

## THE SYSTEM OF PUBLIC FINANCING: THE CASE OF BOSNIA AND HERZEGOVINA

### ABSTRACT

*This article analyzes the system of public financing in Bosnia and Herzegovina (hereinafter BH), whose unfavourable structure is caused by the complex state organization and its asymmetrical fiscal and financial structure that causes enormous public expenditure. The limitation for an effective development of public financing system in BH is a deficient fiscal capacity in collecting the state's own revenues. Fiscal decentralization in BH is a very complex issue and would demand an appropriate reorganization of the fiscal system in the near future. Reducing and equalizing tax rates, steering public expenditure to development and solving problems of public debt represent urgent steps in the following period as a predisposition for increasing economic activity in the country as a whole.*

*Fiscal policy designed in such a manner would then be capable of stimulating investment consumption as well as reducing shadow economy and tax evasion in BH economy. A lack of political willingness and a weak role of state institutions complicate the development of a fiscal frame that could ensure sustainable financing of the public sector in a long term period and could be capable of faster economic growth and development in order to complete European Union accession process successfully.*

*JEL: E6, E62*

**Key words:** *fiscal policy, system of public financing, public revenues, public debt, Bosnia and Herzegovina*

### 1. INTRODUCTION

The current position of BH fiscal policy is quite unsatisfactory. Potential reasons for weak tax capacity in the country and low level of tax revenues could be found in inappropriate fiscal system's structure and a low level of business activity in domestic economy as a whole. Likewise, the complex organization of fiscal system requires huge public expenditure. There is a difference between the level of authorities (e.g. state level, entities level, the District) which define and implement tax policy and those who collect revenues. Therefore, the state itself is responsible for defining trade, monetary and custom policies but does not have a significant level of own revenues, which presents a possible disadvantage for more efficient and effective fiscal policy in BH. Besides, managing the financial system between two entities and one district is completely different, bearing in mind the significant asymmetrical structure of the state. Tax revenues are the most significant revenue in budgets, acquiring approximately 80% of total budget revenues. The fiscal

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decentralization model in BH is very complex and would demand an appropriate redesign in the near future. Reducing and equalizing tax rates, steering public expenditure to development and solving problems of public debt represent urgent steps in the further period, being a predisposition for increasing economic activity. Managing the financial policy in this manner could lead us to a stronger stimulation of private entrepreneurship, reduction of shadow economy and tax evasion. A lack of capacity in political and institutional infrastructure complicates the development of long term sustainable fiscal policy and the system of public financing. Therefore, one of the priorities of future reform is the redesign of fiscal institutional framework which could provide a better base for managing public finance more effectively and efficiently.

## **2. SYSTEM OF PUBLIC EXPENDITURE**

The current unfavourable situation, caused by large public expenditure, will have to be resolved through decomposition of the public financing system and new fiscal framework. Piloting macroeconomic policy considers the existence of a modern and functional state. In such context, BH with its current constitution has two key limitations which affect bad practice in macroeconomic policy and strategy. Firstly, BH has limited fiscal sovereignty which is usual for states with decentralized systems and, secondly, an important limitation for BH is the lack of an appropriate fiscal capacity which could allow continuous functioning and open space for a wider and more active reaction in the field of economic activities such as stronger capital programs. Pressure on the public sector is something that exists in all transition economies, where the only difference is in fact that some of them take responsibilities which lead to budget deficit and some do not. Good examples are Slovenia and Poland. These two countries focused on production revitalization, which helped in resolving social problems during their transition period. BH is specific because it has had huge war destructions, mainly settled through international donations and investment in the public sector. Unadjusted timing between reconstruction and sustainable economy results in an extremely severe situation in tax pressure, which weakens competition ability and possibility for improving trade deficits. GDP account in BH, among other things, is even more complicated because of undeveloped statistics. Meanwhile, impossibility to include shadow economy in official GDP accounts is the biggest problem for BH statistics. Shadow economy includes all activities leading to production of new value though they are covered and not included in official data. The assumptions overheard in public refer to a much higher participation of shadow economy in BH compared to other transition countries. There are some guesses that the percentage of shadow economy in official GDP account goes over 40%. Added value, which is not included in the legal system, has been made by official unemployed labour force. On the contrary, it is really necessary to include shadow economy in the legal system and accounts. A total elimination of the shadow economy is impossible but it is possible to reduce illegal citizen's activities to minimal or acceptable level, which would gain profits for everybody in the country. Comprehension and legalization of shadow economy would solve the problem of estimating the real GDP and would give us a chance to see the real number of people who are unemployed and search for a job, as well as those who are under a social protection programme. Social sector development strategy is directly correlated with possibilities of economic development. There are five questions that dominate the social sector: unemployment, pension and invalid insurance, protection of war invalids and family members of those who died in a war, social protection special segments (invalids, protection of families with children, civil war victims, refugees, depopulated people and outcasts).

