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**A Contribution to the Debate on
the Fiscal Equalization Mechanisms
in the Federation of Bosnia and Herzegovina**

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List of Abbreviations

BiH	Bosnia and Herzegovina
DPA	Dayton Peace Accord
FBiH	Federation of Bosnia and Herzegovina
GAP	Government Accountability Project
GDP	Gross Domestic Product
ITA	Indirect Taxation Authority
LSIT	Law on System of Indirect Taxation
PIT	Personal Income Tax
RS	Republika Srpska
SGU	Sub-government Units
VAT	Vale-added Tax

Executive Summary

The literature on the intergovernmental fiscal relations understands differences in per capita revenues and expenditures between sub-national units within a state as a 'natural' result of the diversity of the resources and economic potential of those units. Bosnia and Herzegovina, with its odd government structure designed to protect power-sharing interests of the 'ethnic' elites, strongly confirm the theory in this respect. At this moment, one cannot find any study that explains the main causes of the fiscal differences between the sub-entity units that have developed in the last decade. This paper partly explains these causes, but only to the extent required for the policy problem that is the focus of the study.

In that sense, the paper analyzes the legal framework and current state structure of Bosnia and Herzegovina as an unavoidable part of any analysis of intergovernmental fiscal relations. This is done with the purpose of presenting relations between municipalities, cantons and entity. It is shown that in the present structure of intergovernmental relations, municipalities are facing numerous problems in their functioning as the first point-of-contact for the citizens, ranging from unfunded or underfunded mandates to legal uncertainties.

The main policy problem addressed in the study is a certain government failure to provide public services equally throughout the entity (the Federation of Bosnia and Herzegovina): huge differences in provision of public services between municipalities, as well as cantons have emerged as a result of the lack of any intergovernmental transfer system that would respond to the 'naturally' emerged differences. The magnitude of horizontal and vertical disparities in the Federation of Bosnia and Herzegovina is shown by analyzing the revenue and expenditure level of its government units. This analysis provides a compelling argument that there are enormous horizontal imbalances between municipalities and cantons that can be remedied only by introduction of some sort of equalization mechanism. In that sense, the importance of indirect taxes will be reiterate, as the sales tax was replaced with VAT.

The paper presents results of an analysis of the new system for allocation of indirect taxes in the Federation of Bosnia and Herzegovina, which was introduced after the nation-wide value-added tax (VAT) system was implemented in 2006, primarily focusing on its horizontal equalization capacities. As a consequence of the introduction of VAT, an entity derivation based system was replaced with a simple, formula-based system for distribution of indirect taxes between three tiers of governments: entity, cantons and municipalities. Weighted indexes of relative needs were calculated and used to come to the final share for each municipality and canton in the entity pool for distribution, which is determined as a percentage of total collected indirect taxes in Bosnia and Herzegovina, after the transfers for financing the State budget and foreign debt service are deducted.

The study confirms its main thesis that the equalization mechanism of the new system is designed in a way to allow for fiscal horizontal equalization across the sub-entity units. It was tested how well the new system performs in equalizing horizontal disparities by running a LSE regression between per capita amounts in the new system and available indicators of expenditure needs and fiscal capacity: population and PIT collection per capita. The analysis shows that throughout the six years period there is an obvious decrease in share of indirect taxes from the entity pool for some municipalities, and increase for others. In the final year of this period, there is a clear negative correlation between the fiscal capacity indicator and per capita amount of new transfer.

The formula will provide municipalities with bigger revenue raising capacity with smaller per capita amount of transfer and vice versa. Richer municipalities will receive a decreasing share from the entity pool, while poorer municipalities receive relatively larger and increasing shares. This is a strong indicator that in the final year the system achieves horizontal equalization between municipalities.

This trend is visible throughout the six year period for municipalities, but the formula for cantons even after the six years period still does not equalize based on revenue capacity.

Finally, the study also covers a number of issues related to familiarity of local government representatives with these changes, their ability to plan their revenues accordingly, and to the measures they plan to undertake to offset negative impact or perhaps how they are going to use the additional revenue inflow. The conclusions in this respect are made after conducting and analysis of a number of in-depth interviews with local-government representatives. A set of policy recommendations is provided for further improvements, focusing not only on the newly introduced system, but on the necessity for some fundamental changes in regulation of intergovernmental relations in FBiH.

1. Introduction

1. Citizens of Bosnia and Herzegovina (BiH) have for ten years been living under a very fragmented and diverse administrative structure. The very complex and dysfunctional governance structure split along ethnic lines represents a serious burden for socioeconomic development and efficient public service performance. Additionally, stark social and economic inequalities have emerged as a consequence of the lack of cooperation among different administrative units and absence of long term strategic planning.

2. The disparities among the cantons in the Federation of Bosnia and Herzegovina (FBiH), but also at the intra-cantonal level, without any active policy for fiscal equalization pursued by the FBiH or cantonal government, have threatened to compromise social equity of citizens of FBiH and its economic convergence. On the one side, the FBiH government neither had sufficient fiscal power, nor was there a political will to equalize between obviously growing disparities. On the other side, cantons were put in a position of being fiscally strongest. A derivation based system of sharing revenues between cantons and municipalities put the municipalities in an unfavorable position of being closest to the citizens, yet having no financial resources to improve services offered to them. This was not by chance: in the fiscal sphere, the primary task for cantons was to retain ethnic control over the financial resources.

3. The newly applied system for allocation of public revenues in FBiH has marked a milestone in intergovernmental relations. After ten years of stalemate, without any major reform processes of the fiscal system, the newly introduced formula-based mechanisms have finally changed the base on which relations between the municipalities, cantons and entity level will develop. The reform was more than necessary having in mind that post-Dayton relations between the tiers of government in FBiH have not been adapted to the changing socio-economic situations in the country.

4. The purpose of this paper is to assess the present system of the intergovernmental fiscal system in FBiH. The study focuses on FBiH since its fiscal system has the features of a federal structure. Republika Srpska (RS) has a 'unitary' structure and any analysis of its fiscal system would be entirely different from one focusing on FBiH. The study primarily focuses on the revenue capacity discrepancies and expenditure differences between the cantons and municipalities. In the literature on intergovernmental fiscal policy, these problems are called 'vertical' and 'horizontal' imbalances. They are usually the result of a non-existent or poorly designed transfer system, and in FBiH they have reached worrying proportions. The study is led by an assumption that these imbalances can be resolved through the introduction of a sharing formula as an equalization mechanism. Furthermore, policy makers in FBiH and their consultants from the international community have taken advantage of the introduction of the Value Added Tax (VAT) at the state level in order to reorder the intergovernmental relations and to apply new formula for sub-entity revenues.

5. The paper is composed of three parts. In the first part, the intergovernmental fiscal system in FBiH is examined claiming that it creates huge vertical and horizontal imbalances between the cantons and municipalities. For that purpose expenditure and revenue assignments are analyzed as well as the legal framework for intergovernmental relations. In the second part of the paper the formula-based system of intergovernmental transfers in FBiH is examined, particularly focusing on its equalization mechanisms. The last part presents results of the research carried out in five case study municipalities. The paper also provides a list of recommendations for policy action in the field.

2. FBiH - A Case of a Premature Decentralization

6. In drawing the maps with internal administrative borders and in designing fiscal arrangements in the FBiH the prevailing criterion was ethnic control over the resources. The cantons were designed according to the wartime distribution of power. They were given enormous legislative authority followed by excessive assignments of functions and revenue sources. Some of these functions are delegated to the municipalities, but cantons or in some cases the federal level retained the administrative control over provision. This was a three-sentence story of the establishment of the cantons as the key fiscal stakeholders in the FBiH.

7. In this paper the policy problem can be divided into three elements:

- i) 'vertical' imbalance – insufficient financing of the municipal mandates;
- ii) 'horizontal' imbalance between the cantons – significant differences in per capita (pc) revenue between cantons, and
- iii) 'horizontal' imbalances within the cantons – significant differences in per capita revenue between municipalities within the same canton.

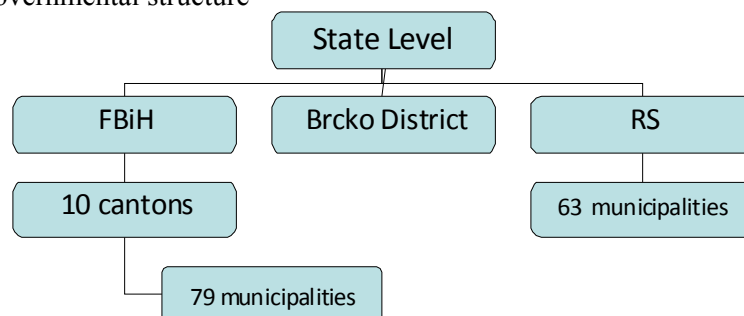
8. One can hardly encounter fiscal arrangements where revenues assigned to the sub-national governments are fully matched with their expenditure needs. Most often, intergovernmental fiscal transfers are used to close the gap between the expenditure responsibilities and revenues-raising capacity, or in other words to close vertical fiscal gap. At the same time, resources available to the sub-national levels can vary significantly, or the expenditures needs for providing standardized basket of service can be different, thus effectively creating a horizontal fiscal imbalance (Bird and Tarasov 2002). Fiscal transfers can also be used to influence spending patters of the sub-national governments or to stimulate local fiscal efforts (Ebel, Bird and Wallich 1995).

9. In order to understand these problems it is necessary to analyze the government structure as well as expenditure and revenue assignments.

