



Bosnia and Herzegovina  
Federation of Bosnia and Herzegovina  
**Federal Development Planning Institution**

**TAX REFORM**  
**FOR THE PURPOSE OF INVESTMENTS AND**  
**EMPLOYMENT**

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## INTRODUCTION

The document "Tax Reform for the Purpose of Investments and Employment" has emerged as a logical sequence of events, caused by the global financial crisis and its consequences for BiH. At a time when the trend of decline in economic activities and employment is evident and when the economy is burdened by high taxes, we think we have the responsibility and obligation to propose such a document. The idea that we will consider is the **idea of a revenue-neutral tax reform**, which would significantly **reduce the direct taxation of labour by increasing the consumption tax and other taxes that do not burden the economy**.

The economic theory suggests that in this way a more efficient tax system would be established. The idea of transferring the burden of taxation from direct to indirect taxes is not new. It is present in theory for many years, but in our practice and the public no one has seriously considered it so far. One of the main tasks of this document is to initiate and launch the debate and dialogue between the key stakeholders, the governments on the one side, and business people and the scientific community on the other side.

For many years, direct taxation of labour and income is considered as very acceptable and fair way of taxation, because it implies that those who have more make a greater contribution to financing public spending. But practice has shown that excessive taxation of capital (income tax) and labour (taxes and payroll contributions) play a crucial role in the relocation of capital from one country to another, i.e. from a country with higher direct taxes to the countries with lower direct taxes, and this is where the competitive position of national economies began to build on, and the **relieving the economy by direct taxes began to be treated as a way to attract foreign direct investments**.

Also, too excessive reliance on direct taxes causes increased costs of administration because the way of collecting them is very demanding and requires great human resources, so that countries were increasingly deciding to use more the indirect taxes such as value added tax, excise and customs duties.

We presented the idea of a neutral tax reform by relieving the economy and additional taxation of consumption and property, the first time in March 2009. The document "Tax Reform for the Purpose of Investments and Employment" is the elaboration of this idea and is the first and only document in BiH since the Second World War to the present day, which deals with the economy relieving in a serious and comprehensive way.

The aim of this document is to consider the negative consequences for the economy caused by unrealistically high taxation of labour, and the impact of radical tax reform to increase in **economic competitiveness in domestic and foreign markets** on the one hand and **reducing the "gray" economy** on the other hand.

The proposed tax reform is in line with current regional and European trends. The solutions we propose fully follow the economic logic, the experience of the global economy and the opinions, views, analyses and studies of famous European and world economists.

## THE ESSENCE OF TAX REFORM

**The objective of the proposed reform is to stimulate investment, production and exports, and to discourage consumption and imports.** This would mitigate the major macroeconomic imbalances of BiH economy, high unemployment rate and high foreign trade deficit.

High payroll taxes and high labour costs discourage foreign investors, which is particularly evident in terms of the overall unfavourable political and economic environment. If we want to avoid problems that have arisen in some countries of Europe (Greece in the first place), there is no other choice for BiH, from the restrictions of public spending combined with a drastic relief of the economy in order to encourage investment, employment and overall industrial and economic growth.

In this paper, we propose to implement tax reform by significant **reduction of direct taxes on salaries**, as follows:

- Contribution for health insurance is reversed (financing by taxes - Beveridge model)
- Contribution for unemployment benefits is reversed (financing by taxes)
- Income tax remains the same as before in variant I (44.23% aggregate rate of net salary taxation), and in variant II (36.06% on net salary) is reversed),
- The rate and collection of contributions for pension and disability insurance (hereinafter: PIO) remain the same as before.

Since the amount of pension depends directly on the payment of contributions for pension and disability insurance, we think that the rate and method of payment for PIO should remain the same.

**Compensation for the missing public revenues** (neutral character of the tax reform) due to the reduction of direct taxes would be executed as follows:

- savings in the public sector,
- the introduction of other, from the standpoint of economic growth, more efficient forms of direct taxes which do not burden the economy (real estate tax, tax on winnings from games of chance, tax on transactions of financial institutions and international payments, taxes on car registration services, the tax on luxury cars, the tax on telecommunications services using the cellular network, tax on uncultivated agricultural land, tax on unused entrepreneurial real estate, tax on undeveloped building land),
- increasing the excise tax on high-tariff goods, and finally, as a last option,
- increasing VAT rate, if necessary.

