THE TAX REFORM IN A FUNCTION OF A REAL DEPRECIATION AND HIGHER COMPETITIVENESS LEVEL

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ABSTRACT: Bosnia and Herzegovina intends to become a member of the EU, and then to join the EMU. A key issue for B&H is to achieve a higher level of competitiveness to increase potential benefits and reduce the potential costs of membership in the single eurozone market. The subject of this paper is an analysis of economic policy measures to increase the competitiveness of the B&H economy for the monetary union and the introduction of the euro. Due to the currency board rules, fiscal policy and tax reform have a relatively high importance in creating greater competitiveness. B&H cannot apply nominal devaluation, but real depreciation has to be achieved by measures of structural reforms of internal adjustment. Internal adjustment, i.e. deflation as a way of real depreciation and creating greater competitiveness, should be implemented through fiscal consolidation and tax reform. A simple, efficient and relatively more competitive tax system is the basis for the faster economic development of the B&H economy towards EU. The aim of this paper is to propose the direction of economic policy, especially fiscal consolidation and tax reforms to adopt B&H’s economy for potentially higher benefits and lower costs, up to the final entry into the EU and EMU.

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KEYWORDS:  Tax reform, taxation of labour, taxation of consumption, Bismarck’s vs. Beveridge’s model, real depreciation, Bosnia and Herzegovina

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1. Introduction

The most important advantages that arise after joining the monetary union are the complete disappearance of currency risk and conversion costs, lower interest rates and more transparent prices, which gives safety with regard to foreign debt, encouraging foreign investment, etc. On the other hand, the inability to conduct autonomous monetary and exchange rate policies to mitigate the cyclical fluctuations in the economy is the largest long-term loss due to entry into the monetary union. Also, in the short term, costs may arise due to the rise or rounding up of prices during the introduction of the euro, as it was also the case in other countries that have adopted the euro.
By applying the Currency Board and its strict rules, as well as the euro as the anchor currency, Bosnia and Herzegovina is practically involved in the European Monetary Union and accepted the monetary policy implemented by the European Central Bank. The benefits and costs of the full introduction of the euro in the future will mostly depend on the economic development of the B&H economy for free competition in the eurozone market. B&H has to overcome the overvaluation of fixed nominal exchange rate of its currency to achieve higher level of competitiveness within the common EMU single currency market. Due to the Currency Board rules, B&H does not have an autonomous monetary and foreign exchange rate policy, and cannot make a nominal devaluation of its currency. B&H needs to reduce the overvaluation of domestic currency and achieve a higher level of competitiveness with other economic policies, primarily with fiscal policy. Structural reforms, including tax reform, should enable relatively reduction of prices in the domestic market compared to prices abroad and thus achieve a real depreciation of the domestic currency.

In order to assess the potential benefits and costs of joining the European Monetary Union, it would be necessary to make a detailed and complete cost-benefit analysis of the effects of joining the monetary union and introducing a common currency. Depending on the ratio of the estimated costs and benefits of joining the monetary union, the economic policy makers, i.e. the Government has a great responsibility to evaluate and decide when it is the best time to introduce the euro.

2. When should the euro be accepted as a common currency?

Any integration (e.g. customs union, common market ...), as well as monetary union, should be a consequence of economic development and convergence among member states so that everyone can achieve net positive effects of benefits and costs. Under the conditions of insufficient development and greater economic differences, the creation of international economic integration leads to even greater divergences between the more developed and less developed regions of the Member States. Therefore, Bosnia and Herzegovina should, in the period up to the EU accession and then to the final introduction of the euro, to achieve a greater degree of real economic convergence, i.e. sufficient economic potential in terms of the size and structure of GDP, as a basis for further development within the Single Market and the Monetary Union. Currently, the economic potential of B&H is far below sufficient for a free market competition on the single monetary and market area of the eurozone. According to data from the World Economic Forum’s Global Competitiveness Report 2017-2018 (WEF, 2018), Bosnia and Herzegovina was ranked on 103rd / 137 place that was much worse in relation to the all EU member states. So, the tax rates were evaluated as one of the most problematic factors for doing business.

