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Improving Performance in the Federation of Bosnia and Herzegovina Tax Administration

Aksel Sorensen, Chris Barlow, Frank Bosch, and William Crandall

Technical Assistance Report | June 2016

INTERNATIONAL MONETARY FUND

F I S C A L   A F F A I R S   D E P A R T M E N T

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GLOSSARY

ADRIS	Risk and audit case management IT system
BDTA	Brčko District Tax Administration
BiH	Bosnia and Herzegovina
CIT	Corporate income tax
CRM	Compliance risk management
CTO	Cantonal Tax Office
DG	Director General
FAD	Fiscal Affairs Department
FBiH	Federation of Bosnia and Herzegovina
FTA	Federation of Bosnia and Herzegovina Tax Administration
HQ	Headquarters
IT	Information technology
ITA	Indirect Taxation Authority
KM	Convertible Mark
LTO	Large Tax Office
MoF	Ministry of Finance
OECD	Organization for Economic Cooperation and Development
PIT	Personal income tax
RMU	Risk Management Unit
RS	Republika Srpska
SOE	State-owned enterprise
SSC	Social security contribution
TA	Technical assistance
TADAT	Tax Administration Diagnostic Assessment Tool

PREFACE

Following a request from the Federation of Bosnia & Herzegovina (FBiH) Minister of Finance Ms. Jelka Milicevic, for technical assistance to the Federation of Bosnia & Herzegovina Tax Administration (FTA) a mission from the Fiscal Affairs Department (FAD) of the International Monetary Fund, visited Bosnia & Herzegovina (BiH) from March 23 to April 12, 2016. The mission was led by Mr. Aksel Sorensen from FAD, and comprised Messrs. Chris Barlow, FAD Regional Revenue Administration Advisor, Frank Bosch, and William Crandall (FAD external experts).

The mission met with FBiH Assistant Minister of Finance, Mr. Hajrudin Hadzimehanovic; FBiH Assistant Minister of Finance, Mr. Tihomir Curak; Advisors to the FBiH Minister of Finance, Messrs. Damir Sapina and Mario Glibic; FTA Director, Mr. Serif Isovic; and senior officials of the tax administration.

The mission also met with Advisor to the Republic Srpska (RS) Minister of Finance Mr. Dalibor Tomas and representatives from the Republic Srpska Agency for Intermediary, Information Technology (IT) and Financial Services. The mission benefitted from consultations with representatives of the business community.

The mission is grateful for the assistance provided by the IMF Resident Representative, Mr. Francisco Parodi, and his staff. The mission wishes to express their appreciation for the excellent support provided to it by Ms. Bosiljka Juzbašić and Ms. Aida Hakalović from the FTA.

This report consists of an executive summary and five sections: (I) Status of the Reform Program; (II) Institutional and Procedural Reforms; (III) Improving Taxpayer Compliance; (IIII) Selected Core Functions; and (V) Technical Assistance. The document was produced with the financial assistance of the European Union.

EXECUTIVE SUMMARY

The purpose of the mission was to advise the FTA on short and medium term measures for enhancing their revenue performance including assessing the progress with respect to organizational and operational reforms. The mission also followed up on the issue of data exchange between the four tax administrations within BiH—the FTA, the Indirect Taxation Authority (ITA) and the tax agencies covering the Republika Srpska (RS) and the Brcko District

The new senior management team have in their short tenure (five months) identified a range of major impediments to achieving a modern and efficient tax administration. The issues identified concern institutional arrangements for tax administration, human resources (HR), organization, operational and procedural issues.

Exchange of data

There is an unexploited opportunity for increasing revenue collection in BiH if automated exchange of bulk taxpayer data between the BiH tax administrations is ensured. The three main tax administrations have the technical capacity to extract and exchange bulk data with each other. This kind of data allows an administration to carry out analyses of compliance trends and taxpayer behaviors.

State level and entity authorities expressed their willingness to engage in bulk data exchange between the tax administrations. The shared data holdings would be held within each administration under strict security conditions. The exchange should also include bulk data from the entity business registry agencies and especially profit and loss statements and balance sheet information and ownership data, which are all electronically available. This data should be exchanged without accompanying fees being payable by the receiving tax authorities.

Draft Law on Tax Administration

The mission was asked to review a preliminary draft for a new Tax Administration Law prepared by the FTA. Comments on specific proposals in the draft addressing organizational, institutional, and procedural issues are provided in Section II of this report.

The draft law includes a provision that the FTA be established as an independent administration with specific rights and responsibilities, and that it would be accountable directly to parliament. There was little context for consideration of these proposals and the complex questions they raise, including the precise nature of such autonomy, the relationship with the Minister of Finance, and the impact on employees. If autonomy reforms were to be pursued, a fuller explanation of current issues and the policy rationale that leads to consideration of an autonomy reform and an assessment of the policy options that would best address the situation, should be prepared.

Staffing issues

There are structural remuneration problems in the FTA, including certain salary inversion situations where managers are paid less than their subordinate staff. These kinds of situations can have a negative effect on both morale and productivity. A general salary increase of up to 30 percent is suggested by the FTA. The solution, however, will be more complex. Across-the-board top-ups of salaries, or an unfettered authority for the FTA Director to supplement any individual salary would be difficult to support, given the risk of over-flows across the government.

A better approach would be to develop a proposal to address specific inversion problems, and submit this case to the Minister of Finance.

Administrative appeals

Responsibility for administrative appeals is considered a core function of tax administration. In FBiH, administrative appeals are the responsibility of the Ministry of Finance (MoF). The mission suggests that administrative appeals should be part of the FTA.

Compliance risk management

FTA has not yet moved towards a strategic approach to Compliance Risk Management (CRM), as has successfully been done in many tax administrations. This requires a significant shift in the FTA from reliance solely on audit programs to detect and correct noncompliant behaviors by individual taxpayers. Instead, a more holistic approach to improving voluntary compliance is required, that incorporates the full range of responses. This includes changes to law, systems and taxpayer service and education programs, as well as tax audits.

A dedicated Risk Management Unit (RMU) should be established and assume responsibility for identifying risks to revenue and for developing plans to mitigate the risks. Electronic cash registry data and information from the business registry agency, already available within the FTA, should be incorporated within the risk analysis tool.

Key recommendations

The major recommendations are:

Exchange of data

- Implement bulk data exchange (Immediate action).

Organization

- Change the current FTA organizational structure to establish a risk management unit, an administrative appeals function and an internal controls unit while including specific targets in the longer-term FTA strategic plan for reductions in the number of regional and municipal tax offices (by January 2017).

Human resources

- Obtain authority to replace, on a timely basis, all employees lost through attrition (Immediate action).
- Implement a comprehensive baseline review of all FTA business processes to determine the appropriate staff level for each function (by June 2017).
- Develop specific proposals to address salary problems in the FTA, including the issue of employees in certain cases being paid more than their supervisors (by December 2016).

Large taxpayer administration

- Adopt a specialized program for large taxpayer administration that includes major compliance related functions, such as taxpayer service and collection in addition to tax audit (by December 2016).
- Revise the large taxpayer selection criteria to ensure the truly largest taxpayers are included, e.g. by addressing the number of employees (by September 2016).

Audit

- Modernize the audit legal framework to ensure adequate audit powers and authorize effective use of indirect audit methods (by January 2017).
- Adopt audit case selection based upon risks as identified by an RMU with only limited scope for other forms of case selection. Ensure the RMU is responsible for selecting audits and approving audit cases suggested by other units (by January 2017).

Social security contributions

- Implement a default assessment procedure in respect of social security contributions (SSC) nonfilers to free up audit resources and to allow a basis for immediate SSC collection enforcement (By January 2017).
- Introduce an easy-to-apply pre-employment reporting obligation on employers to address the issues of undeclared workers thus allowing improvement in SSC enforcement (by January 2017).

Arrears collection

- Strengthen the headquarters oversight of the arrears collection function (by January 2017).
- Adopt a more frequent use of payment installment arrangements (by January 2017).

I. STATUS OF THE REFORM PROGRAM

A. Revenue Performance

1. **The FTA is responsible for administering and collecting personal and corporate income tax (CIT), property tax, and social security contributions in the FBiH**. FTA is also the revenue collecting body for a wide range of FBiH, cantonal and municipality fee's, levies, etc.

2. **Revenue collection is increasing**. In particular, personal income tax (PIT) and other revenues have increased markedly in 2015 over 2014. The mission did not analyze the reasons for the improved performance nor the extent to which it could be attributed either to better revenue administration performance or tax policy changes (Table 1).

Table 1. FBiH Tax Revenue

(In Convertible Marks (KM) millions; unless otherwise indicated)

	2014	2015
PIT	284	330
CIT	161	188
SSC	2,768	2,843
Property tax	82	142
Other revenues	502	729
Total FTA revenue collection	3,796	4,104
SSC share of total FTA revenue	72.9 %	69.3 %
FTA total revenue to BiH GDP	14.2 %	15.%
Nominal GDP for BiH[1]	26,779	27,381

Sources: FTA; and staff calculations.

[1] Projected for 2015.

3. **SSC is by far the major revenue contributor**. The SSC revenue accounts for around 70 percent of total revenue collected by the FTA. Ensuring effective administration of this vital revenue source should therefore be a high priority.

B. FTA Reform Agenda

4. **The FTA has identified impediments to achieving a modern, effective and efficient tax administration**. The new FTA Director (five months in the position) outlined some of the major concerns facing the organization:

- The Civil Service Agency recruitment process is too slow.
- FTA management does not have full authority over the entire organization.
- Inadequate staff remuneration

- An internal control function is absent.
- Administrative appeals not part of the tax administration.
- More clarity and transparency is needed in all activities of the FTA.
- A revised approach to cost-recovery from users of FTA services who do not contribute to its funding is needed.
- Not involved in drafting laws and by-laws related to its operations thus not invited to comment on tax policy changes to address their administrability.
- FTA needs better information from commercial banks to ensure compliance.
- Stronger efforts are needed to address noncompliance, especially in the grey economy which is rampant.
- Better information exchange with other tax administrations and data from third parties is needed.

