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Revenue and reform

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Facts and challenges

Dependence on sharing revenues from VAT and excises (ITA revenue) creates, despite their recent growth, more problems than satisfaction:

- External debt service imposes a burden on local government in both entities.
- There is general discontent, particularly among local governments, on the vertical allocation of resources.
- The horizontal allocation of resources is also controversial, specially in the FBiH.
- Municipalities have to rely too much on fees and charges that are inefficient.
- The sharing of natural resources is constrained and this undermines an important source of local government financing.

Constraints and steps forward

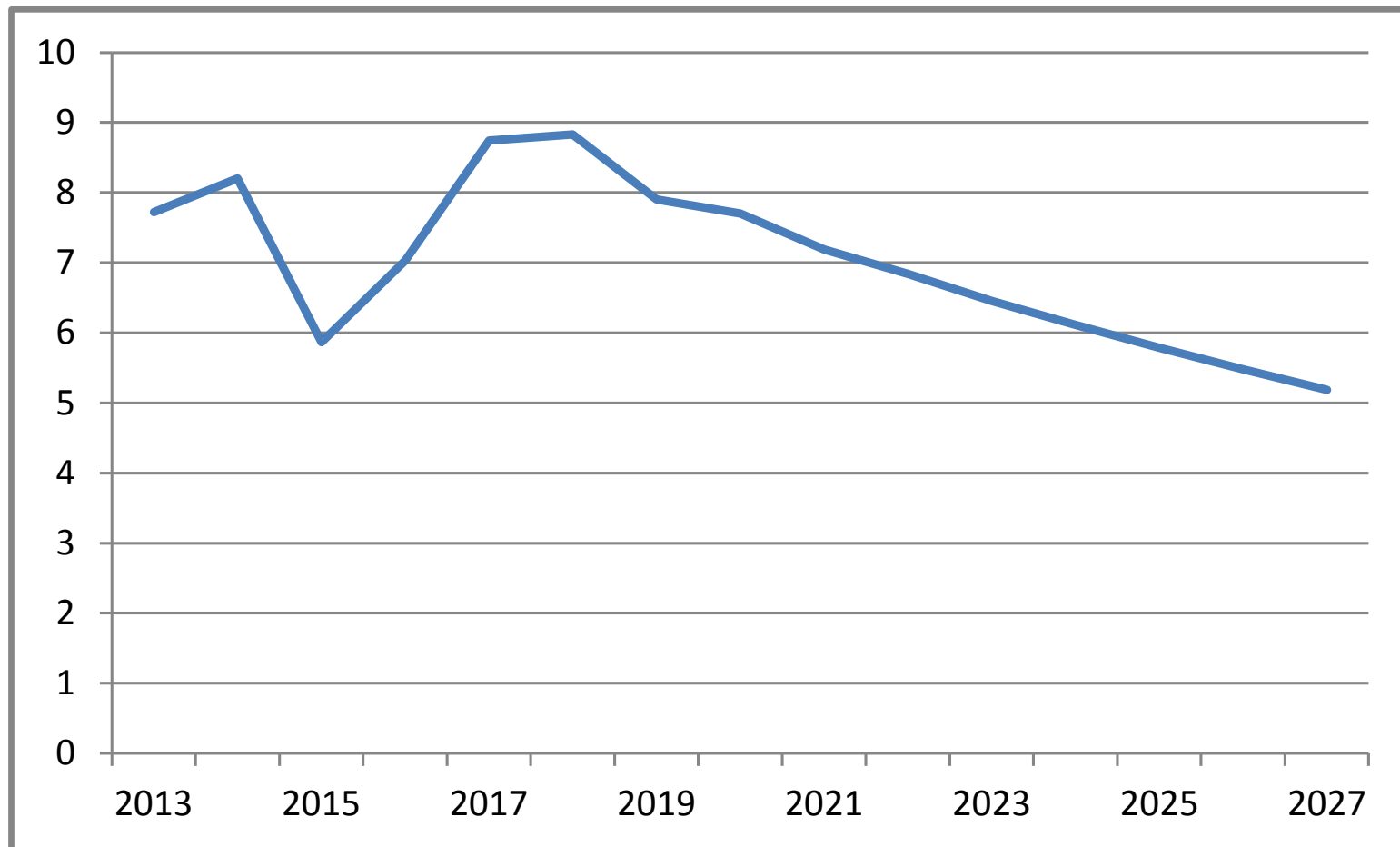
- The burden of government is already high, leaving no room for tax increases to resolve local financing issues.
- A more balanced sharing between levels of government is appropriate, but there is an overall and urgent need for:
 - Significant administrative savings and greater efficiency in service delivery.
 - The strengthening of own fiscal space.

