Analysis on Tax Justice

Bosnia and Herzegovina

CSOs as equal partners in monitoring public finances

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BALKAN MONITORING PUBLIC FINANCES

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This document has been produced as a part of the project "CSOs as equal partners in the monitoring of public finance", which started beginning of 2016 and is implemented by a consortium of 10 organizations from 7 countries and will last for four years.

The aim of the project is to improve the transparency and accountability of policy and decision making in the area of public finances through strengthening the role and voice of NGOs in monitoring the institutions that operate in the area of public finances. In this way, the project will strengthen CSO knowledge of public finance and IFIs and improve CSO capacities for monitoring. Additionally, it will help advocate for transparency, accountability and effectiveness from public institutions in public finance. Moreover, this project will build know-how in advocating for sustainability, transparency and accountability of public finance and IFIs. This project will also increase networking and cooperation of CSOs on monitoring of public finance at regional and EU level. Lastly, it will increase the understanding of the media and wider public of the challenges in public finance and the impacts of IFIs.

Key project activities are research and monitoring, advocacy, capacity building and transfer of knowledge/practices and networking in the field of the 4 specific topics: public debt, public-private partnerships, tax justice and public infrastructure.

More information about the project can be found on http://wings-of-hope.ba/balkan-monitoring-public-finance/ and on the Facebook Page Balkan Monitoring Public Finances

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CONTENT

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1. PERCEPTION OF TAXES

In the region tax-related opinion surveys are a very recent development. In BiH they are still non-existent, revealing a lack of engagement with civil society on the part of institutions and policy makers. The few surveys undertaken are consistent with this approach, focusing on professionals and businesses (e.g. McGee et. al, 2009, Antić 2014, Lazović-Pita and Štambuk, 2015). There is no hard evidence that tells us what the general public thinks about tax.

We can examine business attitudes indirectly by taking the grey economy (estimated at 25-37% of GDP) as a proxy for tax evasion. In the literature, the incentive to evade a heavy tax burden is one of the main reasons for the existence of an informal economy (Schneider et. al. 2010). The majority of South East Europe (SEE) companies interviewed by World Bank Enterprise Surveys (WBES 2013) consider tax rates their biggest concern (19.5%). But in BiH this figure is less than half the regional average (8.2%). It is only a major issue for SMEs (firms with less than 20 employees), and only the third most important issue for larger BiH firms.

A second explanatory factor is tax morale, linked to trust in institutions and social expectations (Schneider et. al. 2010). The quality of institutions is by far biggest problem for Bosnian businesses with 31.4% complaining of political instability, 8.1% of corruption, 7.9% of customs and trade regulations and 6.9% of labour market regulations (WBES 2013). Hence the complexity of tax regulations, maladministration and inefficient tax administration would appear to be an important factor in low tax morale.

A third set of factors affects both business *and* citizens. The failure of the state to provide adequate public services may lead people to exit the formal economy, emigrate or resort to clientalistic networks. We know from the Balkan Barometer 2016 survey that people in Bosnia and Herzegovina were overwhelming concerned with unemployment (76%) and the economic situation (45%), and thereafter by corruption (29%) and crime (12%) (Balkan Barometer 2016). The transparency of public services, the treatment of citizens in the public sector, the time required for obtaining services or information in the public sector, and the price of public services – all these were graded as poor in the survey. Unfortunately as taxation was not included as a specific question we can only make inferences from perceptions of public institutions and services.

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The tax burden, tax morale and the quality of public services *together* shape tax evasion in Bosnia. But it is also clear that the tax burden as such is not as central to the problem of tax compliance as is made out in the recently adopted Reform Agenda.

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2. SHORT OUTLINE OF THE TAX SYSTEM

2.1. Regulative framework and types of taxes

The fiscal system in Bosnia and Herzegovina (BiH) is highly decentralized, corresponding to a complex governance structure, comprising a central level of government, the BiH Institutions, Brčko District (DB), and two Entities—the Federation of Bosnia and Herzegovina (FBiH) and the Serbian Republic (RS) – each of which has its own government, extra-budgetary funds (EBFs), and local self-governance units. FBiH has 10 cantons representing a level of government between the government of FBiH and local self-governance units, and each canton has its own government and some EBFs.