5. **The main vehicle for launching the reform plan is a proposed tax administration law**. A working draft of this law has been prepared by the FTA but the Ministry of Finance is yet to approve it. Section II of this report examines the draft of this law and provide comments on specific proposals addressing organisational, institutional, and procedural issues.

6. **The FTA is also considering changes in its organizational structure, HR regime, and operations**. These initiatives are intended to pave the way for improvements in the management of large taxpayers, the development of an administrative appeals function in the FTA, and the establishment of an internal controls function. HR improvements are needed to address salary and recruitment problems. From an operational perspective, the FTA management supports improved compliance risk management, and more transparency and efficiency in audit, enforced collections and taxpayer services.

7. **The FTA reform plan is not officially articulated as such, but constitutes a sound focus for moving ahead with modernization**. All of its key elements need to find their way into the FTA's newly developed strategic and operational planning processes.

C. Bulk Data Exchange

8. **The memorandum of understanding on the exchange of data has been signed and is operating on a case-by-case basis**. An appropriate IT configuration has been implemented by each administration and a telecommunications structure (Virtual Private Network) adopted. The possibility to receive data for individual taxpayers allows increased efficiency in audit implementation and over time should improve the results of audit.

9. **There is an unexploited potential for increasing revenue collection if automated exchange of bulk taxpayer data between the BiH tax administrations is implemented**. Bulk data is needed by each administration so that analyses can be performed on the basis of

comprehensive taxpayer profiles that can lead to the identification of compliance behavioral trends of taxpayers. These analyses are part of the compliance risk management programs applied by modern tax administrations.

10. In September 2014, FAD recommended implementation of a comprehensive IT configuration to facilitate the exchange of bulk data.[1] This would involve each tax administration providing a database that houses complete taxpayer data with separate user accounts for each cooperating administration. In this way, each administration could directly and automatically extract the bulk data it required from a joint database. This report also indicated that the ITA is willing and able to host a central database to consolidate taxpayer information.

11. RS is willing to participate in the exchange of bulk data but will not accept a centralized solution. The RS authorities clarified that they will not agree to the ITA hosting a central database, irrespective of whether this is the most efficient solution or not. They expressed commitment to commence exchange of bulk data with the other tax administrations.

12. Each administration should provide information about all its taxpayers on a regular basis. Data subject to exchange should include the following:

i. Data from the tax and SSC returns captured in the IT systems.
ii. Registration data.
iii. Fiscal register data.
iv. Assessment data including refunds.
v. Audits—taxpayers, additional tax assessed, reason.
vi. Arrears data.
vii. Import and export data.

13. A noncentralized solution is possible. There is no support to a single data base, but the same revenue gains can be achieved if bulk taxpayer data can be regularly exchanged between the tax administrations in an automated way. In this case, each administration would need to develop its own risk profiling data base. There are no technological impediments for the data exchange to commence.

14. Third party data from the entity level business registry agencies is also critical, and should be shared with the tax administrations. There are significant amounts of data that would in many countries be included in tax returns but in BiH are collected instead by the business registry agencies. This includes profit and loss statement, balance sheet and ownership data. These data need to be available to all administrations regularly and in an automated format.

[1] IMF. "Inter-tax Administration Collaboration for Effective Taxpayer Compliance Improvement—Concepts and Tools," Zake and others, September 2014.

15. Data should be exchanged without accompanying fees being payable by the receiving tax authorities. It is good practice that tax administrations are entitled to receive bulk data relevant for its operations, from other public entities and third parties, without a charge. Such automated reporting arrangements typically include financial institutions, business registry authorities, vehicle registries, real estate registries.

D. Recommendations

- Implement bulk data exchange.
- Incorporate business registry information from each entity within the exchange.

II. INSTITUTIONAL REFORM

A. Proposed Legislation

16. One of the mission's tasks was to comment on draft legislation being prepared related to organization of the tax administration. In this context, a preliminary draft "Law on the Federation Tax Administration" (tax administration law) prepared by the FTA was reviewed. A new tax procedures law is currently being drafted by the MoF but no draft was made available for review.

17. The initial draft tax administration law constitutes a good starting point for advancing a number of critical reforms. However, given the decision to have separate legislation for administration and for procedures (this is the practice in many countries), and that these laws are being initially drafted by different organizations, it is important to have guidance on what is to be included in each. Generally speaking, a tax procedures law could include matters related to issues of interest and relevance to taxpayers, such as provisions on registration, returns filing, payment, deadlines, interest, penalties, audit, enforced collection, and appeals. A tax administration law can focus on matters related primarily (but not exclusively) to the administration itself, such as jurisdiction and powers, governance, structure, confidentiality of information, management, employment issues, and the like. There will always be issues that straddle the line between the two; nevertheless, draftors need some general guidance of this nature to ensure the full compatibility of both laws. The initial draft tax administration law includes many subjects that could be better placed in a tax procedures law.

18. Some of the matters in the initial draft of the tax administration law might be better dealt with in the procedures law. These include the following:

i. Tax registration.
ii. Obligations of banks.
iii. Single system for social contributions.
iv. Liability and enforced collections.
v. Audit.

vi. Penal provisions.

vii. Taxpayer rights and obligations.

19. One of the major proposals in the initial draft law is for the FTA to become an autonomous and independent tax administration. The draft law includes a provision that the FTA be established as an independent and single administration with specific rights and responsibilities, and that it would report its work directly to parliament. However, there is little context for consideration of these and other related provisions and the complex questions they raise, including the precise nature of such autonomy, the relationship with the Minister of Finance, and the impact on employees. The issue of autonomy in tax administration is important and has been examined by many tax administrations, and discussion of it is reasonable when considering further reform in the FTA.

20. If increased autonomy for FTA is to be pursued a policy paper on the topic should be prepared for consideration by the government. The IMF has provided assistance to many countries where efforts to make the tax administration more autonomous have been launched, and movement in this direction can have benefits.[2] However, it is not practical to begin with a draft law—this does not provide enough context for informed discussion. It is more important to develop a policy position paper that would include the following:

- A diagnosis and assessment of the major problems that need to be addressed.
- A discussion of possible solutions to these problems, and the extent to which they can be addressed by increased autonomy.
- An assessment of the policy choices that would best suit the situation (autonomy involves a set of policy choices across a broad spectrum). These normally encompass three areas: (1) the degree of autonomy (legal status, funding arrangements, HR regime, and operational autonomy); (2) the governance framework (role of the minister of Finance, role of any management board established, and the role and powers of the head of the revenue administration); and (3) how the tax administration reports to and is accountable to the government and parliament.
- A full analysis of the implications of more autonomy in the FTA context, including the relationship with the Minister of Finance and the relationship to the civil service.

21. The initial draft tax administration law also includes a provision to address certain salary problems in the FTA by authorizing a special working conditions benefit for all officers and staff of 30 percent of base pay. The mission was advised this should have been "up to 30 percent." It is clear there are serious salary problems in the FTA, including certain salary inversion situations where managers are paid less than their subordinates. These kinds of situations can have a negative effect on both morale and productivity. The solution, however,

2 See IMF publication "Revenue Administration: A Toolkit for Implementing a Revenue Authority," 2010 (especially Sections I and II).

cannot be an across-the-board top up of everyone's salary, or an unfettered authority for the Director to top up any individual salary. Rather, the solutions need to be targeted to specific problems, and considered against relativities in the government and other economic considerations. A better approach would be to develop a proposal to address specific inversion problems, and a limited number of salary insufficiencies at particular grades and levels, and submit this case with a full analysis of all implications to the Minister and the government.

22. Most of the draft law proposals are reasonable though the mission noted areas of reservation or where clarifications are needed. There are also a number of proposals, largely concerning procedures, that the mission was unable at this time to review fully. Table 2 provides a summary of the issues reviewed and the mission's comments on them.

23. Subject to comments made, the initial draft law on the FTA is a step in the right direction. Once issues identified have been addressed, and appropriate consultations are held with the MoF and other government institutions, this law could become a key platform for the modernization and reform of the FTA.

B. Organization

24. A modern, function-based organizational structure now exists for the FTA. Its structure reflects its responsibilities for direct tax collection across the FBiH. The FTA headquarters is in Sarajevo and there are regional offices in 10 cantons. In addition, there are a total of 73 outposts (municipal offices) reporting to the 10 cantonal offices. The current FTA organization is depicted in Figure 1.

25. The FTA still has an inordinately large field office structure. For a relatively small direct-tax-only administration, 10 cantonal (regional) offices and 73 outposts is a large and inefficient structure. Many countries have far fewer offices having shifted workloads away from expensive face-to-face interactions with taxpayers, and paper-based business processes. Previous IMF advice has indicated that a structure of 3 regional offices and about 15 municipal offices could be a doable and efficient structure for the FTA in the longer run. The FTA needs to begin now to set targets in its strategic plan for significant field office compression, and to develop the tools it will need to make this happen, such as early retirement incentives.

26. Reengineering of core business processes is needed to improve efficiency. The FTA continues to be in a poor position to be able to reduce its field presence, since the key to being able to streamline field operations is changing the way the business gets done, and in changing the behavior of taxpayers and citizens. Electronic filing in FBiH is only at around 30 percent, at best, and complex reporting requirements continue to generate large numbers of errors. Efforts should be made to significantly increase electronic filing.