2.1. The Structure of Local Government in FBiH

10. BiH came out after the war as a profoundly decentralized country. According to the Dayton Peace Accord (DPA), BiH was envisaged as a decentralized asymmetric federation, composed of two entities, namely FBiH and RS. In fact, FBiH had been created 18 months before DPA was signed. Two Bosnian “constituent nations” Croats and Bosniaks agreed in 1994 in Washington to establish a ‘Federation’. Both entities are administratively, politically, and until the introduction of State VAT, fiscally independent from the central government. They have very distinct administrative organizations. While RS has kept a form similar to the socialist BiH, with two tiers of government, an intermediate cantonal level was introduced in FBiH. This was necessitated by the deep mistrust between the ethnic groups, a product of war, but also it was caused by the still lively memory of Yugoslav interregional equalization policy, for which Croats in particular Croats had aversion. (Fox and Wallich 1997)

Figure 1: BiH governmental structure



11. According to the DPA, the Central Government had very narrowly defined functions. Those included competencies over monetary policy, foreign policy, immigration and asylum, and debt service (though in the case of the last, only entities were entitled to borrow). The assignment of responsibilities was negatively defined, so that all competencies not assigned to the state level are the function of the entities. These quasi-federal arrangements reflected the Bosnian reality in 1995, and were the only way to maintain the sovereignty of the country. Additionally, weak central government proved to be a one of the main 'system errors' of the new structure. Macroeconomic stabilization, fiscal consolidation, and privatization of state property were some of the critical areas in which the lack of coordination was often translated into bad policy solutions, obstruction or even irrational rejection. It is important also to mention that central authorities on the state level do not have any competencies over the territorial organization of entities or internal administrative structure.

12. FBiH has all the characteristics of a federally arranged state. Cantons are created as sub-government units with their own constitution, government and parliamentary representation, elected through an open and universal election. They have exclusive competencies over health, police, and education. At the time when the FBiH was conceived, assigning of significant share of power to the sub-entity level was the only viable option for maintaining the integrity of the country. Along with the decentralization of functions to the cantons, FBiH has introduced a number of consociational mechanisms such as a vital national interest procedure in the Federal Parliament, to ensure checks and balances in the system between the constituent peoples.

13. The cantons vary significantly in their size and population. Two of the cantons are without ethnic majority, while others have a dominant ethnic group. The size, population and urban-rural division not only between cantons, but also within the cantons, bear impact on the provision of the public goods. The lack of horizontal cooperation between cantons is often translated into duplication or underprovision of services. At the moment, there are 79 municipalities and two cities in FBiH. Municipalities differ significantly in size and population, varying from small detached parts of the pre-war municipalities which formed new ethnically congruent units, to the big urban centers. Cities consist of several urban municipalities, which joined can enjoy the economy of scale and externalities in service delivering.

14. Local councils are elected through open and direct elections with universal suffrage. They cannot be dissolved by the higher authority. However, legal acts such as municipal Statutes can be challenged by the cantonal authorities before the Constitutional Court of Federation, only if such acts are against the Constitution. Furthermore, cantonal laws restrict the scope of supervision only to the tasks delegated by the cantonal authorities to the local level. In accordance with the European Charter on Local Self-Government, the intervention of the cantonal authorities should be kept in proportion to the importance of interests which it protects. Chief local executives (mayors and heads of municipalities) were directly elected in 2004. Municipalities are also free to associate and collaborate with other municipalities in the country and abroad.

15. Local self-government is mentioned in the Constitution of FBiH in section VI, which lists the main competencies of cantons and municipalities where it is stipulated that municipalities are the basic unit of self-government. Further, this matter is regulated on the basic level in Federal Law on Self-Governance. This framework law affirms the underlying notion of subsidiarity from the European Charter on Local Self-Governance, and it stipulates that municipalities are independent within their own scope of competencies. However, the Law does not regulate this matter further, as it transfers the local self-governance to the cantonal level. Effectively, this has created ten different systems of local self-governance in FBiH, though cantons have to operate within the framework law.

16. Cantons violate the autonomy of municipalities by unilaterally changing the revenues sharing formulae or delegated responsibilities to municipalities. For a highly decentralized country, at least to the intermediate level, it comes as a surprise that no government in FBiH at any level has a ministry or governmental agency tasked with the affairs of local self-government. The situation improved somewhat with the strengthening of associations of municipalities and cities, but also partially because of the growing awareness of the importance of the local level, not only in delivering the services efficiently, but what is more important, in building trust between the people. Another factor that might

play a key-role in improving the position of municipalities is the new system of intergovernmental transfers, introduced together with the VAT at the state level, which will be addressed later in the text.

2.2. Expenditure Assignments

17. Those political forces which emerged during the conflict in BiH have set the limits within which new function assignment schemes could be developed. The three nations had different views about the functions that should be assigned to the different tiers of government. The result was a state with extremely weak central governments, and asymmetric decentralization of the two entities of which it consists.

18. State Government had very few expenditure functions assigned to it, and it was without any tax handle at its disposal before introduction of VAT. All functions which are not explicitly assigned to the state level belong to the entities. Until the recent reforms of the defense system, when the competencies were shifted to the state level, the central government practically did not have any major spending responsibilities. This is reflected in the large share of the subnational governments in the overall public expenditure.

Table 1: BiH Consolidated Budget, 2000 estimate. (Source: World Bank 2002)

	<i>Revenues</i>			<i>Expenditures</i>		
	Million KM	% of Total	% of Entity	Million KM	% of Total	% of Entity
Total	4695	100		5233	100	
State	25	0.5		69	1.3	
Federation, o/w:	3452	73.5	100	3713	71.0	100
Federal	892	19.0	25.9	937	17.9	25.2
Cantons	1174	25.0	34.0	1272	24.3	34.2
Municipalities	231	4.9	6.7	294	5.6	7.9
Public Funds	1154	24.6	33.4	1211	23.1	32.6
Repubika Srpska, o/w:	1199	25.5	100.0	1428	27.3	100.0
Central Government	784	16.7	65.3	862	16.5	60.4
Municipalities	107	2.3	8.9	115	2.2	8.0
Public Funds	309	6.6	25.7	451	8.6	31.6
Brcko	20	0.4		22	0.4	

19. The decentralization in FBiH has stopped at the cantonal level. Only 7.9 percent of the entity aggregate budget is executed on the municipal level in the Federation. However, if we exclude budgets of municipalities and measure federal and cantonal budgets as a share of the consolidated budget, one might conclude that BiH is one of the most decentralized countries in Europe. If we take for example only the Federation and compare it with other federal countries, the share of municipal expenditure still remains to be extremely low.

Figure 2: Comparative share of municipal expenditure; Federal countries (Source: World Bank 2002)

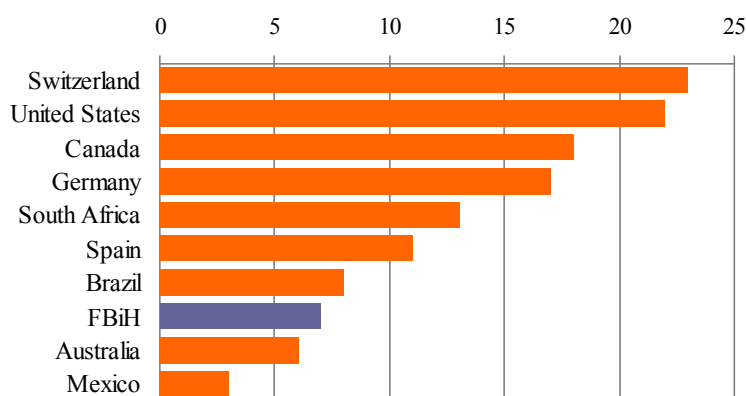
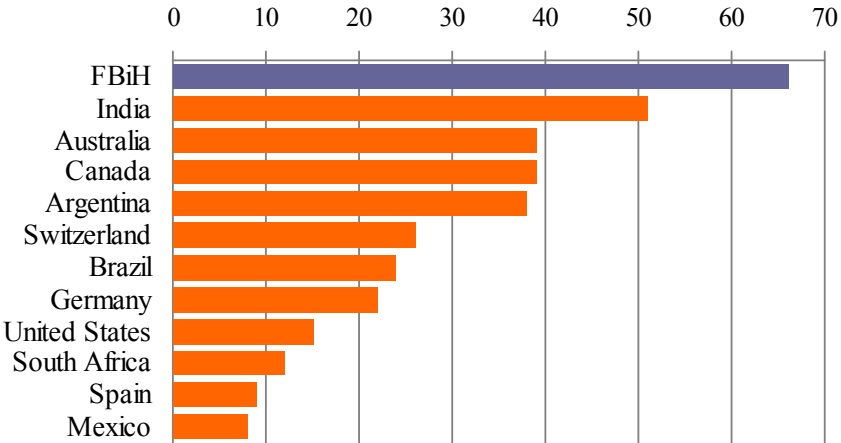


Figure 3: Comparative intermediate government expenditure. (Source: World Bank 2002)



20. In FBiH all functions not directly assigned to the entity level are the competencies of the cantons. This level of authority had a broad range of competencies assigned to it. In designing cantonal borders, the notion of subsidiarity from the European Charter on Local Self-Governance was one of the principles applied. Furthermore, assignment of functions to the cantons also followed the pattern of preserving the resources on territory in the hands of respective ethnic group.

21. The functions assigned to the government authorities can be divided into exclusive, concurrent and overlapping. This division will be used to examine how functions are assigned in FBiH. All expenditure assignments for each level of government in BiH are presented in Appendix A

Functions assigned to the entity

22. FBiH entity was created as a typical federal state, with checks and balance mechanisms and some elements of consociational federalism. Until recently, it had exclusive competencies over the defense and fiscal policy (including tax administration and tax policy), but with the recent establishment of the state ministry of defense and introduction of VAT at the state level, it has lost part of its competencies. Still, the entity government has retained exclusive competencies over economic policies, production and distribution of energy, highways and railways. Extra budgetary funds such as Pension Fund and Road Fund are constituted at federal level. Categorical social assistance for war veterans, the disabled and their families are also part of the federal government functions.