These solutions could be combined with the introduction of progressive taxation of salaries (salary grades), taxation of hot meal allowance and other personal income (transportation costs, etc.), reducing the threshold for coverage of VAT payers, the abolition or reduction of parafiscal charges of the economy (water contributions, contribution for forests and tourist boards), etc.

The essence of the tax reform is **to reduce direct taxes** on labour costs, by which we influence on **the increase in competitiveness of the domestic economy** (liabilities for wages are the cost of the company), with the increase and the introduction of other taxes that do not affect competitiveness, because they are not paid on exports and do not burden economy in costs.

Thus, if in the implementation of the tax reform the rates of indirect taxes change, it should be noted that these taxes (VAT, excise duties) and taxes of citizens, **in no way affect the competitiveness of the economy**. Only direct taxes that burden the labour and capital affect competitiveness by increasing costs of companies, which means that, by radical relieving of the economy that we advocate, we create the conditions for BiH economy as, in tax terms, the most competitive in Europe (we will see later that the rate of 36.06 % on net wages is the lowest in the EU and in the region).

## IMPACT OF TAX REFORM ON ECONOMY, PUBLIC SECTOR AND CITIZENS

The impact of tax reform on the economy, the public sector and citizens can be seen in the long-term and short-term periods.

In the long term conditions are created for new investment and employment (reducing the obligations of companies and increasing the accumulation), which influences the growth of business entities, and thus the **overall economy growth**.

The tax reform will have a positive impact on the public sector in the long term, because there will be **growth and greater stability in public revenues** due to employment growth (more public revenues derived from taxation of salaries) and the growth of private consumption (higher revenues from VAT).

The interest of the citizens will be satisfied in the long term because the economic logic says that there will be a **significant increase in employment** (lower cost of labour influences the increasing demand for labour). There is no greater interest for the citizens than the increased employment because only citizens who work and receive a salary regularly have a chance to meet basic needs and not be poor. It is estimated that the tax reform in 10 years will lead to twice the number of employees in production in the FBiH compared to today's number, on condition that the political crisis in Bosnia and Herzegovina and the debt crisis in the Euro zone and the global financial crisis resolve.

Hence, in the long term, the tax reform is in the interest of all and all actors of society have a significant interest which is not difficult to understand.

In the short term, the positive impact of the reform on the economy is reflected in improvement of liquidity, given the significant reduction in liabilities arising from payroll taxes. Since this is a neutral tax reform, in the short term there will be no impact on the public sector, because public revenues both before and after the reform will remain at about the same level. Only the structure of sources of revenues will be changed.

In the short term, the tax reform will have no greater impact on the sector of citizens. If in the implementation of the tax reform a minimal increase in the VAT rate happens, we

are convinced that a large number of businessmen, especially in labour-intensive industries, would not increase prices because the loss on that basis is significantly lower than the winning due to a decrease in costs of payment of salaries by a significant relief of economy.

If, however, in the implementation of the tax reform a minimal increase in prices would happen (this may be just a one-time increase and in no way get to the inflationary cycle), taking into account the most vulnerable categories of the population, this problem can be relatively easily overcome by social programs and the establishment of fund for the poor, for which it is not a problem to calculate assets by the tax reform.

We should especially bear in mind that companies make profit in which all the other economic entities "embed". Therefore, with the tax reform, we primarily work in the interests of economy to create the conditions for making as big as possible "national cake". Later, when it is created, fair and effective distribution thereof will be much less of a problem than its creation.

## MODELS OF HEALTH INSURANCE – HEALTH CARE FOR ALL

A very important segment which affects the different fiscal burden of labour is the way of financing the health care.

Contributions for health insurance represent a significant fiscal burden on labour (35% of total liabilities arising from salary make up contributions to health insurance), which in terms of labour mobility could have a significant influence on the competitiveness of the national economies.

