

### *Chapter 3*

## **Financial Reforms in the Federation of Bosnia and Herzegovina as an Incentive for Economic Development**

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The current government of the Federation of Bosnia and Herzegovina (FBiH) was confirmed by the parliament on March 31, 2015. Two years into the mandate is a good time to reflect on what has been achieved so far, through the eyes of the FBiH ministry of finance. The primary goal of the incumbent government was to curb public spending growth, improve public revenue collection, and introduce a responsible management of public debt, work towards the settlement of accumulated liabilities and accumulated deficit, along with the modernization of fiscal, financial and market legislation and its harmonization with international practices, as well as the support of a business climate and private entrepreneurship. In addition to the pre-election program and the administration's principles, a significant part of the planned reforms was framed around a document called the Reform Agenda (RA), comprised of crucial benchmarks that will guide all levels of government through a four-year period. Moreover, a series of additional measures was envisaged in the letter of intent that was agreed upon by the state and entity representatives with the International Monetary Fund (IMF), whose objective is financial consolidation, market regulation reform and the advancement of economic growth.

### **Tax Reforms in the Federation of Bosnia and Herzegovina**

With the aim of adopting modern tax regulation, the FBiH ministry of finance in cooperation with the IMF, prepared a new corporate income tax law in 2015, retaining a fairly low tax rate of 10 percent. The law expanded and protected the tax base through a larger coverage of taxpayers, as well as a larger coverage of taxable income, in order to support the fight against tax evasion and to promote growth. The new law was applied in the 2016 fiscal year, and more time is required to conduct a substantial analysis of its effects. The second, and equally important reform was the

personal income tax act, which introduced progressive rates in line with the amount of income and increased tax deductions. The law is currently in the first reading phase of parliamentary procedure, followed by a public debate. Both laws are modeled after international practices and intended to bring about the harmonization of business conditions in both BiH entities.<sup>1</sup> The process of economic relief began with the simplification of processing public revenues in the FBiH, done in cooperation with USAID. The implementation of this project would see multiple benefits both for taxpayers and for the FBiH tax administration, saving time, reducing the average cost of revenue collection, and increasing the level of voluntary settlement of obligations making it easier for businesses to pay their taxes.

With technical support from USAID, the FBiH created a preliminary version of the comprehensive interactive registry of non-tax revenues, structured according to the type of fees and charges. Fully implementing the registry, control and supervision of the introduction of new non-tax revenues will be established on all levels of government, and based on it, an analysis of non-tax revenues will be carried out, which should serve as a basis for proposing reduction of existing burdens for taxpayers, triggering an increase in the employment rate and the growth of new economic investment.

## **Fiscal Stability and Public Revenue Growth**

Significant results have been achieved in maintaining fiscal stability and implementing numerous reform activities aimed at strengthening the process of European integration. The government paid particular attention to reducing the budget deficit, implementing reforms in the area of public finances, fiscal consolidation, fiscal sustainability, and strengthening institutional cooperation between all levels of government.

Through the Fiscal Coordinating Body, which has the Federal Minister of Finance as its Chairman, the FBiH Ministry of Finance and the cantonal finance ministers and representatives of the Association of Municipalities and Towns have greatly improved and deepened cooperation and communication with lower levels of government, as well as the cooperation of lower levels of government among each other. The Fiscal Coordination Body has been continuously working on the improvement and coordina-

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<sup>1</sup> Bosnia and Herzegovina has two entities: The Federation of Bosnia and Herzegovina (FBiH), and Republika Srpska (RS).

tion of fiscal policy. Through the implementation of fiscal coordination measures and a restrictive budgetary policy, the aim is to achieve medium-term sustainability of public finances in the FBiH. The results are shown in the consolidated report described below.

Total public revenues in the Federation of Bosnia and Herzegovina include:

- Budget of the Government of the FBiH;
- Sub-entity budgets (cantons and local self-government units);
- Extra-budgetary funds (the FBiH Institute for pension and disability insurance, the FBiH Health insurance and reinsurance institute, the cantonal health insurance institutes, the FBiH Employment office and county employment services);
- Public enterprise funds (Motorway of the FBiH and Roads of FBiH) and managers for roads at lower levels of government, collected as public revenues;
- Funds of other users of public revenues in the Federation of BiH.

