to customers												
basic scenario												
“7+5”												
“8+4”												

Legend:




 no effects
  partial effects
  full effects

Table 2: Dynamics of spreading the fiscal effects of introducing customs duties in 2014

scenario	2014											
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
A. shifting customs duty backwards												
“7+1+4”												
“8+2+2”												
B. shifting customs duty to customers												
basic scenario												
“7+5”												
“8+4”												

III. TOBACCO PRODUCTS

3.1. Introduction

Tobacco products originating in Croatia have a significant share in B&H imports. In the structure of cigarette market, cigarettes from Croatia hold the share up to 30% in volume and value. Considering these facts, behavior of manufacturers/importers of cigarettes from Croatia after Croatia joins the EU can be of great importance to the market trends and the shift in the structure of cigarettes in the market. The business policy of importers/manufacturers of cigarettes from Croatia will, on the one hand, to a large extent determine business policies of other market participants, major domestic and international tobacco companies, in the fight for the declining cigarette market in B&H. On the other hand, it will be reflected in the fiscal position of B&H, considering the growing importance of revenue from excise duties on cigarettes in the structure of tax revenue in B&H. In fact, in 2011 excise duties on cigarettes and related VAT accounted to 17% of revenue from indirect taxes and for 2012 it is expected the increase of share to 18,5%.

In the methodological part it was pointed out that the assessment of fiscal implications of joining the Republic of Croatia to the EU on the budget of B&H for tobacco products varies greatly from other imported goods. There are three reasons for different analytical procedures.

Firstly, given that the base *ad valorem* of excise duty includes customs duty as well, the assessment of effects of introducing customs duties on imports of tobacco products from Croatia should include the calculation of net effects of increasing *ad valorem* excise duty.

Second, changes in customs regime of imports of tobacco products from Croatia will take place during the continuous increase in special excise tax on cigarettes. In accordance with provisions of the Law on Excise Duties from 2009 B&H will each year increase the special excise tax of minimum 0,15 KM/ per package until the total excise burden reaches 126KM/per 1,000 cigarettes. According to estimates of the Macroeconomic Analysis Unit of the ITA Governing Board the statutory ceiling for the excise burden, if in the meantime the Law in this area does not change, will be reached in 2015. Announced amendments to the Law as part of set of measures which national fiscal authorities should implement as part of a new *stand-by* arrangement with the International Monetary Fund include the harmonization of excise burden ceiling with the new minimum excise tax in the European Union which is 90 EUR/1,000 cigarettes since 2014. It is estimated that alignment of the minimum excise tax in B&H with the EU standards, while maintaining the same rate of *ad valorem* excise duty and the same pace of increase in special excise tax of 0,15 KM/per package annually, will extend the period of harmonization of excise rates in B&H to 2019-2020.

Third, the current continuous increase of excise burden on four occasions (1 of July 2009, 1 of January 2010, 1 of January 2011 and 1 of January 2012) significantly changed the cigarette market in B&H. Policy of continuous increase of excise burden led to a strong increase in retail prices and to a moderate fall of cigarette consumption. In the period of 2008-2011 the value of cigarette market increased by 32%, the tax benefits (excise duty, VAT) increased by 82% and the price before taxation (including all costs, possibly customs duty and profit/margin) is reduced by 29%. The new excise policy, in the terms of continuous market contraction and a strong decrease in the share of taxpayer in the value of trade, requires a development of new business strategies and policies in the tobacco industry companies that hold the majority of cigarette market in B&H.

3.2. Trends (2009-2012)

Past trends in cigarette consumption and average retail prices after four increases and despite strong oscillations as a result of positioning of companies from tobacco group in the market as a whole, have shown a stable price inelasticity of cigarette consumption. In the period 2008-2011 the amount of cigarettes measured by the number of excise stamps declined by 14%, while the weighted average retail price increased by 57%. At the same time revenues from excise taxes are almost doubled (97%). For ten months in 2012 there were strong fluctuations of issuing excise stamps, so in four months the increase of the number of issued stamps ranged up to 17% and in three months there was a significant decrease by over 40%.

Trends of the weighted average retail prices of cigarettes in the last three years confirm the proposed hypothesis that the possibilities for dumping prices have been exhausted. If the additional excise burden of 0,15 KM/pack (+VAT) was transferred entirely to the buyer, the total incidence should be 0,35 KM/pack for any price category. Any increase in the retail price that is below 0,35KM/pack points to the distribution of incidence between the taxpayer and consumer, while unchanged prices point bearing the incidence at the expense of profit. The sharpest struggle for the cigarette market was in 2010 when the average incidence was only 0,25KM/pack. In 2011 there was the exhaustion of possibilities of bearing the additional excise burden by the taxpayer, which led to the more significant increase in the weighted average retail price of cigarette in 2011.

