



## Bosnia's alcoholic daze: The perspective of BiH's industrial future

### SUMMARY

The chemical industry is one of the main pillars of BiH's economy exporting more than 500 million KM worth of products in 2012. At the same time, its development has been impeded due to unfavorable legislation regarding the import of an important ingredient – the denatured alcohol.

As a result, companies are forced to choose between not importing this ingredient at all, thus being unable to develop certain products; or, importing it at extremely high cost. The analysis of just three products in the chemical industry that represent only 9,12% of the total trade volume, reveals that the losses incurred to companies climb to more than 37 million KM in the past nine years.

At the same time, relevant state institution has constantly refuted initiatives to amend the excise law. However, if BiH seriously considers the EU as an ultimate goal, the relevant legislation will have to be changed as the EU is having rather different approach to this particular problem.

Around 130 kilometers north-east from Sarajevo, the capital city of Bosnia and Herzegovina (BiH) lies a small town of Gornji Vakuf. Famous for its breath-taking nature as well as for four centuries old historical monuments, it is also home to "Paloč", a company producing a wide array of chemical products, such as laundry detergents, softeners, liquid soaps, detergents for dishes and scouring preparations. In addition to this, the ambitious company owner, Anto Zeko, expanded the business further and built a power generation facility and a small hydro power plant.

What started as a small start-up with four workers grew into a respected company employing more than forty people. The owner's plans were even bigger; he planned to expand production and introduce additional products, for example defrosters. But the realization of these goals was halted by the state. More specifically, it was halted by a single article of the excise law prescribing heavy taxes on a much needed ingredient, the denatured alcohol.<sup>1</sup>

## Genesis of the Problem

From 1995 until 2004, the excise tax collection was under the jurisdiction of entities. 2003 marked the beginning of the indirect tax system reform in BiH through the adoption of a series of laws designed to create a single state level institution responsible for the collection of indirect taxes, such as VAT, custom duty or excise tax. On 29 December, 2004, both chambers of the Parliamentary Assembly of BiH adopted the Law on Excise Tax in BiH. Three days later, on 1 January, 2005, the law came into force and the excise collection was centralized for the entire territory of BiH. The updated version of excise law has been adopted in the summer of 2009.

The newly created Indirect Taxation Authority of BiH (ITA BiH) was zealously performing assigned duties and the tax income including excises grew steadily. In addition to this, the organization itself was growing and is now the biggest state institution with more than 2,400 employees.<sup>2</sup> Joly Dixon, the former Chairman of Governing Board of ITA BiH, proudly claimed that:

*“ITA BiH successfully united tax administration in BiH, efficiently introduced VAT system and together with Border Police protects the country from smuggling and other criminal activities”.*<sup>3</sup>

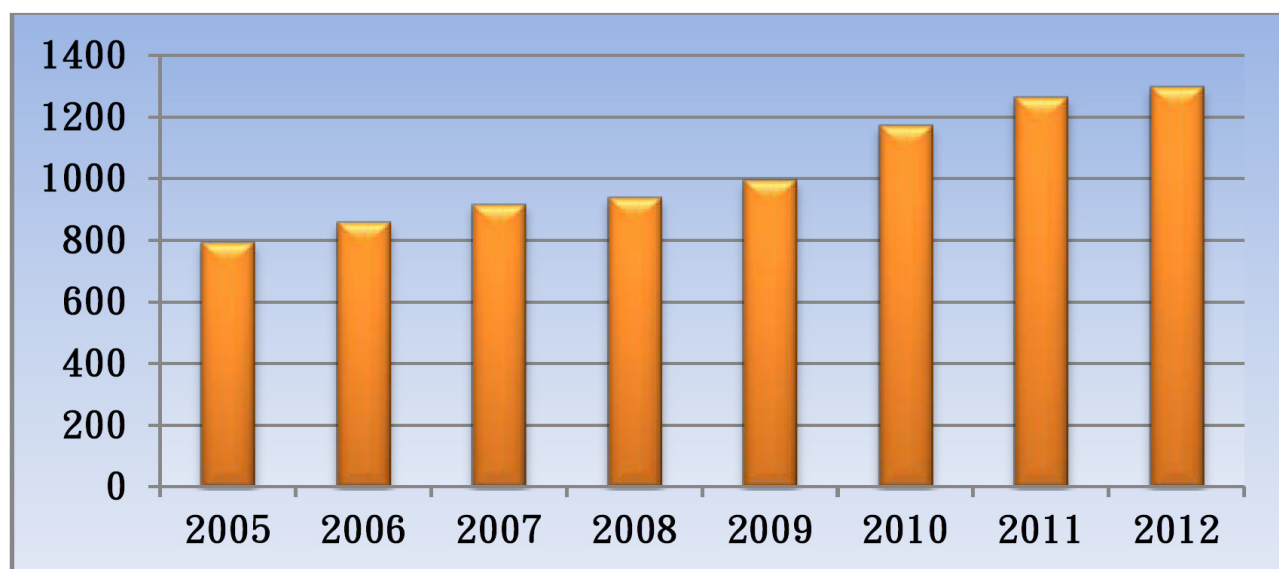
While the establishment of the state-level indirect tax authority could be seen as one of great successes, there is also another side of the story, which is not often in the spotlight. The Law on Excise Tax adopted in 2004 with additional amendments adopted in 2009 proved to be damaging for chemical industry in certain aspects as the rising tax revenue continues to take its toll on the companies.

