

**BOSNA I HERCEGOVINA
FEDERACIJA BOSNE I HERCEGOVINE
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**BOSNIA AND HERZEGOVINA
FEDERATION OF BOSNIA AND HERZEGOVINA
FEDERAL DEVELOPMENT PLANNING INSTITUTION**

**ANALYSIS
OF THE MODEL OF TAXATION OF ALL INCOMES FROM EMPLOYMENT
IN THE FEDERATION OF BOSNIA AND HERZEGOVINA**

Sarajevo, June 2015

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Introduction

Today, the Governments globally fund social needs by payroll taxes, contributions, income tax and other taxes.

Traditionally, our pension and health systems lean on the contributions "from salaries" and "on salaries". In essence, these are obligations arising from the work of an employee which is defined as the tax wedge. The tax wedge is the difference between what the employee receives as compensation for the work and the total amount that the employer sets aside for the employee. In most countries the tax wedge increases as the employee's income increases.

High taxation of labour may have negative effects on employment. These effects are particularly important for workers with low income and low education levels. According to the analyzes that have been done in the process of developing the Europe 2020 strategy, the countries that have historically had high taxation of labour, missed the chance for higher employment and such a thing should be avoided. This strategy paper suggests that the EU Member States should transfer the burden of taxation from labour to energy and environmental taxes, and taxes on consumption.

The current situation in Bosnia and Herzegovina is such that we have a mismatch between the taxation of labour between the Entities, i.e. we do not have a single economic area in this matter. This situation often leads to confusion and problems for investors in verifying the situation on the ground, as well as to a poor business image of both BiH and the FBiH.

In addition to the inter-Entity disharmony in the way of taxation, the facts suggest that the tax wedge in the FBiH is among the highest in Europe. This situation significantly complicates business and reduces the competitiveness of our companies, especially in labour intensive activities.

The current method of taxation of salaries in the FBiH allowed a significant part of the income of workers to be paid through untaxed compensations in the form of hot meal allowance, transportation costs, holiday allowance and other benefits.

All this has a negative impact on economic growth and new employment, and significantly hinders operations and reduces public revenues.

In addition, the high taxation of labour in the FBiH co-exists with a relatively low tax burden by other forms of taxation that do not impact negatively on economic growth and employment, such as taxes on property, real estate, consumption, pollution, energy consumption, etc. This indicates a possibility of shifting the tax burden from labour to other taxes.

Overall, the solutions for all the above imbalances in the tax system should, cumulatively

speaking, lead to the realization of the main objective in the area of tax policy which reads: Reduce, unify, simplify and make more equitable the taxation of labour and thus contribute to a higher economic growth and employment in the FBiH.

To achieve this aim, it is necessary to take actions to reduce the tax burden on labour, especially in labour-intensive sectors, the approximation of methods of salary taxation in BiH, and the abolition of the practice of payment of non-taxable fees which have the character of salary.

It should be noted that the aim of this document is not an increase in public revenues or an additional burden on the economy. In other words, taxation of all benefits based on labour should be revenue neutral, without increasing and without reduction of the existing level of tax revenues.

Inconsistency with the principles of taxation within BiH and the EU

Inconsistency in the way of labour taxation within BiH leads to confusion and negative impact on the single economic space of the country.

According to the applicable regulations, taxation of dependent employment is regulated differently in the Entities. In the Republika Srpska, the base of personal income tax is the difference between taxable incomes of employees (gross salary + all cash and non-cash incomes, fees and benefits in gross amount) and calculated contributions, net of the amount of personal deductions and deductions per the tax card. In the FBiH, the taxable income consists of only gross wage, without other benefits (hot meal allowance, transport, holiday allowance, etc.) that are non-taxable.

When it comes to personal deductions, regulations are also arranged differently in the two Entities.

Below is a comparative overview of personal deductions in the FBiH and in the RS.