The currency board has maintained confidence in the domestic currency. But, due to the B&H’s low competitiveness and labour productivity, the average production costs and thus the prices of goods are considerably higher in B&H than in the eurozone countries. This, along with a fixed nominal exchange rate and liberalized foreign trade, systematically creates overvaluation of the domestic currency which encourages numerous negative economic trends (e.g. continuous foreign trade deficits, rapid growth of external debt, de-
industrialization and employment reduction. This means that the domestic currency is overvalued because real worth less, and foreign currency - the euro is undervalued because real worth more, given the officially fixed nominal exchange rate. The introduction of the euro, under such conditions, will not solve the negative economic trends (foreign trade deficits, growth in external debt, de-industrialization, unemployment ...) that characterize the economy of Bosnia and Herzegovina for many years. Practically, only banks would have a revenue loss, and the population would gain, due to the loss of conversion costs. Also, the population could have costs due to the rounding up of prices in euro.\(^1\)

The key question is: what will be the relationship of nominal and real exchange rate of the domestic currency against the euro at the time of introduction of the euro, or joining the eurozone? B&H should develop and implement a clear economic policy strategy that will reduce the overestimation, or even create an undervaluation of the domestic currency. Only when this is achieved, Bosnia and Herzegovina could be profitably integrated into the single monetary area of the eurozone, with a good basis for further economic development on the principles of its comparative advantage.

The nominal exchange rate between the euro and the convertible mark is fixed through the use of currency board and most likely will not change until the final introduction of the euro. If it could be formally implemented (after the withdrawal of the currency board), nominal devaluation is not a realistic option to reduce the overvaluation due to a number of economic (high openness of the economy, currency substitution and lack of monetary illusions, high external debt, foreign exchange speculation and capital flight, etc.) and non-economic (political instability, distrust in state institutions and the central bank, psychological expectations, etc.) factors. Without the possibility of implementing a nominal devaluation, the real depreciation of the domestic currency should be achieved through a relative reduction in the domestic price level in relation to the price level in the countries of the eurozone. That is why it is necessary to implement radical structural reforms that will reduce the cost of labour and business in the country. One of the most important reforms is tax reform that can achieve real depreciation, i.e. lower domestic goods prices in relation to foreign goods, and thus affect the behaviour of economic entities (consumers and firms).

### 3. The tax system structure in Bosnia and Herzegovina

Tax reform in the function of economic development is one of the most important structural reforms of the transition process. Tax reform should provide a sufficient amount of tax revenue, with lower tax burden and a wider tax base. In other words, this means that tax reform should be implemented through a change in the size and structure of taxes in order to reduce labour costs and stimulate economic development, production and employment. In the long run, the reduction of tax rates on labour and business and the growth of the tax base will also create the growth of tax revenues. First, it is necessary to understand and

\(^1\) The risk of the costs rises because of the rounding up of prices in the new currency is inevitable, which occurred in all countries that have already introduced the euro. But this can be reduced by applying double pricing in the old domestic currency and the new common currency at a given time period (e.g. a year) before and after the introduction of a new currency.
analyse the structure of taxes according to their economic functions. In principle, all taxes have negative effects on economic development, since everything that is taxed (income, consumption ...) is decreasing and so it has to be reduced to a level where, with the widest tax base, maximizes the rate of economic growth. Taxes should be collected on the least harmful way, and spend in the most efficient manner. Theoretically, as long as the marginal cost of the last unit of tax money is lower than the marginal benefit of its consumption, taxation is justified. The collection of tax revenues is more expensive, and the possibility of tax evasion and non-transparency in spending is greater if there are a larger number of different types of taxes in the overall tax structure.

Tax revenues are essential to a certain level, because they serve for the normal functioning of the state (state administration, police, courts, health, etc.). Therefore, in order to reduce tax burdens, it is necessary to simplify the state, i.e. to reform the public sector (public administration reform, the health sector, the pension sector, etc.). The public sector should do as little as possible, inexpensive and focused. Excessive bureaucracy and consequently an inadequate tax system are the main reasons for a slow progress in building full market economies in many transition countries such as Bosnia and Herzegovina. Therefore, public sector reform primarily involves state administration - administration, which is too big in Bosnia and Herzegovina, both in terms of the number of employees and the amount paid in relation to the real sector. Public expenditure in B&H is enormous and amounts to 48% of GDP in 2017. This results in a very high tax burden, especially taxes on labour (over 70%).

