

A federal Bosnia and Herzegovina: can a weak centre lead the way?

Where constituent unit governments spend almost 99% of total public expenditure it is not surprising that there are intractable problems of fiscal imbalance.

THEME II: FEDERALISM, DECENTRALISATION AND CONFLICT MANAGEMENT IN MULTICULTURAL SOCIETIES

BY PAUL BERND SPAHN

Can federalism be a model for conflict prevention and post-conflict reconstruction of countries? The answer appears to be positive.

After World War II the Western Allied Forces had insisted on a federal constitution for Germany hoping that this would incorporate checks and balances to guarantee political stability and prevent the reemergence of abused central powers and dictatorship. The Dayton Peace Accord (DPA) signed in December 14, 1995 under the auspices of the international community reestablished peace for a conflict-ridden region within the territory of the former Republic of Yugoslavia, and Bosnia and Herzegovina, and it laid the ground for a federal constitution for the new country. Will federalism again be successful in reconstructing a post-conflict society as in the case of Germany?

Some similarities and dissimilarities

There are a number of similarities between the two situations.

In both instances the objective was to prevent further conflict and to assist post-conflict reconstruction and reconciliation. In both cases there was need to undo the results of a destructive war: emotional wounds and resentments; shattered homes and damaged physical infrastructure; large numbers of refugees and displaced persons; political and economic frailty; poverty and social quandary. And in both instances there were expectations that a decentralized political structure would fit better for rebuilding and reconstructing a society and its economy than any central authority, because local authorities are closer to the people and in a better position to recognize the immediate needs.

Despite such outward similarities, the results of a federal organization of government are likely to differ significantly between the two countries, because there are variations in the nature of the originating conflicts, and differences in political and economic behaviour.

Germany, despite internal political splits, had essentially become a nation by the end of the war, which fostered economic cooperation

and smoothed the progress toward social cohesion. She could also rely on human capital, entrepreneurial spirit, and administrative proficiencies familiar with modern technologies and market processes.

Bosnia and Herzegovina still remains an ethnically divided polity, and the behavior of its political and economic agents continues to be shaped by values and behavioural patterns of the former socialist system.

Complex architecture of decentralization

Bosnia and Herzegovina has a rather decentralized structure of government. There is a weak central authority, the State of Bosnia and Herzegovina, and two constituent Entities: the Federation of Bosnia and Herzegovina (Federation) and the Republika Srpska (Serb Republic). In March 2000, the Brcko territory was declared an autonomous District. For the time being, the State, the Entities and the District of Brcko remain under the supervision of the Office of the High Representative (OHR) of the United Nations (see diagram 1).

The political, administrative and fiscal structures are distinct in both Entities. The Federation comprises ten cantons and eighty municipalities, and it represents almost 3/4 of the consolidated Bosnia and Herzegovina budget. The Serb Republic counts sixty-two municipalities, but it is administratively and fiscally centralized. Its budget represents about 1/4 of Bosnia and Herzegovina's consolidated budget.

The State of Bosnia and Herzegovina has only limited political power and relies basically on the Entities. The Entities have enacted their own constitutions and are politically, administratively and fiscally autonomous. In their respective jurisdictions, they exert all

public functions that are not explicitly assigned to the State by the State Constitution.

The Entities have retained sovereignty even in policy areas that are typically assigned to the central government in other federations. For instance they are authorized to:

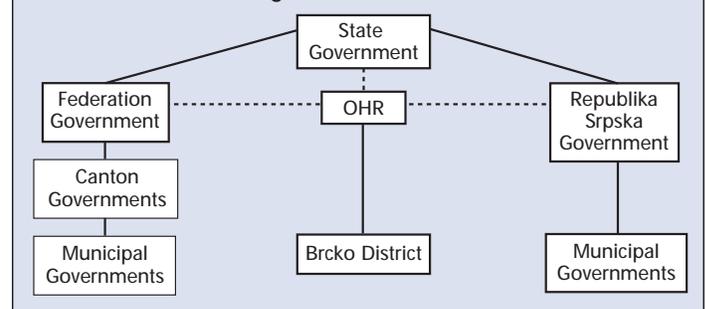
- Establish special relationships with foreign governments and international organizations; and
- Provide defense and social security (including social assistance) to the citizens of their respective territories.

While the State of Bosnia and Herzegovina is administratively and fiscally decentralized, its operation as a federation is severely hampered by a lack of interjurisdictional cooperation.

In the Federation there is an almost complete vertical and horizontal segmentation of government, which is reflected in its fiscal arrangements and budgetary structures. The relatively well-off minority, the Croats, prefer separated governments with no interjurisdictional

Diagram 1:

Bosnia and Herzegovina – Structure of Government



solidarity, while the comparably poor majority, the Bosnians, tends toward the more centralized provision of public services with fiscal equalization across jurisdictions. In the Serb Republic the predominant Serb population is more homogeneous, but interjurisdictional solidarity is also weak.

Given that vertical and horizontal cooperation between governments is extremely poor in practice, most of the coordination of policy takes place under the

auspices of the Office of the High Representative and other international organizations.

A fiscal system that discourages cooperation...

The State is fiscally dependent on the Entities and neither possesses fiscal autonomy nor a proper revenue source of its own, except for some administrative fees. Therefore the share of sub-national governments in total public expenditure is extremely high by international standards (98.7 percent), which reflects idiosyncratic fiscal arrangements that attribute all public revenue sources (including customs duties) to subnational levels of government.