Table 1: Overview of personal deductions in FBiH and RS

Category	Federation BiH	Republika Srpska
Basic personal deduction	3,600 KM annually or 300 monthly.	2,400 KM annually, or 200 KM monthly
Deduction based on a dependent family member	Differentiated height of deduction, e.g. 150 KM monthly for a dependent spouse and the first child, 210 KM monthly for dependent second child, 270 KM monthly for dependent third and each subsequent child.	900 KM annually, or 75 KM monthly for all dependent members linearly.
Limit for the status of dependent family member	3,600 KM of revenue annually, or 300 KM monthly.	3,000 KM of revenue annually, or 250 KM monthly

Source: Tax Administration of the Republika Srpska

Table 2 shows the comparative overview of payroll in the FBiH and in the Republika Srpska. The main difference is that in the Republika Srpska the gross base for calculating contributions includes all incomes that are taxed in accordance with the Law (hot meal allowance, transport, etc.), while this is not the case in the Federation of BiH. In the RS, the tax base (gross income less contributions) is reduced by personal deduction of 200 KM (every employee has this deduction, regardless of having the tax card or not) and a deduction based on the tax card (deduction for dependent immediate family members) and thus we get a base for the calculation of income tax. In the Federation of BiH, unlike in the RS, the right to deductions by the amount of basic personal deduction and on the basis of dependent family members are defined together by one tax card, and an employee who does not have a tax card, he/she cannot use the aforementioned deductions.

Table 2: Comparative overview of calculation of salaries in FBiH and RS

Comparative review of calculation of salaries in FBiH and RS	
FBiH	RS
Gross salary (base for calculating contributions) (1)	Gross salary (1)
- Contributions from the base (31%)	+ All taxable personal incomes (food, transport, etc.) + all "benefits" based on work
= Taxable salary (net salary with tax) (2)	
- Utilized personal deductions (per tax card)	
= Tax base (3)	= The base for the calculation of contributions (2)
x 10 %	- Contributions (33%)
= Amount of tax (4)	= Taxable salary (3)
Net for payment = (2) – (4) (5)	- Deduction for personal deduction and on the basis of tax card (4)
+ Non-taxable incomes (food, transport, etc.)	
= Total to be paid out to employee (6)	= Tax base (5)
	x 10% (5)
	= Income tax (6)
	Net incomes of the employee (7) = (3) - (6) (7)
Contributions paid by the employer are calculated at the aggregate rate of 10.5% on gross salary.	Contributions paid by the employer are not calculated!

Source: Tax Administrations of the FBiH and the Republika Srpska

As a result of disparities in the economic area and the principle of taxation, we have a situation in which the FBiH is represented as a place with a higher tax burden, while the reality is completely different.

High tax wedge (high taxation of earnings) in the FBiH

The taxation of the costs of earnings has three main components: the share of employees in social security contributions, the share of employers in social security contributions, and personal income tax. In accordance with the above, the FBiH is ranked very high by the

taxation of labour in comparison with other countries.

Table 3 and Chart 1 show the total tax wedge in some OECD countries in 2014. The overview of countries is conditioned by available comparable data. Given that the countries usually have different levels of taxation for different levels of income and number of household members, for easier comparison, the level of the tax wedge is presented for a single individual without children, with an average level of income.

Looking at Table 3 and Chart 1, it is obvious that the FBiH is just behind Belgium by the tax burden on labour (before Austria) with the productivity of the FBiH not even close to the productivity of Belgium or Austria. It should be noted that these data are indicative in the sense that most of listed countries have lower rates for a lower level of income, so that a lower level of income is taxed at a lower rate. In nominal terms, in terms of the competitiveness of our workforce, the lower level of income in developed countries corresponds to the above-average incomes in BiH. This is important given that the taxation of income in the FBiH is linear (proportional), and there is a single tax rate and uniform deductions, both personal and for the family members.