Indirect taxation - customs, VAT and excise duties - is administered at the level of joint institutions of Bosnia and Herzegovina; whilst **direct taxation** is administered at the Entity level.

Revenues from indirect taxation are shared among the BiH Institutions, the Entities, and DB. From the funds available for each Entity, the cost of servicing the foreign debt of the entities is first subtracted, and the remaining funds are distributed among the government levels according to Entity laws.

Indirect tax legislation includes the Law on Indirect Taxation System in BiH, the Law on Value-Added Tax in BiH, the Law on Customs Policy and the Law on Customs Tariff in BiH, the Law on Excises in BiH. These laws apply countrywide and are administered by the Indirect Tax Authority.

Direct tax legislation includes the Law on Income Tax in FBiH, the Law on Profit Tax in FBiH, the Law on Social Contributions in FBiH, the Law on Personal Income Tax in RS, Law on Corporate Profit Tax in RS, and the Law on Social Contributions in RS.

2.2. The structure of budget revenues and costs

In comparison with both the SEE average (excl. BiH) and the EU28 average, BiH shows the following tax revenue characteristics:

- less than half the regional average in direct taxes as a proportion of total revenue

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- significantly higher revenues from taxes on social security contributions,
- slightly lower revenues from value added taxes on goods and services than SEE, but significantly higher than EU28,
- significantly lower revenues from taxes on personal income, profits and gains; business income, profits and gains.
- significantly lower revenues from property in the region
- significantly higher total tax revenues in GDP terms than SEE; just above the richer EU28 countries.

From the point of view of public finance sustainability, it is clear that the **predominance of indirect taxation** is too limited a base to maintain current expenditure, leading to overtaxation.

Following the introduction of a VAT (Value Added Tax) with a flat tax rate of 17% in 2006 government current expenditures increased from an average of around 38.5% of GDP to around 41%. The flat rate VAT is a regressive form of taxation that hits the poorest sections of society the hardest, causing an increase in the fiscal burden of consumers by ¼.

The **informal economy**, estimated at between 25-37% of GDP, also erodes the base for taxation. As a result rates for taxes and social security contributions are higher than would be necessary otherwise. Significantly the authorities make no effort to measure either the informal economy nor levels or components of tax efficiency. The tax gap has been variously estimated at 25% of potential tax revenues, or 4.2% of GDP, but these figures can only be taken as indicative (SELDI, 2016; Schneider et. al. 2012; Harremi, 2014; EY, 2016).

The complexity of tax legislation is also a barrier to **tax efficiency,** the difference between current revenue levels and those obtained if the law was perfectly enforced. VAT **policy efficiency** is high, since there are few exemptions and no reduced rate (IMF 2016). Policy efficiency of CIT (corporate income tax) is low, given multiple tax incentives and exemptions. However enforcing **tax efficiency, i.e. compliance** is a huge problem. As a proxy for tax compliance, consider tax in arrears: while the VAT debt collection ratio has improved since 2011, tax in arrears has remained stable at 7% of annual tax revenue. Combined RS and FBiH tax and social security contributions (SSC) debt amounted to a staggering 3.3 billion KM at the end of 2016.

Hence tax evasion, complex regulations and inefficient tax administration place great strains on public finance sustainability. We can see this in the following government expenditure characteristics:

- public sector expenditure (41% of GDP), is the second largest in SEE
- expenditure on social benefits is significantly less than SEE (37%:48%)
- expenditure on public sector wages and consumption of goods is significantly more than in SEE.

2.3. Key challenges of the tax system

A major recent development was the adoption of a Reform Agenda and ratification of the EU Stabilisation and Association Agreement. The IMF Standby Agreement (SBA) includes the following measures to improve tax system efficiency, defined as structural conditions in Bosnia and Herzegovina's Letter of Intent (IMF 2016):

- simplification and harmonization of regulations and tax laws between the entities;
- providing for a more sustainable taxation system by removing exemptions and incentives, and increasing tax coverage;
- reduction of the tax burden on labour (social security contributions) to provide incentives for tax compliance and combat the informal economy;
- harmonization of corporate income tax laws to avoid double taxation between the entities and promote economic integration;
- improvement of the efficiency of tax administration and greater efforts to collect outstanding tax debts.