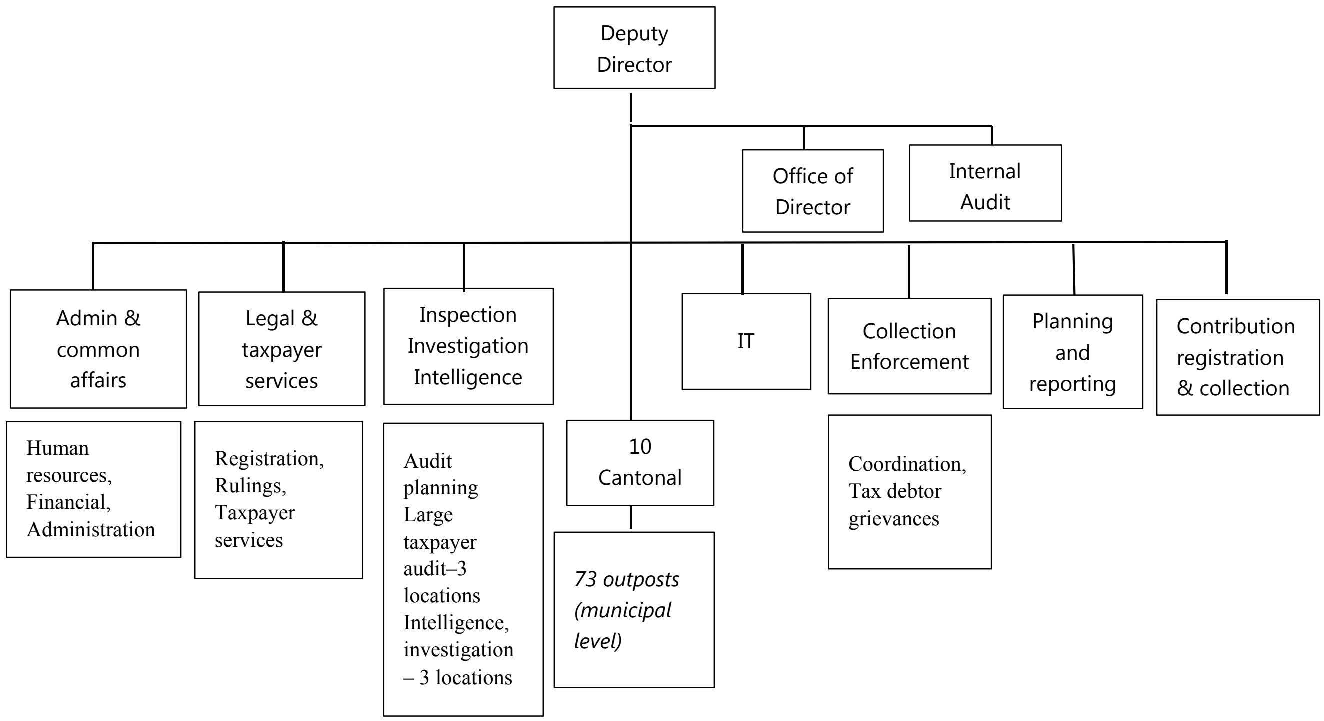
27. Responsibility for administrative appeals is generally considered a core function of tax administration. In FBiH, administrative appeals are part of the MoF. This issue is discussed in Section II. D. of this report, and a recommendation is made that this function should be in the

FTA. It is recommended this be either a division under the Legal Affairs, Rulings, and Taxpayer Services Department, or a separate department reporting to the Director.

Table 2. Summary of Selected Proposals in the Draft Law, and IMF Comments

Subject	Proposal	IMF Comment
Autonomy	Single independent agency	Requires policy paper
Financing	Appropriations plus 2 percent of taxes imposed by cantons and municipalities but collected by FTA, plus 4 percent of collections related to chambers, associations, etc.	These percentages essentially represent a fee-for-service or cost recovery, practised by many tax administrations. The mission has no specific view on the amounts to be charged.
Appeals	Move administrative appeals to the FTA (from the MoF).	Agree. See discussion in Section D. on administrative appeals.
Law changes	The FTA should participate and have an active role in adoption of laws and regulations to be implemented concerning its operation.	Agree. All tax administrations need to be able to do this, and to have a solid and on-going relationship with the MoF, especially those units responsible for tax policy.
Management	Change title of Director to Director-General (DG), Heads of cantonal offices to be called director, etc. Provides clarity on role of DG and authority over staff, and requirements of subordinate staff and managers to carry out FTA objectives and DG's orders.	Some measures here are related to the autonomy issue (like appointment of DG) and should be considered in the policy paper. Others are supported in-principle from a tax administrative perspective, but implications of local laws (such as employment laws) must be considered.
Organization	There are to be three levels of structure—headquarters, cantonal offices, and tax offices in municipalities.	This structure in the law is supported, provided it does not impede in any way the eventual compression of the field office network.
Internal control Unit	FTA to have an internal control responsibility with regard to employee conduct and behavior.	Agree. Discussed in more detail in section B.
Strategy and development	Provides authority for FTA to develop strategy, analysis, risk management, etc.	Agree.
Internal Organization—Headquarters (HQ), Cantons, Outposts	Proposes general functions at the different organizational levels.	Agree in principle. Specific details may need discussion.
Employment—hours, obligations, etc.	Proposes authorities for the DG concerning assigning work to employees, working hours, overtime, etc.	Proposals generally make sense from an operational perspective, but need to be reviewed against other related legislation.

Figure 1. Existing Organization Structure of the FTA



28. **A separate unit is required for internal control**. Internal control (sometimes called internal affairs) is a function that provides a capability to investigate allegations of employee misconduct. It needs to report directly to the Director in the organizational structure (or indirectly, say, through the Office of the head. An internal control unit can also have broad responsibilities for the general issue of integrity. Box 1 provides an overview of the elements required for an effective high-integrity organization based on international experience. The FTA has some of these features already in place, with even more expected with the passage of the tax administration law.

C. Human Resources

29. **There is currently an unfunded shortfall in actual FTA staffing levels (1,194) compared to the approved position establishment (1,744)**. The shortfall is 550. However, senior management indicated to the mission that the official establishment level (rulebook level) was too high, and that a staffing level of around 1,500 would be sufficient for the FTA to achieve its goals. This would still represent close to a 25 percent increase over current staffing levels compared to today. Tables 3 and 4 demonstrate, respectively, position establishment and staffing levels for the entire FTA (headquarters and cantonal levels) and for the headquarters (HQ) alone.

Box 1. Elements of a Strategy to Address Integrity in Tax Administration

Building a system to promote integrity in tax administration requires both the implementation of measures to combat corruption and ongoing vigilance to ensure that the measures operate as intended. To deal effectively with corruption, there must be a commitment from the government to address the problem. The key steps are as follows:

- ✓ ***Establish a clear, easy-to-understand policy framework*** including an effective penalty system; and an independent and effective appeals mechanism that limits opportunities for discretion in decision making without effective review; and provides accountability through effective oversight.
- ✓ ***Devise simple and transparent procedures*** that begin with self-assessment and include (1) a one-step process for the presentation of tax returns; (2) minimum information and documentation requirements; (3) consistent interpretations; and (4) computerized processing of tax returns.
- ✓ ***Build the professionalism of the tax administration*** with clearly defined responsibilities and accountability, including (1) professional management; (2) adequate compensation and working conditions; (3) regular staff rotation; (4) training; (5) merit-based promotions; (6) fair recruitment practices; (7) separation of responsibilities; and (8) complaint monitoring.
- ✓ ***Establish performance standards*** that enable policy makers to ensure that the expected performance is being met and that problems can be identified.
- ✓ ***Develop and enforce a code of conduct*** that clearly articulates expectations and the actions that will be taken when these expectations are not met.
- ✓ ***Develop and maintain an effective internal audit function*** designed to ensure compliance with operational procedures and integrity in all dealings with taxpayers.
- ✓ ***Ensure the effective operation of an independent internal affairs (internal control) function*** that can investigate allegations of employee misconduct.

Table 3. Position Establishment and Staffing Levels in the FTA

Organizational Unit	Position Establishment	Staffing Level	Difference (Shortfall)	Percent of Establishment Staffed
Headquarters	234	145	89	62
Cantonal Tax Office - BIHAC	149	105	44	70
Cantonal Tax Office - ORASJE	49	28	21	57
Cantonal Tax Office - TUZLA	258	172	86	66
Cantonal Tax Office - ZENICA	222	139	83	63
Cantonal Tax Office - GORAIDE	32	20	12	63
Cantonal Tax Office - NOVITRAVNIK	159	114	45	72
Cantonal Tax Office - MOSTAR	180	151	29	84
Cantonal Tax Office - LJUBUSKI	98	75	23	77
Cantonal Tax Office - SARAJEVO	280	178	102	64
Cantonal Tax Office - LIVNO	83	67	16	81
Totals	**1,744**	**1,194**	**550**	**68**

Source: FTA.

Table 4. Position Establishment and Staffing Levels in the FTA Headquarters

Organizational Unit	Position Establishment	Staffing Level	Difference (Shortfall)	Percent of Establishment Staffed
Director and office	15	9	6	60
Internal audit	4	2	2	50
Administration and common affairs	32	23	9	72
Planning, analysis, and reporting	7	1	6	14
Legal, rulings, registration, taxpayer services	22	7	15	32
Inspection, intelligence, investigation	88	64	24	73
Enforced collection	10	7	3	70
Information technology	31	14	17	45
Contribution collection and control	25	18	7	72
Totals	234	145	89	62

Source: FTA.

30. The percent of establishment levels actually staffed at headquarters (62 percent) is slightly lower than is the case for the field offices (69 percent). At headquarters, the staffing levels for certain functions, such as internal audit, taxpayer services, planning, and information technology are very low, and are a matter of some concern. At the regional level, imbalances are apparent: the Sarajevo canton is staffed at a much lower level of establishment (64 percent) than, say, Mostar (84 percent) or Livno (81 percent).