Functions assigned to the cantons and functions delegated to municipalities

23. Cantons have a wide range of functions assigned to them including health care, education policies implementation, cultural affairs, housing, social assistance, tourism and local businesses. Cantons can delegate some of the functions to municipalities, and in case that a municipality has an ethnic majority other than that of the canton, it is constitutionally mandated to do so. Each canton has adopted a Law on Local Self-Governance, which further regulates municipal responsibilities and sharing of competencies between these two levels. The subsidiary principle was used in assigning the expenditure responsibilities to cantons. Too strong a federal government would not have enabled for the specific ethnic interest to be realized. In this sense, the border of the cantons and new municipalities which emerged did not take into account economies of scale in providing services and spillover effects.

24. Though it has been constitutionally guaranteed that cantons can shift responsibilities to the federal level, this has not occurred so far. In the area of education, cantons have retained all the competencies: educational policy in general, academic curricula and research, and teacher’s salaries, in all three levels of education. Some cantons are even responsible for school maintenance and pupils transportation. Furthermore, it is also important to emphasize the inability of cantons to internalize the

spillover effect in providing educational services, especially on the tertiary level. This has caused underprovision of services and misallocation of the public funds, because the cantons cannot restrain students from other jurisdictions in capturing part of the benefit.

25. Social protection is also the responsibility of the cantons, though the federal government provides “categorical” social assistance and unemployment benefits. The delivery of the service is delegated to the municipal level, while financing is provided by cantons. This fragmented system of social protection has resulted in huge disparities in the level of social assistance. Richer cantons (e.g. Sarajevo) with a higher taxable base and revenue raising capacity provide their citizens with significantly higher social assistance (for orphans, elderly and displaced persons and refugees) than the poor cantons (Canton 10, Gorazde or Posavina). As a result of the unfunded mandate, the arrears of unpaid entitlements in those cantons have been already accumulating for years. Though the mobility of the population is relatively low in BiH, cantons cannot provide the redistributive effect which the entity would have as a bigger territorial unit. Therefore, as in the case of education, financing of social assistance should be done by the federal level, but actual delivery of services needs to be retained in municipalities.

Concurrent responsibilities

26. The Federal Constitution provides that the Federation and cantons can exercise joint functions in certain areas. The Federal government has concurrent responsibilities with cantons and municipalities in the health policy implementation, education, internal affairs, environmental protection and social protection, but all functions not explicitly assigned to the federation are the responsibility of cantons.

Functions assigned exclusively to municipalities.

27. As it is provided by the Constitutions and Laws on Local Self-Government, municipalities have exclusive responsibilities in urban planning, provision of local utilities (delivered by the off-budget municipal utility companies), pre-school education, student transportation, libraries, green areas, parks and museums, cemeteries and other responsibilities delegated by cantons. Regardless of legal provisions, municipalities in FBiH have been severely restricted as decision-makers in any of these fields, and it is even more pronounced by the weak own-revenues assigned to the municipalities. The municipal level not only in the FBiH, but in the whole country, has been seized by the post-war political setting in which the prevailing criteria were of ethnic character, not the economic efficiency or citizen welfare.

28. One of the main problems of the FBiH fiscal system is its fragmentation to ten small cantonal systems that compounded with the inability of FBiH to actively pursue any equalization policy, creates large fiscal disparities. Decentralization inevitably has as a result some degree of inequality between the richer and poorer jurisdictions. “Equal treatment of equals” (Buchanan 1950) can only be achieved by using intergovernmental fiscal transfers.

29. Equalization requires a consensus that social citizenship and solidarity among all citizens apply with equal force nationwide as opposed to being region-specific (Boadway 2004). This has not been the case in FBiH. The Human Development Report for BiH (UNDP 2005), as well as other sources, states that there are huge differences in the level of education expenditure among administrative units (cantons). These differences work against the uniform application of human rights and the modernization agenda. The same report further notes in the health care sector, administrative duplication is strongest in FBiH than in RS where, in addition to the cantonal authorities, the Federal Ministry also exercises a coordinating role.

30. As can be concluded from some of the financial indicators, the increasing horizontal imbalances in the FBiH are the consequence of the lack of planned policy of equalization. The differences in fiscal

capacity between the cantons and municipalities as well as the lack of horizontal equalizing grants have a direct impact on the delivery of publicly provided services. The political reality of 1990s in which decentralization was done had profound consequences on the public service provision on the cantonal and municipal level. The following table illustrates the magnitude of the disparities between the cantons in the FBiH in the areas of education and public security.

Table 2: Public expenditure inequalities across 10 federal units (Source: ESI 2004)

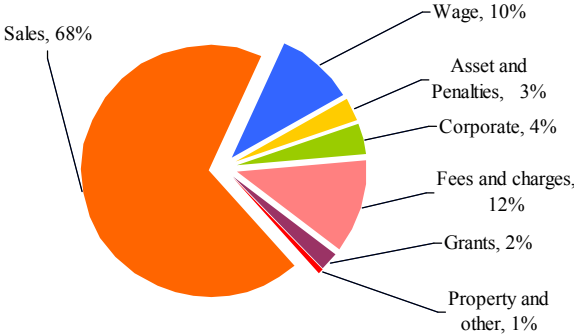
Canton	Population	Education expenditure		Public security expenditure	
		million KM	per capita	million KM	per capita
Gorazde	35,258	4.6	131	5.0	142
Posavina	43,706	5.9	136	7.6	175
West Herzegovina	81,304	18.6	228	12.2	150
Livno	83,974	9.8	117	9.1	108
Herzegovina-Neretva	217,333	39.6	182	21.6	99
Central Bosnia	239,728	34.5	144	26.2	109
Una Sana	305,905	44.9	147	29.1	95
Zenica-Doboj	397,201	59.5	150	32.2	81
Sarajevo	400,498	148.4	371	62.1	155
Tuzla	507,490	79.1	156	38.8	76

2.3. Revenue Assignments

31. Revenue sharing in FBiH was regulated by the Law on Allocation of Public Revenues. FBiH was exclusively assigned custom and excise revenues and corporate income tax revenues from the companies owned by the FBiH government. Before VAT introduction, the customs policy was harmonized across entities by the state government. Currently, customs entirely accrue to the state governments. Corporate income tax is assigned both to the Federation and to the cantons, but the tax rate and tax base is regulated by the FBiH government.

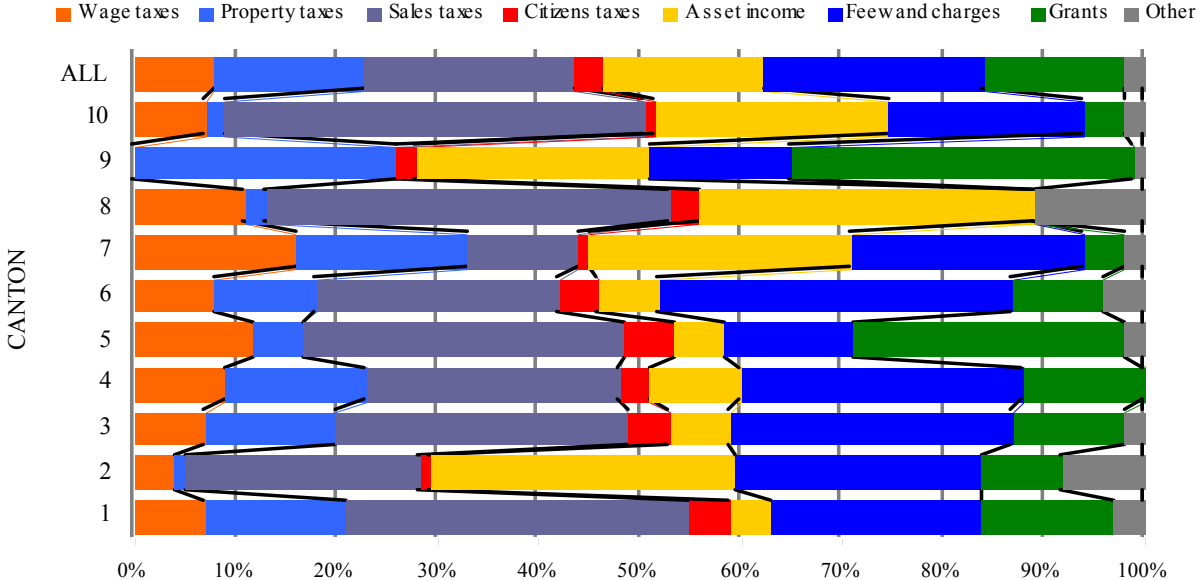
32. Each canton, with the exception of Sarajevo, has passed a Law on Revenues Sharing which regulates sharing of revenues for each respective canton and its municipalities. The most important shared tax was Sales tax, a general turnover tax, which is assigned 100 percent to cantons, and shared with the respective municipalities. Personal income tax (PIT), in the form of a wage tax also accrued to the cantons, but the rate and the tax base are determined by the Federal government. It is again based on the derivation principle, ensuring that the tax stays in the canton/municipality of origin, or better to say of place of work. Property and property transfer tax is shared between the cantons and municipalities, with 80 percent going to the canton and 20 percent to the municipality in most of the cantons. The tax is regulated by cantons, but the potential of this tax is still not fully understood by the subnational authorities.

Figure 4: Structure of cantonal revenues for 2003. (Source: GAP 2005)



33. Municipal taxes are the taxes over which the lowest tier of government has the right to regulate tax base and/or tax rate. These taxes have not been used adequately to finance municipal expenditures or to re-allocate resources at the local level. Municipalities prefer to rely on the shared taxes, which does not allow for development of a genuine local tax effort. Very few of these taxes are regulated exclusively by cities/municipalities, except for the user charges which are collected and appropriated by the off-budget companies. On the one side, these charges and taxes are extremely fragmented and on the other, the potential of the property tax as the most buoyant and stable local tax is still underutilized (GAP 2005).