The reform proposals

- Addressing vertical imbalances
 - Reallocation of external debt service (both entities).
 - Rebalanced sharing of revenue between cantons and municipalities in FBiH (in context of agreeing responsibilities).
- Addressing horizontal imbalances
 - Allocation of ITA revenues to cantons and municipalities (especially in FBiH) using a two-pillar grant system.
 - Allocation of CIT on a broader spatial base (both entities).
- Creating a wider fiscal space
 - A Municipal PIT surcharge to replace fees and also create more room for fiscal maneuver (in both entities).
 - Fewer constraints on the use of natural resource revenues (in both entities).
 - Strengthening the administration of the property tax (RS).

Addressing vertical imbalances

External Debt Service as percent of net ITA revenues



Addressing vertical imbalances

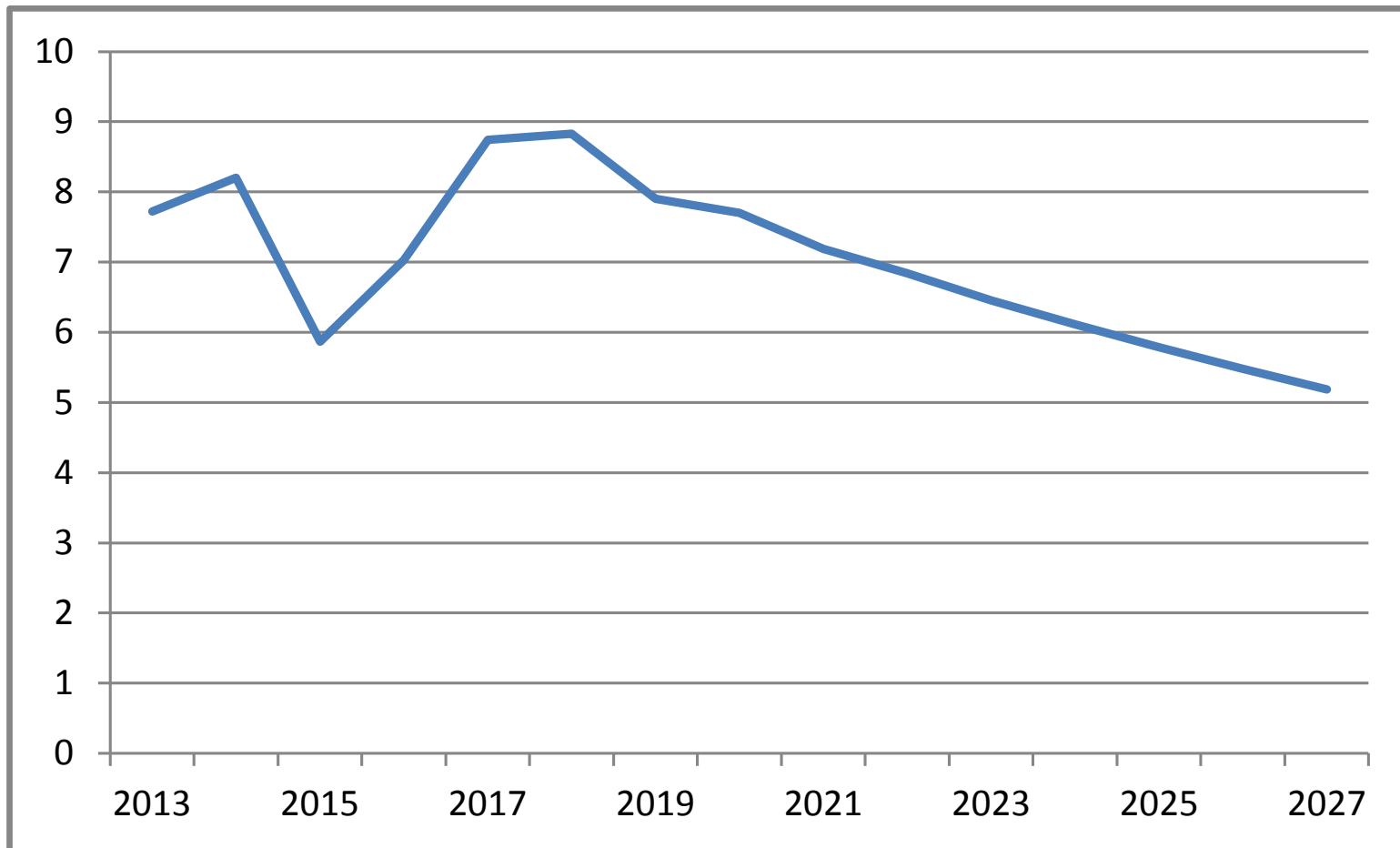
Reallocating external debt service

	Current System		New System	
	<i>percent</i>		<i>percent</i>	
Total TA transfer to FBiH	115		115	
Foreign Debt Deduction	15		15	
Net revenues	<u>100</u>	100	<u>115</u>	100
Allocation to central government	36	36.2	51	44.5
Allocation to roads/highways	4	3.9	4	3.4
Allocation to cantons	51	51.5	51	44.5
Allocation to municipalities	8	8.4	8	7.3
Allocation to Sarajevo City	1	0.2	1	0.2

System could be applied to both entities

Addressing vertical imbalances

External Debt Service as percent of net ITA revenues



Addressing vertical imbalances

The allocation of ITA Revenues to Cantons:

- The use of special coefficients largely dictates the final allocation.
- Need for simplification and renegotiation of the revenue-sharing formulae.
- Option is to replace the current system by a two-pillars grant system:
 - Pillar 1** would allocate revenues according to the derivation principle
 - Pillar 2** would be dedicated to reducing the fiscal gap—between expenditure needs and revenue capacity—across cantons.

Addressing vertical imbalances

The allocation of ITA revenues to cantons

- The current system of coefficients would be eliminated and replaced by a system of special grants to:
 - (i) compensate for some special spending needs (like the expenses incurred by the capital city);
 - (ii) provide for entity-wide priorities including, perhaps, to secure a minimum allocation for smaller cantons; and
 - (iii) promote development and collaboration.