31. Declining staff levels over time indicate that recruitment is not keeping pace with attrition. Average age of staff is 55 years, and attrition levels have been high. For some years now, a staffing freeze has been in place, whereby replacement recruitment has been treated as new staffing and generally not approved. In 2015, attrition was particularly acute (85 staff due to retirements and other reasons) and levels are expected to remain high (40–50) over the coming years. New staffing of some 125 persons (including 28 auditors) was approved for 2015. However, the recruiting process for the 28 auditors, launched 5 months ago, has not yet resulted in a single new appointment and the process for the nonauditor staff has not yet begun. At a minimum, the FTA requires assurance going forward that it can replace, on a timely basis, all employees lost through attrition.

32. A full review of resource requirements is needed. The resource constraints are severe yet the authorities acknowledge that the approved position establishments overstate the gap and are no longer realistic. Technological changes will continue to put down pressure on the true staffing needs. FTA should determine the appropriate staff level for each function. This review needs to be coupled with an on-going examination, simplification and re-engineering of business processes so that resource requirements are based fully on the expected modernized environment that the FTA is attempting to create.

D. Administrative Appeals

33. Administrative appeals are dealt with by the MoF. Appeals are managed by an Appeals Group under the assistant minister for legal affairs in the MoF. The Group has an official establishment of 13 positions, 5 of which are filled. A significant backlog of cases was said to exist. The mission was informed that there currently is a procedure, in FBiH legislation referred to as a first instance appeal procedure, where taxpayers are asked to provide comments to audit reports before issuance of an audit assessment. (Tax administrations often do this as an integrated part of the audit procedure without characterizing it as an administrative appeal.)

34. Administrative appeals are usually managed by the tax administration rather than the ministry of finance. Almost all member countries of the Organization for Economic Cooperation and Development (OECD) have an administrative appeals function in the tax administration and only two of the countries (Slovenia and Slovakia) have an appeals function in the MoF.[3] It is considered good practice that the MoF is not involved in specific taxpayer cases.

35. MoF officials opined that having administrative appeals at the MoF was a necessary part of MoF oversight of the tax administration. While some level of oversight may indeed be provided by conducting the appeal process, this is not the recommended approach. To the extent that the MoF requires oversight (or perhaps assurance that tax administration is effective), it can rely on such features as FTA strategic and operational planning, annual and other reports, FTA quality assurance processes (such as internal audit), and other institutional aspects of a modern tax administration that provide accountability and transparency.

36. Important reasons exist for having the appeals function included in the tax administration. This will provide an opportunity for the tax administration to feedback the

[3] OECD (2015), Tax Administration 2015: Comparative Information on OECD and Other Advanced and Emerging Economies, OECD Publishing, Paris.

results of appeal decisions and trends to their taxpayer service, risk management and audit areas, an important aspect for improving compliance risk management. Furthermore, it can facilitate early detection of nonuniform application of tax legislation and other quality issues while ensuring a minimum standard in the cases being appealed to the judicial system. Giving the taxpayer the opportunity to comment on the audit report before its issuance is good practice and should be maintained, but as an integrated part of the audit procedure and not as an administrative appeal. Inclusion in the audit report of the taxpayer's comments and the tax administrations counter arguments should be ensured.

E. Recommendations

Proposed legislation

- Provide guidance for draftors on the subjects to be included in the tax procedures law and those to be included in the tax administration law.
- Develop specific proposals to address salary problems in the FTA, including the issue of employees in certain cases being paid more than their supervisors.
- Take account of specific issues identified by the mission in developing the next draft of the tax administration law.
- Use the development of the tax administration law, and its eventual implementation, as the key platform for the next phases of reform and modernization at the FTA.

Organization

- Change the current FTA organizational structure to establish a risk management unit, an administrative appeals function and an internal controls unit while including specific targets in the longer-term FTA strategic plan for reductions in the number of regional and municipal tax offices. Human resources
- Obtain authority to replace, on a timely basis, all employees lost through attrition.
- Implement a comprehensive baseline review of all FTA business processes to determine the appropriate staff level for each function.
- Develop specific proposals to address salary problems in the FTA, including the issue of employees in certain cases being paid more than their supervisors.

Administrative appeals

- Remove the administrative appeals function from the MoF and establish it in the FTA.

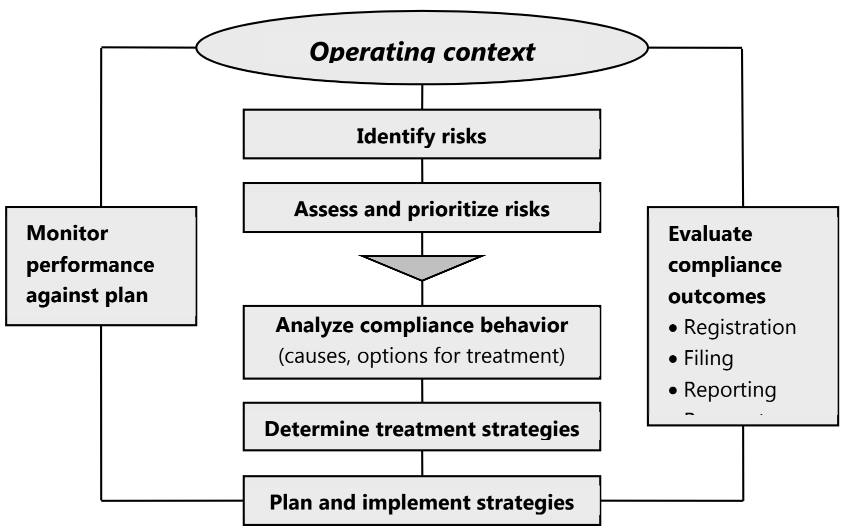
III. IMPROVING TAXPAYER COMPLIANCE

A. Strategic Compliance Risk Management

37. FTA has yet to adopt a strategic approach to CRM. Many modern tax agencies have come to accept that a more strategic "top-down" focus on compliance risks across particular business sectors, or taxpayer segments (such as large taxpayers), or particular taxes, is more effective than a case-by-case "bottom up" approach in driving compliance improvement. This requires a significant shift away from reliance solely on audit programs to detect and correct noncompliant behaviors by individual taxpayers. Instead, a more holistic approach to improving voluntary compliance is used to address specific compliance risks identified for larger groups of taxpayers using a broader range of intervention tools.

38. Acceptance of the need to apply risk-management concepts in FTA operations is now gaining traction. Risk management principles are already being applied in relation to selection of audit cases. In addition, technical assistance (TA) has been provided through FAD missions and expert visits to develop a CRM framework to focus on compliance risks across the four tax administrations in BiH.[4] The framework is consistent with the OECD Risk Management Process Model, as described in figure 2.

Figure 2. Organization for Economic Cooperation and Development Risk Management Process Model



39. Key elements of the model include the following:

- Focus on identified compliance risk issues, rather than simply high risk taxpayers to be audited. Examples of compliance risk issues are (i) nonpayment of tax or nonfiling of returns; (ii) extensive shadow economy activity in particular sectors; (iii) undeclared employees; etc.
- Prioritization of those risks to ensure focus on highest risk issues for maximum results.

[4] IMF, "Improving and Coordinating Tax Compliance Management," Zake and others. June 2014; IMF, "Inter-tax Administration Collaboration For Effective Taxpayer Compliance Improvement—Concepts and Tools," Zake and others, September 2014.

- Research to understand the underlying causes that drive the noncompliance in order to develop the most effective intervention plan. Such a plan is likely to involve a range of intervention tools (not just audit) to mitigate the compliance risk and improve compliance behavior. The intervention plan would provide key guidance for functional departments with respect to their operational planning of taxpayer services, audit, and enforcement activities. Where, for example, taxpayer education is identified as part of the mitigation strategy for a certain risk, care must be taken to ensure that the right information is presented to the right taxpayers using the most appropriate communication medium.
- A feedback process whereby results of compliance interventions are evaluated and lessons identified for future improvements.

40. A sophisticated CRM framework was developed for implementation across the four tax administrations.[5] This framework contained all the features found in similar models that are successfully used in modern tax administrations and can therefore be considered a model for good international practice in CRM. However, an untested feature was that it sought to establish a single framework across multiple tax administrations, to accommodate the unusual make up of the tax system in BiH. Achieving this presented special challenges in relation to sharing of information between the separate jurisdictions (discussed in Section I.C.) and establishing an effective governance framework to oversee the compliance improvement process. In respect of the latter, such a framework was never implemented.

41. Acknowledging the special challenges, a phased approach to implementation was proposed. Two projects were selected to serve as pilot projects and gain further traction for the initiative across the organizations.[6] The ITA undertook a project to address compliance risks in the construction industry, while the FTA similarly focused on the hotel industry. Unfortunately, there has been insufficient cooperation between the administrations during the implementation of the projects. Neither project has thus far successfully followed the CRM model and for various reasons omitted key steps in the process. This resulted in both projects so far being debased into no more than audit projects.

42. Box 2 describes the pilot compliance project designed to implement this initiative in the hotel industry.

[5] Ibid.

[6] A compliance pilot project was also planned by the Brčko District Tax Administration (BDTA) to address compliance issues related to a large open market site with multiple traders. The mission was not able to follow up with BDTA on progress with this project.

Box 2. Pilot Compliance Project

In November 2014, the FTA commenced a pilot project focused on managing compliance in the hotel industry. This project was based on an action plan drafted at a workshop facilitated during an IMF short-term expert assignment. The intent of the project was to trial the CRM approach to improving compliance in the hotel sector. The project initially proceeded in accordance with the operational plan. Specifically**:**

- An agreement was reached with the Statistical Department on the basis that their information could be utilized.
- A number of relevant websites were examined to identify properties being offered for rental by small and medium-sized hoteliers in Sarajevo.
- Information obtained was matched with the FTA database. Of 60 identified taxpayers it was found that 21 were not registered.
- A memorandum of understanding was agreed with a utility company that allowed for information concerning the account holders of properties to be obtained via email.
- A meeting was held with a hoteliers association and established their cooperation including their willingness to provide information voluntarily.
- A media campaign was in the planning phase and an email account to be used to receive information was established.
- Meetings were arranged with both ITA and RS Tax Administration to discuss progress.