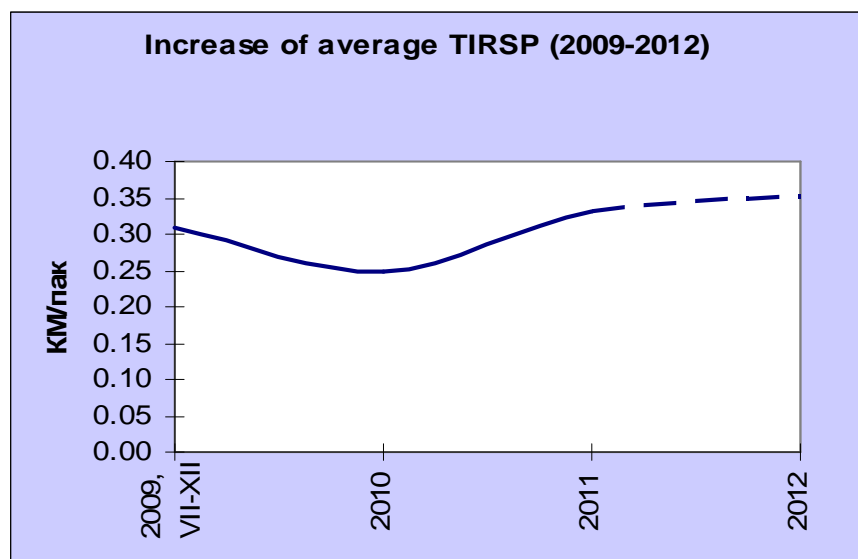


Chart 2

Chart 3 shows that tobacco companies bore the initial impact of excise burden from 1 of January 2012 at the expense of their own profit and/or commercial margins in order to retain customers, and after that the business policy was directed to the increase of prices (May – July), even through the additional tax burden, sacrificing sales volume.

Fact that the weighted average retail price for the observed period of 2012 amounted to 2,86 KM/pack indicates that the business policy of B&H tobacco industry companies in the market was directed not only to compensate for the loss of profit of tobacco companies from the beginning of 2012 but also to achieve the extra profit of 0,03 KM/pack, all in the conditions of fierce fighting for the reduced market.

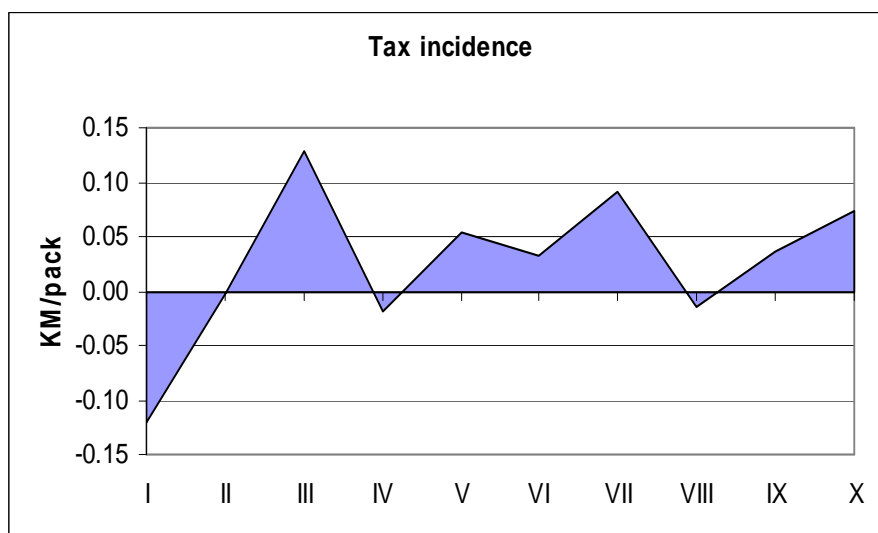


Chart 3

3.3. Effect assessment for 2013

3.3.1. Assumptions

Given the projected increase in special excise duty of 0,15KM/pack per year and reducing the maneuver space of the tobacco industry for conducting stricter pricing policy in B&H, it is expected a slowdown in the increase of the average retail prices by 2015 and a slowdown in the fall in cigarette consumption based on the following assumptions:

- We assume that after several consecutive increases in retail prices of cigarettes classes of citizens who have irregular incomes have dropped the cigarette consumption and only those who have sustained and stable incomes remained;
- Process of harmonization of excise duties on cigarettes with the EU standards in the countries of region significantly reduced the risks of increasing the black market and cigarettes smuggling in B&H, although there is a threat because of the slowing down the harmonization process of excise duties in Serbia;
- A gradual recovery of B&H economy is expected by 2015, which would bring higher income and it should be reflected in the increase of cigarette consumption.

Based on the above-mentioned assumptions according to conservative scenario, we expect the further reduction in cigarette consumption by a moderate pace of 5% per year as well as shifting the entire tax incidence to the retail price of cigarettes. Estimates of the effects of introducing customs taxes on imports from Croatia for 2013 and 2014 require unchanged excise tax policy by 2015. Tobacco companies, manufacturers/importers of cigarettes from Croatia can try to mitigate the initial impact of introducing customs duties in two ways:

- By stockpiling the cigarettes prior to 1 of July 2013
- By bearing customs duty of first month or two at the expense of their own profit or margin.

In the long run companies have the ability with selective approach depending on the elasticity of the consumption of individual brands to perform so called sideward shifting, i.e. to shift customs duty

backwards in whole or in part at the expense of their own profit or margin with cheap cigarettes and to shift customs duty on the retail price at the expense of buyers of more expensive cigarettes.