Today, there are four basic models of financing health care in the world:

- Beveridge model,
- Bismarck model,
- Semashko model, and
- Market model.

**Beveridge model**, named after William Henry Beveridge, who in 1942 introduced a comprehensive report on social policy to the British Parliament. The report contained concrete proposals on a comprehensive health insurance, which later became the foundation of the British health care system after World War II. For Beveridge model is significant that it **covers the entire population**, is mainly **financed from the state budget** and the amount of contributions to financing health care is uniform. According to this model of health care, **the entire population uses for free a number of rights within the national health care system.**

This means that the availability of health services and their financial coverage are provided by the state, that the state provides health facilities (hospitals, doctors), finances their work and manages the overall health care system. The State provides

financial coverage by taxes and manages the funds through the Ministry of Health. Today, the Beveridge model is **used in the UK, Ireland, Iceland, Scandinavian countries (Norway, Sweden, Denmark, Finland), Italy, Spain, Portugal, Greece, Canada, Australia and New Zealand**. The disadvantages of this model are an increased risk of under-investment of funds in certain aspects of the health care system and "competition" of health care system for the same funds from the budget in relation to other social segments, such as education, culture and sports. These deficiencies can come to the fore in periods when there are no problems with the financing of public spending. In conditions of crisis like the present case, these shortcomings cannot be regarded as decisive. When troubles occur in financing the health care sector, the advantage of this model comes to the fore, and this is the easier control of spent funds, lower administration costs, and more efficient financing of health care.

**Bismarck model** comes from Germany, from the German Chancellor Otto von Bismarck who in 1883 was the author of the idea of mandatory social health insurance. It was founded in the second half of the 19th century, when workers during treatment were financially vulnerable because they had higher expenses for services of doctors and medicines, but did not receive wages for the time of absence from work.

It is typical that this model is based on the principle of non-profitability and solidarity among all insured persons and their organization in special organizations (agencies, funds, institutions, hospitals cash registers), that provide for their right to health care. The funds are collected in the cash register paying appropriate contributions by the employer and the employee. Usually the contribution is expressed as a percentage, so that policy holders with lower value of earnings contribute less to the common fund.

From the collected funds, insurance companies (funds, agencies, bureaus) enter into contracts with service providers and thus enable insured people to use health care services. It is important to emphasize that **health care contributions are paid according to the ability (depending on income), and health care is used according to the needs**. The largest number of continental European countries has Bismarck model of insurance (**Austria, Belgium, Czech Republic, France, Netherlands, Germany, Slovenia, Switzerland, Luxembourg**) as well as some countries of the world (**Japan**). The main disadvantages of this model are difficult control of invested funds and demanding administration. Bismarck model is used in BiH and in the FBiH.

In Eastern European countries there are still remnants of the socialist **Semashko model** which originated in the Soviet Union in response to the Beveridge model. In this model the **entire system is supported from the central state budget**. Decisions on the rights and obligations of the insured are assumed by the Government, where the entire population is insured, so that at the level of service delivery, **health care is free of charge** (the patient, the insured person pays no participation fee), as the overall service was already paid from the central budget. The biggest problem of this system are too high expectations of the population that the state will provide high quality health care accessible to all without any extra charges or participation of private funds. However, today the system is still present in some Asian countries (**China, Mongolia, North Korea, Vietnam**) and in **Cuba**.

The United States use the **market model**, which is characterized by market mindset ("you get what you pay for"). This model suppresses the social solidarity. Because

insurance premiums that are subordinated to risk, the sick have to pay more than healthy, which **violates the principle of solidarity**. Through a process known as negative selection, premiums for the insured increase with risk, so that healthy people are practically excluded from the insurance. The market model is **based on private insurance funded from the private funds of the population**. The main disadvantage of this system is that a large part, mainly poorer population, loses health insurance. For example, in 2007 in the USA, 15.3% (45.7 million) of the population was uninsured, with as many as 8.1 million children under the age of 18 were without health insurance. Only 27.8% of the population have health insurance paid by the state, mainly through Medicare package, for people older than 65 years, and Medicaid, for people with low monthly income (vulnerable social groups).