High tax burdens have resulted in the escape of the labour force and capital into the shadow economy (Figure 1), which has a negative effect on the size of the public revenue.

In addition, public expenditure in B&H is predominantly non-productive. If the government takes from those who work and create capital (i.e. from production enterprises) and finances those who do not work (non-production public consumption), this has the direct consequence of the economic crisis, i.e. very high unemployment, low economic growth rates and low income per capita (as it has been in the case of Greece). It is therefore necessary to simplify and reduce unproductive state administrative apparatus, to reduce the difference of wages in the public and private sectors, and to reduce the tax burden in the private manufacturing sector. Economic development should be created by the private sector and not by the government, except in the situation of deep recession when the government through public investments can be the actuator of economic development. State unproductive consumption should be reduced to the minimum required level. If the government spends more, then it only redistributes income and creates inefficiency.

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1 For example, the US government’s total public spending was only 2.5% of GDP when it became the most powerful nation in the world. Today is much more, but still much less than in Bosnia and Herzegovina. Since 2009, the US has consistently reduced the share of public spending, and thus tax burdens (Trading Economics (2018)).

2 In the 80s of the twentieth century, Arthur Laffer calculated that if the government through taxes takes more than 50% of earnings, then the economic growth is stopped, unemployment increases and tax revenue decreases.

3 “When we increase taxes for drivers who drive fast they will stop driving fast, when we increase the tax on cigarettes, smokers will stop smoking, when we raise taxes on work, this will lead to a reduction in the number of employees. When the taxes take money from those who are working, earning and create capital, and transfer that money to those who do not work, the number of those who do not work will increase.”; from the Arthur Laffer’s speech in University of Sarajevo on October 30th, 2017.
Reducing tax rates does not have to mean a reduction in revenue, except in the short term. In the long run, a reduction in tax burden can also increase public revenues if the tax base or production is increased. The reduction rate of direct taxes (income taxes, contributions and corporate tax), employers will be less motivated to tax evasion, but will decrease the shadow economy.

In the case of B&H, it is realistic to expect, given the extremely high tax burden on labour (over 70%), high unemployment and the share of shadow economy. Therefore, it is necessary to reduce the average overall tax rate on the lowest level and to achieve a greater tax base, because it will then disappear motive for the shadow economy, and the government will be more honest and more efficient. In addition to reducing the overall tax burden, it is very important to determine the optimal structure of the tax. Some types of taxes have more and some less negative economic effects, depending on what is taxed and

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1 In economic theory, this is explained by the Laffer curve.
2 The MasterCard Company has published the results of the research about shadow economy in eight countries in Central and Eastern Europe (Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Poland, Serbia, Slovakia and Slovenia), entitled "Reducing the Shadow Economy through Electronic Payments". According to this research, the share of shadow economy in Central and Eastern Europe varies from 11.3% in the Czech Republic to 25.5% of GDP in Bosnia and Herzegovina, while the EU average is around 15% of GDP (MasterCard - Ernst & Young (2017)).
3 When Ronald Regan was elected President of the United States, tax burdens were 70%, inflation 14%, etc. But, after the implementation of the economic program measures, whose creator was economist Arthur Laffer, during the two terms of President Reagan (1981st to 1989th), taxes were reduced to 25%, inflation at 3%, and 20 million new jobs were created.
4 However, the correlation between low taxes and low shadow economy, i.e. high taxes and high shadow economy does not have to be. Some Scandinavian countries, for example Norway and Sweden have high tax burdens, but also the low level of the shadow economy. Thus, the confidence of citizens in the state and the feeling that the money collected from taxes is spent in their favour may be more important than the level of tax burden.
how to use tax revenues.¹ According to the tax base and economic functions, taxes are divided into taxes that burden consumption, labour and capital. Taxes that burden consumption include all indirect taxes that can be shifted forward through charging higher prices to consumers (VAT, customs, excise and other taxes on consumption). Taxes on labour are all direct taxes that burden labour income (income tax, pension and health insurance contributions, unemployment insurance contributions, surtax etc.) paid by the worker or the employer. Taxes on capital are all taxes that have assets in the tax base (real assets, intangible assets and financial assets) as well as income from property, or anything that is not covered by taxes on consumption and labour. Tax structure should be determined so as to provide essential public revenues, but with the growth of production and employment. The tax structure should be simple in order for tax collection to be cheap, fair to reduce tax evasion and thus least harmful and economically stimulating for the economy. If taxes are taxed the poor citizens and workers and funded non-productive administration, then it is not good taxes. If the tax base is capital and richer population and finances healthcare, education and public infrastructure, then they are good taxes.