Total public revenues in the FBiH in 2016 recorded a growth of 9 percent compared to 2014. If only tax revenues are observed, they were realized with a growth of 13 percent or 437 million BAM. Within this category, the highest growth was recorded in the collection of corporate income taxes, which compared to 2014 were higher by more than 50 percent, or by 83 million BAM. The total collection of non-tax revenues also recorded a slight increase of 2 percent, or 25 million BAM, as well as total contributions of extra-budgetary funds, which are higher by 7 percent, or 192 million BAM.<sup>2</sup>

In 2016, all levels of government in the FBiH achieved a positive financial result in the consolidated amount of 124.4 million BAM. The budget of the Federation of Bosnia and Herzegovina reached a surplus of 85 million BAM, the cantonal budgets had a surplus of 21.5 million BAM, and the municipal budgets a surplus of 27.5 million BAM. The FBiH government has, despite an inherited accumulated deficit of 173 million BAM at the end of 2014, through a two-year positive budget execution, the entire amount of accumulated deficit has been rehabilitated. Thus, at the end of 2016, for the first time in over ten years, the FBiH recorded an accumulated surplus in its budget. At the very beginning of their mandate, the FBiH

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<sup>2</sup> FBiH Ministry of Finance.

**Table 1. Consolidated overview of total public revenues in the FBiH: 2014–2016**

Consolidated Table – Federation of Bosnia and Herzegovina in BAM millions

TITLE	2014	2016	Difference	Index
I. Tax income	3.268	3.705	437	113
1. Income from indirect taxes from the Single Budget Account	2.689	2.971	282	110
2. Toll-based revenues 0.10 BAM / L for highways	63	76	13	121
3. Corporate Income tax	163	246	83	151
4. Personal Income tax	277	315	38	114
5. Taxes of citizens	75	97	22	129
II. Non-taxable Income	1.009	1.034	25	102
1. Fees, fines, and other non-taxable income	498	502	4	101
2. Special fees	160	199	39	124
3. Federal fees for the use of roads	25	29	5	119
4. Other non-taxable income, out of:	327	304	-23	93
Dividend	167	78	-89	47
End-user revenues	110	192	83	175
Other	50	33	-17	66
Total tax and infringement revenue (I + II)	4.277	4.740	463	111
III. Extra-budgetary Funds	2.790	2.983	192	107
1. Contributions for pension and disability insurance	1.548	1.647	99	106
2. Contributions for health insurance	1.116	1.200	84	108
3. Unemployment insurance contributions	127	136	9	107
Total (I + II + III)	7.068	7.722	655	109

NOTE: Included in the amounts presented is a part of the revenues intended for repayment of external debt. The revenue plan does not include the proceeds of privatization and grants.

government implemented significant cuts in public sector wages and overall government employees, by limiting new government employment, drastically bringing down expenses.

In 2017, the FBiH ministry of finance developed a strategy for public finance management for the period 2017–2020. The aim of this strategy was to provide a comprehensive and integrated framework for planning, implementing, and monitoring the implementation of reforms. The goal was to improve macroeconomic stability, ensure the efficient and targeted

use of public resources, and improve the services provided by the state administration. At the same time, they aimed to increase the accountability, efficiency, transparency, and functionality of public finance management, and fulfill the necessary conditions for joining the European Union. The strategy is divided into six key pillars and includes a sustainable medium-term macro-fiscal and budgetary framework, revenue mobilization, budget planning, a plan for budget execution, the introduction of effective internal controls, and the provision oversight of public finances through external audits.

In addition, in 2016, the ministry issued a “manual for the preparation of a statement on the fiscal assessment of laws and planning acts on the budget,” which ensured the timely planning of expenditures for implementation of regulations and planning acts, and the inclusion of fiscal estimates in budgetary processes. By adopting this rulebook, stipulating the forms on which a statement on the fiscal assessment of regulations is issued, their implementation is closely related to the economic classification of the budget and sources of financing. This, among other things, provides the ministry of finance better control of the assessment of fiscal effects on the budget. The rulebook is one of the key instruments of good fiscal governance that enables the forecasting and control of future spending, thereby retaining or even reducing the level of public expenditures. Such an assessment has increased the transparency of the decision-making process, providing information on the potential fiscal consequences of the application of a particular regulation.