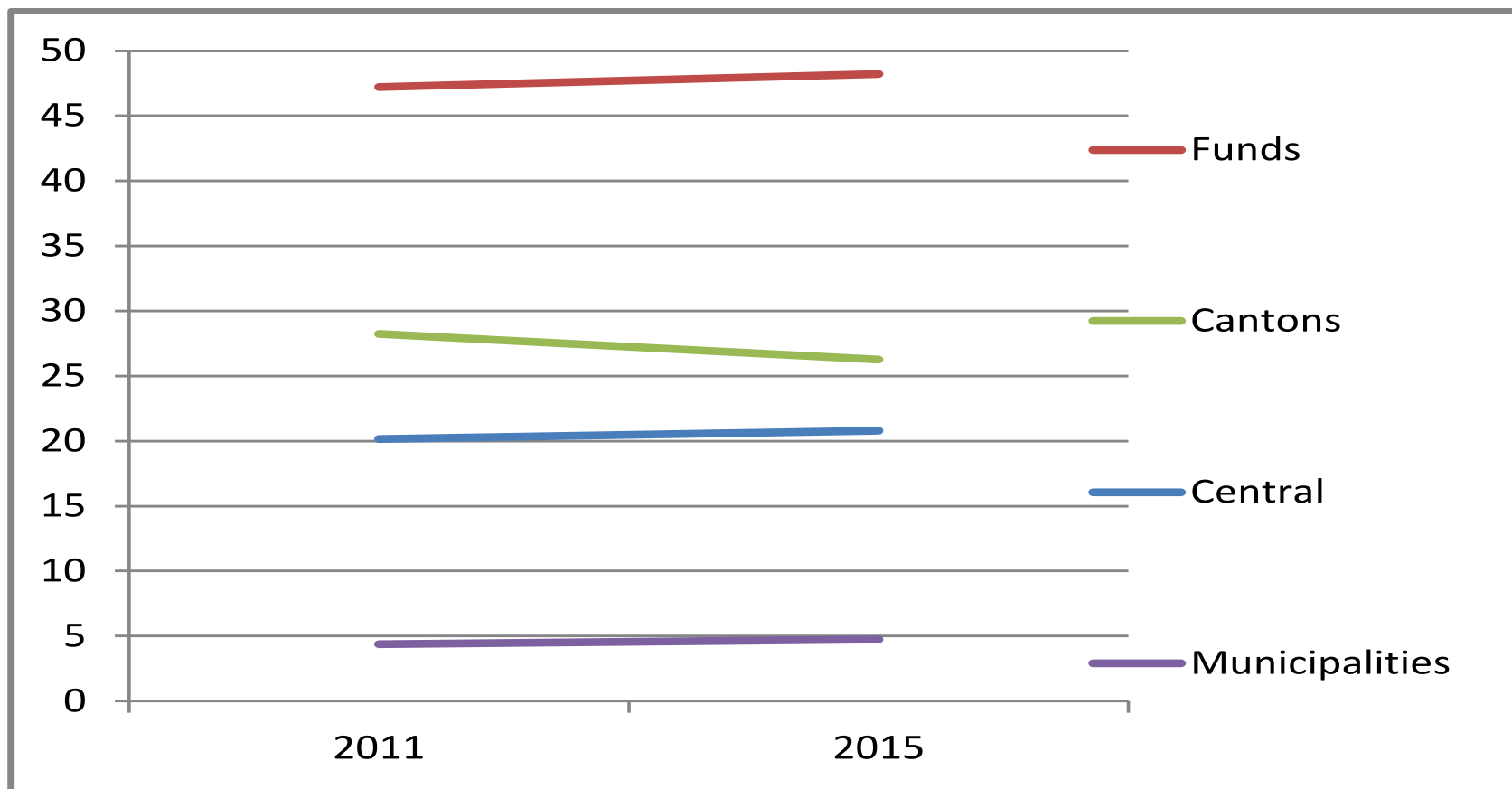
Addressing vertical imbalances

Rebalancing revenue between cantons and municipalities in FBiH

- Allocation between cantons and municipalities is a most controversial issue,
- Leading to no general solution valid for all cases.
- Proper balance depends on arrangements like:
 - Actual delegation of funded mandates from cantons to municipalities,
 - Actual sharing of PIT and CIT revenue,
 - Allocation of specific grants from cantons to municipalities.
- Imbalance could be substantially corrected with:
 - Larger PIT and CIT shares to municipalities
 - Elimination of unfunded mandates.

Addressing vertical imbalances

FBiH Taxes and Contributions: Percent Shares, 2011-15.