**Figure 2. Indirect, Individual, Corporate and Social Security Tax Rates for 2017. (Comparison of Bosnia and Herzegovina and the European Union Average)**

![Graph showing tax rates](image)

Source: KPMG (2017).

Tax reform in B&H should be implemented in the direction of relative reduction of the relative reduction in taxes on labour and profits in relation to the taxation of consumption and capital. By reducing taxes on labour and profits, labour costs would become lower and higher amount of profit could be reinvested, which would help industry and attracting FDI, the expansion of the tax base and higher exports, and higher public revenues. In that sense, Bosnia and Herzegovina has a good advantage because of the relatively low corporate tax rate at 10 percent (Figure 3) and a flat 10 percent income tax rate that is a significantly lower in relation to the average of the EU member states.

¹ Well-known saying of Professor Arthur Laffer: "All taxes are bad, but some are worse than others." (See, e.g. Childs, M., 2018).
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FIGURE 3. CORPORATE TAX RATES (%)

Source: KPMG, 2017

FIGURE 4. EMPLOYEE SOCIAL SECURITY TAX RATES (%)

Source: KPMG, 2017

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Although the flat income tax rate of 10% is low, total labour taxation is still high due to very high social contributions (old-age pensions and unemployment and health insurance, Figure 4). This negatively affects new employment and investment and creates a shadow economy.

Labour taxation (income tax and contributions) is a complex calculation and requires large human resources, and thus expensive collection of tax revenues. On the other hand, value added tax - VAT is the highest yielding taxes, easy to collect and fair because everyone pays the same percentage. Value added tax (VAT) rate in B&H is flat rate of 17% (Figure 5) and it is one of the lowest rates in Europe. Also, VAT is charged on the principle of destination of goods, which means that the VAT rate on exports from Bosnia and Herzegovina is 0%, thus stimulating export-oriented enterprise.

![Indirect Tax Rates](image)

Source: KMPG, 2017

Due to its characteristics, VAT is the most widely used system of taxation of goods and services in the world. Indirect taxes (Figure 5) on consumption (VAT, customs and excise duties) are much more favourable and economically more acceptable for collecting public revenues from direct taxes that directly burden the production (income tax, contributions) or reduce reinvestment (corporate tax). Also, with a differentiated VAT rate, higher rate on foreign goods and lower rate on domestically-produced goods, it is possible to stimulate the growth of domestic competitiveness and reduce the foreign trade deficit, which is a chronic problem of the economy of Bosnia and Herzegovina.

4. The tax reform measurements and its consequences

The goal of tax reform should be a reduction in the overall tax burden, as well as the adjustment of the tax structure which will reduce costs and thus affect the real depreciation of the domestic currency. In this way, it should be possible to encourage production, employment and exports and reduce consumption from imports. In this regard, we should first implement public administration reform (reduce unnecessary public administration)
which would allow a reduction in the overall level of tax burden. Second, tax reform should enable relatively reducing taxes on labour and exports in relation to the level of taxation of consumption and imports. This means that tax reform should be implemented through the transfer of tax burden from direct taxes (income tax, contributions and income tax) to indirect taxes (VAT, excise duties and customs), which would facilitate business and the overall tax system made less expensive and more efficient.

In accordance with the economic efficiency criterion, the few recent OECD studies on tax and economic growth and its empirical results (e.g., Kneller, Bleaney, & Gemmell, 1999; Johansson, Heady, Arnold, Brys, & Vartia, 2008; Arnold, Brys, Heady et al., 2011) has established the ranking of tax forms as follows:

1. Recurrent taxes on immovable property
2. Taxes on property transactions
3. Consumption taxes
4. Personal income taxes
5. Corporate income taxes

Corporate income taxes are recognized as the most harmful for economic growth, because they restrict the economic activities of the firms and investments. So, the personal income taxes (income tax and social security contributions) are recognized as more harmful for economic growth than consumption taxes. Finally, the recurrent taxes on immovable property and taxes on property transactions are recognized as good taxes because they shift some investment out of housing into higher return investments and increase the economic growth (Arnold et al., 2011, pp. F70-F71).