The project was suspended in December 2014 due to a change in priorities. Planned meetings with RS Tax Administration and ITA did not proceed and a planned media strategy was not implemented, instead it was decided to continue with the initiative as a standard audit project.

The audit program focused on specific compliance risks. Focus was on identifying taxpayers in the hotel industry who had failed to register as a business, failed to register employees, failed to issue fiscal receipts, and other record keeping offences**.** Audits were undertaken on 126 businesses with 45 of these being fined a total of KM 59,000; an average of KM 1,311 each). The audits did not seek to identify unpaid taxes or social contributions relating to earlier periods. These were partial audits that take on average less than two days to complete. If an offence was established the business would usually be closed until the underlying issue was resolved. For instance, if a business was found to be operating without a fiscal register it would be closed until that requirement was properly met. Some of the hotel businesses were subsequently subjected to a comprehensive audit. Unfortunately, the numbers and results of these audits were not monitored.

It was not possible to audit a number of taxpayers due to a legal technicality. This arose when private property, such as an apartment, was made available for rent. As the apartment is considered to be private property the FTA was unable to enter the property to establish if it was being rented. This would be the case even if the owner held more than one property. This significantly weakened the FTA's ability to verify compliance in such cases.

Noncompliant businesses continue to be monitored. Businesses and workers who have been identified as unregistered through this process continue to be monitored after the completion of the audit. Relevant information is provided to the Contribution, Registration Control and Collection Department who then monitor the status of the taxpayers and may propose that a further audit be undertaken if suspicions of ongoing noncompliance persist. A small number of more serious cases have been referred for possible criminal investigation. Where significant discrepancies can be established an attempt will be made to prove the amount of tax and contributions evaded to be used in a possible prosecution.

Although the full scope of the CRM process was not applied, the pilot project nevertheless provided valuable lessons. The project focused on a high-risk sector and targeted specific compliance risks (i.e., failure to register a business, failure to register employees, failure to issue fiscal receipts and failure to maintain adequate business records). Even though the full impacts on the compliance behavior of participants in the hotel industry were not closely monitored, there is general consensus that the project achieved positive outcomes.

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[1] "Improving Taxpayer Compliance and Fighting Tax Fraud: An Action Plan," John Middleton and Joshua Aslett, IMF, September 10, October 2014.

43. A less ambitious and practical approach is needed in order to reinvigorate the CRM initiative. Given the lack of success with the pilot projects and having the benefit of hindsight, the objective of establishing a single CRM framework across four tax administrations has proven too ambitious. While the need for improving information sharing and the benefits this will provide for all of the tax agencies remains unchanged, a localized approach to risk identification and implementation of appropriate mitigation interventions will facilitate better progress. In the case of the FTA, this would mean using the results of its own risk assessment work to develop its own compliance improvement plan and using its own functional resources to address those compliance risks in relation to its own clients.

44. To successfully implement the CRM approach, the FTA will need three key organizational capabilities:

- *Robust risk identification and analysis*—Data and information sources need to be identified and analyzed to identify existing and emerging factors that may negatively impact on compliance behaviors.
- *Effective compliance improvement strategy and work plan development*—compliance planning and management programs need to be developed to identify and prioritize risks to revenue and how they will be addressed.
- *Efficient core business operations*—key tax administration functions must be adequately resourced and equipped to deliver treatment strategies through an appropriate mix of interventions—these include taxpayer services, filing, intelligence and risk management, audit and investigations, collection enforcement, and fraud/criminal prosecutions, etc. Issues relating to strengthening selected tax administration functions are discussed in Section IV.

45. Increased coordination across all four tax administrations in BiH is recommended. Focusing on compliance risks in respect of taxpayers registered with the FTA, should not prevent the FTA from sharing its risk assessment results and compliance improvement plan with other tax agencies in BiH and cooperating with them in areas of common risks. Joined initiatives potentially lead to enhanced results beyond what can be achieved by any agency alone.

B. Establishing a Risk Management Unit

46. A dedicated RMU is a critical component of a successful CRM framework. Tax administrations that have adopted a successful CRM framework invariably have established such a unit to support their CRM process. Establishment of such a unit in the FTA will similarly be a key success factor to an effective CRM process. This unit should assume strategic and operational responsibility for identifying risks to revenue across the organization and to develop plans for how to mitigate the risks and evaluate their implementation. An effective RMU would typically comprise two teams as follows:

- *Risk Identification and Analysis Team.* This team is responsible for capturing and analyzing data from a wide variety of internal and external data bases, and using analytics such as datamining technology to identify existing and emerging compliance risks. Section D below describes the risk analysis process in greater detail.

- *Compliance Strategy and Planning Team.* This team is responsible for developing a set of strategies and work plans to promote compliance and deal with noncompliance. The compliance strategy team develops risk response strategies delivered through the various functional departments and presents the plan for consideration by the oversight body (Compliance Council).

47. Governance over the CRM process can be assigned to an FTA Compliance Committee. The council should be chaired by a very senior manager, preferably the Director himself, and include key managers involved with the implementation of the CRM process. The role of the council will be to approve the priority compliance risks identified by the RMU and, with the added input of its members, approve the compliance improvement plans, including the suggested mitigation strategies presented by the RMU. The Council should also receive regular reports on the implementation of the various compliance improvement initiatives that are in progress and monitor the results.

C. Risk Identification

48. Some progress has already been made in developing a risk analysis capability in the FTA. An audit case selection tool has been developed and deployed, as part of an initial application of risk management principles in the audit function. This tool was built with the help of international consultants, initially as part of the Single Account System for SSC. It was subsequently expanded to also include taxes. The system accesses some of the internal data sources and applies pre-set risk assessment parameters to calculate a risk score which is then used to select high-risk scoring candidates for audit scrutiny. Data currently accessed for this exercise includes monthly returns for paid wages and contributions, corporate income tax summary return information, number of employees and audit results for the previous five years.

49. Essential data sources are currently omitted in the audit case selection tool. Retailers and wholesalers are required to use an electronic cash register directly linked with the tax administration providing daily updates on turnover information. However, this data is not used to identify noncompliant taxpayers. Furthermore, profit/loss statement and balance sheet data electronically available from the business registry agency (FIA) is currently not used. The explanation is that the data is only available with 8–9 months' delay due to a manual data entry process. FTA should ensure that this data is used in the risk analysis even though it would result in some of the audit cases being identified with some months' delay compared with the current approach. Import, export and value-added tax data from the ITA could also significantly strengthen the capacity to identify noncompliant taxpayers.

50. Some significant benefits of the risk-based audit case selection tool are not being realized. Although the tool uses a list of sound basic risk parameters to identify potential cases of noncompliance, few of the cases selected based on this process are actually completed in the field offices. Only ten such cases are assigned to a cantonal office and the manager retains discretion not to assign the case if it is perceived that other local cases may be greater priority. Furthermore, there is no effective feedback loop to allow the results of risk-based selected audit cases to be evaluated. Such feedback would be invaluable in establishing the relative quality of cases selected using this method and assist in gaining greater acceptance for this selection technique from field managers. Feedback would also allow ongoing "sharpening" of the risk parameters used to select the cases.

51. A wider approach to risk analysis will be needed to support CRM. While the audit case selection tool seeks to identify individual noncompliant taxpayers for specific audit attention, the CRM process seeks to identify specific compliance issues that may apply across much larger groups of taxpayers. A common approach is to focus on four common compliance risk genres: (1) registration risks; (2) filing risks; (3) payment risks; and (4) reporting/declaration risks. The taxpayer base is then segmented into smaller groups such as industries, sectors, geographical areas, activity types, legal form, size of turnover, etc. By then measuring performance within the selected group against the four above-mentioned risk genres, trends can be revealed that are rarely observable when similar analysis is performed across the entire taxpayer population. Identifying risk issues in this way also facilitates more appropriate intervention strategies that are targeted to the characteristics of the specific group in respect of which the compliance risk has arisen.

D. Recommendations

- Introduce the CRM process within the FTA.
- Establish an RMU to perform compliance risk analysis and prepare the compliance improvement plans.
- Establish a strong compliance council chaired at a senior level to manage a compliance strategy focusing on revenue risks.
- Adopt audit case selection based upon risks as identified by an RMU with only limited scope for other forms of case selection.
- Ensure the RMU is responsible for selecting audits and approving audit cases suggested by other units.
- Audits that are requested by other authorities should still flow through an RMU endorsement procedure. It is also essential that meaningful feedback is provided to the RMU after the completion of each audit.

IV. SELECTED CORE FUNCTIONS

A. Large Taxpayers Administration

52. **The FTA does not have an effective program for large taxpayer administration**. The strategic plan calls for the establishment of a dedicated large taxpayer office to be responsible for all key tax administration functions for selected large taxpayers, but such a facility has not yet been implemented.

53. **A limited program is in place to undertake audits of selected large taxpayers**. The FTA has identified 747 large taxpayers who are singled out for closer audit scrutiny through a headquarters unit and three regional units partially dedicated to this task.[7] These units have a combined total of only 26 auditors. Results of the large taxpayer audit program are set out in Table 5 below.

Table 5. FTA: Large Taxpayer Audit Results (2014–15)

(In KM million; unless otherwise specified)

	2014	2015
Number of audits	358	621
Audit coverage	48%	83%
Cases with discrepancies	108	178
Strike rate	28%	28%
Additional assessments	88.6	59.7
Actual collections	13	24
Percentage collected	15%	40%

Source: FTA.

54. **The modest audit results raise questions about the effectiveness of the large taxpayers audit program**. As can be seen from Table 5, during 2015, the program resulted in completion of 621 audits (an audit coverage of 83 percent) but a very low strike rate of 28 percent. Additional taxes and penalties were assessed in the amount of KM 59.8 million of which only KM 16.9 million was collected.[8] This modest yield from these large taxpayer audits may well be the result of an insufficient scrutiny rather than high compliance by large taxpayers, as suggested by some officials. The limited audit techniques currently applied are unlikely to facilitate detection of significant under reporting resulting from complex tax avoidance arrangements often used by large taxpayers. Strengthening the audit program for large

[7] Auditors in these units spend about two thirds of their time on large taxpayer audits and one third on medium-small taxpayers when diverted to these activities as part of audit projects directed from headquarters.