Figure 5: The Structure of Municipal Revenues by Canton. Source: GAP

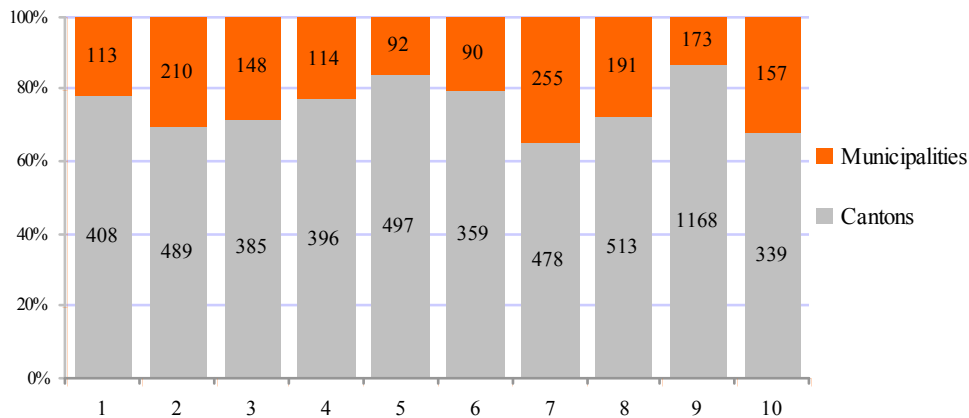


34. In 2003, municipal revenues from all sources amounted to 268 million KM of all public spending in FBiH. More importantly, municipal revenues in 2003 represented only 3.2 percent of FBiH’s GDP, which was 8.340 million KM. This all suggests that municipalities in the Federation are under-funded, and that the system is in serious vertical imbalance.

35. Horizontal fiscal imbalances are also huge in FBiH. There are serious disparities in per capita revenues between municipalities and cantons. This does not come as a surprise, having in mind that that share of the taxes assigned to municipalities differs significantly from canton to canton. Additionally, the fiscal capacity of the cantons varies, which compounded with the derivation based taxation further exacerbates these disparities.

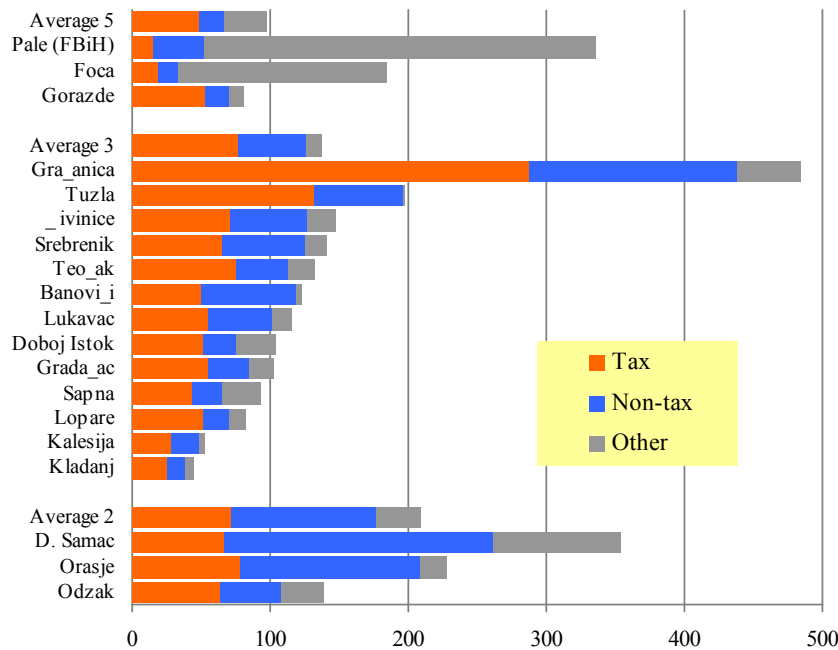
36. None of the cantons (perhaps with exception of Canton Tuzla) has introduced a mechanism for fiscal equalization. By far the richest canton (Sarajevo) has three time bigger per capita revenue than the poorest canton (Central Bosnia). The magnitude of disparities between the cantons is illustrated in the figure below where the difference in income can be clearly seen as well as the difference in share of the municipal revenue.

Figure 6: Cantonal per capita revenues shared between the two layers of government (2003, in KM) (Source: Djikic, J., Lenic B. and Levitas T. 2005)



37. Even in the case of Canton 3, where the five poorest municipalities were assigned larger share of revenues, the disparities still remain large. Disparities caused by the poor fiscal capacity of the municipalities cannot be eliminated unless there is a proactive equalization policy, but FBiH has no available tax revenues that could be used for this purpose.

Figure 7: Estimates of Disparities in Per Capita Municipal Revenues: Canton 2, 3 & 5. (Source: GAP 2005)



38. Vertical and horizontal imbalances in FBiH which are result of non-existence of transfer system have reached worrying proportions. Measure of *the Minimum of GDP per capita to FBiH average* for example shows that Canton Una-Sana has only 66,7 percent of the GDP per capita of the average. Another measure, *Maximum to Minimum Ratio (MMR) of GDP per capita* for the ten cantons comprising FBiH reveals that the ratio between the poorest and richest canton is 2.8:1. At the same time, municipalities in FBiH in 2003 constituted only 11% of all public spending in the entity, or 3.2 percent of GDP. This is very low in comparison with RS meaning that municipalities in FBiH are radically underfunded. (GAP, 2005)

3. A Policy Window – Value-added Tax Introduction

39. Until the recent introduction of VAT the Central Government in BiH did not have any taxation power. According to DPA, it was given only some minor fees (such as passport issuing) without any own source revenues. Financing of the State expenditures was done by transfers from the entity level. FBiH contributed two thirds to the state budget, while RS's contribution was one third. This asymmetric and decentralized solution for revenue assignments left the central government without any real tax leverage. This had as a consequence huge disparities in the revenues of the subnational governments, most notably between cantons and between municipalities. Before the reform of the taxation system the central government or the FBiH government did not have any active policy aimed at decreasing those disparities.

40. Sales tax was the most abundant revenue source for the municipalities in FBiH until the VAT introduction. It was a tax levied on all purchases of goods and services under the jurisdiction of a canton. The revenue sharing rate for sales tax varied from one canton to another, but the average rate was 80% for the canton and 20% for municipalities. The mechanism that was in place was 'derivation' based, i.e. all taxes collected within jurisdiction of a canton would be returned to that canton (100 percent) and shared with municipalities. Tax rate and tax base were set on a federal level, thus effectively making these revenues as unconditional grants for municipalities.

41. At the beginning of 2006, a nation-wide VAT system was introduced in BiH administered by the central government agency Indirect Taxation Authority (ITA). A framework Law on System of Indirect Taxation (LSIT) and Law on VAT were passed in the state parliament. The tax base and a single rate (17%) were determined uniformly for the whole country. ITA collects all indirect revenues, including excise and custom fees to a single treasury account and has competencies on the whole territory of the country. The Law on VAT and LSIT determine that financing of the central government and servicing foreign debt have priorities in distributing the pool of revenues from the single account (Art. 21).

42. Collection of indirect taxes and customs is now centralized at the state level. Tax policy has also been transferred to the state level, thus effectively leaving entities with very little power in the fiscal domain. The revenues collected to the ITA's Single Account are ceded to the entity level, after the share for financing state budget is transferred, and based on the entity share of the processed VAT invoices, which was the subject of much political debate.

43. LSIT does not oblige ITA to trace the origin of the revenues below the entity level. Therefore, as of 1 January 2006, the derivation principle can no longer be applied for allocation of indirect revenues in the FBiH. The state has priority in being financed from the Single Account revenues, but there is a need for developing a mechanism for allocation of what is left to the sub-entity governments. These revenues represent a huge portion of the sub-entity income, amounting up to 70 percent of the cantonal income and 21% of municipal.

44. The sharing ratio between the entities and the Brcko District is defined in the LSIT, but it has been the subject of much political debate recently. It depends on the number of processed VAT invoices from entities, a procedure which RS representatives see as biased and unjust, as according to them, invoices from the FBiH are given priority. The amount to be distributed to the entities may vary in the future, depending on this highly politicized decision. Consequently, the federation, cantons and municipalities could face uncertainties in the amount of income from the Single Account. This is partially offset by the improved tax collection and fiscal compliance, which is inherent to the VAT.

45. ITA has justified its existence by collecting, 1.55 bill. KM of indirect taxes and customs in the first five months of 2006, which is comparably much higher than the amount of 1.39 billion KM collected by the three separate tax and custom authorities. The plan for 2006 was to collect 3.5 billions KM of indirect taxes and customs, which is realistic, having in mind that the tax rate of 17% was set higher than to be a neutral tax rate replacing the sales tax. Additionally, the fact that the Law on VAT does not envisage exemption or zero rate, except for exports, contributes to this.

46. Under the shared revenue scheme for grant distribution, each SGU receives a share of tax collected within its boundaries. This type of grant allocation scheme was operating on the cantonal level in FBiH before the introduction of VAT. Revenue sharing distribution schemes are inherently not equalizing, as richer municipalities and cantons were receiving proportional larger amounts of tax. Another problem with this approach is that it discourages autonomy and accountability at the local level, as the tax being centrally collected and tax rate and base centrally determined, the local population would not hold local officials responsible for quality of services provided. This was very much the case in FBiH municipalities and cantons. Though there were not too many centrally determined expenditure mandates for municipalities, local officials did not use this freedom in spending the revenues to increase accountability and improve quality of living, except in rare cases.