The last year has seen significant legislative activity to comply with the Reform Agenda and IMF SBA:

(i) In 2016 the Indirect Taxation Authority (ITA BiH), Tax Administration of FBiH, the Tax Administration of RS and the Tax Administration of the BD signed a Memorandum of Understanding on Data Exchange and Coordination to improve tax collection by strengthening the capacity to detect taxpayer compliance risks. The ITA established a unit for the prevention of VAT fraud. Currently, about 30% of ITA audits are based on risk-assessments and the intention is to improve this share. The FTA and the RSTA will move to a risk-based approach in their compliance activities with IMF assistance.

(ii) In 2016, both RS and FBIH adopted new CIT laws covering more taxable revenues and more categories of taxpayers. These harmonize the concept of residence in order to avoid double taxation. But while income from interest on bank deposits and capital gains from the disposal of shareholdings are now taxed in FBiH, they are exempt in RS. In line with IMF conditionality, exemptions for exporters have been eliminated and incentives for investment increased, but without achieving harmonisation. However the 10% corporate income Flat Tax, one of the lowest in the whole of Europe, stays.

(iii) The 2017 FBiH Law on Contributions reduces the SSC rate from 41.5% to 33%. The cost will be borne by the employee alone: employee contributions will increase from 31% to 33%, while employers no longer have to contribute (a 10.5% share). In 2016, FBiH brought non-wage benefits into the calculation of gross salary, significantly extending the tax base. In both respects, FBiH law has been harmonized with RS law.

(iv) This is not the case with personal income tax (PIT) law. While the RS 10% Flat Tax stays, in FBiH it will be replaced with progressive rates: 10% up to 800 KM per month, and at a rate of 20% thereafter. At the same time, the tax threshold has been increased from the current 300 KM to 700 KM per month.

In FBiH progressive tax rates of 10% and 20% now also apply to income derived from self-employment, investment capital, property and property rights. Income from capital dividends and interest on savings deposits will be taxed. However, capital gains will be exempt in RS. Taxation of property has not been harmonized either within FBiH (where it is regulated at the cantonal level) or between the two Entities. However, in both Entities the tax base is extended by taxing income, including capital gains, from property rights.

Reviewing these reforms the European Commission and IMF have made the following recommendations (European Commission 2016; IMF 2016):

- Introduce e-payment tax services and implement the new customs law to simplify customs procedures and reduce tax evasion.
- Improve cooperation between the ITA and the tax administrations of the Entities, including through joint audits, to strengthen tax administration;
- Amend the Law on Excises and align it with the EU acquis.
- Increase fuel excise tax to finance road infrastructure projects like the EU ‘Corridor 5c’; a new tranche of IMF credits is conditional on this reform.
- Implement legislation to address the sizable stock of unpaid SSC and taxes accumulated by loss-making public sector enterprises, particularly in the health sector (IBRD 2017).

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In what follows we will consider the likely impact of the Reform Agenda from the perspectives of tax justice and public finance sustainability, and suggest some policy alternatives.

3. TAX DODGING

The informal economy combines **tax avoidance** (technically legal activity that results in the minimisation of tax payments) and **tax evasion** (illegal activity that results in not paying or under-paying taxes).

As noted above, the tax authorities do not monitor the informal economy. As a proxy, we will look at the structure of employment in the informal economy: in terms of the percentage of those employed in a main paid job, for which at least one of the below was true (SELDI 2016a):

- No written contract on the main job, 11%
- Actual remuneration higher than that written in the contract, 16%
- No social security was paid on the main job, 15%
- The taxable income for social security paid was at the minimum wage level, although the actual salary was higher, 38%
- The taxable income for social security paid was the amount written in the contract, but actual remuneration was higher, 16%
- No health insurance was paid on the main job, 17%

The largest category of evasion takes advantage of a legal loophole whereby the tax base for social SSC is above the level of the minimum wage, thereby enabling employers to avoid SSC. Next in size is a form of avoidance: under the law benefits (hot meals, travel expenses, 13th month salary) in FBiH could rise to 250 KM a month before entering the tax base, stimulating ‘envelope salaries’ higher than the reported wage, which would usually be declared at the minimum SSC base. Entity laws have not in the past defined penalties for underreporting, thus opening the door to envelope salaries or ‘grey pay’ (Lazović-Pita 2015). Nor are the penalties sufficient. It is more profitable for employers not to comply with the law. Fines or bribes paid are significantly less than the benefits of withholding taxes (Lazović-Pita 2015).