Therefore, contributions represent a financial instrument for collecting public revenues for non-budgetary public funds and in some elements they differ for taxes, fees, etc. Financial theory did not exactly ratify which characteristics should have induced financial instruments to be comprehended in contributions, except the fact that they represent a system of responsibilities with previously defined purpose. However, the main dilemma of financial theory, also obvious in

practice, is that contributions for pension and health insurance in the so-called heredity system “intergeneration solidarity” are obligatory in transition economies. Regarding the redistribution of contributions, they are similar to taxes except that the base is wage’s account and that assignment depends on tax rate. That means that the principle of proportional secession for social needs and using rights is not recognized. The correlation between absolute and relative dimensions can be regarded through the plan of income or expression of needs. Obvious disproportion between financial strength and needs results in the level of its satisfaction that reflects on social expenses financed from budget or funds. A logical continuation of the description is the situation in the sector of recharging revenues, especially recharging the contributions. Fixed attaching of payment to social protection forms in scale of reached resources in funds, with slight support from budget, makes apparent the state of extended economic power of those who are alimeted from these resources or (are) completely relied on services that are financed from funds.

Fiscal system infirmities (weaknesses) are the result of incompatible competence in collecting all of the public revenues in budgets and funds at all authorities’ levels according to fiscal federalism principle and revenues qualification. There is also a problem of state responsibility according to the social programme in the field of social, health insurance and insurance of people who are losing their jobs and a situation that is mainly caused by tributary’s tax moral. Evasion of contributions and indirect taxes is the main problem that represents a “robbery” of state on the part of those who are accredited to transfer collected resources to government bills. This goes beyond moral and represents the greatest crime, which obstructs the stability of government institutions. Payment of contributions should have a precisely defined date when payment obligation is due. That means that the tax tributary is obligated to submit his gross income account on a specific date in the current month for the previous month, and for the bearer of equilibrium of payment it is obligatory not to “admit” net income. It is necessary to transfer the competence of “automatic” turnoff from equilibrium of payment to tax office for those who don’t respect balance of payment rules.

Reform and structural adjustment of pension insurance system represent one of the crucial elements of market reform process in BH. Moreover, the developed part of the world is confronted with the need for reconstruction of the pension insurance system because the current dominant benefit - driven system financed according to the principle current revenues – current expenses were presented as fiscally unsustainable and demands high rates of contributions and generates constant fiscal deficit. In such a system, rights dominate on real economic possibilities for their financing, which do not have a direct relation with resources that one retires as contributions during a year of work. For example, the American agency for international development – USAID announced Croatia’s reform as the best one among transition countries, which was confirmed by the director of USAID mission for Croatia William Jeffers (Jutarnji list, Zagreb – Swiss, French, and Swede learns about pension reform from Croatia, from February 28<sup>th</sup> 2004). Just the fact that pension reform was successfully completed in eighteen months and that it was based on the principle of learning on mistakes made in Poland, Hungary, Chile and Mexico presents a great success. USAID help for Croatia was not omitted and it amounted, according to William Jeffers, to about 168 million dollars. Steps that Bosnia and Herzegovina should follow are primary structural reforms which should offer achievable solutions that could be achieved while related to: transmission to gross salary system with obligation to exclude contributions from salary and contributions on salary month by month, increase the role of labor union as partner in the protection of employees in private and public sectors through the social security system: pension and health insurance and protection for the unemployed, ratification of collective agreements between syndicates and managers about the height of salary based on gross account salary principle. The pension insurance system in Bosnia and Herzegovina is confronted with the constant problem of unsatisfactory financial resources for the current pension’s payment. One of the key reasons for the existence of this gap is in charging contributions (due to high participation of shadow economy), trend of growing number of pensioners and unfavorable ratio between the number of employees and the number of pensioners. Pension insurance system in Bosnia and Herzegovina is a public system of intergeneration