47. On the other side, revenue sharing is stable and predictable source of income for SGUs. It allows them to plan and forecast future revenues with certainty. However, it is more difficult for the central government, as it was the case in FBiH, to influence the fiscal area. FBiH Government did not have tax capacity to equalize between cantons and municipalities, as all major taxes were either assigned or shared with the cantons.

48. For the first time after the fall of the socialist state, the BiH central government and entity governments have the opportunity to use their fiscal strength for horizontal and vertical equalization between the entities, cantons and municipalities. Although the fiscal arrangement is more centralized now, the design of this system will have to respect not only economic and social issues, but also realities of the political landscape of post-Dayton BiH.

49. FBiH has to take advantage of this reform in order to reorder the intergovernmental relations and to apply a new formula for entity and sub-entity revenues. Unlike with the previous solution when each canton had its own revenue-sharing law, the new FBiH Law on Distribution of Public Revenues employs distribution formula to allocate the revenues between cantons and municipalities, with gradual introduction over a period of six years. A myriad of cantonal revenues-sharing laws have been abolished and replaced with a single law, which despite the fact that FBiH is no longer in control of indirect taxes, still allows for an active policy role to be played.

50. In the following section the new system of intergovernmental transfers in FBiH will be examined, specifically focusing on its equalization aspects. This will be complemented by testing how the newly introduced formula-based transfer treats sub-national governments with respect to equalization. Per capita amount for the last year of the transition period will be calculated. Finally, its correlation with fiscal capacity and expenditure needs of cantons and municipalities will be calculated using multiple regression techniques.

4. New Formula-Based Allocation Mechanism in FBiH

51. Two external particulars make the argument about the necessity of an equalization policy more realistic. The first is the fact that the equalization principle is imprinted into the European Charter of local self-government (Art. 9). Secondly, all the European countries “follow financial equalization policies, more or less developed, in order to reduce the disparities of resources and/or charges between local authorities” (Berthier 2005 2). Taking into consideration the slow pace and character of political change ‘from inside’ in BiH it is obvious that these external standards might speed up necessary reforms.

52. As has already been discussed, vertical fiscal imbalances in FBiH are significant. Absence of any kind of information about municipal expenditures and the very few available for the cantons makes the task of quantifying the imbalance very difficult. Still, it can be said, using estimates, that the municipalities are underfunded, while the most buoyant taxes are assigned to the cantonal level. Horizontal disparities between cantons and between municipalities also pose a serious obstacle to the economic convergence and creation of a single economic space in BiH.

53. The new transfer system in FBiH has taken historic information on cantonal and municipal revenues as a starting point (year 2005), trying to increase their share in the public revenues through the new transfer system. In general, a transfer system can be used for fiscal equalization between the sub-national jurisdictions. Horizontal inequalities are a natural occurrence, and they reflect the diversity of the resources and economic potential of the sub-government units (SGUs). Mobility of the people and capital from less productive to more productive regions increase efficiency, but the fiscal system should be designed to have minimal impact on the allocation of the factors of production. Additionally, equalization policy of the government can also be implemented by assigning the own-source revenues to the SGUs, but more typically it is done through a transfer system. Fourth, externalities occur when the SGUs decided to underspend on the service with significant spillover effect. Transfers can be used to correct these anomalies, and at the same time central government can influence spending patterns of the SGUs.

54. The government of FBiH has passed a new Law on Allocation of Public Revenues (Official Gazette 22/06), using for the first time formula for distribution of revenues to sub-national level. Both entities and Brcko district will receive revenues from ITA’s Single Account according to the processed invoices from their territories, and after the revenues are transferred to the state budget for financing its functions. Of this amount, FBiH will distribute:

36.2 percent for financing function of entity level;
 51.48 percent for financing of cantonal functions,
 8.42 percent for financing municipal level functions,
 3.9 percent for the Road Fund.

55. The formula for distribution of the FBiH pool of indirect taxes is based on a number of weighted factors which try to capture differences in expenditure needs and revenue capacity of cantons and municipalities.

Table 3: Weights for cantons and municipalities used in allocation formula

Government level	Area	Population	Elementary School Children	Secondary School Children	Development Index
Cantons	0.06	0.57	0.24	0.13	-
Municipalities	0.05	0.68	0.20	-	0.07

56. In addition to this, the formula contains a weight for special spending needs of Sarajevo canton (2). Two cantons, Gorazde and Livno, which had the smallest revenue from the sales tax in the derivation-based system, are also given a special weight (1.8). The formula has a factor of 1.2 for municipalities with over 60.000 of inhabitants, and 1.5 for the municipalities covering the costs of elementary schools.

57. Index of development actually measures the fiscal capacity factor of the municipality. It is calculated as the ratio of the collected sales tax and income tax for the respective municipality for 2005 from the FBiH average for those two taxes. Weights for the fiscal capacity are in the range between 1.8 for municipalities with below 20 percent of the FBiH average collection of those taxes, to 1.2 for municipalities with below 80 percent of average. All data used in the formula are collected by the Statistical Agency of FBiH, and are the best available data obtainable at the moment. However, it is unclear what method was used in calculation of particular weights attached to formula factors. At the moment, it is not possible to obtain any reliable information on municipal expenditures which could be used for calculation of weights, either using regression or simply as historic information.

58. The new Law envisages a six year phase-in period for implementation of the system. This solution is fully understandable having in mind the magnitude of current horizontal fiscal disparities and the level of investments and long-term expenditure in richer cantons and municipalities. The phasing-in period combines percentages of sales tax collected prior to the introduction of the new system, and gradual introduction of percentages according to the new formula:

Cantons	Municipalities
Year 1 (2006): $Cs = (0.9*HCs + 0.1*NCs)$	$Ms = (0.9*HMs + 0.1*NMs)$
Year 2 (2007): $Cs = (0.7*HCs + 0.3*NCs)$	$Ms = (0.7*MCs + 0.3*MCs)$
Year 3 (2008): $Cs = (0.5*HCs + 0.5 *NCs)$	$Ms = (0.5*MCs + 0.5 *NMs)$
Year 4 (2009): $Cs = (0.3*HCs + 0.7*NCs)$	$Ms = (0.3*HMs + 0.7*NMs)$
Year 5 (2010): $Cs = (0.1*HCs + 0.9*NCs)$	$Ms = (0.1*HMs + 0.9*NMs)$
Year 6 (2011): $Cs = (NCs)$	$Ms = (NMs)$
Legend: Cs, Ms – Percentage of the share in the pool of indirect taxes for cantons and municipalities; HCs, HMs – Historical share in the sales tax in FBiH of cantons and municipalities; NCs, NMs – Percentage of share according to new system for cantons and municipalities.	

59. The pool of indirect taxes available for distribution in FBiH is determined as a percentage of the indirect taxes, in the first place VAT collected to the Single Account of ITA. ITA’s estimation is that in 2006 about 3.5 billion KM of indirect taxes will be collected. The state budget forecasts KM566 million of indirect taxes to be transferred for 2006 from the Single Account for financing central government functions and service of foreign debt. This leaves amount of 2.93 billion KM to be allocated between FBiH, RS and Brcko District.

60. If one takes percentages for June 2006, which allocate 66.77 percent to FBiH, 29.76 percent to RS and 3.46 percent to Brcko District, and applies them to the amount forecasted for 2006, then the amount available for distribution in FBiH is 1.95 billion KM. Applying percentages for allocation between FBiH level, cantons and municipalities, in 2006 cantons will receive 1.008 billion KM and municipal level 164.9 mil KM. Comparing to the 2005 level, municipalities will receive 72 percent more and cantons 2 percent more of indirect taxes. At the moment, information on loan servicing for FBiH for 2006 was unknown to us. The Federal pool for distribution would decrease after the loan repayment is deducted, and consequently so too the per capita amount calculated for municipalities.

61. At the end of the phase-in period, municipalities will have at their disposal a significant share of the public revenues in FBiH. This will call for a re-evaluation of the assignment of functions to municipalities, and possible re-aligning of functions between tiers of governments in FBiH. Any changes in intergovernmental relations should reflect the role of municipalities as the closest tier of

government to the citizens, but also potential threat of low capacity at the local level to implement newly assigned functions.

62. To test how well the new formula-based transfer system does the job, simple LSE regressions will be used to determine the correlations between the dependent variable - amount of transfer per capita for cantons and municipalities, and several indicators of revenue capacity and expenditure needs – independent variables (See Appendix B). As an indicator of revenue capacity, we have selected GDP per capita and Personal Income Tax per capita of cantons and municipalities.

63. As an indicator of expenditure needs, population size will be used. Sarajevo municipalities were given as one sum, and the number of observations was reduced from 79 to 71, keeping all Sarajevo municipalities together. The results of regression for 2006 and 2007 are given below while calculated per capita amounts of transfers to all municipalities until 2011 can be found in Appendix C (t-statistics is given in parenthesis):

Cantons:

$$\text{Transfer}_{2006} = 44.11 + 0.118 * \text{GDPpc} \quad (3.42)$$

$$\text{Transfer}_{2007} = 96.52 + 0.102 * \text{GDPpc} \quad (3.95)$$

Municipalities:

$$\text{Transfer}_{2006} = 32.67 + 0.575 * \text{PITpc} \quad (3.74)$$

$$\text{Transfer}_{2007} = 43.78 + 0.423 * \text{PITpc} \quad (1.65)$$

64. Looking at the results of the analysis, one cannot find any statistically significant correlation between per capita transfer and population at either 5 or 10 percent of significance.