The majority of the informal economy is in trade, catering and construction, activities which do not involve major investments in technology or production, but prosper through tax evasion and sweating employees. Employees without contracts often work significantly longer hours with no additional compensation or right to sick leave (SELDI 2016). If they decide to leave, they often forfeit the last month’s wages or months of unpaid wages. It is this very precarity that forces employees to keep quiet about tax evasion in order to hang on to a job. Wages can be as much as 50% lower in the informal than in the formal sector (SELDI 2016a). Many employers avoid paying taxes and contributions, and their employees are reported as unemployed so that they can receive minimum social benefits, placing additional strains on public revenues. In 2015, approximately 40 percent of the total work force was unregistered and in the informal economy. That year official unemployment was 44 percent: however, unemployment based on the ILO definition, which factors in unregistered workers in the informal economy, was only 27 percent (US Department of State 2015).

In 2014, the wages of 77.5% of employees were paid into accounts at financial institutions (EY 2016). Hence a significant proportion of wages are unreported and paid in cash. BiH is still a primarily cash-based economy. Cash payments are linked to money laundering, which mainly focuses on tax evasion in BiH. For the only two years (2007-8) for which data exists some $200 million in illegal financial outflows left the country, presumably the tip of the unreported iceberg (Kar and Freitas, 2012). Publicly available information shows that there are a number of BiH citizens involved in tax evasion through tax haven. Although LuxLeaks and Panama Papers mention BiH several companies, there is no systematic study of the fiscal impact on tax revenues.

According to the (one and only) report on money laundering by the Financial Investigation Division (FID) of the State Investigation and Protection Agency, 95 reports of suspicious financial transactions were received during the first six months of 2015, mainly from the banking sector, totalling 9.5 million KM (FID 2015). The majority of reports were related to specific elements of tax evasion, followed by fraudulent legal operations and withdrawal of cash from accounts on the basis of fictitious business documents. Considerable amounts of successive payments of unknown origin were observed. The FID concluded that this money did not originate from business operations or other known sources of funds, indicating suspected money laundering related to repayment of loans, founders' loans for liquidity of businesses and deposits of daily takings.

3.1. Measures against tax dodging

In 2015, Bosnia and Herzegovina made a high-level political commitment to work with the Financial Action Task Force (FATF) and MONEYVAL (Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism). By 2017, the FATP's assessment was that, notwithstanding the adoption of anti-money laundering (AML) legislation, BiH

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was a 'jurisdiction with serious deficiencies' (FATF 2017). It urged BiH to to address its AML deficiencies, including by: (1) implementing an adequate supervisory framework; (2) implementing adequate cross-border currency controls; and (3) ensuring adequate procedures for the confiscation of assets.

Some of the measures contained in the Reform Agenda, if actually implemented, will also hinder tax evasion by: 1) simplifying tax regulations and reporting and remitting procedures for the employer, especially the introduction of an e-payments system; 2) strengthening tax authority enforcement capacities through more efficient and transparent inspections and rigorous penalties; and 3) closing policy loopholes by removing exemptions from tax payment.

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4. TAX COMPETITION

4.1. Race to the bottom

The model of growth promoted by the Reform Agenda is based on attracting foreign direct investment (FDI) with lower corporate tax rates and tax incentives. However there is no hard evidence that tax incentives or relief lead to increased investments or employment (Stiglitz, 1988). In fact, a complex set of variables determines the location of investment - not just wage levels, but skills, labour productivity, proximity to markets and transport costs, which in turn are related to the nature of the product (Walsh and Yu, 2010). The role of development policy cannot be reduced to finding attractive ways for corporations to avoid paying tax. This is a race to the bottom and raises the question of tax justice, of who benefits.

CIT, at a flat 10%, is one of the lowest in Europe. Corporations contribute only 3% to total tax and SSC revenues. The relief on SSC will cut CIT (total taxes and contributions) from 22.6% to 10.8%, compared to averages of 33.8% in Europe and Asia and 40.9% in high income OECD countries (World Bank Doing Business and own calculation).