solidarity so called “PAYG” (Pay As You Go) system that is based on the principle of current pension payment from contributions that current employees pay. The crucial criterion in creating new pension system should be its fiscal sustainability in the long term. There is an attempt to resolve the imbalance between the pension system, incomes and obligations by measures with a reduced scope and is related with the reduction of users’ rights in fields of cure, rehabilitation, habitation. A risk that must be sustained when transitioning to a new capitalism system of direct account is extremely high transitioning costs and social tension. Meanwhile, positive reform effects that could be expected are savings and investment growth, reduction of shadow economy and tax evasion, growth of demand for all types of financial instruments (government bonds, shares etc.), capital market development motion, greater survey of economic policy by private sector and state financial stability. Of course, all of this can be achieved if there is a basic assumption for the successful implementation of pension system reform, firstly economic and political stability, powerful political willingness for reform, law regulation which doesn’t allow speculations and getting public trust. If all barriers are removed and all basic assumptions are satisfied, pension reform could have positive effects on economic growth and state development and also can be a crucial solution in removing the cause of macroeconomic imbalance. Socialization, apropos defraying costs for taking over the risk by the state goes to past, and capability of risk ruling is becoming one of the most required skills. Therefore, the responsibility is transferred from the state to individuals.

### **3. SYSTEM OF PUBLIC REVENUES**

Since 2006, indirect taxes (value added tax, customs and excise duties) have been collected by a newly established institution at the state level, called Indirect Taxation Unit. It is important to emphasize that indirect tax revenues are the own revenue source for the state budget from 2006. Based on macroeconomic assumptions, total indirect taxes revenues in 2007 were projected to 3.8838 billion KM, while 594.8 million KM for state institutions and 3.289 billion KM were distributed to entities and the District Brčko. This approach is coherent with Law on VAT where in the case of Federation of Bosnia and Herzegovina it results with projected level of revenues from indirect taxes from 2.196,2 million KM in 2007 (Indirect Tax Administration Unit, [www.uino.gov.ba](http://www.uino.gov.ba)). From the total sum transferred to the Federation of BH for servicing the external public it is planned 159.3 million KM and for distribution among Federation, ten cantons, municipalities 2.036,8 million KM. From the total distribution sum, regarding specified projection, 36.2% (737, 3 million KM) goes to Federal government, 51.48% (1.048, 5 million KM) goes to cantons, 8.42% (171, 5 million KM) goes to municipalities and 3.9% (79, 4 million KM) goes to Direction for roads. Total VAT revenues are projected in the amount of 2.2707 billion KM in 2007 which represents a growth of 1% in comparison to 2006. VAT revenues growth in the further period is related to the movement of nominal GDP and projected in amounts of 2.4433 billion KM in 2008 and 2.6388 billion KM in 2009. Total expected level of customs in 2007 amounts 507 million KM that represents a downfall of 7.8% if compared to 2006. Projected customs downfall in 2008 amounts to 57 million KM and in 2009 to 64 million KM more. The main arguments for the reduction of these public revenues are negotiations with the European Union in relation to gradual custom reduction for goods and services import from EU member countries. According to high prices of fuel oil on the world market that did not stimulate oil consumption in the country, revenues from fuel oil excise duty were modest in 2006. Revenues from tobacco consumption continue its significant growth in 2007 and it is expected to grow 10% per year in future. The total amount of excise duty in 2007 was 911.4 million KM that represents a growth of 8.2% if compared to 2006. Expected revenues from excise duties in 2008 are 980.6 million KM and 1.059,1 KM in 2009.

#### 4. PUBLIC DEBT IN BOSNIA AND HERZEGOVINA

Total Bosnia and Herzegovina's public debt is one of the most important elements for credit rating review of the state. External public debt of Bosnia and Herzegovina is defined by the state's law and it is serviced from the state budget from fiscal sources which transfer from unique account for indirect taxes collection, though the real problem of domestic public debt is still outstanding.