Previous experiences with increasing excise burden indicate that companies from tobacco industry used all three forms of behavior. First they increased the amount of cigarettes in the month prior to the increase in excise tax rate (for example, in June 2009, in December 2009, 2010 and 2011, see Chart 4) in order to increase sales in the current year, but then after increases in excise rate they came out with dumping prices bearing partly the burden of additional excise tax and VAT. Positioning of large companies by conducting the policy of dumping prices was of limited range for two reasons:

- Low level of prices before taxation leaves little room for long-term dumping pricing policy,
- Most of major importers do not have much room for dumping pricing policy in B&H at the expense of profit earned in other markets as they had to adjust the pricing policy in the EU market after the member states from 1 of January 2011 began with the gradual harmonization of excise tax rates on cigarettes in line with the new minimum excise tax in the EU.

The third are, however, confident in price inelasticity of consumption of their brands, increased retail prices by amounts that exceeded the required increase of excise tax and part of VAT, compensating for losses of profits with brands with elastic consumption (usually cheaper brands).

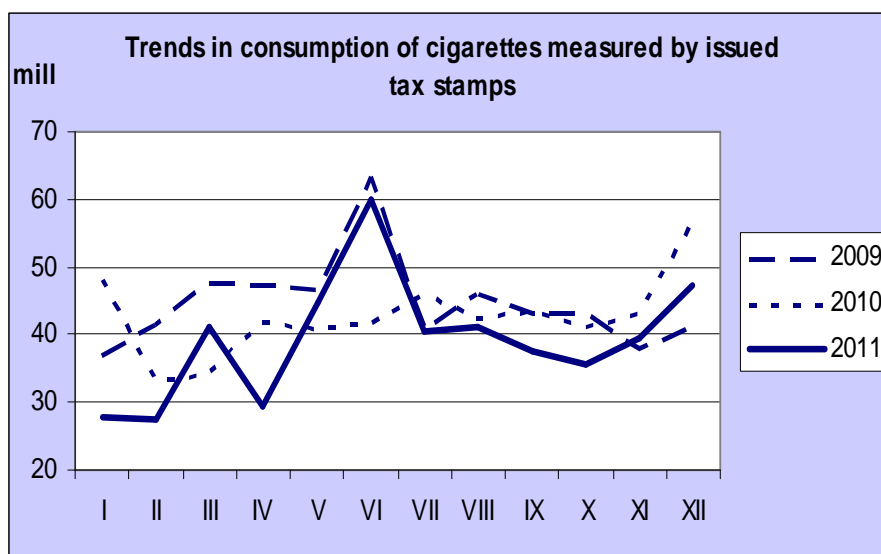


Chart 4

It is realistic to expect that manufacturers/importers of tobacco products from Croatia will apply similar business tactics immediately before Croatia's accession to the EU. The option of bearing customs duty is more cost effective than the option of stockpiling because the total financial outlay (denial of profit) is less than the amount of excise liabilities on accumulated inventories. Although stockpiling may be initiated by the customer before the announcement of price increases prior to Croatia's joining to the EU, accumulation of cigarette supplies prior to the 'D' day has its limits given that the total excise duty must be paid within 5 days from the day of taking over excise stamps which in the case of imported cigarettes includes allocating significant funds month or more before the placement of cigarettes in the market. From 2008 until 2011 the share of excise duty in the structure of cigarette market value has increased from 40% to 61% and for eight months of 2012 to 65% of the turnover value. With the new increase of special excise duty as of 1 of January 2013 this share will be increased to 70%. Increasing the special excise duty to 0,75 KM/pack, with the expected reduction in

consumption of 5%, manufacturers/importers of cigarettes from Croatia will be obliged to pay approximately 25 million KM of indirect taxes more than in 2012. Therefore, further straining of companies regarding the insurance of cash for paying in advance excises duties will be difficult to finance. In such a situation imports of exceed supplies of cigarettes from Croatia before 1 of July 2013 may be an option only for the short term, unless the costs of hiring additional cash or interest expenses, in the case that excise duties are financed by short-term loans, were significantly less than the amount of customs duty (+ excise tax and VAT on that amount).

In the given circumstances, considering previous behaviors of companies and the market response, there were evident certain short-term moves in the form of stockpiling or transferring the customs duties on imports of tobacco products from Croatia at the expense of profit of manufacturers/importers in only a few critical transitional months (June-August) to retain the market. But after that, especially with the new increases in special excise tax from 1 of January 2014, it can be expected a full shifting of customs duty and additional burden to customers.

3.3.2. Calculation of the effects

In addition to the above outlined assumptions based on past trends and assumptions that are common to both groups of concerned products, which are pointed out in the methodological approach chapter, to calculate the effects of introducing customs duties on tobacco products from Croatia we start from the following specific assumptions:

- static assumptions – keeping the same structure of brands, i.e. consumption of cigarettes
- dynamic assumptions:
 - a decrease in cigarette consumption by 5% annually
 - an increase of special excise tax on cigarettes, as follows: 0,75 KM/pack from 1 of January 2012 and 0,90 KM/pack from 1 of January 2014.