There are several incentives for foreign direct investment, including exemptions from payment of customs duties and customs fees on the import of equipment as part of capital investment. Profits transfered abroad are not taxed in FBiH if they were previously subject to taxation abroad. In RS withholding tax is not payable on repatriated profits which have already been taxed in RS. The Stabilization and Association Agreement with the EU provides for the free export for almost all goods to EU countries that meet EU standards. CIT allows the offsetting of losses against profits over a five-year period.

The tax reforms abolish export incentives but exporters will still be excused VAT. Such relief is of questionable domestic benefit given the lack of any overall development policy to stimulate competitive export sectors. The progressive removal of export incentives is a key precondition of EU accession and integration into the single market.

Investment incentives have been restructured. In FBiH businesses which make investments totalling 20 million KM over a period of five consecutive years are no longer fully exempt. Instead, their tax obligation has been reduced by 50%. In RS investments in equipment, facilities and real estate are

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entitled to a reduction of the tax base to the value of the investment. Taxpayers who in a calendar year employ at least 30 new employees are entitled to a tax base reduction for the amount of tax paid on income and contributions for these workers. In FBiH taxpayers who invest at least 50% of profit in production equipment and machinery are liable to a 30% reduction in CIT for the pertinent fiscal year. They can also claim tax deductions of twice the annual gross salary of each new employee. In RS foreign corporations are freed from withholding tax on interest on loans and loans used for investment in equipment, plant and immovable property.

The BiH Law on Free Trade Zones allows the establishment of free trade zones (FTZs) as part of the customs territory of BiH. Currently there are four free trade zones: Vogošća, Visoko, Hercegovina-Mostar, and Holc-Lukavac. The FTZ are fully privately owned, while the Visoko Free Zone is operated under a PPP arrangement. Customs and tariffs are not paid on imports into FTZs and export goods are exempt from excise.

According to the OECD, the four zones in Bosnia and Herzegovina have been active since the end of the war, but were established in former industrial hubs around existing manufacturers, and so have not attracted considerable additional new investment (OECD 2017). Even though the Law on VAT from 2005 explicitly excludes SFZ from paying VAT on production equipment, the implementing acts were never introduced. Although companies have successfully sought compensation in the courts, the uncertainty about the application of incentives has acted as a deterrent to further investment. There is a "need to weigh the economic benefits of FTZ against the considerable (notably fiscal) costs entailed in…their incentives; and…the considerable negative consequences that can arise from a potential incentive race to the bottom" (OECD 2016).

4.2. Effects of the race to bottom

Significantly there are no official studies of total incentives in monetary terms or the total revenue lost. All in all, the benefits of tax incentives seem questionable. There is evidence in the case of FTZ that they have failed to attract investment. We also know from BiH practice that a complex system of incentives creates larger tax distortions and more difficult tax administration. Indeed it is arguable that it is the lack of tax harmonization, complex legal and regulatory frameworks, non-transparent business procedures, corruption, and a weak judicial system, that is the major barrier to FDI. Hence tax incentives should be abolished. The money restored to public finances could be more wisely spent pursuing development projects attractive to both domestic and foreign investors.

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5. PROGRESSIVE TAXATION

In order to get some perspective on progressive taxation, let us first compare BiH with the Croatian progressive tax system. In Croatia the highest bracket of PIT is 40%, while the lowest rate is 12%. The rate most widely applied, to incomes of between 0.46−1.38 units of the average wage, is 25%. SSC is also fairer than in BiH, with employees contributing 17.2% of gross salary and employers 20%. In Croatia PIT brings in double the share - 10.6%- of total tax and SSC revenue compared to BiH.

At a flat rate of 20%, CIT in Croatia brings in 5.6% of total tax and SSC revenue, compared to 3% in BiH. Revenue levels from all direct taxes in BiH are less than half the Croatian and regional average. With respect to indirect taxes, in Bosnia and Herzegovina as much as 83% of tax revenues come from VAT, while in Croatia it is only half. While many countries have a higher standard VAT rate than BiH, they usually have a multiple rate structure. The VAT threshold in BiH is one of the lowest in the region, pulling in many small and medium-sized taxpayers. While the standard rate is significantly higher in Croatia at 25%, there is a reduced VAT rate of 13% for accommodation, food and newspapers, and a 5% rate is applicable to selected foodstuffs, books and medical equipment. Compared to the Croatian VAT model, the Bosnian model is regressive and there is no higher rate of VAT on luxury goods.