## MODELS OF HEALTH INSURANCE

Table 1

Characteristics	Bismarck model	Beveridge model	Semashko model	Market model
Financing	Contributions of employers and employees	Taxes, state budget	State budget	Private funds of citizens
Management	Special structures composed of representatives of employers and the insured	State and its bodies	Central Government	Private organizations, agencies
Deciding on the rights and obligations of the insured	Holders of public insurance authorized to manage financial funds	State and its bodies	Central Government	No special structure, based on supply and demand
Coverage of population	Most of population	Entire population	Entire population	Decision on insurance in individual, there is no obligation

In the European countries, two most used models are: Bismarck model of social health insurance and Beveridge model of national health care.

The essential difference between the two models is in the mode of financing, and the level and scope of health care. **Beveridge model is financed through taxes and provides some level of health care for the entire population. Bismarck model is financed through contributions and provides a higher level of health care, but the entire population does not have to be covered inevitably.**

Today, the "clean" health care systems are almost nonexistent. They are all slowly taking over certain solutions from other countries and thus taking some of the characteristics of other models. Especially with public systems, private systems are increasingly promoted as complement health care with private facilities, insurance and other financial means.

**Today the health care system in the UK is considered to be the best organized, and is based on the Beveridge model.** It is this model of health care that we advocate in this paper.

## **SOCIAL INSURANCE IN BIH AND FBIH**

BiH and the FBIH use the health insurance system which is based on the Bismarck model. The main source of funding for health insurance is contributions, though additional funds flow in from the budget (e.g. for socially vulnerable categories), and through the participation fees and grants.

**Payment of health insurance is mandatory** and is done at the expense of the employee and the employer. All employees must be included in the health insurance system, and there is no option for an employee to decide that he/she does not want to participate in the "health cashier," and thus give up health insurance, that is, to seek out private health insurance. **Payers of health contributions are entitled to use the services of health care when necessary.**

Compulsory health insurance is implemented by Entity and cantonal health insurance funds. Compulsory health insurance provides medical treatment in state institutions in accordance with the package of rights from compulsory insurance. The rights from compulsory health insurance include the use of primary (outpatient), specialist and hospital health care, use of orthopaedic and other medical devices, dental health care, and the use of drugs from the list of drugs and medical devices. In the FBIH the concept of complementary, additional, or private health insurance has not come to life yet.

**Financing of unemployment insurance and pension and disability insurance in BiH and FBIH is also done through contributions.** In addition to taxes and three contributions (for pension-disability, health care, unemployment) in FBIH people pay a special fee for protection against natural and other disasters in the percentage of 0.5%.

Contributions are mandatory paid to the State, as well as taxes. In contrast to tax the use of which is not pre-determined, the allocation of funds from contributions is determined in advance, and payers acquire certain rights in accordance with the amount of paid contributions.

In the FBIH, contribution for pension and disability insurance is 23% for health insurance 16.50% and for unemployment insurance 2%, and they are paid on the base which is the gross salary of employees.

Contribution for Pension and Disability Insurance (PIO) is used for the payment of pensions of current retirees, while workers on the basis of paid PIO gain the right to old-age pension in proportion.

### **PAYROLL TAX RATES - FBiH (Example of Sarajevo)**

Table 2

	<b>Gross salary base</b>	<b>Net salary base</b>
PIO	23,0%	36,06%
Health Care	16,5%	25,87%
Unemployment	2,0%	3,13%
Protection against accidents	-	0,50%
Income tax	10,0%	8,17%
<b>TOTAL</b>	<b>51,5%</b>	<b>73,73%</b>

According to the latest World Bank report "BiH - Challenges and recommendations for reforms – An overview of public expenditure and institutions" of February 2012, the rate of social contributions in the FBiH are a lot higher than in other countries.

According to this report, the overall rate of social contributions in the FBiH is 41.5% on the gross salary, which is much higher than the average of the Organization for Economic Cooperation and Development (OECD) countries - 29.5% and the average of 8 new EU member states (Poland, Hungary, Czech Republic, Slovenia, Slovakia, Estonia, Lithuania and Latvia) - 38.1%.