Above mentioned static and dynamic assumptions are included in both scenarios (A and B) and in all their variants.

i. Scenario A – shifting customs duty backwards

The net effects of shifting backward customs duty calculation implies the recalculation at the rate of 13,04% to the average monthly customs base for one or two months of imports. Month-borne shifting would manufacturers/importers of cigarettes from Croatia ‘cost’ 0,8 million KM. Two variants of scenario A implies shifting to customers in the rest of the year, the last four months of 2013 (variant “7+1+4”), i.e. the last two months (variant “8+2+2”). The calculation of the net effects of these months includes the calculation of customs duty at the rate of 15%, calculation of additional *ad valorem* excise tax at the increased base and additional VAT. In addition to these net effects caused by the introduction of customs duty on imports of tobacco products there will be the effects of changing the excise policy due to the regular increase in special excise taxes that are reflected in the calculation of *ad valorem* excise duty and VAT.

Table 3: Calculation of net effects according to scenario A (in mil KM)

Variants of scenario	Customs duty at the expense of taxpayers	Customs duty at the expense of customers	Additional <i>ad valorem</i> excise tax	Additional VAT	Total additional taxes
“7+1+4”	0.832	3.374	3.260	1.128	8.594
“8+2+2”	1.664	1.687	1.630	0.564	5.545

ii. *Scenario B – shifting customs duty to customers*

The calculation of the net effects implies the calculation of customs duty at the rate of 15%, the calculation of additional *ad valorem* excise tax due to the inclusion of customs duty in the calculation of the base of this excise tax, and the calculation of additional VAT on the amount of customs duty and additional *ad valorem* excise tax. In addition to these net effects caused by the introduction of customs duty on imports of tobacco products there will be effects of changing the excise policy due to the regular increase in special excise taxes that are reflected in the calculation of *ad valorem* excise tax and VAT.

Table 4: Calculation of net effects according to scenario B (in mil KM)

scenario	Customs duty	Additional <i>Ad valorem</i> excise tax	Additional VAT	Total additional taxes
basic scenario B	5.061	4.890	1.692	11.643
“7+5”	4.218	4.075	1.410	9.702
“8+4”	3.374	3.260	1.128	7.762

3.3.3. Recapitulation

Previous analysis of scenarios and previous practice of companies in the tobacco industry while increasing excise tax burden indicate sustainability of three variants of mentioned scenarios. Possible policy of performance in the market of cigarettes in B&H in the conditions of the changed customs regime include stockpiling of cigarettes prior to 1 of July 2013, at least to the extent to meet increased customer demand before the price increase of the products, and selective pricing policy towards certain brands. Shifting customs duty backward at the expense of the own profit and margin will be the certain business tactic for the cheaper price cigarette groups. We can conclude that the companies that have more brands in different price groups are prone to lateral shifting of new tax levies charged to more expensive brands with inelastic consumption, i.e. customers with higher incomes. Therefore, it is likely that the net effects of introducing customs duty on cigarettes from Croatia in 2013 on the revenue from indirect taxes will range between 7 and 10 million KM in that year. Given the current changes in the excise tax policy it means that companies importing cigarettes from Croatia in 2013 will pay total between 32 and 35 million KM of additional tax liabilities for indirect taxes.