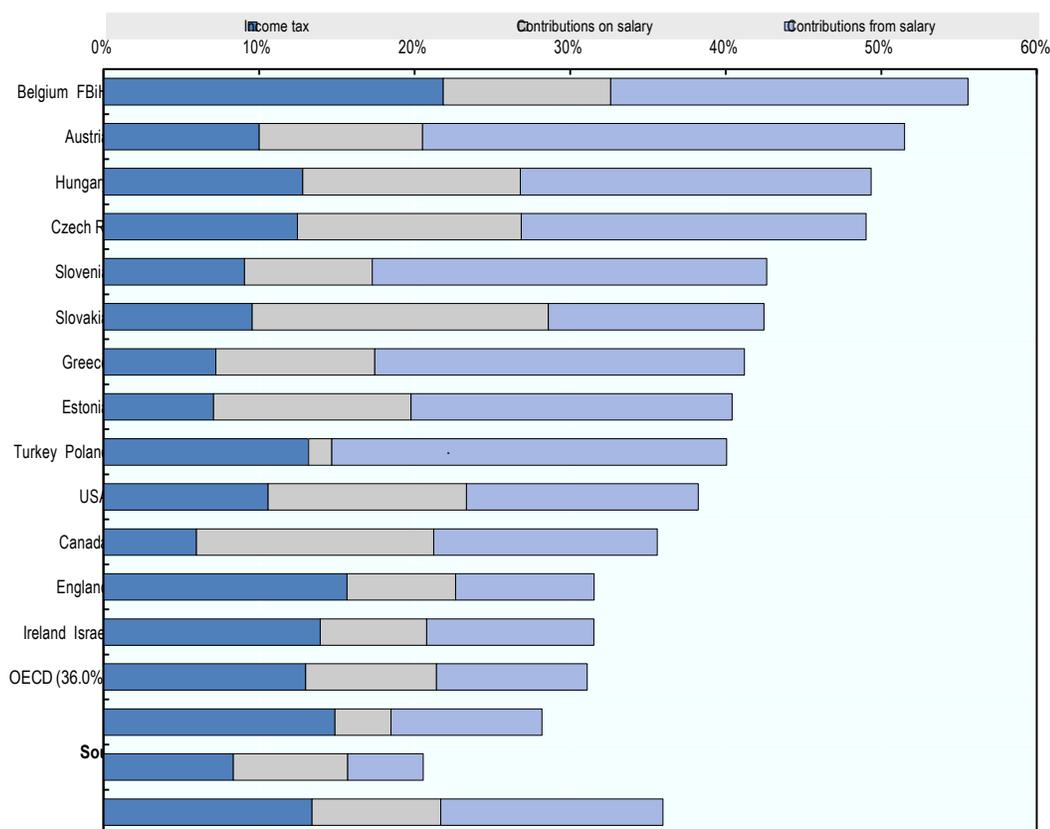
The taxation of labour, measured by the tax wedge, includes contributions paid by employers, contributions paid by employees, income tax, and, in the case of the FBiH, IT includes unemployment insurance and other specific taxes.

Table 3 The tax wedge in the OECD countries, the tax and contributions rates in% (contribution base of gross salaries)

	Personal income tax	Contributions on salary	Contributions from salary
Belgium	21.8	10.8	23.0
FBiH	10.0	10.5	31.0
Austria	12.8	14.0	22.6
Hungary	12.5	14.4	22.2
Czech Republic	9.1	8.2	25.4
Slovenia	9.6	19.0	13.9
Slovakia	7.2	10.2	23.8
Greece	7.1	12.7	20.6
Estonia	13.2	1.5	25.4
Turkey	10.6	12.8	14.9
Poland	6.0	15.3	14.4
USA	15.7	7.0	8.9
Canada	13.9	6.8	10.8
England	13.0	8.4	9.7
Ireland	14.9	3.6	9.7
Israel	8.3	7.4	4.8
OECD average (36.0%)	13.4	8.3	14.3

Source: country submissions, OECD Economic Outlook Volume 2014 (No. 96).

Chart 1 Income tax and contributions on salary and from salary in 2014 as% of labour costs



As we can see from the chart 1, the level of taxation of labour as a percentage of total labour costs in the FBiH is presented as one of the highest in Europe. This perception is partly conditioned by the method and manner of calculating the salaries because in the FBiH there are additions to salary, such as hot meal allowance, transportation allowance, holiday allowance, etc., which are not taxed and which represent real income for employees (sometimes very important part of income especially among workers with lower wages, and they are numerous), but that was not taken into account in the presentation of the situation. Due to this situation, the FBiH sends an incorrect picture that it is a region with the highest labour taxes, which basically is not true.

Therefore, there are reasonable reflections on the approximation of methods of calculation of liabilities arising from work at the BiH level and with the EU and OECD countries, so that all benefits based on labour would be taxable, with the reduction of aggregate rates of taxation in order to achieve a neutral effect, both in terms of public revenues, and in terms of the overall burden on the economy.

Non-taxable allowances

The FBiH has inherited the practice of paying out allowances for work which are not taxable. Due to the relatively high contribution and tax rates, these allowances have largely taken over the function of salaries (especially in the case of lower incomes), as shown in the Table below.