## MACROECONOMIC INDICATORS OF FBiH IN THE PERIOD 2004 – 2010

In the period from 2004 to 2008, the FBiH recorded a significant inflow of foreign capital on the basis of foreign borrowing and privatization, which resulted in high rates of economic growth, on average, 5.15% per annum. In the same period, capital inflows from abroad enabled the FBiH to finance the extremely high trade deficit (on average around 42% of GDP). Significant capital inflows enabled BiH and FBiH to record, despite a significant current account deficit, an increase in foreign exchange reserves until 2007. In 2008 and 2009 there was a slight fall in foreign exchange reserves and again a slight increase in 2010. Foreign exchange reserves in BiH at the end of 2010 amounted to nearly 6.5 billion KM, and in recent years they have been on a stable level.

In the recession period there was a sharp decline in BiH exports and a strong fall in private consumption, although the total domestic consumption in relation to GDP is at a very high level (the reason is the decline and slow GDP growth in 2009 and 2010). **Reducing the value of exports of goods and services led to a general fall in production and employment in the real economy and caused a decline in disposable income of households and public revenues.** This caused a drop in final consumption, particularly investment, resulting in a sharp drop in domestic demand. The fall in cash inflows from foreign remittances further jeopardized disposable income, the decrease of which led to a nominal and real decline in private consumption.

The situation further exacerbated by the **sharpening of credit criteria by commercial banks**, as well as a decline in the profitability of BiH companies, which was a blow to private investment and consumption of consumer goods. In 2009, in FBiH there was an increase in the deficit of the government sector (4.4% of GDP), which was caused by the decline in public revenues and insufficient cuts in public spending, which resulted in a sharp decline in public investments.

Since the global financial crisis occurred in BiH in the second half of 2008 (continued today), there was **a decline of almost all key macroeconomic indicators in 2009 and 2010**. In 2009, in the FBiH the GDP decreased in a percentage of 2.9%, and in 2010 it slightly increased in the percentage of 0.7%. The global economic crisis significantly slowed the inflow of foreign direct investment (in 2010 only 0.7% of GDP) and clearly demonstrated the weaknesses of the current model of macroeconomic balance and pointed to the challenges that BiH will face when privatization revenues dry up, and the possibilities for foreign borrowing are limited by the amount of accumulated foreign debt.

## MACROECONOMIC INDICATORS 2004 - 2010 – FBiH

Table 3

	2004.	2005.	2006.	2007.	2008.	2009.	2010.
Gross domestic product, real growth	5,5	2,8	6,5	5,8	5,7	-2,9	0,7
Gross domestic product, per capita, in KM	3.635	3.843	4.310	4.872	5.492	5.338	5.450
Gross domestic product, mil. KM	10.350	10.945	12.261	13.879	15.647	15.231	15.615
Final consumption expenditure, % GDP	93,9	97,3	94,5	89,9	95,6	102,5	99,3
Gross investment, % GDP	17,1	22,6	18,6	25,8	27,4	19,8	17,8
Productions of tradable goods, %GDP	51,4	54,7	54,7	55,3	55,6	50,9	46,5
Export of goods, % GDP	18,9	23,6	28,9	29,9	29,7	24,2	30,3
Import of goods, % GDP	60,4	71,4	66,1	71,4	72,6	53,9	57,0
Import export ratio	31,3	33,0	43,7	41,9	40,9	44,9	53,2
Trade deficit, % GDP	-41,5	-47,8	-37,3	-41,5	-42,9	-29,7	-26,7
Foreign direct investment, % GDP	5,7	1,9	2,0	3,2	2,7	2,2	0,7
Balance of public finances, % GDP	-1,7	-1,0	-0,5	-0,2	-0,3	-4,4	-2,1
Unemployment rate in %	45,6	47,2	48,2	47,0	44,0	44,8	45,4
Inflation, end of period*	-0,3	3,0	5,9	1,9	7,7	-0,3	1,8
Physical volume of industrial production	113,2	106,1	110,4	108,6	107,9	86,5	104,2

\* In 2004 and 2005, retail prices and then the consumer prices

Source: Federal Bureau for Statistics and the Federal Ministry of Finance

Looking at Table 3, we can notice very high rates of domestic consumption (both public and private) in relation to GDP, which did not left too much room for significant investments that would enable sustainable economic growth in the longer term.