The Letter of Intent expresses a willingness to raise VAT if it should prove necessary to find extra revenues to maintain current expenditure commitments. The regressive trend towards parafiscal indirect taxes continues. The next tranche of IMF credits is conditional on a hike on fuel excise to finance infrastructure projects. This tax led to an estimated 48 million KM in lost revenues in 2009-14 due to the substitution of diesel by consumption of heating oil, a form of tax avoidance (Odelenje 2014). Critics argue that small farmers will be hit hard with negative effects on agriculture.

Before turning to the likely impact of PIT tax reforms in FBiH, let us examine the progressivity of the current tax system, drawing on a series of unique microsimulations that take into account not only SSC and PIT, but also income that is not included in the annual tax calculation, but which is subject to withholding tax at source that is treated as final liability (Kramer, 2016).

The overall effective PIT rate is around 5%, as opposed to the statutory rate of 10%. This means that tax allowances are as high as the collected flat tax, and that the effective tax revenue could have been doubled if there had been no policy exemptions. There is moderate progressivity due to the 0% bracket that is formed through significant tax allowances. Personal exemption is 300 KM and deductions are

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150 KM for a dependant spouse and first child, 210 KM for the second child, and 270 KM for all children thereafter. Taxpayers are on average exempt completely in first two decile income groups and partially in third decile group.

Pre-tax and after-tax income is unequally distributed. The share of the top decile group in total income before tax is 33%, but its share in total collected tax is 50%. The top decile group's effective tax rate is 7.69%, whereas the bottom group has a rate of 5.5%. However, effective rates from the first to the tenth decile group have a strange pattern. The effective tax rate decreases in first four decile groups, and then rises in the fifth. The ninth and first deciles have almost the same effective rate. It may be hypothesised that people in the first decile do not claim deductions because they are working in the informal economy, and thus pay a higher effective rate on the income they choose to declare. Based on this data, there is evidence of significant under-reporting of income and social security contributions.

The Gini coefficient of inequality is slightly reduced after taxation (by 2.21%). Nevertheless the flat tax system has a very low Kakwani index of progressivity (0.0188). The microsimulation also applied Slovenian and Croatian tax parameters to FBiH, with the proviso that a given tax system cannot be exactly reproduced in a different institutional context. Under Croatian parameters, SSC revenues would fall by 13%, while PIT revenues would double (209%). Total taxes (SSC + PIT) would rise by 6%, while net income would decrease by 4%. The first and top three (in particular the top two) decile groups would experience a decrease in net income. All in all, there would be 7% less inequality of after-tax income and the index of progressivity would increase dramatically (by 2.34 times), but not quite as much as under Slovenian parameters, since the Slovenian system has 4 tax bands and 3 progressive personal tax allowance bands.

By contrast, the new BiH progressive PIT system has little progressivity. As is noted in the Letter of Intent to the IMF, reductions in SSC will be paid for by broadening PIT and SSC bases (IMF). Hence the integration of non-wage benefits into the tax base and the removal of the deductions for dependent spouses, family members and children. At the same time, personal tax allowance will be increased from the current 300 KM to 700 KM per month. For this reason, the authorities claim that the expansion of the tax base will not hit low-income workers and that 55% of the workforce will be exempt from PIT.

However the official presentation deliberately confuses SSC paid by workers with that paid by employers. While workers will have to pay more in SSC (from 31% to 33%) employers will benefit from a reduction in labour costs of 2.57% or 150 million KM. So, firstly, the reform involves fiscal redistribution from employees to employers. Secondly, under the previous system employees received

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up to 250 KM a month in non-taxable benefits on top of their salary, enabling both employees and employers to lower their SSC burden, that is avoid taxes. As this income is now taxed, the 80% of the workforce that earns up to 1000 KM a month will experience an increase in its SSC burden. Furthermore, as we move up the income brackets, that is, above 1000 KM a month, and the former untaxed supplement remains constant, this burden becomes proportionately smaller. Therefore, as the head of the employers' federation Adnan Smailbegović concedes, the second result is fiscal redistribution from lower to higher earners (Interview20, 2017).