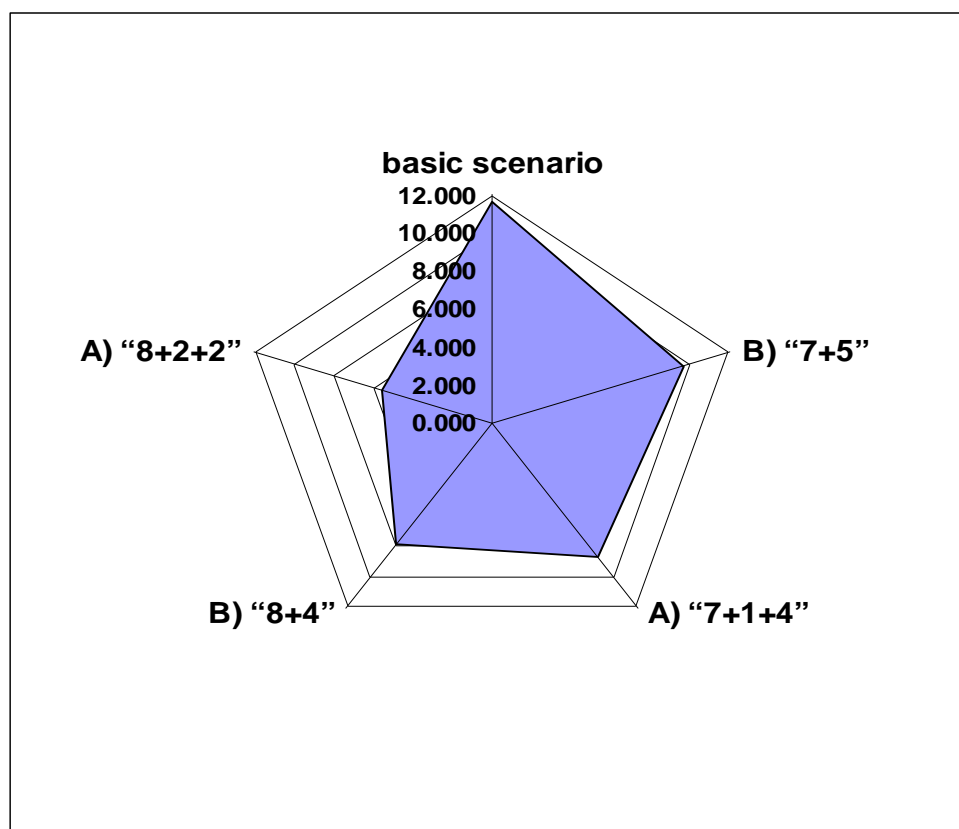


Chart 5

3.4. Estimate of the net effects in 2014

Estimates of the net fiscal effects of introducing customs duties on cigarettes from Croatia in 2014 are based on the decrease of cigarette consumption by 5% in that year and increase in special excise tax of 0,90 KM/pack. Increasing the excise burden in such conditions will require about 22 million KM of additional revenue from indirect taxes on imported cigarettes from Croatia. All this leads to the belief that in this year all possibilities for shifting customs duty and additional tax burden at the expense of importers would be exhausted. In addition, long-term increase of special excise tax on cigarettes gradually leads to the elimination of poor quality and the cheapest brands from the market and narrowing the price range between the cheapest and the most expensive cigarettes. For example, prior the entry of the new Law on Excise Duties into force the price range of leading brands of cheap and expensive cigarettes was 1,20 : 3,10 KM, and in 2012 this range was 2,50 : 3,50 KM. Narrowing of the price range differences in the brand prices are becoming less relevant for consumers. The calculation of the net effects depends on the policy of companies that import cigarettes from Croatia and their strategy of performance in the B&H market in 2013 at the time of Croatia's accession to the EU. The amount of the net effects in 2014 is influenced by factors such as the amount of import of cigarettes on which customs duty has not been paid and the amount of cigarettes for which customs duty has been shifted backward at the expense of profit or margin. Every major movement in relation to the standard pattern of imports and stockpiling of cigarettes prior to 1 of July 2013 increases asymmetry of effects in 2014 in favor of the collection of revenue from indirect taxes in that year. Shifting customs duty backward has the same effect. The larger the quantity of cigarettes for which customs duty has been shifted backward in 2013, the higher the fiscal effects in 2014 will be. According to estimates it can be

expected that the net effects of introducing customs duty on the revenue from indirect taxes in 2014 will amount between 12 and 14 million KM.

IV. OTHER PRODUCTS

4.1. Static analysis of the effects

Static analysis of the effects of introducing customs duty on other products is based on the assumption of maintaining the same volume of imports after 1 of July 2013. According to Annex III (d) of the Agreement with the EU customs duties remain on imports of certain products originating in the EU belonging to tariff numbers 01-24. The share in the amount, measured by kilograms, and the share in customs value are shown in Table 5. Customs burden of products of particular tariff numbers, depending on the height of *ad valorem* rates and specific customs duty will exceed 50%.

Table 5: Static estimate of the annual effects of customs duty per tariff numbers

Customs tariff heading	% value	% amount	Customs burden
1. Live animals	4.49%	3.36%	33.48%
2. Meat and edible meat offal.	2.40%	0.94%	51.03%
3. Fish and crustaceans, mollusks and other aquatic invertebrates	0.18%	0.11%	34.10%
4. Dairy produce; birds' eggs; natural honey; edible products of animal origin	12.84%	9.13%	17.39%
6. Live trees and other plants; bulbs	0.00%	0.00%	9.03%
7. Edible vegetables	0.55%	2.02%	29.32%
8. Edible fruits and nuts; peel of citrus fruit	0.23%	0.55%	18.06%
16. Preparations of meat, fish, crustaceans, mollusks or other aquatic invertebrates	2.24%	3.51%	54.24%
17. Sugars and sugar confectionery	10.70%	2.42%	9.03%
18. Cocoa and cocoa preparations	4.52%	2.39%	4.34%
19. Preparations of cereals, flour, starch or milk; pastry cooks'	1.02%	2.24%	24.45%
20. Preparations of vegetables, fruit, nuts or other parts of plants	6.16%	0.59%	19.44%
21. Miscellaneous edible preparations	40.86%	1.72%	2.48%
22. Beverages, spirits and vinegar	100.00%	71.02%	15.27%

Two scenarios are possible when assessing static effects. The first scenario involves shifting additional customs duty entirely backward at the expense of importers, i.e. of the previous phases in the supply chain. The second scenario means shifting customs duty and additional VAT entirely to retail prices,

i.e. to customers. Summary of the calculated effects of both scenarios on the customs duty base from 2011 is given in Table 6.