## Burden for Companies

Article 19, Chapter 4, of the Law on Excise Tax<sup>4</sup> sets out the rule that the excise tax for one liter of imported absolute alcohol<sup>5</sup> is 15 KM.<sup>6</sup> No differentiation is made between denatured (industrial) alcohol and drinking alcohol, and the same amount of taxes is levied on both products.

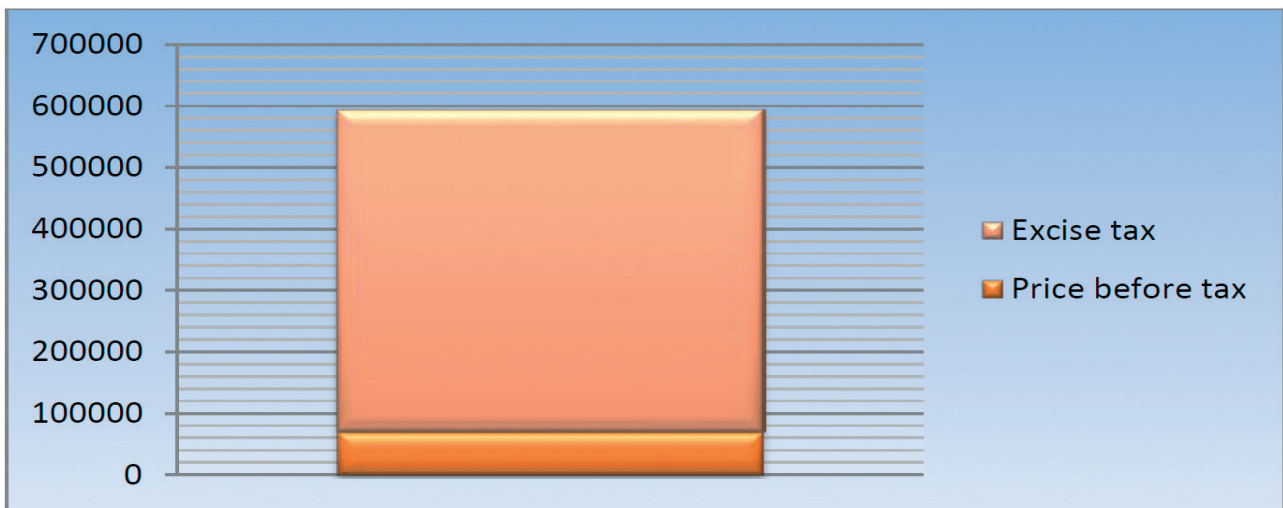
15 KM is the cost of 1 liter of imported absolute alcohol regardless of its use (chemical industry or beverage industry).

The only concession made to the importers of denatured alcohol is that they can request a refund of excise taxes they paid for imported goods once the tax authority successfully confirms that the imported alcohol was used as an intermediate product for industrial purposes. But how does this look like in practice?