Since the corporate tax is recognized as the most harmful, a good measure would be to completely avoid this type of taxation. This can be done by following the example of Estonia, where the corporate tax was replaced with the tax on paid earnings, and the tax is charged only on the dividend paid to the shareholders, i.e., which leaves the company and not on reinvested profit. The share of revenues from corporate income tax in total fiscal revenues is minimal, and its abolition would not have a significant loss for the state. The abolition of corporate tax will encourage entrepreneurship, so the loss of revenue would be quickly compensated through new production and reinvestment (new technology and equipment, training of personnel, etc.) which would bring very positive effects for the economy and society as a whole.

Contributions have a dominant share in the taxation of labour, while the income tax is rather low. Therefore, special attention should be paid to the reform of contributions (contributions for health, pension and unemployment insurance). Health insurance contributions have the highest share in total liabilities on wages of 35%, which significantly affects the price of labour and competitiveness. The model of health and pension financing in B&H is based primarily on the contributions, known as the Bismarck model.² The Bismarck

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¹ According to the International Tax Competitiveness Index 2017, Estonia has the most competitive tax system in the OECD (35 developed countries (Tax Foundation, 2018).

² Bismarck’s model, named after the German Chancellor Otto von Bismarck, designed in the second half of the XIX century and applied in many countries (Germany, Austria, Switzerland, France, Czech Republic, Netherlands, Luxembourg, and Japan).
model is based on the solidarity of all insured persons and unprofitability, where employers and employees pay contributions at a certain percentage, enabling all insured persons minimum health care and retirement payments to existing retirees. Bismarck's Social Insurance System is based on solidarity because those who earn more and pay more, but everyone has equal opportunities to realize health care as needed. But, due to the high burden of labour costs, this model of health care financing is not sustainable in the long run, and it is necessary to transform it from the model of financing by contributions (Bismarck model) into the model of financing by the taxes from the budget (the so-called Beveridge model). The essence of the Beveridge National Health Insurance model is that the state mainly provides for the financing of health insurance by allocating funds from the budget and all the population freely uses certain health care services.

| CHARACTERISTICS                        | BISMARCK'S MODEL                                              | BEVERIDGE'S MODEL                                              |
|----------------------------------------|--------------------------------------------------------------|---------------------------------------------------------------|
| Financing                              | Contributions of employers and employees from wages          | All public tax revenues in the budget                          |
| Management                             | Independent bodies composed of representatives of employers and insured persons | The State Government                                            |
| Deciding on the rights and obligations of the insured persons | The bodies of public or social insurance who are responsible for managing funds | The State Government                                            |
| Coverage of the population             | Most of the population                                       | The whole population                                           |

Source: WHO, 2011.

The pension system and unemployment insurance are also funded from contributions on the principles of Bismarck's model. This system also is not sustainable for a number of reasons: poor general economic situation, deterioration of relations employed/unemployed, an increasing share of the older population, longer life expectancy, etc.

Changing the model of the health and pension insurance system from the financing with contributions (Bismarck model) to the model of financing with indirect taxation from the budget (Beveridge model) will allow significantly lower tax burden on labour and higher international competitiveness of the economy. This would create the preconditions for higher production, FDI inflow and export growth.

By reducing the tax burden on labour and the abolition of corporate tax, and by collecting the necessary revenues dominantly through indirect taxes, the tax system in B&H would become more efficient, simpler and more transparent.

The reduction of public revenues in the interim period, due to a significant reductions or abolition of direct taxes (corporate tax and contributions) should be offset by public sector savings or, if it is necessary, by increasing taxation of consumption and luxury (VAT and

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1 Beveridge's model, named after William Henry Beveridge, designed as a basis for Britain's National Health System after Second World War and is used today in many other countries (Great Britain, Ireland, Iceland, Norway, Sweden, Denmark, Finland, Italy, Spain, Portugal, Greece, Canada, Australia and New Zealand).
excise) and other direct taxes which do not burden the economy (taxes on immovable property, taxes on uncultivated agricultural land, taxes on unused economic buildings).