Table 6.: Static estimate of the annual effects (mil KM)

Scenario	<i>Ad valorem</i> customs duty	Specific customs duty	Total customs duty	VAT	Total effects
A. Shifting backwards	12.979	43.999	56.978		56.978
B. Shifting to customers	17.740	43.999	61.739	10.4956	72.235

4.2. Dynamic analysis of the effects for 2013

Static effects can serve not only as a landmark on the scale of introducing customs duty, but also as a basis for creating scenarios that will be adapted to the real situation. *First*, given that customs regime of imports of certain products from Croatia is to be changed as of 1 of July 2013, the effects are not spread throughout the year but partly in 2013 and partly in 2014. *Second*, it is necessary to take into account the possible business policies of importers of products from Croatia and reactions of consumers in B&H. *Third*, dynamic scenarios involve the assumption of decrease in consumption of goods from Croatia caused by the introduction of customs duties. We estimate that the fall in consumption of goods from Croatia would amount to 10%. The assumption on the fall in consumption of goods from Croatia is based on the fact that customs rates imposed are high on most of goods. *Ad valorem* customs duty ranges up to 10% (excluding tobacco products where the rate is 15%) and specific rate up to 3,5 KM/kg. For this reason, it is unlikely that the enterprises in the conditions of the harsh economic crisis and illiquidity could bear most of customs duty at their own expense on the long term. Shifting customs duty backward at the expense of profit or predecessor in the chain (supplier) is not insignificant in financial terms. Calculations show that in this case the additional customs duty will amount to 21% of the current customs value. Due to the high share of revenues from specific customs duty, which according to statistical estimate amounts to even 77%, it is possible that domestic buyers will turn to domestic producers if they are more competitive than the Croatian. In addition, it is necessary to calculate a certain drop in consumption due to the substitution of goods from Croatia with goods from other CEFTA countries (Serbia, in the first place) that are under the duty free regime.

On the other hand, there are factors that could mitigate the decline in imports from Croatia. First factor is a structure of imports on which the customs duty will be paid. Since the range of goods that will be under the customs regime is limited to food goods that belong to local goods that are price-inelastic, the price increase could be absorbed by the customer. This is also confirmed by the cases of rising prices of raw materials, energy and food products at disorders in the world market in 2008 and the rise in energy products price in 2012 which spilled over to retail prices. Similarly, a five-year reduction of customs duties on products from the EU brought no reduction in retail prices in the country, which once again confirms the assumption of inelastic local goods. It is a well known fact that large portion of goods imported from Croatia have their regular customers in B&H. These are trusted brands of manufacturers from Croatia with a long tradition dating back to the time of Yugoslavia and even before that time. Given that many customers prefer brand in relation to price, the consumption of goods from Croatia can be largely price inelastic, so an increase in retail prices following the introduction of customs duties should not be an incentive to reduce consumption. Besides the tradition, propensity of B&H citizens for consumption of goods from Croatia has also been determined geographically given that certain regions in B&H inclined to gravitate towards consumption of goods

from Croatia. We should not neglect the impact of political factors on the choice of consumer goods. According to data of the Agency for Statistics of B&H and Agencies for Statistics of Entities the share of Federation B&H in total imports of B&H amounts 69%, but in imports of goods originating in Croatia this share amounts to almost 87%. Therefore, it can be expected that the effect of substitution of imports from Croatia by imports from other CEFTA members (primarily Serbia) will not be drastic in the FB&H, and in RS if imports from Croatia reduced in half, the total decline in consumption of goods from Croatia in B&H should not exceed the projected 10% due to the low weight of imports of RS.

As with the assessment of effects of tobacco products, two basic dynamic scenarios are developed as well as several variants within them. The scenarios are based on limited shifting of customs duty backward and stockpiling the products prior to 1 of July 2013. In the rest of the year the shifting is done to the customer. Decline in consumption of 10% is only limited to imports in the months in which the shifting of customs duty is performed to customers. The above assumptions are included in both scenarios (A and B) and all their variants.

i. Scenario A – shifting customs duty backward

The calculation of the net effects of shifting customs duty backward of products that will be burdened only by *ad valorem* excise tax implies the calculation of customs duty by the recalculated customs rate on an average monthly customs base for one i.e. two months of imports. The calculation of the effects of shifting customs duty backward with products that will be burdened by both *ad valorem* and specific customs duties is complex because it needs to include the effects of both customs duties. Scenario A is developed in two variants. Variant „7+1+4“ means increasing imports in the first six months of 2013 for additional one-month supplies, and one-month shifting backwards. Variant „8+2+2“ means increasing imports in the first six months of 2013 for additional two-month supplies, and two-month shifting customs duty backwards. Two variants of scenario A include shifting to customers in the rest of the year, in the last four months of 2013 (variant „7+1+4“), i.e. in the last two months (variant „8+2+2“). The calculation of the net effects for these months includes the calculation of certain *ad valorem* customs duty, the calculation of specific customs duty and additional VAT on duties to be shifted to the customer.

Table 7: Calculation of net effects according to scenario A (in mil KM)

Variations of scenario	<i>Ad valorem</i> customs duty backwards	<i>Ad valorem</i> customs duty to customers	Specific customs duty backwards	Specific customs duty to customers	Total customs duty	VAT	Total effects
“7+1+4”	1,137	5,750	1,210	14,331	22,430	3,413	25,844
“8+2+2”	2,274	3,021	7,413	7,289	19,998	1,752	21,751

ii. Scenario B – shifting customs duty to customers

The net effects calculation implies a reduction of the amount imported, i.e. customs basis, due to the consumption decline, then the calculation of customs duties (*ad valorem* and specific) prescribed by the Customs Tariff for import from the EU for each product at the reduced base except for tobacco products for which a separate effect calculation has been previously made. The basic scenario corresponds to the semi-annual static evaluation according to scenario B, i.e. in the case of the year

2013 it includes six months of imports by the current regime and six months of shifting to the customer. Calculated effects include additional VAT on the effects of customs duties to be shifted to the customer.