No data on the likely fiscal impact of the reforms on different income categories has been made public. The authorities claim that only net salaries above 1500 KM a month will end up paying more tax. While it is true there is now a formally progressive PIT system, the expansion of the tax base means that the effective tax burden on the overwhelming majority of tax payers will not be reduced. Even on own terms it is not particularly progressive; the top band is half that of the Slovenian or Croatian systems. The tax system is still overwhelmingly one based on indirect taxation which disproportionately affects the least well off, while CIT is not progressive.

In FBiH the same progressive tax rates now also apply to income derived from self-employment, investment capital, property and property rights. No official calculations have been released as to potential tax yield but we can assume given the same size of the tax allowance that only higher capital incomes will face a higher effective tax rate.

Turning to tax efficacy, the literature would suggest that the shift from a flat to a progressive system will increase complexity and thus decrease tax efficiency. However, the inclusion of non-taxable benefits into the tax base may make it harder to evade taxes by declaring minimum wage returns and thus increase efficacy.

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6. EXPANDING SOCIAL SERVICES

The problem of tax evasion is directly related to the quality of public services given the contributory nature of the social security, health and pension systems. As we saw, lost revenues due to evasion have been variously estimated at 25% of potential tax revenues, or 4.2% of GDP, representing a significant potential addition to public spending. The introduction of progressive taxation in the field of corporate income, and a higher top band of personal income tax would also secure further sources of revenue and promote tax justice.

The recent tax reforms are designed to stabilise public revenues. However, according to the Fiscal Council's Global Fiscal and Policy Framework and the Letter of Intent, the level of public spending as a share of GDP in the period 2017-2019 will be reduced and consolidated at a level below 40% of GDP, and fall over the period from 41.8% to 37.6% of GDP (Fiskalno Vijeće 2016).

Tax reform is thus linked with less comprehensive public services, where SSC funds minimal health and pension coverage, and citizens are encouraged to take out private insurance and/or tax revenues are diverted to private service providers. Bosnia faces a growing tax burden of an aging population on those in work, and it is clear that new revenues will have to be found to cover increased costs or to plug the gap in unpaid SSC of public sector firms. Some critics argue that the excise tax represents a model whereby new indirect and para-fiscal taxes will fund gaps in public spending and will be extended to health and pensions.

The highly fragmented nature of the administration of welfare provision leads to substantial duplication and inefficiencies, increasing costs. Furthermore spending on war veterans swallows up non-contributory social assistance, representing in effect a guaranteed income denied to the unemployed or other social categories at risk. As a result the poorest 20% of the population receive only 36.8% of the total social assistance budget, while the richest quintile receives a disproportionately high share of social assistance benefits (17%). Hence the problem is not social spending as such but maladministration, corruption and a distribution of resources skewed towards the wealthy.

As things stand, extra public revenues would not translate into better public services but would simply be extracted by the political class and its clients in public administration in the form of higher wages and benefits. Hence we conclude that while comprehensive public services depend on tax justice, it is also clear that tax justice depends on a new model of public investment and spending.

CONCLUSIONS AND RECOMMENDATIONS

The tax authorities must begin comprehensive monitoring of the informal economy and introduce Eurostat/OECD methodology for non-observed economy adjustments to GDP. Regular tax gap assessments should be undertaken and cross-checked with statistical assessments of the size of the informal economy. Policies need to be regularly reviewed according to findings.

In order to tackle tax evasion, tax regulations and reporting and remitting procedures should be simplified for employers, especially by introducing an e-payments system. Tax authority enforcement capacities should be strengthened through more efficient and transparent inspections and rigorous penalties. Independent monitoring mechanisms need to be developed to oversee the work of tax authorities.

A progressive VAT structure should be implemented with a higher rate of 25% on luxury goods and a bottom rate of 5% for staple food products. The excise tax should be abolished. The tax burden on labour should be slashed by sharing SSC fairly between employees and employers. PIT needs to be made more progressive with the introduction of a top tax bracket of 40% for higher earners. Tax allowances should also be progressive and aligned with income brackets.

Corporate income tax should be made progressive with a lower band at the Eurozone average of 24% and an upper band of 40%. An appropriate tax allowance should be introduced to encourage SMEs. Corporate tax incentives should be reviewed with a view to their abolition.

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