Collected excise tax on imported and domestic products (in millions KM)

Source: Indirect Tax Authority of BiH



Cost breakdown – import of single cistern of denatured alcohol in BiH (in KM)<sup>7</sup>

Source: ITA BiH, Populari interview

If “Paloč” decided to import a single cistern with 35,000 l capacity of denatured alcohol, it means that the company owner would have to pay 525,000 KM of excise tax on top of the 70,000 KM paid for the alcohol itself. In other words, the excise tax on alcohol amounts to 88% of the total cost and would temporarily inflate the cost of alcohol as raw material used in production.

Using this alcohol for industrial production, the company would be entitled to claim excise return. But to do this, it would have to go through a rigorous procedure of proving that the imported alcohol was strictly used for industrial production and not for drinking or production of alcoholic beverages. The law prescribes that this procedure can take up to one month, which still creates a significant financial pressure on the already stretched balance sheets of BiH companies.

Crediting the state with a more than 500,000 KM over a one month period is something that very few companies can do and stay afloat, as this seriously undermines liquidity.<sup>8</sup> Understandably, the owner of “Paloč” decided to forsake any further development in the chemical sector, because he simply could not afford to import denatured alcohol any longer.

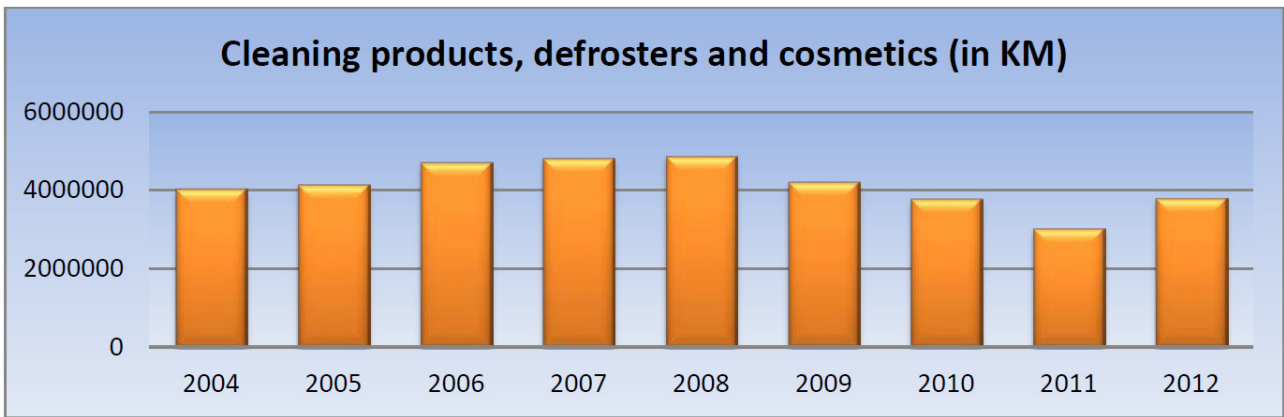
Nowadays, other companies that, despite all odds, continue to pursue the production of this type of products are forced to improvise and take substantial losses in the process. For example, a company from Sarajevo, “Likval”,<sup>9</sup>

was forced to contract one Slovenian company to buy denatured alcohol in Croatia, transport it back to Slovenia, carry out the necessary processing operations, and finally sell it back to “Likval” as a final product.<sup>10</sup> While the final product of this sort is exempt from taxation under the Excise Tax Law, “Likval” was forced to pay Slovenians almost 30% of the sale value, thereby undermining profitability of the entire operation. This way the money is unnecessarily extracted from BiH economy and transferred to foreign companies, which further hampers domestic business development.

Bosnian companies are losing almost 30% of the contract value due to unfavorable legislation.

Just by looking at three types of products such as cleaning products, defrosters and cosmetics we can roughly estimate that around 37 million KM has been extracted from Bosnian companies in last nine years and transferred abroad. It is worth remembering that the total value of these three groups of products that is around 186 million KM constitutes merely an 9.12% of total chemical industry trade volume.

But prior to all these losses actually happening, Likval, Paloč and many other similar companies tried to send this message across to relevant institutions - the state Parliament and the working group drafting the updated excise law back in 2003.