Table 8: Calculation of net effects according to scenario B (in mil KM)

Variations of scenario	<i>Ad valorem</i> customs duty to customers	Specific customs duty to customers	Total customs duty	VAT	Total effects
Basic scenario B	9,534	23,885	33,420	33,420	33,420
“7+5”	7,065	17,761	24,827	24,827	24,827
“8+4”	5,751	14,332	20,083	20,083	20,083

According to surveys of the effects by the above scenarios, the net effect of introducing customs duty on indirect tax revenues in 2013 could be in the range of 20 to 33 million KM.

4.3. Dynamic analysis of the effects of 2014

Estimates of the net fiscal effects of introducing customs duty on other products from Croatia in 2014 are based on the assumption that, due to the present economic crisis, the business policies of importers/manufacturers of products from Croatia which include measures to mitigate the effects of introducing customs duty (stockpiling prior to 1 of July 2013, shifting customs duty backwards) will be exhausted in 2013 and that in 2014 it will come to shifting customs duty entirely to buyers. It is assumed that the import volume will be lower in 2014 by 10% compared to 2011. The net effects of introducing customs duty in 2014 are obtained in a way that static annual estimates are reduced by the effects manifested in the second half of 2013. The net effect calculation depends on scenario of events in 2013. Every major movement in relation to the standard pattern of imports and stockpiling prior to 1 of July 2013 increases the asymmetry of effects in 2014 in favor of the collection of indirect tax revenues in that year. The same effect has the shifting customs duty backwards. The larger the quantity of goods on which customs duty is shifted back in 2013 is, the higher the fiscal effects in 2014 are going to be. Rejecting extreme scenarios, it can be expected that the net effects of introducing customs duty on revenue from indirect taxes in 2014 will amount between 21 and 34 million KM (Chart 6).

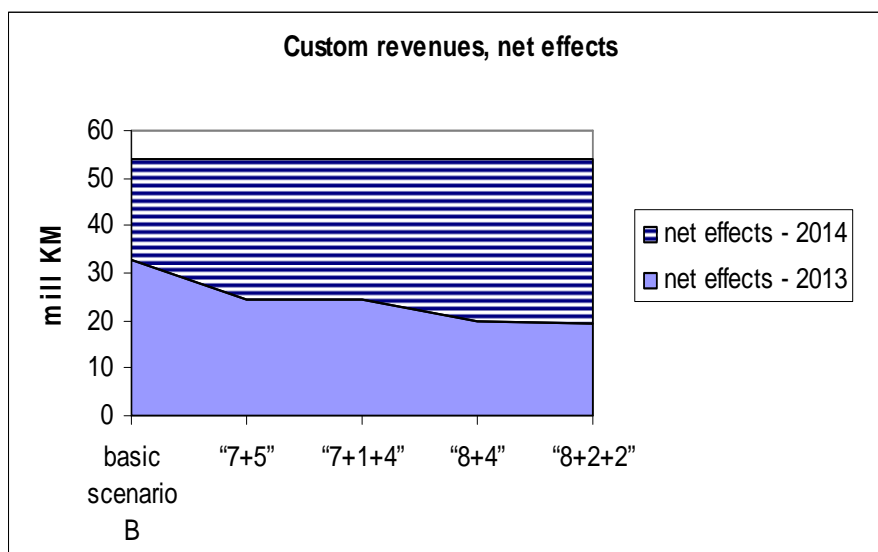


Chart 6

V. RECAPITULATION OF NET EFFECTS

Table 9

(in mil KM)

scenario	customs	excise	VAT	total
2013				
Shifting backwards				
“7+1+4”	28,658	3,260	4,477	36,396
“8+2+2”	22,960	1,630	2,283	26,873
Shifting to customers				
Basic scenario B	37,839	4,890	7,264	49,993
“7+5”	28,578	4,075	5,551	38,203
“8+4”	23,078	3,260	4,477	30,815