Table 4: Summary of non-taxable benefits paid out in December 2014

Paid out in total	Number of employees who received allowances	Average per employee
Hot meal allowance	Hot meal allowance	Hot meal allowance
55.452.664,00 KM	278.023	199,00 KM
Transportation	Transportation	Transportation
9.937.537,00 KM	147.683	67,00 KM
Holiday allowance	Holiday allowance	Holiday allowance
1.041.919,00 KM	3.344	312,00 KM (monthly 26,00 KM)
Other incomes ¹	Other incomes	Other incomes
4.736.284,00 KM	8.685	545,00 KM (monthly 46,00 KM)

Source: Federal Office for Statistics

Model of taxation of all incomes from employment - neutral principle

The analysis presents a model in which, in addition to net salary, all the previously tax-free incomes would be taxed. Total non-taxable income includes food, transport, holiday allowance and other income, material benefits and rights of employees in accordance with collective agreements (severance pay, help in case of death, serious disability or long-term illness of the employee and/or immediate family member, help, donations and other income in accordance with the collective agreement).

The model is designed so to keep liabilities arising from payroll taxes at the same level as in the current model, which means that in the total amount at the FBiH level, there is no increase in the cost of business entities on this basis.

The calculation was made according to the data of the FBiH Tax Administration for December 2014 on average monthly net salary per employee (820.00 KM), the average

¹ Other incomes, wages and benefits of employees include: severance, assistance in case of death, serious disability or long-term illness of the employee or an immediate family member, help and donations of money and other employee benefits in accordance with the collective agreement.

monthly personal deduction per employee (406.00 KM) and the average monthly income tax per employee (46.00 KM).

For the purposes of this model we used the data on the non-taxable benefits of the Federal Bureau for Statistics for December 2014. The amount of the average non-taxable income in Table 1 was calculated by dividing all total paid out non-taxable incomes with the number of employees who received them. Total average monthly non-taxable income paid per employee in December 2014 amounted to 338 KM (the average in relation to the number of workers who received these benefits in 12/2014). This amount consists of hot meal allowance (199 KM per month), transportation costs (67 KM per month), holiday allowance (26 KM per month) and other incomes (retirement benefits, help in case of death, disability and long-term illness of the employee or an immediate family member, help, donations in money and other incomes in accordance with the collective agreement - 46 KM per month). Holiday allowance and other benefits were reduced to monthly payments, since the calculation was made on a monthly basis. In Table 2 we used the data on average monthly non-taxable income in relation to the total number of employees who received salary regardless of whether they received non-taxable benefits or not (185 KM).

Net salary includes salary paid for the work performed, as well as remunerations from the employment for holidays, paid leave, public holidays and non-working days established by law, sick leaves which shall be borne by the business entity, paid absence from work, interruptions in business without guilt of employee.

Looking at Table 5 we can conclude that the rate of payroll taxation (gross salary base) in the model of taxation of all employee benefits would be reduced from the current 45.17% to 35.60% (neutral approach whereby the liabilities arising from salary are identical in both cases - 567.00 KM). Payroll taxation rates (net salary base) would be reduced from the current 69.15% to 48.96%. The total contribution rate based on salaries would be reduced from current 41.5% to 32.71% (gross salary base), and from 63.54% to 44.99% (net salary base).

The calculation in Table 5 is given for employees who received benefits in December 2014 that are non-taxable under the current regulations. From the point of total expenditures of employers who paid these benefits, the calculation is neutral while the liabilities arising from salaries are identical in both variants.

However, it is clear that in case of the application of these rates, public revenues would be reduced because the rates of payroll taxation would be reduced to all employees, including employees who did not receive untaxed payments in December 2014. Therefore, we provide a new adjusted calculation in Table 6 with the objective of a neutral approach for public revenues.

The amount of the average untaxed income in Table 6 (185 KM) was obtained by

dividing the total untaxed benefits paid out in December 2014 according to the data of the Federal Bureau for Statistics by the total number of employees (384 965 - data of the Federal Bureau for Statistics)

According to the consolidated calculation in Table 6, in the variant of taxation of all employee incomes, the **aggregate rate** of payroll taxes would be **reduced from 45.17% to 39.37% (gross salary base)**, i.e. **from 69.15% to 56.42% (net salary base)**.