[8] FTA officials informed that actual collection from audits is higher since they only record collection during the calendar year where the audit assessment was issued.

taxpayers therefore requires a deepening of audit penetration through greater specialization and more effective auditing techniques.

55. The limited number of auditors and their dispersal over multiple sites restricts the development of specialist skills. The 26 auditors deployed on large taxpayer audits represents a low number by international standards. These auditors are effectively charged with the control over the bulk of the total revenue collected by FTA and contributed by the largest and most complex businesses in the country. These auditors require far higher skills and knowledge than demanded of other auditors in order to be equipped to deal with the complexities that the tax affairs of these large taxpayers present. Although some auditors have received more specialist training (e.g., transfer pricing arrangements) the current arrangements do not allow any formalized specialization, such as by industry groupings. In addition, the limited scope for allocating cases also raises potential integrity issues.

56. The 747 taxpayers currently identified as large have been selected on the basis of four mutually independent criteria as follows: (1) those with turnover exceeding KM 13 million and assets exceeding KM 4 million; (2) those with assets exceeding KM 50 million, irrespective of turnover; (3) financial organizations (banks, insurance, fund managing companies, brokerage firms, and operators of games of chance); and (4) other financial institutions with turnover exceeding KM 1 million. The selection is revisited each year.

57. Criteria for selecting large taxpayers could be improved. Given the large contribution of social security contributions to total FTA collections, the absence of a criterion focused on employee numbers is notable. Furthermore, the current criteria do not guarantee the largest taxpayers by turnover (particularly those with high turnover but without at least KM 4 million in assets in BiH) are selected.

58. The benefits of a specialized large taxpayer program are now almost universally acknowledged. This is evidenced by the proliferation of dedicated large taxpayer offices in most tax administrations around the world. Realization of those benefits initially arises from the more concentrated focus resulting from the deployment of a tax agency's best staff on the affairs of a small number of the largest taxpayers who collectively contribute a high percentage of total tax collections. Additional benefits can be ensured if the large taxpayers administration has the appropriate organizational competencies to effectively manage the compliance risks that arise from the different characteristics associated with the largest and most complex taxpayers.

59. The FTA would benefit substantially by establishing a more comprehensive large taxpayer administration program. Treating large taxpayers the same as any other taxpayer presents a missed opportunity to exercise more effective control over the small group of large taxpayers who contribute the largest share of revenue contributions. Effective control over this group requires a program that more closely tailors administrative processes across the functional areas to be more aligned to the characteristics of this group. Typical features of a more aligned program include the following:

- **Strengthened taxpayer service**. Large taxpayers or their representatives don't typically come to the tax office to ask questions of staff who frequently have no understanding of their complex business needs. To adequately inform large taxpayers about their taxation obligations requires a more targeted and proactive approach, including advisory visits, senior manager interviews, making available dedicated staff with appropriate knowledge for the taxpayer to contact, etc.
- **Immediate follow up on filing and payment defaults, ensuring accelerated enforcement processes**. Standard collection processes (reminder letters, etc.) are often not sufficient to deal with such large cases effectively. Typically, a large taxpayer would be contacted by telephone within 24 hours of a payment default and all efforts made to work with the taxpayer to ensure the noncompliance is quickly resolved.
- **Closer and more in-depth audit scrutiny using staff trained in more specialized techniques and industry specific knowledge, etc.** Although large taxpayers are usually reputable businesses that do not engage in fraudulent activities or blatant tax and SSC evasion, they do treat tax and SSC as just another expense to be minimized. To achieve this, they will deploy sophisticated arrangements to avoid their revenue liabilities. FTA auditors need to be appropriately skilled to detect such arrangements and present an effective counter to such activities.

60. **Auditor specialization**. Large taxpayers differ from other taxpayers and present special challenges. Effective administrative control of large taxpayers must take into account the typical characteristics of this group. Large taxpayers often have access to in-house legal and taxation advice enabling them to use complex structures, systems, operations and transactions in their business activities and often operate in a global environment, making them major players in cross-border dealings. This means that the FTA must also stay abreast of those changes. Staff will require expert level knowledge about how specific industries work and how the revenue laws should be applied in the wide range of complex situations that arise.

61. **To effectively administer large taxpayers, the FTA will need to develop the right competencies**. Appropriate competencies that are needed if the FTA is to effectively administer large taxpayers include the following:

- *A capability to focus on defined markets and an understanding of taxpayers' business and behaviors*. This will require building expert knowledge of key industries and knowing how taxpayers operate within those industries.
- *Expert knowledge of commercial law and practices, accounting practices, tax law, and auditing procedures and methods*. The knowledge of relevant staff will need to be much higher than that required of other staff. The complexities of large taxpayers' affairs will often result in complex technical and legal issues, in respect of which large taxpayer staff will need ready access to expert advice.

62. Building such competencies will not be an easy task and in some cases will require some years to be fully achieved. Although some of these competencies will already exist to some extent, they will likely require significant strengthening to facilitate improved understanding between businesses and the LTO and secure better compliance outcomes.

B. Audit

63. Audit responsibility is spread across the organization. The Large Taxpayer Audit Divisions (Sarajevo, Mostar, and Tuzla) are part of the Inspection, Intelligence and Investigation Department. The Contribution Registration, Control and Collection Department has an audit Division based in Sarajevo. The 10 Cantonal Tax Offices (CTOs) each have an audit function. Currently there are 202 audit staff.

64. The FTA 2016 Audit Plan sets out the approach to be taken by all three audit areas. The main aim of the audit plan is to identify those taxpayers that have not been subject to audit recently, those that continually violate tax laws and those that make the largest revenue contributions. The plan stipulates:

a. how audits shall be conducted;

b. the types of audits to be conducted; and

c. the parameters and criteria for determining the number of audits to be undertaken and the selection of candidates for audit.

65. The types of audits to be undertaken are split into three broad categories- comprehensive, partial or informative. Detailed calculations are set out in the plan to arrive at an audit program for each audit division. These plans include the number and types of audits and the revenue to be generated by each auditor. Auditors in the CTOs will generate on average extra revenue of KM 621,395 each whilst those operating in the other two divisions will generate an average of KM 2,502,548 each.

66. The general expectation is that all audits are undertaken by two auditors working together. The time allocated to each audit varies from 20 days for a comprehensive audit of a large taxpayer down to four days for a partial audit of a small taxpayer.

67. The Audit Plan mandates that 50 percent of audits will be risk based. Table 6 summarizes the types of audits planned by source for the CTOs and LTO and audits concerning SSC.

68. Fifty percent of ad-hoc audits undertaken in the CTOs are required to be completed within two days. These audits are restricted to four specific compliance topics. The remaining 50 percent of ad-hoc audits will be comprehensive or partial audits focusing mainly on liquidations and requests for audits by other public bodies and citizens.

Table 6. FTA Planned Distribution of Audit Types 2016

Audit Distribution		Audit Type	CTO	LTO	SSC
Risk-based audits	**50%**	Comprehensive audits	40%	50%	0%
		Partial audits	60%	50%	100%
Ad-hoc audits	**50%**	Audits requiring up to 2 days (quick audits)	50%	10%	10%
		Comprehensive audits	30%	50%	-
		Partial audits—contributions, income	20%	40%	90%

Source: FTA.

69. A similar split of ad-hoc audits is mandated for the other audits services. The ad-hoc audit program has been a success since its introduction late in 2015 particularly in raising the awareness of the FTA's activities. An investment of 50 percent of FTA audit resources is a very significant investment. As the risk based case selection and broader compliance risk management strategies are developed it will be necessary to rebalance the effort put into this work.

70. The audits selected by the centralized risk analysis IT system (ADRIS) are based on a number of criteria. The criteria have a risk weighting that, when added together, generates a risk score to be used as a basis for audit case selection. The criteria utilized currently are listed below. The risk data base needs to be enhanced with additional data as discussed in Section III.C. in order to allow design of effective risk parameters:

a. Failure to file.
b. Late filing.
c. Number of business units.
d. Business structure, e.g., limited company.
e. Industry.
f. New or existing business.
g. Total income.
h. Time elapsed since last audit.
i. Number of employees.

71. During 2015 the audit case selection was predominantly based on factors other than risk assessment. Table 7 analyses the planned and completed audits during 2015 and shows that less than 2 percent of audits completed were selected based on a risk assessment. Although this situation has improved during 2016 it is still the case that less than 5 percent of audits have been selected on the basis of a centralized risk assessment.

72. The audit results for 2015, in terms of the value of additional assessments, appear quite high particularly when measured on a return per auditor basis. A review of the top five audit results revealed that they all related to nonfiling of SSC returns. A break-down of audit results by tax type was not available. However, based on available information it appears that a significant proportion of the additional assessments raised through audits relates to nonfiling of SSC returns. Table 8 summarizes the audit results for the last two years.

Table 7. Planned and Completed Audits, 2015

	Number of Audits		Percent of Total
Description of Audits	**Planned**	**Completed**	**Completed**
Total audits	3,453	8,965	100
Audits lasting up to 2 days	2,077	6,840	76
Audits lasting more than 2 days	1,376	2,125	24
Non-IT-risk based audits	2,432	8,809	98
IT risk based audits	1,021	156	2

Source: FTA.

Table 8. Audit Results (2014–15)[1]

(In KM millions)

	2014	2015
Number of audits	5,776	8,588
Cases with discrepancies	-	3,139
Strike rate	-	37%
Additional assessments	122.4	176.3
Actual collections	16.3	35.9
Percentage collected	13%	20%

Source: FTA.