**Table 1.**

##### **Public debt in Bosnia and Herzegovina**

<b>Total public debt of Bosnia and Herzegovina (nominal, mil. KM)</b>	<b>10.545,70</b>
Domestic debt (positive regulation)	4.824,70
External debt (Status 31.12.2005. Ministry of finance of BH)	4.257,00
Restitution (from the Studies of Economic Institute in Sarajevo)	1.464,00

*Source: The Economics Institute Sarajevo, 2007.*

For the example of Bosnia and Herzegovina it is hard to weigh debt on intergeneration level. Firstly, it is hard to define BH public debt as a whole. Secondly, it is hard to weigh certain forms of debts, irrespective of whether these are unpaid pension benefits or debts for confiscated funds or financial assets. There are certain views which consider decision making between debt and taxes to be a moral issue. Regarding the conditions of internal debt issues in BiH, it is also a political question which causes attention of diverse political options on position principles and oppositions without real economic criteria. According to the Maastricht criteria of convergency the upper limit for a whole debt of one country is 60% GDP (Paul De Grauwe, 2000), which purports managing public BiH debt. The maintenance question of debt is imposing an additional limit which is linked to the income of the past fiscal year. The limit is established at the law level of 18% . On the allocated debt remains the implementation of the next criterium: «in so far as the period of debt amount maintenance debt for the whole internal and external debt and guarantees which are maturing every next year, including maintenance for the new proposed debt and every advance for what is guaranteed». This presents more restrictive for the new debt whose aim is the fiscal viability and its obligations to budget balancing on every level of authorities as assumed macroeconomic stability: currency stability, inflation, employment, GDP growth etc. Internal public debt till today is not fully defined. In the context of stand-by arrangements with the International monetary fund, BH has taken the obligation to prepare a comprehensive strategy to reconcile its internal public debt. Internal public debt is a result of domestic debts and like this it is presenting a barrier for investments and development. The main goal of managing the public debt is financing the budget deficit and capital projects, minimizing debt expenses and regular paying off in the medium-term and long-term period. A country like BH has to ensure managing public debt a better position in the monetary policy and developing its own financial market on a long-term basis. Managing the public debt with quality insures prerequisites for minimizing debt expenses. Every new debt has to be in the context of relations of tax incomes with gross domestic product. Accumulating debts, such as it was the case in BH during the war, can lead to a fiscal breakdown. These cases are known after both world wars.

## **4.1 Internal public debt**

The law on determining and methods on reconciling internal BH debt (Official Gazette 44/2004.) is the current dissolved question of internal debt. Likewise, BH has all international obligations transmitted on entities. According to the law, the entities of BH are obligated to deliver information to the country about the direct foreign-debt, although the country has no direct obligations for maintenance of the same. The state of BH has brought the Law of debt, debt and guarantees of BH (Official Gazette 52/2005). Passing the Law with the new solutions has defined the whole limitation on new debentures of all authority levels towards the assurance of fiscal viability and macroeconomic stability. Passing the law on the entities level limit debentures are established with the meaning that the maintenance of internal and external debt, including obligations for the new loans, cannot be above 18% of total revenues collected in the previous fiscal year. The new concept of debentures still leaves the space for new debt, while the size of debt will depend on loans in maturity and interest rate levels. In any event, based on this law, it will be possible to affirm new debentures in BH for every following year and their distribution between entities and District Brčko. The question of public debt is not only a methodological question but also a vital one. Among the key information about budget indebtedness and budget funds it would be necessary to include the indebtedness of public companies and nonfinancial institutions. However, the question still remains of how to assemble consolidated account and the system of reporting on every authority level.

The key problem is the pecuniary flow control as the assumption on fiscal discipline. In any event, applying the Law of determining and the way how to acquit internal debt in BH represents the postulate to establish a regime on directing budget from the solvency aspect and public debt, because in principle of creating obligations it leads to debt growth.

Additionally, changing the taxation system and partition the public finance can change the financial flow. Institutional capacity building at the state level could improve the position of the state's Ministry of finance which would be substituting the existing fiscal board and taking over direct responsibility over the custom institutions and tax administration.

Afterwards, the primary problem in the BH budget system would be the inspection at the financial positions of the state and building up the assessment system and obligation analyses. At the same time, that means creating space for using the Law on investing public reserves and how it can insure the placement of surplus budget reserves at the money market. The key question is the manner of handling monetary budget potential, increasing budget solvency, allocating budget surplus, consolidating and handling outward budget funds, controlling local communities debts and overlooking debentures of public companies and agencies. The key role in leading public debt policy should be that of the Ministry of Finance at BH level who should be offering, based on law solutions, debt strategy, debentures dynamic and taking over the debt system.