## **Public Debt Management**

This FBiH government has completed the task of curbing the growth of public spending and preventing the further growing of the public deficit. In March 2017, the public debt of the FBiH amounted to 6,201.92 million BAM, a reduction of approximately 47 million BAM from two years prior. This data is especially important considering the FBiH recorded significant GDP growth, while under the previous government, the public debt increased for 1.5 billion BAM. Since October 2015, the FBiH ministry of finance has regularly published quarterly reports on the debt levels.

In the first year of its mandate, a medium-term debt management strategy was adopted in order to define strategic debt management guidelines, optimize risks and borrowing costs, and increase the transparency of borrowing operations. Furthermore, the ministry has, as of 2016, published

an annual plan of borrowing operations. This transparency has shown positive results, with increased investors responses and low borrowing costs, and most importantly, with timely insurance of the planned funds needed for efficient liquidity management of the budget.

Despite many inherited problems, all parameters show that the FBiH ministry of finance has been implementing a very cautious and transparent borrowing policy. In order to continue this positive trend and prevent excessive public debt creation in the near future, the ministry has prepared a completely new legal framework for public sector debt in the Federation of BiH in order to establish stricter fiscal rules and more effectively manage the total public debt in FBiH. They plan to finalize the draft law on debt, send it to the government for consideration, and then to the parliament to be adopted during regular proceedings.

## Preparation of Laws and Other Regulations

Through parliamentary procedure, the ministry has prepared and implemented more than 20 laws in the last two years. Some of them are brand new, while others are amendments to existing laws.

A few of the important laws:

- **The law on internal payment transactions** prescribes the execution of internal payment transactions in the FBiH, determines participants and organizations authorized to perform payment operations, defines the types of accounts, the methods of payment, rights and obligations for internal payment transactions.
- **The factoring law** regulates factoring, defines the types of factoring, factoring contracts, conditions for the establishment, operation and termination of factoring companies, risk management, financial reporting, as well as auditing and supervision of the operations of factoring companies.
- **The financial operations law** regulates the issues related to the basic rules of financial operations, the obligations of the administration and the supervisory board in the conduct of the entrepreneurs, taking measures for liquidity insurance, the risk in financial operations, the deadlines for the execution of monetary liabilities of entrepreneurs and public law entities, legal consequences of delays in the performance of monetary obligations, the nullity of certain provisions of the contract on business transactions, as well as the obligations of

the entrepreneur in the event of illiquidity, and the supervision of entrepreneurs and public law entities.

- **The law on amendments to the law on a unified system of registration, control and collection of contributions** was adopted with the aim of suppressing blackmail and increasing discipline in the field of contributions. The legislation was prepared by the tax administration in cooperation with the USAID FAR project.
- **The law on banks** was adopted with the aim of raising the level of resilience of individual banks, as well as the overall banking system in order for capital-enhanced banks to provide more support to the real sector and to establish a comprehensive legal framework for bank restructuring aligned with international banking standards.
- **The insurance act** regulates the insurance market in the FBiH following EU standards.
- **Treasury act** is a revised and updated version of the Treasury act (2002), which prescribes the introduction of a treasury system and operations through a single account for all municipalities, cities and extra-budgetary funds in the FBiH region.
- **The law on games of chance** regulates the market in the field of games of chance, improves the financial discipline of business entities, and establishes an efficient and reliable system of supervision and control of the entire business and the realized turnover of the game organizers of games of chance.
- **The law on voluntary pension funds** creates the legal basis for the further development of the pension system in the FBiH and the capital markets where new types of funds will appear, which differ in the way and criteria of investment.
- **Financial management and control act** is based on risk management and is introduced to improve financial management and decision-making in the realization of the organization's objectives, such as compliance with business regulations, plans, contracts, and policy procedures. It also provides protection of assets, liabilities, and other resources from losses that may result from poor management, unreasonable consumption and use, and protection against irregularities, abuse, and fraud.
- **The law on amendments to the law on internal audit in the public sector** implements reforms in the field of internal audit in accordance with the international standards of professional practices

of internal audits, published by the International Institute of Internal Auditors, as well following best practices from EU member states.

The parliament should soon have a second reading, the Accounting and Auditing Act, which improves the quality of financial reporting, encourages professional behavior of accountants and auditors, facilitates public access to information on the company's performance and financial position, and generally increases public confidence in the accounting profession.