[1] Excluding results for Large Taxpayer Audit.

73. The low rate of collection disclosed in Table 7 is a cause for concern.[9] Given the significant level of arrears, it is vital that audits do not simply add further debt onto an already difficult situation. This is particularly the case if taxpayers are simply not filing further returns in light of their inability to service their current level of debt. An alternative approach may be required so that scarce audit resources can be focused on audits that can generate real outcomes and have a real impact on taxpayer behavior.

[9] FTA officials informed that actual collection from audits is higher since they only record collection during the calendar year where the audit assessment was issued.

74. Currently the audit selection process is dominated by a range of mandated activities that are not based on an assessment of risk. The FTA should continue to increase the share of casework identified by ADRIS and to reduce the focus on less productive sources of audits. The requirements of other functional areas within the FTA, along with requests for assistance from other agencies, should be channeled through the proposed RMU for profiling and prioritization. A critical review of the approach to auditing nonfilers with significant existing arrears should be undertaken to identify alternative approaches that could free up scarce audit resources for more beneficial work.

75. Powers available to the FTA to undertake audits have a range of limitations as indicated by officials:

a. **Legislation does not support use of computer assisted audit tools**. Although the FTA can compel a taxpayer to provide relevant information it does not have the authority to specify the format in which the information is to be provided. This limits the ability of the FTA to use modern computer assisted analytical tools, which have proven very efficient in other tax administrations. These tools can, inter alia, guide the auditor to more efficiently detect whether the bookkeeping is reliable and to guide the auditor in detecting the noncompliance.

b. **Inordinate level of veracity given to a taxpayer's books and records**. As a consequence of the precedence given to official business books and records auditors have difficulty utilizing audit methodologies involving indirect income measurement. Before these methodologies (e.g., gross profit calculations and examining unexplained wealth) can be utilized the auditor must firstly directly prove that the official books and records are incorrect. Without explicit evidence this is very difficult and unreasonably limits the FTA's ability to raise assessments based upon circumstantial grounds.

c. **Auditors are not routinely able to access all bank account records of a taxpayer or an associated person**. Bank accounts are categorized as being "business" or "private" with the FTA only being able to obtain records relating to nominated business accounts. This limitation is an unreasonable constraint on the FTA that limits its ability to identify and quantify undisclosed tax and SSC liabilities.

d. **Auditors are unable to obtain records relating to nonbusiness assets and expenditures of taxpayers and associates**. Records of unexplained wealth and conspicuous consumption can play a vital role in enabling an auditor to identify and quantify undisclosed income and business activity.

76. The effectiveness of the FTA audit program could be significantly strengthened by modernizing the legal framework. The following legal amendments to the tax procedural legislation are recommended to overcome these issues:

a. Provide the FTA with the authority to require persons to provide information to it in a certain format, including a specific electronic format.

b. All inhibitions or restrictions, placed on duly authorized FTA officers, to obtain documents relating to nonbusiness financial and other relevant records concerning the financial position (including level of income and personal expenditure) of a taxpayer and associated entities should be removed.

c. Clear legislative support may be necessary to enable effective use of indirect income measurement measures. These should include specific measures to overcome the precedence given to the information contained in official books and records of a business.

d. Empower auditors to require banks to provide balance, interest and transaction data, for all bank accounts, including private accounts, held by audited taxpayers.

e. Appropriate changes to offence provisions to ensure adequate sanctions are available to promote taxpayer compliance with these obligations.

77. Comprehensive audits are mandated for a wide range of cases. These audits are undertaken by two auditors and usually take up to 20 days. The audit is in no way tailored to address the risk that caused the case to be selected. A standard methodology is followed and the audit covers five years unless previously audited. The audit is focused on an analysis of the information contained in the official books and records and a comparison with information in returns and other filings.

78. Audit methodologies should be tailored to address specific risks and audit timeframes should be adjusted accordingly. Comprehensive audits are currently a blunt tool that involves a standard review of a range of material. As risk identification and treatment approaches evolve it may be beneficial to introduce a "review" as a first stage in an audit process. A review can be used to identify specific risks relating to a particular taxpayer and allow a tailored audit plan to be prepared in consultation with the relevant audit manager.

79. There is a procedure available to the FTA whereby auditors may utilize indirect methods of income measurement. However, this approach is only available when the books and records of a taxpayer are shown to be incorrect. The mission was advised that this is often a difficult process. Only a small number of audits have been completed using indirect method.

80. A further impediment to an effective audit is the inability of the FTA to obtain and utilize information concerning the private assets (including bank accounts) of individuals to identify undisclosed sales and other relevant anomalies. This means that a taxpayer can effectively divert income away from business bank accounts with little fear of the FTA being able to uncover these transactions. On the same basis taxpayers can accumulate unexplained wealth or expenditure with little risk that these transactions could be used as evidence of hidden taxable supplies. This places serious limitations on the ability of auditors to identify undisclosed sales, unregistered businesses and fraudulent refunds.

81. A capability to undertake more complex audits involving indirect audit methods and dealing with difficult technical and procedural issues should be nurtured. It is important that the FTA build an expert capability that is able to take on the most difficult and challenging cases. It is often beneficial to identify a team of experienced and highly capable staff who can be devoted to this work and to also train others in the law and practice utilized in these circumstances.

C. Social Security Contributions

82. SSC collections amount to more than 70 percent of the total revenue collected by FTA. SSC revenue is distributed to the relevant cantonal health and pensions funds.

83. The contribution base for the calculation of SSC for employees consists of the salary and noncash benefits (e.g., free housing and provision of a motor vehicle). Both the employer and the employee are required to make a contribution. The liability to pay contributions arise upon payment of salaries/provision of benefits and have to be declared and paid on a monthly basis. Table 9 specifies the SSC rate structure.

Table 9. Social Security Contributions—Contribution Rates

(In percent)

Insurance	**Employer**	**Employee**	**Total**
Pension and Disability	17.0	6.0	23.0
Health	12.5	4.0	16.5
Unemployment	1.5	0.5	2.0
Total	31.0	10.5	41.5

Source: FTA.

84. FTA plays a crucial role in providing the benefit entitlement data to the various insurance funds. Data on payment of contributions for each individual is provided electronically by the FTA to the relevant funds. Confirmation of entitlement to health benefits is required every three months, where the health insurance card is subject to renewal based on confirmation from the FTA that the required contributions have been paid. It is not sufficient that the contributions have been withheld from the salary. Pension entitlements will likewise not be credited before the withheld contributions and the employers' contributions are paid to the FTA.

85. SSC filing is required in two stages. Monthly filing (form 2001) is required summarizing the total SSC liability arising from salary/benefit payments in the previous month. Whenever payment is made a declaration (form 1023) has to be filed specifying how the paid contributions shall be attributed to the individual staff members. The later data is submitted by

FTA to the relevant funds as the basis for provision of benefit entitlements. Table 10 specifies employers SSC filing performance for 2014 and 2015.

Table 10. SSC Filing Compliance for Registered Businesses (Form 2001)

Returns filed by Jan. 31, 2016	Number of Returns 2014	Number of Returns 2015
Filed	380.672	358.664
Filed on time	255.080	268.188
Filed with up to two-months delay	73.117	63.698
Not filed	47.202	119.924

Source: FTA.

86. **The mission met with business representatives who raised concerns about the extent of noncompliance with SSC obligations and its impact on the labor market**. The mission was informed that compliant businesses are struggling to compete with competitors that are operating in the "grey economy," particularly with respect to the payment of cash wages. Avoidance of the SSC was stated as the major motivation for this behavior.

87. **State-owned enterprises (SOEs) are to a large extent not compliant with the their SSC obligations**. The mission was advised that a significant proportion of SOEs and other major employers have difficulty paying SSC or have ceased paying all together. As a result, it appears that a practice has emerged whereby pension contributions for retiring employees are only paid when an employee is retiring. Health benefits for employees of noncompliant SOEs appear to be granted even though the required contributions have not been remitted to the FTA.

88. **Extensive nonfiling of SSC returns hampers collection efficiency**. As at end-January, 2016 there were for 2014 and 2015 over 160.000 unfiled returns from employers. Where an employer does not file the monthly SSC return, providing the aggregate SSC liability, the FTA is unaware of the amount due. FTA has to launch, according to current procedures, an audit against the employer, to establish the undeclared contribution liability on a staff specific level, in order to create an enforceable title which can form a basis for collection initiatives. This approach constitutes a major drain on the limited audit resources.

89. **A default assessment procedure for SSC nonfilers could free-up significant audit resources**. FTA should be allowed to issue an estimated default assessment in respect of businesses that have not filed the monthly declaration despite being registered as an employer and having registered specific staff members with the authorities. The assessment amount should be estimated on basis of the information available to the FTA.

90. **Issuance of the estimated default assessment would create an enforceable title which could be immediately pursued by the collection function**. Any collected amounts

could either be off set against entitlements for the registered staff according to a predetermined formula (e.g., health and unemployment benefits before pension) or deposited in an interim account. A return filed by the contributor for the relevant period should automatically replace the default assessment. Discrepancies between that amount of contributions, that should as minimum arise, based on the number of staff that the employer has registered with the local tax outpost, and a return filed by the contributor after issuance of default assessment, should be captured and feed into the risk assessment analytical work to determine the appropriate mitigation strategy.

91. Reporting obligations for new staff seem inadequate. FTA is often unable to prove that undeclared workers, present at work premises, have not started working on the same or a few days previously. Employers have to report data about new staff to the local tax outpost within seven days of employment commencement. Amendments to law were recently prepared to shorten this deadline, requiring the reporting to be made at the latest on the day the new staff commenced working. However, the amendment was not adopted by parliament. In order for such a reporting obligation to be efficient, it ought to require reporting, at latest on the day before the employment arrangement starts. It should be feasible to enable this reporting obligation to be available on-line in a user friendly format to minimize the administration burden on employers.