65. We have also tested how the system will function at the end of phase-in period. We have for that purpose calculated per capita amounts in 2011, and correlated them with GDPpc, PITpc and population. Here are the results:

Cantons:

$$\text{Transfer}_{2011} = 267.38 + 0.053 * \text{GDPpc} \quad (-1.23)$$

Municipalities:

$$\text{Transfer}_{2011} = 82.98 - 0.107 * \text{PITpc} \quad (3.82)$$

66. Coefficients for population, as a proxy for index of relative need were not statistically significant. However, it is much more important that in the final year of implementation there is a clear negative correlation between revenue capacity indication-PIT per capita, and amount of new transfer per capita, which shows that at the end of transition period, the formula will provide smaller per capita amount of transfer to municipalities with bigger revenue raising capacity. This is visible from the calculated per capita amounts for 79 municipalities. One can observe a pattern: urban and richer municipalities will receive decreasing shares from the entity pool, while poorer municipalities receive relatively larger and increasing shares. This is a strong indicator that in the final year system achieves horizontal equalization between municipalities.

67. This trend is visible throughout the six year period for municipalities, but the formula for cantons even after the six year period still does not equalize based on revenue capacity.

5. First experiences with the new system at the local level and future prospects

68. In this chapter, we present some insights into how the introduction of the new system of sharing revenues in FBiH is perceived at the local level. The focus is on the following questions:

- information that local government officials (heads of financial departments) have about the new system, its main characteristics and functioning;
- their perception how the system will influence the revenues of the city/municipality, and related to this, ability of local governments to forecast indirect revenues;
- What will be the response of the local governments in case of shrinking or increasing indirect revenues?
- Local borrowing prospects in FBiH, after the introduction of VAT.

VAT Impact at the local revenues

69. As it can be seen from the analysis of per capita amount of indirect taxes in the next six years, some local governments will receive significantly higher revenue, measured as share of the entity pool, than compared to base year (2005). On the other side, a number of (mainly urban) municipalities will lose a significant portion of their indirect taxes in the same period. This can partially offset in absolute numbers, as the collection of indirect taxes (VAT in the first place) is significantly higher than forecasted, in the first place because some flows of informal economy have been included in System of Indirect Taxation. The other reason is that VAT single rate of 17% has been set at the higher level than the tax neutral rate of 16 percent. However, this one-time increase in the first year of VAT will not repeat in the future, and local governments with declining share of indirect taxes should prepare some policy solution for this problem.

70. Although the local governments' autonomy of the setting tax base, tax rate or in collection of own-revenues in FBiH is generally limited to only minor fees and charges, we wanted to test our assumption that declining relative share of entity pool of indirect taxes will produce some pressure on the local governments to increase efforts in collecting own-source revenues. This is possible certainly because the new formula for distribution of indirect taxes in FBiH does not include own-revenues as measure of fiscal capacity. In this way, there is no negative incentive for local governments to reduce efforts in collecting own revenues, and to fill this gap by increased transfers from indirect taxes.

71. As general rule, Heads of Financial Department in five selected municipalities we visited during the data collection were aware of the changes in the system for distribution of revenues for FBiH. They obtained this information through official channels (in most cases Official Gazette where the distribution coefficients for 2006 and 2007 were published). However, their understanding of how new system functions is limited. Equalization aspects of new mechanism were almost unknown to them, or any information how the system was conceived. As a general finding, their expectations that indirect taxes revenues would increase in 2006 are realized. However, representatives of municipalities with decreasing shared revenues from indirect taxes (over the 6 years period) did not have clear understanding of this fact.

72. Some municipalities use the coefficients for distribution of indirect revenues for 2006 and 2007 to forecast their own revenue, but the majority of them use previous years budget figures (one to three) as a base in preparing a budget proposal. In addition, they lack any information on how much revenues have been collected through ITA, and how much will be allocated between entities and Brcko District. This is exacerbated by political bargaining over the coefficients for 2006, and thus permanent uncertainty over the amount for distribution in FBiH.

73. In two municipalities, coefficients for distribution are declining throughout 2011. The Head of Financial Departments were not, however, aware of this fact. Therefore, any active policy measures aimed at offsetting this negative trend have not been proposed yet, apart from other measures local governments are pursuing to improve collection of local taxes. This is also conditioned by nuisance

taxes assigned to the local level, leaving them with small maneuvering space for raising additional own-source revenues.

74. Three municipalities have increasing share from federal pool until 2011. They plan to spend these funds for capital investments in their municipalities. Heads of Department claimed that this inflow will not be used for operating expenditure increase. However, without an enabling environment for capital borrowing at the local level, these increased revenues will not produce results in the medium and long run.

Local Borrowing in FBiH and VAT introduction

75. Local borrowing in FBiH has been banned in the past few years by the entity government Law on Execution of the Budget. On the other hand, it is allowed through provisions given in Law on Local Self-governance and Law on Budgets. The entity government anxiety about local borrowing is understandable for two reasons. First, the legal framework had some ambiguous provisions built into it, creating uncertainties for local lenders and borrowers. Second, this is a novelty in financing of local government projects, and as such local governments often lack capacity and skills to engage in these operations.

76. Some municipalities, however, have engaged in borrowing from the local banks in the past few years, for various purposes, in some cases for financing recurring expenditures or paying salary arrears. From the results of our visits we can conclude that there is a huge need at the local level for financing infrastructural projects, especially because of declining foreign assistance and (still) necessity of post-war recovery. Borrowing for financing of infrastructural and multi-year projects is more than justified.

77. Some of the municipalities selected for our research have already engaged in some sort of local borrowing. This has been done through domestic banks and in some cases through international institutions. These funds were used mainly for infrastructural projects, though in some cases also for covering operating expenditure and arrears.

78. Having in mind great need for investing in local projects (mainly multi-year infrastructural), increase in VAT revenues is seen as the opportunity for municipalities (especially fiscally weak) to secure a stable stream of revenues in the future, which can be used to finance loan repayment. All of the visited municipalities expressed their commitment to finance capital investments from the increased indirect taxes. This of course will not depend only on the local revenues, but also on the enabling environment for local borrowing.

79. Procedures for selection of local capital projects on the local level are not always clear. Much effort has recently been invested in building the capacity of local government to establish a participatory and inclusive approach for selection of capital investments. Some municipalities have developed a mechanism for active participation of citizens in selection of capital projects, but in some these decisions are still taken through non-transparent procedures.

80. Finally, some of the interviewed officials complained about unclear selection of capital financing from the entity and cantonal level, and often failure to transfer matching funds for planned projects. This is resulting in budgets having to be revised during the fiscal year, stopping the project or demanding additional funds from the local budget.

6. Policy recommendations

The new system for allocation of indirect taxes in FBiH incorporates both expenditure needs and fiscal capacity indicators. For the first time, a derivation based system is replaced with a clear and simple formula, which will enable municipalities and cantons far more stable budgeting, and hopefully, better local governance. The formula uses simple and verifiable data for the calculation of transfers and it allows for easy modifications, which will certainly take place in the following years. The formula captures the expenditure needs differences across the municipalities and cantons, as well as fiscal capacity differences. In the last year of the transition period, transfers per capita vary negatively with the Personal Income Tax per capita indicator at municipal level. This is the indicator that the formula is performing well in correcting horizontal imbalances.

Necessity of capacity building and accountability strengthening at the local level

❖ Though the formula represents somewhat of an enigma for cantonal and municipal authorities, at the end of the six year phase-in period poor local governments in FBiH will have at their disposal significantly larger revenues compared to the present system. This is partially improved by the increased compliance and tax collection inherent to VAT. In that sense, it will be necessary to accompany present reforms of the fiscal sector with parallel projects of capacity building at the local level, especially for inclusive and participatory capital project selection.

❖ The first and foremost task will be to improve financial management in municipalities and cantons through training local officials for project preparation and management. Moreover, it is necessary to improve their accountability by opening channels for communication with citizens and for citizens' active role in local government affairs. Introduction of program and performance budgeting and multi-year budgeting would be good mechanisms for this.

Local governments need to improve their own fiscal capability

❖ Regardless of whether local governments will receive more or less of indirect taxes, an effort should be made to increase collection of own-source revenues. This is especially important for predominantly urban municipalities, with concentration of real estate and businesses, but is equally important for smaller municipalities. The formula does not contain negative incentives for collecting of own-revenues, but it would be necessary to strengthen the capacity of local governments to collect those revenues.

❖ This will need to be accompanied with reform of the direct taxes in FBiH (Income Tax and Property Tax in the first place), to provide municipalities with more fiscal space for collecting their own revenues - especially important for those municipalities with decreasing indirect taxation revenues.

More cooperation between different jurisdictions in BiH is needed in order to achieve optimal fiscal balances

❖ Although the legislation regulating allocation of indirect taxes has been harmonized to a certain degree between Entities, it would be of great importance for nation-building efforts to have a State Law uniformly regulating this area for the whole country. This, of course, is hardly achievable in present relations between entities, as there would be a necessity to obtain political consent in the first place as it would also require harmonization and realigning of revenue and expenditure assignments. Still, potential benefits in terms of creating a single municipal fiscal space, solidarity and cooperation between municipalities should not be neglected in a country such as BiH.

Enhance measurement of fiscal needs and improve system of transmission of the information to local governments

❖ The formula ingredients might change to include more precise measurement of fiscal need and capacity, as it becomes available. These changes would then reflect more accurately the situation in municipalities and cantons, and therefore provide better capture of real needs of local government

units. In this light, it is also necessary to work on the mechanism for informing municipality about changes in the fiscal sphere, not only through official gazettes, but by organizing rounds tables and seminars where changes, such as introduction of this new system could be discussed. There should also be a mechanism easily accessible for municipalities to assist them in the budget planning process, by providing information on collected indirect revenues for the whole country, and for each entity.

Assure for outright decentralization

❖ The increased flow of revenues for local governments might provide incentives for realigning of the intergovernmental relations in FBiH by assigning additional responsibilities to municipalities. If this happens it will be necessary to direct reform so that municipalities are not assigned only mandated functions, but that there should be genuine devolution of power to the local level.