Addressing horizontal imbalance

New allocation of ITA revenues to Cantons

	Current System	New System	
Allocation to cantons	100	100	Allocation to cantons
<i>Divide by sum of coefficients</i>	12.4	15	Deduct grants (say, 15%)
Unit of allocation	8.1	85	Allocation to pillars
Allocation to 6 cantons (6.0)	48.4	59.5	Allocation to Pillar 1 (say, 70%)
Allocation to Sarajevo (2.0)	16.1		--allocated on derivation basis
Allocation to B-P canton (1.8)	14.5	25.5	Allocation to Pillar 2 (say, 30%)
Allocation to Posavina (1.5)	12.1		allocated for equalization
Allocation to Canton 10 (1.1)	8.9	—	perhaps, with minimum)
	100	85.0	

Addressing horizontal imbalance

A new two pillars-based grants system

Pillar 1: Derivation-based Pillar 2: Equalization-based

BASED ON TAX (PIT)
COLLECTED

BASED ON DIFFERENCE BETWEEN TAX
CAPACITY AND EXPENDITURE NEEDS

30 % of total in case of cantons
20 % in case of municipalities

70 % of total in case of cantons
80 % of total in case of municipalities

Addressing horizontal imbalance

Rebalancing CIT: More efficiency and equity.

- Present system allocates revenue according to location of headquarters:
 - no link with production or with cost on environment
 - huge spatial concentration of revenue
- Revenue goes to cantons/entity.
- Sharing with municipalities is only an option.
- Options for reform:
 - Allocation according to the place of production using amount of wages paid in each plant or office
 - Municipalities entitled to receive a share of CIT that is determined by canton.

Creating a wider fiscal space

A surcharge on the personal income tax

- Creates much needed fiscal accountability at the local level
 - local government in can ask directly of its citizens.
- Is simple to administer, being is levied on the present tax base
- A PIT surcharge may be also an instrument to rebalance revenue from cantons to municipalities.
- Rebalancing operates through deduction of the surcharge (tax due to municipalities) from PIT to entity.
 - Amounts to a transfer from cantons to municipalities.

Creating a wider fiscal space

A surcharge on the personal income tax--options:

1. Deduction from tax to tax—a strong rebalancing impact with no increase in total tax burden.
2. Deduction of the surcharge from taxable income.

	Deduction tax from tax		Deduction tax from taxable income
	First option	Second option	
	100%	50%	
Taxable income	100	100	100
Municipal surcharge (blue)	3	3	3
Gross tax to entity/canton	10	10	100 - 3 = 97
Net tax to entity/canton	10 - 3 = 7	8,5	97 * 0,1 = 9,7
Share to Municipality (30%)	2,1	2,55	0,3 * 9,7 = 2,91
Share to entity/canton (70%)	4,9	5,95	9,7 * 0,7 = 6,79
Total PIT to municipality	3 + 2,1 = 5,1	5,55	3 + 2,91 = 5,91
Total PIT to entity/canton	4,9	5,95	6,679
Total tax paid	10	11,5	12,7

Creating a wider fiscal space

Sharing of natural resources revenue

- Revenue from natural resources is partially shared, in both entities, with lower level governments,
- Represents an important revenue source for poor, underdeveloped and mountainous municipalities.
- However, the use of these revenues is earmarked, in both entities, for investment projects.
- Projects take time and money to elaborate, leading to delays, arrears in disbursements and, finally, to undermining the value of this revenue.
- Suggest that at least half of revenue be spent with no constraints and used, e.g., for social care.

Creating a wider fiscal space

Property tax in RS after January 2019

- Property taxation is an important and largely unexploited source of own revenue, but:
 - a large proportion of properties reportedly still excluded from the tax net
 - cadastres are often out of date or incomplete and use is complicated by uncertainty of ownership.
- Municipalities should consider:
 - the adoption of simpler methods for the determination of values of properties
 - employing modern digital technologies (e.g. blockchain) for mapping/managing registers