Down to the Cantonal level, the Federation is perhaps one of the most decentralized government structures in the world, with cantonal governments enjoying substantial decision-making power on fiscal policies, at least on the expenditure side. The share of sub-Entity government expenditures (considering Cantons and municipalities together) is roughly three quarters of the Entity's total expenditures. However, from the Cantonal level downward to municipalities, the Federation is one of the most centralized fiscal structures, with only 8 per cent of the Entity's aggregate budget being executed at the municipal level. In the Serb Republic the share of local expenditures (excluding Brcko) is comparably low. In both Entities, municipalities enjoy very little discretionary powers in fiscal matters.

By statute, customs duties, excise taxes and profit tax (except for some smaller corporations in the Federation) are *exclusively assigned* to the Entities. The sales tax (a tax on the turnover of goods and services) and the personal income tax—both the wage tax and the so-called “citizens tax”—are the most important shared taxes in both Entities. In the Federation, the property tax (mainly a real estate tax), the property transaction tax (on sales, inheritances and gifts), and “road taxes” (including the motor vehicle registration tax) are also shared between Cantons and municipalities.

All tax revenue is apportioned on a derivation (origin) basis. This is true for the three levels of government in the Federation (Entity, Cantons, and municipalities) at uniform sharing ratios, and for the two layers of government in the Serb Republic, where there is some differentiation of municipal sharing ratios in favor of economically lesser-developed local jurisdictions.

Sales and wage taxes account for about 5/6 of the Cantons' budgetary revenues in the Federation. And municipal budgets are highly dependent on sales taxes and personal income taxes – for more than 80% of their revenues in both Entities.

Local taxes (on which local authorities have some discretionary power) have not been given much attention in Bosnia and Herzegovina. Their importance as a policy instrument to improve the allocation of resources at the local level and to finance the budget has not been recognized.

Local governments are accustomed to rely on shared taxes. This dependency creates perverse incentives, since local authorities do not feel directly responsible for these resources and are not accountable toward their citizens.

...creates imbalances...

The problem of fiscal imbalances is particularly serious since compensation mechanisms between the Entities and the Cantons have been frustrated because of a politically charged climate and ethnic tensions. The vertical imbalances are aggravated by the fact that the Entity governments make tax policy decisions and that cantonal governments tend to delegate social expenditures, which affects both the budgets of Cantons and municipalities, respectively.

Vertical fiscal imbalances clearly work against the State (the central government) and the municipal sector. The State's own revenues cover only one half of its operational expenditures, and municipalities faced a collective deficit of about one third of their expenditure responsibilities in 2000. Unfunded mandates of the lowest tier of government entail either substantial payment arrears, or a lack of basic service delivery.

As for horizontal fiscal imbalances, sub-Entity governments differ considerably in terms of their ability to raise revenues. Their economic potential (e.g., natural resource endowment, agricultural activities, industrial development, employment, factor productivity) is unevenly distributed across regions. For instance gross value-added per capita is four times higher in the canton of Sarajevo than in the canton of Gorazde. There are also distinct expenditure needs—owing to differences in the costs of services (e.g., civil security, water, energy, housing, transportation) and the share of population with special needs (e.g., refugees and displaced population, children to be educated, elderly, poor).

While the proportion of displaced persons is about 20% in the Federation and 30% in the Serb Republic, these shares vary substantially across municipalities within each Entity. About two-thirds of the inhabitants are displaced persons in some municipalities, while their proportion is less than 5 percent in others.

...and leaves poor regions behind

The current system of tax assignment based on the derivation principle tends to exacerbate existing horizontal imbalances across regions, because regional tax capacity is inversely related to regional poverty indicators. The poorer and economically stagnating regions tend to be left behind in the process of development, and economic convergence is put in jeopardy. This is a fundamental obstacle to nation building and achieving social cohesion.

Horizontal fiscal imbalances are usually addressed through equalizing grants, but given the ethnically driven tendency toward budget segmentation and the lack of cooperation, such equalizing transfers are practically nonexistent in the country.

In the Serb Republic the situation is slightly better than in the Federation, because there are some small grants-in-aid to municipalities (especially for investments), and the differentiation of the sharing ratios also eases financial discrepancies, albeit on a minor scale. Transfers among governments of the same level are unthinkable in both Entities.

Given the considerable divergence in taxable capacity across regions, the prevalence of the derivation approach for allocating revenue will perpetuate the current disparities in public expenditures and service delivery among Cantons—and municipalities, let alone among Entities—and this will end up aggravating an imbalanced economic pattern of growth across regions for the foreseeable future.

New incentives required

Federalism may mobilize resources and growth through decentralization and competition among jurisdictions, but this potential is easily squandered where there is little or no interjurisdictional cooperation and fairness. Where federalism is understood to mean fiscal segregation and budget segmentation, existing regional inequities will persist and even become aggravated, social cohesion will remain illusory, and latent conflicts are likely to build-up further.

The challenge for Bosnia and Herzegovina and the international community is to judiciously create the necessary incentives for greater interjurisdictional cooperation, to strengthen the elements of nation building, and to bring about regionally more balanced growth through intergovernmental transfers that aim at equalizing economic and social opportunities across regions. If Bosnia and Herzegovina and the international community fail to achieve these objectives, there appears to be only one ultimate alternative: political division. Germany chooses unity. 