92. The FTA has introduced a strategy of "ad-hoc" audits that focuses on a range of issues including unreported workers. The mission was informed that the strategy involved the imposition of fines for petty offences and that there had been a positive impact. The strategy had identified approximately 1,100 unregistered workers, 260 unregistered businesses and closed temporarily 460 businesses until such time as they complied with the applicable legal requirement, e.g., properly register all their employees. The use of quick interventions such as these increases public awareness of the FTA's attitude and is a sound addition to the range of approaches being utilized to improve compliance.

93. The system of fines and penalties has some limitations. The following shortcomings were drawn to the attention of the mission:

a. Only the minimum fine can be imposed by the FTA.

b. Regardless of the number of transgressions, e.g., 10 unregistered workers, only one fine can be imposed.

c. The FTA does not have the ability to increase the fine with respect to repeat offenders.

94. The same regime of fines is also utilized for a range of other petty offences such as the failure to issue a fiscal receipt. Consideration should be given to updating the law relating to such fines to ensure they work effectively to improve compliance. This should include a change where the level of the fines better reflects the seriousness and extent of the offence.

D. Arrears Collection

95. Tax and contribution arrears are significant. The stock of tax and contribution arrears under enforced collection action stands at some KM 2.3 billion (or 56 percent of total FTA collections).

96. A major amount of arrears is not accounted for in the IT system. The official arrears amount understates the true level of arrears because tax and contributions that were not paid by the due date but not yet transferred from the local tax office to the cantonal enforced collection units are not included. An accurate figure for this debt was not available to the mission, but officials estimate this amount at approximately KM 1 billion. This would make the stock of debt approximately 80 percent of total collections—a figure that should be cause for concern.

97. There are several reasons for this high level of arrears. The key reasons are the following: (1) There is incomplete and weak headquarters oversight of the recovery process; (2) The recovery process itself is less than effective; and (3) the stock of debt is not well managed. Action is required to address each of these issues if the level of tax and contribution arrears is to be brought under control and reduced to a more acceptable level.

98. Headquarters oversight of the tax debt recovery process has many gaps. Responsibility for the payments enforcement function lies with the Tax Collection Management Department, which comprises two divisions (a division for approving deferred payment and installment arrangements and a division for coordination, monitoring and reporting on field office activities. The entire department presently has only four staff and, like other areas of the headquarters, is critically under resourced. Apart from this obvious weakness, other factors affecting the ability of the department to exercise effective oversight of the recovery process are as follows:

- **Focus is confined only to the enforced collection activities of the cantonal offices**. Debt is not counted as arrears until it is transferred to the cantonal office, which only happens after the local tax office has issued a payment order and 10 days has elapsed. Good practice is to consider all overdue payments as arrears immediately after payment default arises. While the use of payment orders, which serve as a reminder to taxpayers and a warning of consequences if the payment is not made within a specified time, is good practice, the timely issuance of such orders and the prompt transfer of unresolved cases for enforced collection action is an important component of the recovery process. Automated issuance of payment reminders would offer significant advantages.
- **There are insufficient performance standards to effectively monitor the recovery process.** Although some actions are subject to statutory time frames, such as the 10-day period after the issue of a payment order before enforced collections can be commenced, other key activities are not subject to such controls. For example, there is no set time after initial payment default that a payment order must be issued. Work pressures on individual officers dictate timing for this activity. In addition, headquarters staff have no means for

being assured that all such orders are in fact issued and all cases are transferred to the enforced collection divisions, as the process is largely manual. Their estimate of KM 1 billion churn in this process may be indicative of a significant problem.

99. The current approach to arrears collection is not effective. Once a debt case is transferred to the enforced collections division in the cantonal tax office the immediate action is to place a freeze on taxpayer's bank accounts. This is the preferred action because it is considered easy and inexpensive. However, no information is collected on the effectiveness of this action although officials point to anecdotal evidence in support. Further action is taken in the form of identification of debtors' assets and placing a lien on any suitable items found. Such assets can be sold to recover the debt owed. Only partial information is available on the results of the recovery effort, but information that is available shows very modest results that made little impact on the overall debt position. To address this situation, FTA could consider the following:

- *Adopt a more collaborative approach to collection of tax arrears*. Successful collection agencies have come to realize that hard enforcement actions do not always produce the best results. In many cases, a more collaborative approach—working together with the taxpayer to resolve their debt situation—has proven successful. This involves interviewing the taxpayer and gaining an understanding of their payment difficulties and exploring options for how these difficulties may be overcome. Cooperative taxpayers will often agree to take out a bank loan, mortgage their property, sell nonessential assets, etc. Sometimes a deferment or an arrangement to pay by installments is also necessary. Enforced collection than becomes a last resort.
- *Allow taxpayers to request a payment arrangement before enforced collection has started*. The current practice is too restrictive and taxpayers could be allowed arrangements as soon as they realize their payment difficulties. The number of deferments and installment arrangements approved in 2015, is very modest and allows considerable scope for expanding the use of this recovery tool.
- *Limit the use of bank account seizures*. While the freezing of bank accounts should remain an option, the extensive use of this recovery technique in many cases will only augment the taxpayer's difficulties and reduce his ability to conduct business and eventually meet his obligations. A freeze should not be allowed to remain in place indefinitely. In any event, the large number of frozen bank accounts currently in place (purportedly in access of 70,000) has not resolved the FTA's debt recovery problems and may well be forcing greater informality.
- *On a selected and strategic basis, initiate bankruptcy and liquidation procedures*. At present, FTA only joins in on bankruptcy cases but does not initiate its own cases. Given the low revenue returns this should be done sparingly, but is nevertheless a useful tool to stop some taxpayers from continuing to accumulate arrears.
- *Implement better IT support for the arrears collection function*. Lack of adequate IT support means that processes are mostly manual. Modern tax agencies have significant parts of the

process automated, such as payment policing, sending automated reminders, case management, etc. Greater IT support would also better facilitate monitoring of the collection processes and compliance with performance standards.

100. The stock of tax and contribution arrears requires closer management. Of those cases under enforced collection action, some 61,000 cases (77 percent of all cases) representing KM 1.4 billion (62 percent of debt) are in excess of 2 years old. Much of this debt is probably uncollectible and should be removed from the debt stock. Its inclusion significantly overstates the true value of this debt asset and may lead to unrealistic future recovery expectations. Some strengthening of legal provisions may be necessary to support better debt management. For example, current rules for applying the statute bar provisions could be simplified to create better certainty for taxpayers and collections staff alike. Good practice in managing the debt stock requires the following:

- *Temporary removal of all amounts that, following all reasonable enforced collection efforts, cannot be recovered or are uneconomic to recover, to a passive file*. Such amounts can be reinstated as active debts if new collection opportunities arise at a future time.
- *Permanent write off of all debts that can never be collected in the future*. Such debts typically include amounts that have become statutorily barred from being collected because of the expiry of the statutory time period for collection, the taxpayer is a legal person that has been liquidated and no means for further recovery exits, etc.

E. Recommendations

Large taxpayers administration

- Adopt a specialized program for large taxpayer administration that include major compliance related functions, such as taxpayer service and collection in addition to tax audit (by December 2016).
- Revise the large taxpayer selection criteria to ensure the truly largest taxpayers are included, e.g., by addressing the number of employees (by September 2016).

Audit

- Introduce greater flexibility in the comprehensive audit methodology so each audit is tailored to the individual risks of each taxpayer.
- Modernize the audit legal framework to ensure adequate audit powers and authorize effective use of indirect audit methods.
- Ensure that audit cases identified by FTA headquarters as high risk are among those audited by the field offices, while implementing an effective feedback loop allowing the risk analysis findings to be evaluated and continuously improved.
- Alternative approaches should be implemented for dealing with nonfiling taxpayers who already have significant debts.

Social security contributions

- Design and implement a holistic strategy to address the significant level of noncompliance with respect to SSC.
- Implement a default assessment procedure in respect of SSC nonfilers to free up audit resources and to allow a basis for immediate SSC collection enforcement.
- Introduce an easy-to-apply reporting obligation on employers to address the issues of un-declared workers thus allowing improvement in SSC enforcement.
- Revise the penalty regime to support improved SSC compliance by employers.

Arrears collection

- Strengthen headquarters oversight of the arrears collection function.
- Adopt a more frequent use of payment installment arrangements.
- Implement a more active debt write-off program to cleanse the debt base of uncollectible amounts.

V. TECHNICAL ASSISTANCE

101. FAD has not provided technical assistance (TA) to the FTA over the last 12 months. The most recent TA interventions were in 2014 and mainly concerned data exchange between the BiH tax administrations and compliance risk management.

102. U.S. Agency for International Development (USAID) have supported the development of ADRIS and assistance to further develop the tool is expected. The FTA is currently in dialog with the Swedish International Development Cooperation agency on concluding an agreement on receiving TA from the Swedish Tax Administration in the area of CRM and on establishing a RMU.

103. FAD technical assistance is available to support the FTA in further developing and implementing its reform agenda. Financial support from the EU and the Swiss Secretariat for Economic Cooperation (SECO) allow deployment of FAD TA in FTA priority areas. FAD has a roster of highly qualified external tax administration experts covering all areas of tax administration, thus allowing deployment of experts specialized in the relevant subject matter.

104. FTA management finds that FAD technical assistance would be beneficial in a number of areas. Preparation and implementation of institutional reforms, implementation of the FTA strategic plan and improving audit and collection efficiency are among the identified areas where TA would be valuable.

105. A Tax Administration Diagnostic Assessment Tool (TADAT) assessment could help in framing future priorities and reform needs. TADAT is a diagnostic tool which provides a comprehensive assessment of the strengths and weaknesses of a tax administration across various operational areas. Completion of a TADAT assessment would be the best way to establish the "baseline" of the FTA and help identify reform priorities. A possible TADAT assessment will be further discussed with FTA management.

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