In the long run, the tax system will be more efficient and generate higher total revenues due to the expansion of the tax base and accumulation of capital. This will be a direct consequence of a reduction in overall tax burden and a better tax structure in terms of a relatively larger reduction in direct labour tax (contribution) than taxation of consumption and other taxes that do not burden the economy. The wider tax base will be the result of cheaper business and the entrance of unregistered producers from shadow economy into registered producers. Also, the reduction of taxes on labour (income tax and contributions) and the abolition of corporate tax should increase the attractiveness of Bosnia and Herzegovina for business and inflow of FDI.¹ In the globalized world economy, the level of taxation and labour costs are one of the key factors that affect the movement of capital from countries with higher taxation to countries with a lower level of tax burden on labour and business. Excessive bureaucracy with high tax burden and a segmented market are the main reasons which discourage foreign investments.

In the long run, the production and higher income lead to greater consumption and higher revenues from VAT.

As a negative consequence of tax reform may be a short-term price increase if it is necessary to increase VAT. But in the long run, VAT growth should not cause an inflation spiral. Namely, in the long run, lowering taxes on labour and business will cancel the impact of the higher rate of VAT on prices. It is realistic to assume because labour costs - wages are the main share in the total costs of most production. The overall effect of the tax reform will not be negative because the increase of production, employment and exports will create higher national income that will increase the standard of living, regardless of a certain increase in prices due to VAT growth.

Finally, in addition to the size and the structure of the tax, it is very important and how to use tax revenues. The government should use the new revenue for productive public investment (e.g. infrastructure construction), which are complementary to the rest of the economy as drivers of economic growth and multiplied growth in private investment. If new revenues are used in unproductive or administrative spending, the multiplier effects on the economy will be negative. Taking taxes from those who produce and create jobs and transfer to unproductive public spending has catastrophic economic and other consequences (unemployment, continuous deficits of foreign trade and foreign debt, capital flight, poverty, emigration from the country, etc.).

In addition to reducing or abolishing fiscal burdens, subsidies in the most promising economic sectors that have a high value-added need to be introduced, because it affects the growth of wages. As taxes limit and make less attractive a particular branch, subsidies make more attractive certain economic branches.

¹ According to the Forbes’ Best Countries for Business 2018, Bosnia and Herzegovina is the worst European country for business. Bosnia and Herzegovina is ranked on 97 place among 153 nations on different factors such as: tax burden 111, property rights 115, innovation 122, technology 68, corruption 72, personal freedom 92, trade freedom 42, monetary freedom 33, red tape 145 and investor protection 60 (Forbes, 2018).
Reducing the tax burden and the introduction of subsidies should enable an increase in the tax base, which will result in the maintenance and growth of tax revenues.

Lower tax burdens on labour and business would reduce costs and domestic price level, as well as the overvaluation of the domestic currency. By achieving the real exchange rate, or even undervalued exchange rate of its currency, B&H could be successfully integrated in the EU common market as well as the single monetary area of the eurozone.

5. Conclusion

The direction of tax reform is clear. The public sector reform (public administration, health and pension system) should allow cuts in public spending and the overall tax burden. Also, the overall tax system should be restructured with regard to sources of taxation, so the tax burden should be reallocated in a way that stimulates the production, investment and exports, while discouraging excessive consumption and imports. It is necessary to reduce the relative share of taxation of labour and business, and increase taxation of consumption and assets. Lower total tax burdens will not reduce public revenues, but in the long run they should increase. The lower taxation of labour and business will affect the higher economic growth and employment. Necessary tax revenues should be created with lower tax burdens on a wider tax base, but not through higher tax rates or by introducing new tax forms. By reducing the taxation of labour and business, the economy would be more competitive abroad because of lower costs and prices, as well as more attractive for FDI inflow. This would also reduce the overvaluation of the domestic currency, increased the potential benefits and reduce costs after B&H’s entry into the common market of the European Union and then into the European Monetary Union.

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