The Law on the banking agency is expected to be passed soon. The parliamentary procedure is undergoing for the law on contributions, and the law on microcredit organizations, the law on compulsory insurance in transport, and the law on development banks.

A special thanks, for the creation, and often also the implementing of laws, goes out to international institutions, in particular the IMF, the World Bank, and government agencies, such as the USAID and the Swedish SIDA. The international experience the IMF is offering through its technical assistance, or USAID's municipal treasury projects, are important support mechanisms in our reform process.

## **Economic Trends**

While the previous part of this chapter mainly dealt with initiatives by the FBiH ministry of finance, this last part will focus on indicators from the private sector, comparing results in 2014 and the same period in 2016.

The data that follows is the result of aggregated data and balance sheets annually submitted by taxpayers to the Financial Information Agency. The total number of business entities operating in the FBiH region recorded a slight increase of about 2.2 percent between 2014–2016. This trend is accompanied by a positive balance of newly registered companies in relation to those that closed down.

However, although the growth of active companies is not high, the results of the business have a stronger positive trend. The value of operating revenues in 2016 amounted to more than 42.4 billion BAM, which is an increase of 2.1 billion BAM from two years prior.

The structure of operating revenues is dominated by revenues generated on the domestic market, while the share of export revenues in total revenues is relatively modest. However, in the observed period, export earnings recorded growth, both by value and by share.

**Table 2.**

<b>Subjects</b>	<b>2014</b>	<b>2016</b>
Economy (total)	21.401	21.875
Small	18.401	18.813
Medium	2.292	2.325
Large	708	737
Banks	38	34
Insurance companies	16	17
Total	21.455	21.926

Source: The FBiH ministry of finance / Financial Information Agency.

**Table 3.**

	<b>2014</b>	<b>2016</b>
Value of export earnings (BAM)	5.984.302.403	6.479.931.945
Share in business income (%)	14,84%	15,24%

Source: The FBiH ministry of finance / Financial Information Agency.

**Table 4.**

<b>Year</b>	<b>2014</b>	<b>2016</b>
Fixed assets (BAM)	37.911.531.119	38.643.740.074
Current assets (BAM)	19.869.107.279	20.805.363.956
Total assets (BAM)	60.176.460.355	61.706.235.266
Capital (BAM)	30.828.890.772	31.756.091.247
Long-term liabilities (BAM)	9.291.366.548	9.096.100.676
Short-term liabilities (BAM)	17.444.565.503	18.360.704.379

Profitable companies (12,570, or about 60 percent of the total number of active companies) generated 2 billion BAM and 230 million BAM in net profit in 2016, which is 13.03 percent more than the profit realized two years earlier (1.97 billion BAM). At the same time, the number of loss-making companies also decreased (from 6,712 in 2014 to 6,120 in 2016), and total losses also declined (from 1.6 billion BAM in 2014, to 990 million BAM in 2016).

Such generally positive business trends in companies in the Federation of BiH resulted in an increase in the value of assets, as well as capital, which are available for creating new value. The total value of corporate assets increased from 60.18 billion BAM in 2014 to 61.71 billion BAM in

2016, an increase of 2.54 percent. The growth of current assets is somewhat more intense than the growth of fixed assets—4.7 percent, compared to 2.54 percent. The value of equity capital (share capital in joint stock companies and shareholders' equity in limited liability companies), which finances the business activity of companies in the Federation of BiH in the observed period, increased by 3.0 percent, from 30.83 billion to 31.76 billion BAM.

As expected, the number of employees in FBiH companies is growing, from 309,982 in 2014 to 326,155 at the end of 2016. As a result, employment grew by 5.22 percent over this period. Salaries also grew, with average monthly salaries in 2014 standing at 833 BAM, while in December 2016 they increased to 861 BAM.

## **Conclusion**

The Federation of BiH is still a young market, burdened with difficulties of post-war recovery, a complex political structure, and slow eradication of corruption. More than 10 billion BAM-worth of bank deposits indicate that there is space for further investment of capital. There is no doubt that it is a strong priority of BiH authorities to continue creating a welcoming climate for the development of a private sector entrepreneurship, with the market, not the state, as the leading actor. Important steps have been taken, but they need to be further expanded and developed. Eliminating para-fiscal charges, facilitating the registration of economic entities, computerization and digitization of businesses will open ways for creative entrepreneurship, increased employment, and economic growth.