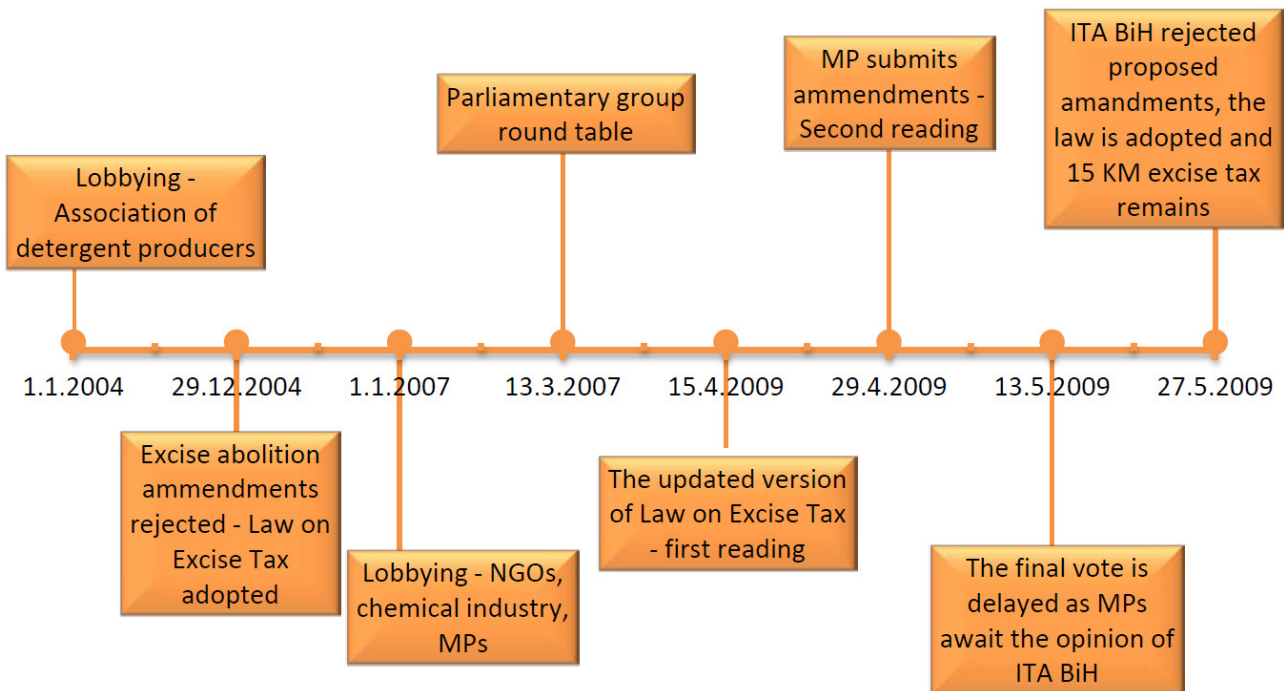
Value of money BiH companies lost during the production of three specific products

Source: Agency for Statistics of BiH

## Lobbying

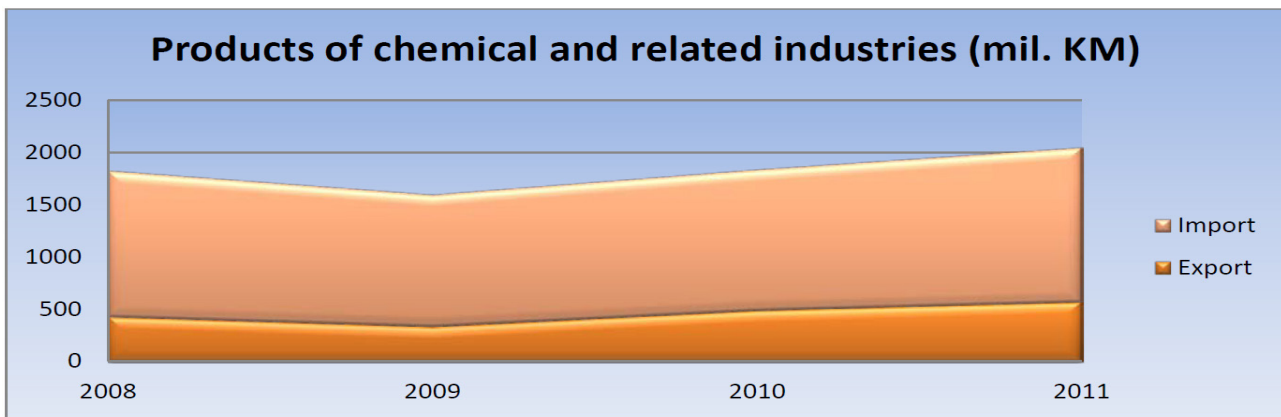
Year 2002/2003 witnessed extensive lobbying activities of chemical companies directed towards the state level parliament. During this period, the working group<sup>11</sup> of ITA BiH was drafting the excise tax law, and parliament was subsequently discussing amendments. To get their message across, entrepreneurs formed an Association of detergent producers and presented their case to the state parliament. But there was no success in that regard as all proposed amendments were rejected and the working groups of ITA BiH never met with private sector representatives.