Allow for local government access to capital markets

❖ Of special importance will be regulation of how municipalities and cantons access capital markets. The conditions are already created which enable some municipalities to borrow even now, and this will become even more realistic as the situation with local finances improves. This requires that the new law is adopted in the course of the fiscal reform, allowing for local government access to capital markets, but at the same time issuing upper tiers of government from bailing-out municipalities and cantons.

❖ Finally, if the role of local governments becomes more important, there will be a need for central data collection, monitoring and analysis of local governance performance. A new ministry, either at entity level or at the state level, if political reality permits, will need to be established to coordinate efforts in this area and also to harmonize different policy solutions between entities. It is not possible to predict future political developments in BiH, but one can believe that as it was incomprehensible that there would be some model of fiscal equalization introduced in FBiH, one can hope that at some point in the near future there will be a fiscal equalization scheme for the whole of BiH. Only in this way will it be possible to reduce the disparities between the two BiH entities, and through that process additionally strengthen integrative forces in the society.

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Appendix A: Assignment of expenditures in Bosnia and Herzegovina

Expenditure Assignment	State	Entities				
		FBiH			RS	
		Entity	Canton	Municipalities	Entity	Municipalities
Immigration, Refugees and Asylum Policies Immigration, Monetary policy	Immigration refugees and asylum policies Immigration Monetary Policy				Refugees and displaces persons	
Justice, International Security and Police	International and Inter-entity Criminal Law enforcement	Internal Affairs/Justice and Police	Police		Internal Affairs/Justice and Police. Transfer of Police to State level pending successful negotiations	Local Police
Communications	State Regulatory Agency	Inter-entity regulations	Regional TV and radio		Intra-entity regulation	
Public Transportation	Regulates National Trans. System and Inter-entity	Intra-entity	Regulates intra-canton		Intra-entity	
Social Safety Net and Welfare	Refugee Programs	Pension System	Social Assistance-joint	Social Assistance joint	Pension System	Social Assistance
Energy	State Transmission Regulation	Intra-Entity Regulation			Intra-entity regulation	
Roads		Highway Roads	Regional Roads	Local Roads	Highway Roads	Local roads
Defense	Reformed to State level					
Education			Universities Teachers salaries Secondary and primary education	Pre-school education Primary schools partially maintenance School buses	Universities Teachers salaries School buildings	Pre-school Primary school partially maintenance
Health Care		Federal Health Insurance Fund	Primary and Secondary Health Care Health Insurance Funds	Ambulance services	Primary and secondary Health Care Republic health Insurance Fund	Ambulance services
Sanitation				100%		100%
Water and Public Utilities				100%		100%
Housing and Spatial Planning			Housing Policy	City planning	Housing policy	City planning
Sewage Treatment				100%		100%
Culture, Sport, Recreation, Parks, Street Lighting			Museums, Theaters	Culture, sport, parks, street lighting	Museums Theaters	Culture, sports, parks, street lighting
Fire protection			Joint responsibilities	Joint responsibilities	Joint Responsibilities	Joint Responsibilities
Libraries				100%		100%
Environmental and use of natural resources		Concurrent responsibility			Concurrent responsibility	

Appendix B: Distribution of transfers to cantons for 2006, 2007 and 2011.

Cantons	2006		2007		2011	
	% of FBiH Pool	p/c transfer, in KM	% of FBiH Pool	p/c transfer, in KM	% of FBiH Pool	p/c transfer, in KM
Una-Sana	9.499	331.55	9.799	342.03	10.733	374.62
Posavina	1.84	447.83	1.743	424.23	1.404	341.68
Tuzla	17.095	346.97	17.247	350.10	17.782	360.91
Zenica	12.538	315.013	12.972	325.92	14.627	367.50
Gorazde	1.714	500.92	1.830	534.82	2.122	620.10
Central Bosnia	8.017	315.613	8.37	329.52	9.603	378.04
Neretva-Herzegovina	8.90	392.55	8.821	389.00	8.525	376.03
West Herzegovina	3.426	413.44	3.385	408.50	3.205	386.74
Sarajevo	34.768	855.15	33.275	818.43	28.110	691.39
Livno	2.203	269.62	2.578	315.51	3.890	476.10

Independent variables used for regression.

Canton	GDP per capita, in KM	Population
Una-Sana	2120.8	288,935
Posavina	2862.4	41,436
Tuzla	2749	496,885
Zenica	3019.9	401,401
Gorazde	2430	34,508
Central Bosnia	2851	256,175
Neretva-Herzegovina	4376	228,649
West Herzegovina	3011.2	83,570
Sarajevo	5957.8	410,031
Livno	2411.6	82,402

Appendix C: Distribution of transfers to municipalities for period 2006-2011

Municipality	2006		2007		2008	
	% of FBiH Pool	p/c transfer, in KM	% of FBiH Pool	p/c transfer, in KM	% of FBiH Pool	p/c transfer, in KM
Bihac	4.922	133.37	4.432	120.09	3.945	106.88
Bosanska Krupa	0.934	54.90	1.015	59.66	1.094	64.32
Bosanski Petrovac	0.259	53.27	0.303	62.32	0.346	71.25
Buzim	0.423	39.65	0.509	47.72	0.596	55.85
Cazin	2.334	62.43	2.481	66.36	2.625	70.22
Kljuc	0.495	40.89	0.572	47.26	0.649	53.61
Sanski Most	1.52	54.51	1.613	57.84	1.703	61.08
Velika Kladusa	1.473	51.98	1.596	56.32	1.719	60.65
Domaljevac-Samac	0.261	95.99	0.243	89.37	0.226	83.21
Odzak	0.682	69.60	0.674	68.78	0.666	68.00
Orasje	1.212	96.17	1.109	88.00	1.007	79.87
Banovici	0.996	64.38	1.012	65.41	1.027	66.41
Celic	0.636	72.85	0.628	71.94	0.620	71.05
Doboj-Istok	0.727	118.78	0.66	107.83	0.593	96.93
Gracanica	2.269	72.74	2.24	71.82	2.215	71.03
Gradacac	1.825	65.19	1.842	65.80	1.854	66.24
Kalesija	0.789	37.28	0.956	45.17	1.120	52.90
Kladanj	0.541	58.51	0.576	62.29	0.610	65.99
Lukavac	1.731	55.39	1.823	58.33	1.918	61.36
Sapna	0.468	55.40	0.504	59.66	0.537	63.55
Srebrenik	1.476	59.49	1.536	61.90	1.592	64.17
Teocak	0.612	136.53	0.547	122.03	0.481	107.40
Tuzla	9.848	123.65	8.834	110.92	7.826	98.26
Zivinice	2.013	61.61	2.093	64.06	2.176	66.59
Breza	0.263	29.30	0.342	38.11	0.420	46.83
Doboj-Jug	0.187	69.91	0.181	67.67	0.176	65.84
Kakanj	1.222	46.61	1.344	51.26	1.498	57.13
Maglaj	0.444	31.10	0.566	39.64	0.685	48.00
Olovo	0.225	28.94	0.312	40.13	0.400	51.46
Tesanj	1.463	50.79	1.59	55.20	1.716	59.56
Usora	0.192	44.76	0.211	49.19	0.232	54.04
Vares	0.202	29.48	0.273	39.85	0.347	50.71
Visoko	1.263	52.15	1.313	54.22	1.362	56.26
Zavidovici	0.71	30.74	0.938	40.61	1.175	50.85
Zenica	4.013	51.86	4.304	55.62	4.596	59.39
Zepce	1.03	54.84	1.105	58.83	1.179	62.76
Foca	0.034	30.35	0.051	45.52	0.067	59.80
Gorazde	0.979	51.16	1.043	54.51	1.108	57.88
Pale	0.019	28.57	0.028	42.10	0.038	57.39
Bugojno	0.733	32.30	0.921	40.58	1.108	48.84
Busovaca	0.328	33.80	0.412	42.46	0.496	51.14
Dobretici	0.009	22.43	0.015	37.38	0.020	49.50
Donji Vakuf	0.348	40.60	0.419	48.88	0.490	57.10
Fojnica	0.274	36.55	0.338	45.09	0.403	53.79
Gornji Vakuf	0.377	31.96	0.494	41.88	0.611	51.75
Jajce	0.545	36.92	0.66	44.71	0.773	52.33
Kiseljak	0.893	70.87	0.869	68.96	0.846	67.13

Table continued

Municipality	2006		2007		2008	
	% of FBiH Pool	p/c transfer, in KM	% of FBiH Pool	p/c transfer, in KM	% of FBiH Pool	p/c transfer, in KM
Kresevo	0.18	51.87	0.197	56.77	0.213	61.48
Novi Travnik	0.494	32.92	0.627	41.78	0.760	50.67
Travnik	1.916	56.85	2.013	59.73	2.106	62.49
Vitez	1.696	112.32	1.533	101.53	1.368	90.57
Capljina	0.941	65.55	0.976	67.99	1.006	70.11
Citluk	0.945	94.79	0.897	89.98	0.848	85.08
Jablanica	0.331	45.91	0.387	53.68	0.440	61.10
Konjic	0.875	49.51	1.018	57.60	1.158	65.54
Mostar	8.35	123.80	7.634	113.18	6.916	102.54
Neum	0.322	112.36	0.301	105.04	0.280	97.66
Prozor	0.253	24.82	0.383	37.58	0.512	50.21
Ravno	0.016	19.55	0.035	42.76	0.059	71.52
Stolac	0.208	25.73	0.295	36.49	0.377	46.59
Grude	1.691	178.06	1.465	154.26	1.235	130.10
Ljubuski	1.436	100.02	1.344	93.61	1.248	86.92
Posusje	1.035	105.75	0.997	101.87	0.955	97.61
Siroki Brijeg	2.111	124.02	1.917	112.62	1.720	101.06
Sarajevo Centar	18.99	76.39	18.357	73.85	17.723	71.30
Hadzici						
Ilidza						
Ilijas						
Novi Grad						
Novo Sarajevo						
Stari Grad						
Trnovo						
Vogosca						
Bosansko Grahovo	0.072	56.15	0.106	82.67	0.141	109.90
Drvar	0.347	48.85	0.396	55.74	0.446	62.75
Glamoc	0.175	58.40	0.223	74.42	0.271	90.28
Kupres	0.22	102.95	0.229	107.16	0.239	111.89
Livno	1.755	89.30	1.718	87.42	1.679	85.43
Tomislavgrad	1.442	85.92	1.425	84.91	1.408	83.88