Total rate of contributions would be reduced from the **current 41.5% to 36.18% (gross salary base)** and **from the current 63.54% to 51.84% (net salary base)**.

Table 5 Calculation of labour costs by gross principle

A Option of retention of the current situation		B Option of taxation of previously non-taxable income						
DESCRIPTION	AMOUNT	Contribution rate %		AMOUNT	Contribution rate %		Difference (5-2)	
		Gross	Net		Gross	Net		
1	2	3	4	5	6	7	8	
1	Gross base	1.255		1.593			338	
2	Contributions from salaries	389	31,0	47,44	389	24,42	33,59	0
3	Net salary with tax	866			1.204			338
4	Average personal deduction	406			406			0
5	Tax base	460			798			338
6	Income tax (average)	46	10,0*	5,61	46	5,76*	3,97	0
7	Net for payout	820			1.158			338
8	Contributions on salary	132	10,5	16,10	132	8,29	11,40	0
9	Total contributions (2+8)	521	41,5	63,54	521	32,71	44,99	
10	Total liabilities (6+9)	567			567			0
11	Average non-taxable income	338						-338
12	Re-calculated income tax rate		3,67	-		2,89	-	
13	Aggregate salary tax rate (9+12=13 in col 3 & 6, 6+9=13 in col 4 & 7)		45,17	69,15		35,60	48,96	
14	Total net earnings of employee (7+11)	1.158			1.158			0
15	TOTAL AVERAGE COST OF LABOUR (1+8+11)	1.725			1.725			0
							DIFFERENCE IN GENERATED PUBLIC REVENUES	0

Source: TA FBiH, FOS; processed by: FZZPR

NOTES:

The base for the income tax is net salary with accrued income tax reduced by an average personal deduction without sick leave.

The calculation was made for legal entities that paid out to employees the non-taxable benefits in December 2014.

Data in S/N. 4 on personal deduction, in S/N. 7 on net pay salary and in S/N. 6 on income tax is the data of the Tax Administration of the Federation of BiH, while the data on gross base and contributions are calculations of the Federal Development Planning Institution, on the basis of data of the FBiH Tax Administration.

Information on non-taxable income is the data of the Federal Bureau for Statistics.

Table 6 Calculation of costs of labour by gross principle

	A Option of retention of the current situation				B Option of taxation of previously non-taxable income			
	DESCRIPTION	AMOUNT	Contribution rate %		AMOUNT	Contribution rate %		Difference (5-2)
			Gross	Net		Gross	Net	
1	2	3	4	5	6	7	8	
1	Gross base	1.255			1.440			185
2	Contributions from salaries	389	31,0	47,44	389	27,01	38,71	0
3	Net salary with tax	866			1.051			185
4	Average personal deduction	406			406			0
5	Tax base	460			645			185
6	Tax (average)	46	10,0*	5,61	46	7,13*	4,58	0
7	Net for payout	820			1.005			185
8	Contributions on salary	132	10,5	16,10	132	9,17	13,13	0
9	Total contributions (2+8)	521	41,5	63,54	521	36,18	51,84	0
10	Total liabilities (6+9)	567			567			0
11	Average non-taxable income	185			0			-185
12	Re-calculated income tax rate		3,67	-		3,19	4,58	
13	Aggregate salary tax rate (9+12=13 in col 3 & 6, 6+9=13 in col 4 & 7)		45,17	69,15		39,37	56,42	
14	Total earnings of employee (7+11)	1.005			1.005			0
15	TOTAL AVERAGE COST OF LABOUR (1+8+11)	1.572			1.572			0
DIFFERENCE IN GENERATED PUBLIC REVENUES								0

Source: TA FBiH, FOS; processed by: FZZPR

NOTES:

The basis for the income tax is net salary with accrued income tax reduced by an average personal deduction without sick leave.

The calculation was made for the total number of employees in December 2014, regardless of whether they received non-taxable benefits or not.

Data in the S/N. 4 on personal deduction, in S/N. 7 on net salary and in S/N. 6 on income tax are the data of the Tax Administration of the Federation of BiH, while the data on gross base and contributions are the calculations of the Federal Development Planning Institution, on the basis of data of the FBiH Tax Administration.

Information on non-taxable income is the data of the Federal Bureau for Statistics.