Struggling companies revived the pressure once again in 2007 organizing round tables and other events, while the updated version of the Law on Excise Tax reached the parliament in 2009 independently of their actions. This time the amendments addressing the excise tax problem were proposed by Šemsudin Mehmedović, a Member of Parliament (MP) from the Party of Democratic Action. But once again, the Governing Board of ITA BiH refused to accept any amendments. Dragan Vrankić, Minister of Finance at the state level at the time and member of the Governing Board of ITA BiH, explained reasons behind this:



Timeline of activities regarding the two unsuccessful bids to change the Law on Excise Tax

Source: State Parliament's transcripts, Populari interviews



Trade volume in the chemical and related industries  
 Source: Agency for Statistics of BiH<sup>14</sup>

*“All those amendments that you are proposing were already discussed in the first phase while working group was drafting the law... There were no objections on the proposed law from entity parliaments...And members of Governing Board informed me that they will not accept any changes”.*<sup>12</sup>

The question then arises on what is the rationale behind state institutions’ refusal to accept any changes to the law. According to Dinka Antić, the chief of Macroeconomic Analysis Department of ITA BiH, the reason lies in the fact that:

*“Unlike in the EU where excise products can be traced and monitored electronically, BiH does not have such system and it is understandable that the state wants to prevent tax evasion.”*<sup>13</sup>

Keeping in mind that this issue was on the agenda back in 2003 already, and that ten years have passed since then, one could rightfully expect that all objections including the risk of tax evasion could have been sorted out during this period. It is unfair to punish law-abiding companies because few might attempt fraud; in addition, this risk could be greatly reduced if BiH adopted the EU model, which makes the process of reverting denatured alcohol back to its original condition near impossible.

By continuing the current model of excise tax collection, the state might be hurting the hand that feeds it by ignoring the wider socio-economic

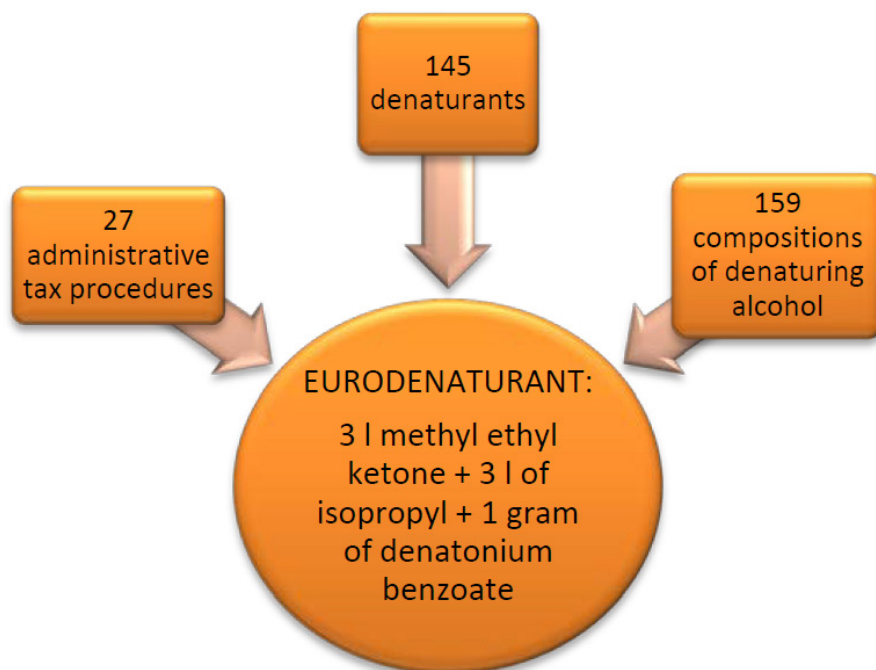
context of law legislation. Having exported more than 500 million KM worth of products in 2012, the chemical and related industries are an important pillar of BiH economy.