**Table 2.****List of obligations towards District Brčko and Federation BH**

<b>Obligation type</b>	<b>Statutory amounts (million KM)</b>
Obligation structure	
BH:	4.824,70
General obligations	1.345,70
Exchange saving	1.979,00
Recovery- war period	1.500,00
Federation BH:	2.968,90
General obligations	958,90
Exchange saving	1.110,00
Recovery- war period	900,00
Republic Srpska:	1.761,70
General obligations	386,80
Exchange saving	774,9
Recovery- war period	600,00
District Brčko:	94,00

*Source: The Economics Institute in Sarajevo, 2007.*

Internal public debt is described in the domestic currency, (in) the currency system which insures convertibility in foreign currency and it is required to consider it in conformity with developing the system, controlling internal debt through adapting structures of maturity. Long term maturity reduces the need of refinancing. Therewith the average maturity limit is acceptable. In the applicabe example on BH case, there exists a combination of these approaches. The adopted concept of reconstructed obligations from the year 2004, (who were) reflected in 200% of GDP are reduced on the net value 20% of GDP. Some obligations are solved, or they will be solved in cash, while most\_of the obligations will be payed in bonds with the term of maturity of up to nine years. In the structure of internal debt, the largest part has the old so called frozen foreign currency accounts. The issue on this repayment is the most delicate and requires a special treatment and a real judgment on budget based on real sources and handling costs. Along with the latest change in law and regulation, it is estimated the first issue of national bonds with the maturity term of 9 years will have the aim of solving debt on base of frozen foreign currency accounts. The Central bank of Bosnia and Herzegovina would take the role of the state's fiscal agent .

#### **4.2 External public debt**

According to Finance Ministry data, the external debt of BH on December 31<sup>st</sup> 2005 amounts to 4.258 million KM. From that amount, 2.737 million KM lapses to the Federation of BH and 1.521 million KM to Republic of Srpska. External debt of BH comes from contracted loans, amount that on December 31<sup>st</sup> 2005 was 6.312 million KM. The difference between contracted loans and external debt represents the amount of non-involved loans (1.320 million KM) and the amount of paid off principal (743million KM). More than a half of external debt on the named date (about 54%) represents the loan obligation towards the World bank, approximately one-fifth (23%) is the loan of the Paris club member state, the other (23%) goes to the London club, European investment

bank, European bank for reconstruction and development, European commission etc. All obligations based on external debt are regularly repaid. The repayments for the year 2005 were 230,46 million KM, where 62% of the amount is the paid-off principal and 38% are interests, banking commission and other expenses. That is regulated with the Law of debenture, debt and guarantees of which the external debt such as part of public debt is defined as a state obligation in first order. The structure of total external debt is set according to the time of its existence. The time of delimitation was April 2<sup>nd</sup> 1992, the date on which the state had to take over the international financial obligations prerequisite for accession to IMF and World Bank. Debts created toward foreign creditors made so far are called old debt (e.g. like the old foreign currency accounts), and the resulting debt after December 14<sup>th</sup> 1995 is categorized as a new debt. The old debt shows a tendency of falling absolute assets, but the new debt is scaling up with the tendency to increase in absolute and relative asset. Consumption structure based on the new external debt is: 42% - public consumption, 40% - investing in infrastructure and 18% in economic activities. The level of interest rates on old debt is approximately 3.5% and the new approximately 2.15%. Average interest on total debt is 2.75%. The debt grade of the state, apropos the viability of external debt, is measured with the realtion assets of external debt and GDP. For the year 2005, the content of external debt as % of GDP was approximately 30%. According to that, BH could be treated like a relatively low indebted country. Regarding to other countries in its surroundings, Albania is the only one with a lower rate of indebtedness - 22%; Romania is a bit higher indebted from BH (31%), as well as Russia (33%). According to this standard, Estonia is indebted on the level of 89% of GDP and Hungary 70%. In the case of Croatia, the net external public debt as % of GDP at the end of 2007 was 40.8% (Annual Report for 2007, [www.hnb.hr](http://www.hnb.hr) ). On the other side, a bigger problem for BH is the internal public debt because it is still neither precisely quantified nor the model of the repayment is known. By looking at macroeconomic indicators of BH, it may be concluded that the biggest problems are in the real sector: big unemployment and huge trade deficit. Gross domestic production is still low and has a rate of real growth of approximately 5%. Unemployment is rarely high and it is still growing. Public consumption is still high and it is above 50% of GDP.