Table continued

Municipality	2009		2010		2011	
	% of FBiH Pool	p/c transfer, in KM	% of FBiH Pool	p/c transfer, in KM	% of FBiH Pool	p/c transfer, in KM
Bihac	3.383	91.65	2.9427	79.73	2.723	73.76
Bosanska Krupa	1.187	69.74	1.2588	73.98	1.295	76.10
Bosanski Petrovac	0.397	81.59	0.4360	89.68	0.456	93.73
Buzim	0.695	65.16	0.7728	72.45	0.812	76.01
Cazin	2.793	74.70	2.9238	78.20	2.989	79.96
Kljuc	0.737	60.92	0.8066	66.64	0.841	69.50
Sanski Most	1.808	64.85	1.8909	67.81	1.932	69.29
Velika Kladusa	1.860	65.64	1.9705	69.54	2.026	71.49
Domaljevac-Samac	0.206	75.86	0.1906	70.11	0.183	67.23
Odzak	0.657	67.08	0.6502	66.36	0.647	66.00
Orasje	0.888	70.50	0.7960	63.16	0.750	59.50
Banovici	1.045	67.58	1.0596	68.49	1.067	68.95
Celic	0.611	70.02	0.6042	69.21	0.601	68.82
Doboj-Istok	0.516	84.37	0.4562	74.54	0.426	69.62
Gracanica	2.185	70.04	2.1604	69.26	2.148	68.88
Gradacac	1.871	66.84	1.8846	67.32	1.891	67.55
Kalesija	1.310	61.88	1.4585	68.91	1.533	72.43
Kladanj	0.650	70.28	0.6810	73.65	0.697	75.33
Lukavac	2.025	64.80	2.1090	67.48	2.151	68.83
Sapna	0.576	68.23	0.6073	71.90	0.623	73.73
Srebrenik	1.659	66.87	1.7114	68.97	1.738	70.02
Teocak	0.406	90.66	0.3476	77.55	0.318	71.00
Tuzla	6.663	83.66	5.7531	72.24	5.298	66.53
Zivinice	2.269	69.46	2.3427	71.70	2.379	72.82
Breza	0.511	56.91	0.5815	64.80	0.617	68.74
Doboj-Jug	0.170	63.49	0.1649	61.66	0.162	60.74
Kakanj	1.656	63.18	1.7804	67.91	1.842	70.28
Maglaj	0.824	57.71	0.9325	65.32	0.987	69.12
Olovo	0.501	64.40	0.5794	74.53	0.619	79.60
Tesanj	1.861	64.61	1.9748	68.56	2.032	70.53
Usora	0.255	59.37	0.2726	63.55	0.282	65.64
Vares	0.431	62.91	0.4964	72.46	0.529	77.24
Visoko	1.420	58.62	1.4644	60.47	1.487	61.40
Zavidovici	1.442	62.41	1.6508	71.47	1.755	76.00
Zenica	4.931	63.71	5.1927	67.10	5.324	68.80
Zepce	1.264	67.31	1.3310	70.87	1.364	72.65
Foca	0.086	76.73	0.1008	89.98	0.108	96.61
Gorazde	1.182	61.75	1.2394	64.77	1.268	66.26
Pale	0.049	73.96	0.0578	86.93	0.062	93.42
Bugojno	1.324	58.36	1.4933	65.80	1.578	69.53
Busovaca	0.593	61.11	0.6687	68.92	0.707	72.90
Dobretici	0.026	65.06	0.0310	77.25	0.033	83.34
Donji Vakuf	0.571	66.60	0.6346	74.03	0.666	77.74
Fojnica	0.478	63.70	0.5357	71.46	0.565	75.34
Gornji Vakuf	0.745	63.13	0.8499	72.04	0.902	76.50
Jajce	0.903	61.19	1.0058	68.13	1.057	71.60
Kiseljak	0.819	64.98	0.7977	63.30	0.787	62.46

Table continued

Municipality	2009		2010		2011	
	% of FBiH Pool	p/c transfer, in KM	% of FBiH Pool	p/c transfer, in KM	% of FBiH Pool	p/c transfer, in KM
Kresevo	0.233	67.01	0.2475	71.33	0.255	73.50
Novi Travnik	0.913	60.87	1.0333	68.86	1.093	72.85
Travnik	2.215	65.74	2.3010	68.28	2.344	69.55
Vitez	1.179	78.06	1.0308	68.27	0.957	63.37
Capljina	1.044	72.73	1.0735	74.78	1.088	75.80
Citluk	0.792	79.49	0.7488	75.12	0.727	72.93
Jablanica	0.503	69.83	0.5527	76.66	0.577	80.08
Konjic	1.321	74.76	1.4488	81.97	1.513	85.58
Mostar	6.092	90.32	5.4466	80.75	5.124	75.97
Neum	0.256	89.21	0.2367	82.60	0.227	79.29
Prozor	0.660	64.81	0.7769	76.23	0.835	81.94
Ravno	0.083	101.40	0.1021	124.79	0.112	136.48
Stolac	0.474	58.58	0.5494	67.97	0.587	72.66
Grude	0.974	102.52	0.7686	80.93	0.666	70.14
Ljubuski	1.140	79.39	1.0552	73.50	1.013	70.55
Posusje	0.910	92.94	0.8737	89.27	0.856	87.44
Siroki Brijeg	1.496	87.86	1.3198	77.53	1.232	72.37
Sarajevo Centar	16.994	68.37	16.4241	66.07	16.139	64.93
Hadzici						
Ilidza						
Ilijas						
Novi Grad						
Novo Sarajevo						
Stari Grad						
Trnovo						
Vogosca						
Bosansko Grahovo	0.181	140.80	0.2115	164.99	0.227	177.08
Drvar	0.503	70.74	0.5470	77.00	0.569	80.12
Glamoc	0.325	108.61	0.3685	122.96	0.390	130.13
Kupres	0.250	117.04	0.2587	121.06	0.263	123.08
Livno	1.635	83.21	1.6011	81.47	1.584	80.60
Tomislavgrad	1.388	82.71	1.3726	81.79	1.365	81.33

Independent variables used for regression:

Municipality	Population size	PIT per capita
Bihac	60,876	102.97
Bosanska Krupa	28,065	35.68
Bosanski Petrovac	8,020	43.23
Buzim	17,596	25.06
Cazin	61,673	35.82
Kljuc	19,966	27.84
Sanski Most	45,998	33.63
Velika Kladusa	46,741	25.16
Domaljevac-Samac	4,485	44.42
Odzak	16,163	44.52
Orasje	20,788	77.33
Banovici	25,519	64.14
Celic	14,400	18.20
Doboj-Istok	10,096	48.99
Gracanica	51,450	41.27
Gradacac	46,179	52.13
Kalesija	34,911	29.51
Kladanj	15,252	65.51
Lukavac	51,551	48.56
Sapna	13,934	16.55
Srebrenik	40,929	49.95
Teocak	7,394	35.13
Tuzla	131,374	113.92
Zivinice	53,896	56.77
Breza	14,804	52.41
Doboj-Jug	4,412	55.31
Kakanj	43,245	75.43
Maglaj	23,550	38.97
Olovo	12,823	55.80
Tesanj	47,514	48.54
Usora	7,076	30.60
Vares	11,301	57.66
Visoko	39,948	66.57
Zavidovici	38,102	35.85
Zenica	127,646	95.07
Zepce	30,980	33.95
Foca	1,848	45.66
Gorazde	31,563	70.32
Pale	1,097	52.27
Bugojno	37,434	39.88
Busovaca	16,005	52.42
Dobretici	662	33.64
Donji Vakuf	14,140	39.25
Fojnica	12,365	93.64
Gonji Vakuf	19,459	39.13
Jajce	24,351	46.30
Kiseljak	20,786	57.40
Kresevo	5,724	53.43
Novi Travnik	24,753	48.84
Travnik	55,590	69.37
Vitez	24,906	62.07
Capljina	23,678	65.90
Citluk	16,444	73.13
Jablanica	11,892	70.74
Konjic	29,154	49.43

Mostar	111,259	126.34
Neum	4,727	80.97
Prozor	16,811	27.30
Ravno	1,350	25.72
Stolac	13,334	33.58
Grude	15,665	74.00
Ljubuski	23,683	63.78
Posusje	16,144	51.49
Siroki Brijeg	28,078	66.36
Sarajevo Centar	70,294	368.27
Hadzici	21,958	76.16
Ilidza	48,291	129.81
Ilijas	15,462	59.29
Novi Grad	119,883	148.53
Novo Sarajevo	73,381	239.10
Stari Grad	38,000	243.31
Trnovo	2,187	38.20
Vogosca	20,575	112.80
Bosansko Grahovo	2,115	51.82
Drvar	11,718	27.54
Glamoc	4,943	48.45
Kupres	3,525	57.77
Livno	32,418	48.27
Tomislavgrad	27,683	33.28