Chemical and related industries achieved more than 500 millions KM worth of export in 2012.

The success of ITA BiH in the tax revenue collection is countered by the rising unemployment with rigid tax regulations discussed and perceived solely in their fiscal aspect. Even the composition of the ITA BiH Governing Board is a reflection of this logic, as finance ministers are the only representatives of state and entity governments. At the same time, the state Minister of Foreign Trade and Economic Relations, as well as entity ministers of trade and industry are not included nor invited to the sessions. Their exclusion is hindering the assessment of proposed tax laws in their entire economic and social context.

### How It’s Done in the EU?

At the time when BiH is coping with its backward system, the EU is taking a rather different approach towards the issue of excise tax on denatured alcohol. According to the EU regulations, denatured alcohol used for industrial purposes and made unfit for drinking by adding specific denaturants<sup>15</sup> is exempt from excise tax. The Council Directive on the harmonization of the structures of excise duties on alcohol and alcoholic beverages of 1992



European Commission plan to streamline the administrative processing of denatured alcohol  
 Source: Joint Research Center, European Commission

(92/83/EEC) provided a clear definition of the alcohol products that are subject to excise duty, detailed how the duty is calculated and provided exemptions from duty. Furthermore, after the negotiations for full harmonization of excise duty rates failed, the Directive on the approximation of the rates of excise duty on alcohol and alcoholic beverages (92/84/EEC) resulted in the adoption of minimum rates that need to be respected by all EU members.

Further complicating this issue, each Member State uses its own list of denaturants with approximately 145 denaturants allowed on the EU level. This proved to be a significant administrative burden, and as the list of denaturants was growing larger, the EU decided to counter this problem. In 2007 European Commission instructed the Joint Research Centre (JRC)<sup>16</sup> and a large numbers of chemical laboratories to come up with a common denaturing procedure (euro-denaturants<sup>17</sup>) for the purposes of completely denaturing the alcohol. In June 2011, the JRC published its final report outlining the common denaturing procedure to be applied in all Member States as of 1 July, 2013.<sup>18</sup> The ideal, completely denatured alcohol is to be achieved by adding 3 liters of *methyl ethyl ketone* plus 3 liters of *isopropyl* plus 1 gram of *denatonium*

*benzoate* to 100 liters of alcohol.<sup>19</sup> Using this method, the denatured alcohol will be relieved from excise tax and the administrative procedure streamlined throughout the entire EU. At the same time, laboratories will regularly monitor the content of denatured alcohol to make sure there is no fraud. This way the 'Eurodenaturant project' was born.

BiH is also equipped with the laboratory equipment needed to test the content of alcohol and detect relevant denaturants, as has been pointed out by Šemsudin Mehmedović.<sup>20</sup> However, despite existing equipment, the current Excise Tax Law makes its usage pointless as despite test results, chemical companies would still have to pay excise tax. But as in many other things, there is neither political will nor interest to push for the resolution of this problem. In order for it to be solved, institutions such as trade chambers and relevant ministries should finally stand behind such an initiative and put it on the agenda of the Council of Ministers. In that case there would be a certain leverage behind such demands, and if private companies were not successful in pushing their amendments through, perhaps the Governing Board of ITA BiH would listen more carefully to its colleagues from other state institution.

On its road to the EU, BiH is perhaps unsuccessful in solving Sejdić-Finci case due to political dimension of the question, but many other issues such as the one elaborated in this policy brief, can be solved without any implications for the political arena. It will require some effort to address the problem of denatured alcohol's excise tax, but this nonetheless must be done sooner or later as BiH should comply with EU regulations if it considers

its European integration process as a priority. What is more, positive effects of resolving this issue would be felt by companies in both entities, while the state would prove it is capable of making concrete economic reforms. In the time of great problems, it is small steps that can give hope in a better future and increase the levels of much needed optimism.