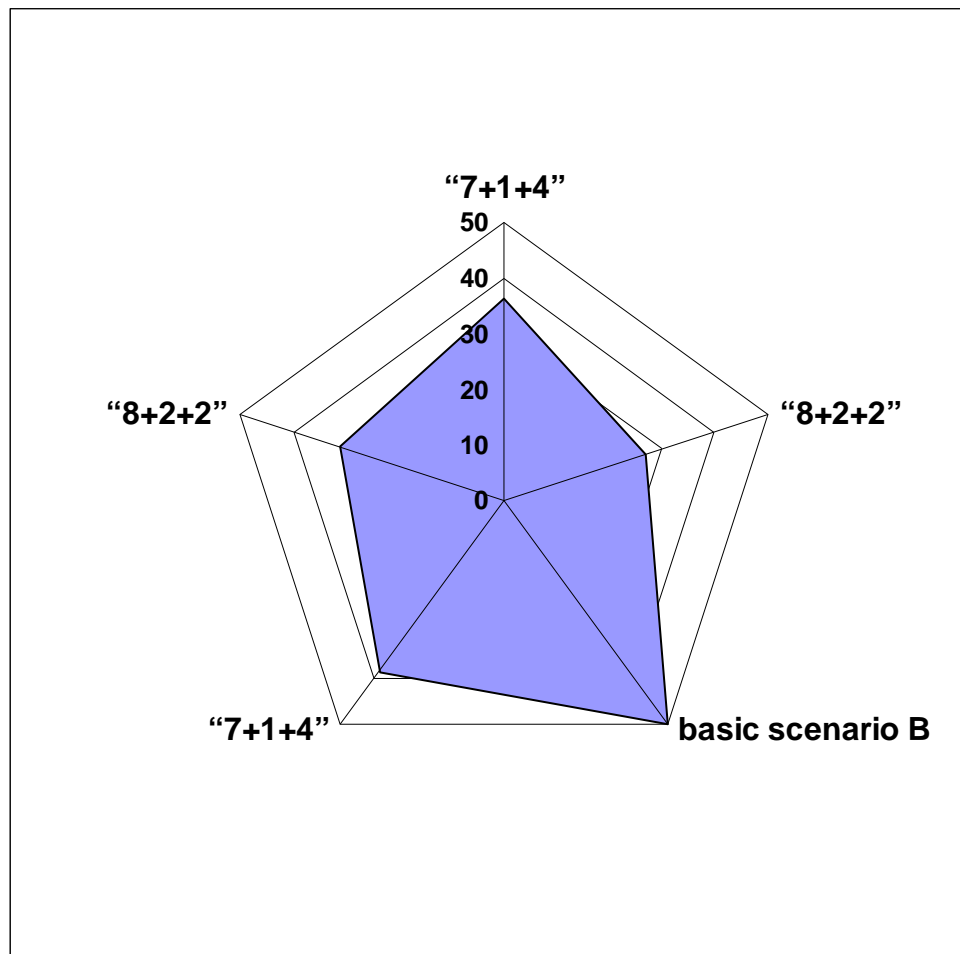


Chart 7

Table 10

(in mil KM)

2014				
Shifting backwards				
“7+1+4”	35,759	6,031	7,104	48,894
“8+2+2”	42,288	7,661	8,491	58,440
Shifting to customers				
Basic scenario B	25,747	2,953	4,624	33,324
“7+5”	35,007	3,768	6,337	45,112
“8+4”	40,507	4,583	7,410	52,500

VI. MID-TERM FISCAL SCENARIO (2013-2015)

It should be noted that the calculated effects for 2014 (Table 10) represent the net effects of the current year compared to the previous one (G_t/G_{t-1}). However, the projections for revenue from indirect taxes for 2014 require a different approach. Given that the basic scenario of projections for revenue from indirect taxes (see Chart 1) does not include changes to the customs policy towards Croatia for the purpose of drafting the program scenario for 2014, it is necessary to take the total annual effects in 2014 that for customs duties amount to 63 million KM.

In addition, it is necessary to bear in mind that the basic scenario of projections also includes customs duties that are charged on a limited range of goods within the CEFTA. In this sense, in drafting program scenario for projections for 2014, the total annual effects of introducing customs duties on imports from Croatia are needed to be reduced for the amount of revenue lost due to the discontinuation of the CEFTA Agreement on imports from Croatia (Chart 8).

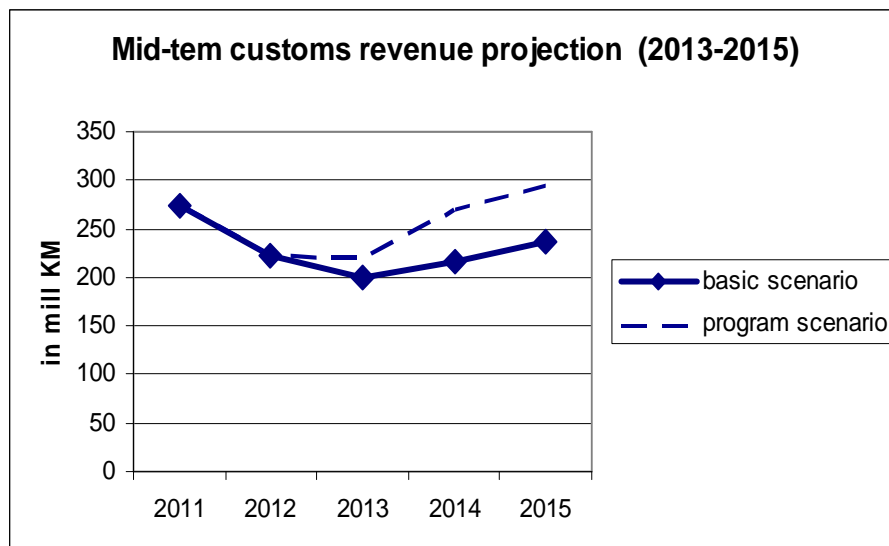


Chart 8