### **4.3 Restitution**

Restituting earlier deprived property to their owners presents a mainly financial problem, as well as political and moral. BH still has not defined the adequate approach to solving this problem. The commission for restitution was formed on the state level in 2004. Physical and legal entities are invited to deliver their demands for refund regarding property which is under the Restitution. Irrespective of a possible unified solution on restitution in BH, it is still uncertain whether it will be performed in the same manner within the whole country. Towards the polls which performed the commission for restitution, requests for property refunds were applied by 375.000 claimers in asperit deemed value of 55.8 billion KM. It is assumed in the study (Economics Institute Sarajevo, 2006) that the value of property under the restitution will be reduced to two-thirds above the mentioned asset i.e. to about 37.2 billion KM. That is an extremely high debt related to the economic and financial strength of the country (for Federation of BH estimated asset relates to less than 60%, in Republic Srpska about 40% and District Brčko 0,5%). There are three possible solutions: physical return, swap restitution and financial (money) restitution. It is suggested in the quoted study that the physical return should be in one of the named forms and could be fulfilled in the time frame of 2013 till 2028. Financial restitution, i.e. the payoff value of the deprived property in money, is estimated on the principal asset of 1464 million KM.

## 5. Conclusion

Managing fiscal policy and public finance in an effective manner implies a modern and functional state structure. The absence of political consensus and an insufficiently strong role of relevant state institutions for managing fiscal policy is a barrier to a faster development of fiscal framework that would insure a sustainable public sector financing of BH in the long term. The model of fiscal decentralization in BH, with current asymmetric structure, will clearly require an appropriate redesign as the process of future constitution reform takes place. BH still does not have an adequate fiscal capacity in order to finance necessary development programs which would postulate faster growth to catch up with other countries in the region. Measures which BH has to attempt in the next period are of structural nature and enforcing reforms in the area of public sectoral activities such as reforming the system of retirement and health insurance, reform of social welfare, adopting the long term financial planning system, introducing efficient financial controlling system of paying contributions and taxes. All implemented reforms, which are of strategic significance for the country, should ensure BH a fiscal sustainability and help in the process of European integration while fulfilling fiscal criteria of EU convergence as a long term objective.

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# SUSTAV JAVNOG FINANCIRANJA: SLUČAJ BOSNE I HERCEGOVINE

## SAŽETAK

*Rad se bavi raščlambom sustava javnog financiranja u Bosni i Hercegovini, čije nepovoljno stanje je, između ostalog, prouzročeno i složenošću organizacije države, te njenom asimetričnom fiskalnom strukturom, što rezultira velikim državnim izdancima. Bosna i Hercegovina nema dovoljan fiskalni kapacitet u vidu izvornih prihoda, što je veliko ograničenje funkcioniranja učinkovitog sustava javnog financiranja. Fiskalna decentralizacija, (koja je) prisutna sama po sebi, složena je i zahtijevat će odgovarajuće restrukturiranje fiskalnog sustava u doglednoj budućnosti. Smanjivanje i ujednačavanje poreznih stopa, preusmjeravanje javne potrošnje u razvoj te rješavanje problema javnog duga, predstavljaju nužne korake u budućem razdoblju kao predispoziciju povećanja gospodarske aktivnosti. Fiskalna politika kao takva može potom značiti stimuliranje investicijske potrošnje, smanjenja udjela sive ekonomije i općeg izbjegavanja plaćanja poreza.*

*Nedostatak političke volje i slaba uloga institucija države usložnjavaju razvoj fiskalnog okvira, koji bi osigurao održivo financiranje javnog sektora u dugom roku i kao takav bio okosnica bržeg gospodarskog rasta i razvoja zemlje u cilju uspješnog okončanja procesa pristupanja Europskoj uniji.*

*JEL: E6, E62*

***Ključne riječi:*** *fiskalna politika, sustav javnog financiranja, javnih prihodi, javni dug, Bosna i Hercegovina*