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## Endnotes

- <sup>1</sup> Denatured alcohol is ethanol made unfit for the drinking by adding another chemical to it and is heavily used in chemical industry.
- <sup>2</sup> "Šest godina postojanja UIO BiH", 22 October, 2010
- <sup>3</sup> Dnevni avaz, 29 April, 2006 "Dikson: Dodik želi destabilizirati UIO".
- <sup>4</sup> Law on Excise Tax in BiH, PSBiHNo.370/09.
- <sup>5</sup> Ethanol containing not more than 1% mass of water. Ethanol (C<sub>2</sub>H<sub>5</sub>OH, ethyl alcohol) is one of the alcohol class of compounds, and is the main psychoactive ingredient in alcoholic beverages.
- <sup>6</sup> Based on the middle rate for foreign currency exchange, 1 KM is equal to 0.51 EUR. 13 September, 2013
- <sup>7</sup> Import price is the average price BiH companies pay to import denatured alcohol from Croatia.
- <sup>8</sup> Liquidity represents the ability of a company to pay short-term and long-term expenses as they fall due.
- <sup>9</sup> "LIKVAL" Ltd. Sarajevo is a company for the production and processing of chemical aperients, as well as a trading company.
- <sup>10</sup> "Zakon o akcizama uništava domaću proizvodnju", Oslobođenje, 20 November, 2006.
- <sup>11</sup> The working group consisted of experts working for the Governing Board of ITA BiH, representatives of ITA BiH, and representatives from both BiH entities.
- <sup>12</sup> Transcript from the 54<sup>th</sup> session of House of Representatives of BiH Parliamentary Assembly, held on 27 May, 2009
- <sup>13</sup> Populari correspondence with Dr. Dinka Antić, Head of Macroeconomic Analysis Department at ITA BiH, 17 May, 2013
- <sup>14</sup> Info on the detailed list of products included in the chemical and related industries available at Agency for Statistics of BiH website in the document "Activity based product classification in BiH".
- <sup>15</sup> Denaturants are added to the alcohol during the process of denaturation. Examples: acetic acid, ethanol, methanol, formaldehyde etc.
- <sup>16</sup> The Joint Research Centre is the scientific and technical arm of the European Commission. It is providing the scientific advice and technical know-how to support a wide range of EU policies. The JRC has seven scientific institutes, located at five different sites in Belgium, Germany, Italy, the Netherlands and Spain, with a wide range of laboratories and other unique research facilities.
- <sup>17</sup> Eurodenaturants is a name given to the list of agreed denaturants currently used in the EU.
- <sup>18</sup> Commission implementing regulation (EU) No 162/2013
- <sup>19</sup> "Europe's Complete Denaturing Obsession", Robert Vierhout, Ethanol Producer Magazine.
- <sup>20</sup> Populari interview with Šemsudin Mehmedović, a Member of the state level Parliament, House of Representatives on 21 May, 2013

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## Glossary

Alcohol usage	<p>Apart from the usage described in this brief, there is more than one use for alcohol:</p> <ul style="list-style-type: none"><li>• Drinking – significant percentage of the adult population drink alcohol</li><li>• Burning – it is possible to use ethanol and methanol instead of fossil fuel as it burns cleanly and produce carbon dioxide and water only</li><li>• Wearing – certain types of alcohol are used in perfumes and the amount added depends on whether company is making perfume, toilet water or cologne</li><li>• Dissolving – ethanol is used to dissolve chemicals that are indissoluble in water</li><li>• Cleaning – the mixture of ethanol and methanol is very good for cleaning paint brushes although it is highly poisonous</li></ul>
Industrial chemistry	<p>The manufacture of basic chemicals such as oxygen, chlorine, ammonia, and sulfuric acid provides the raw materials for industries producing textiles, agricultural products, metals, paints, and pulp and paper. Specialty chemicals are produced in smaller amounts for industries involved with such products as pharmaceuticals, foodstuffs, packaging, detergents, flavors, and fragrances. To a large extent, the chemical industry takes the products and reactions common to “bench-top” chemical processes and scales them up to industrial quantities. (Britannica)</p>
Excise Tax	<p>Excise duties are indirect taxes on the consumption or the use of certain products. In contrast to Value Added Tax (VAT), they are mainly specific taxes, i.e. expressed as a monetary amount per quantity of the product. In BiH the excise duties are applied on alcohol, manufactured tobacco products, oil derivatives, wine, beer, coffee and non-alcoholic beverages.</p>

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