The high level of consumption (in 2010 99.3%, in 2009 as many as 102.5% of GDP), also led to high trade deficit, so that the average export-import ratio in the period 2004 - 2010 is only 41%.

Data on exports, imports and export-import ratio in 2009 and 2010 are more favourable than before. This progress is a result of the impact of the global economic crisis (drastic reduction in imports), and not of an increase in the competitiveness of the BiH economy, and therefore we will not go into more detailed comments.

Basic problems in foreign trade in the FBiH are a low level of export-oriented production and poor structure of BiH exports. In the structure of exports almost 45% is related to processing (lohn jobs). Factory in textile and leather industry work with 30-40% of capacity, of which 90% of jobs relate to lohn jobs. In the last years loan jobs are present in the metal industry.

Although high economic growth rates were accomplished in the period from 2004 to 2008, an extremely high unemployment rate in the FBiH did not significantly reduced, and in the past two years there was an increase in the unemployment rate.

**Slow job creation and generally low labour demand is a key problem of unemployment in BiH.** There is the process of creating jobs that can absorb the influx of labour in the labour market.

BiH, compared to other countries in the region, particularly EU Member States, has, like Macedonia, the lowest rate of employment of the labour force. Of the total number of the unemployed, 86.6% are long-term unemployed, i.e., unemployed for over a year. Half of the unemployed (50.3%) are unemployed for over five years.

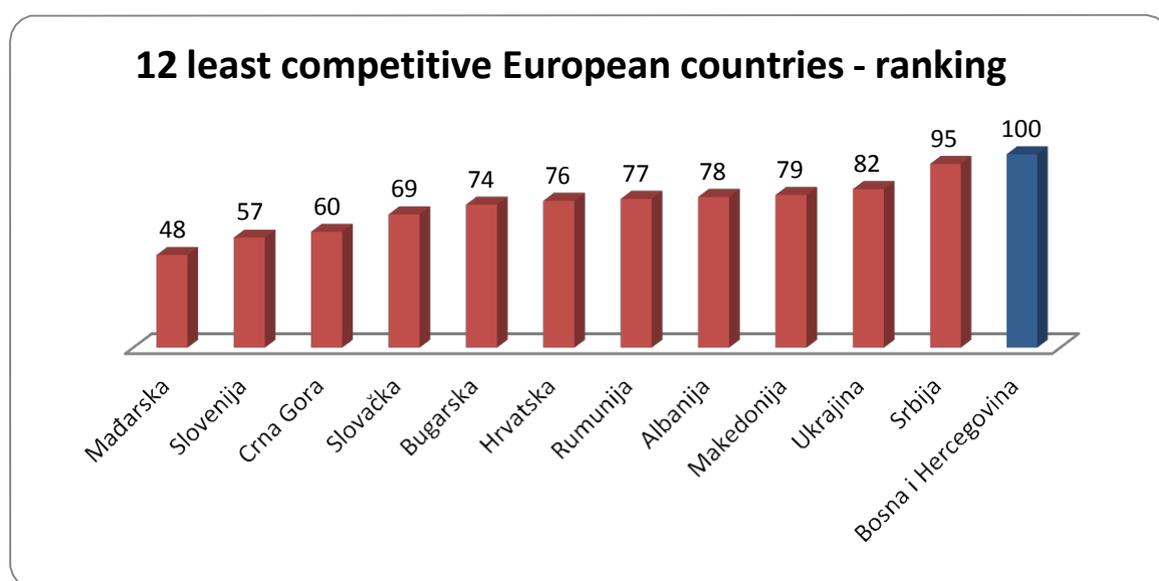
**The main macro-economic challenges** in the coming period before BiH and the FBiH, are of fiscal and foreign trade nature and relate to:

- High level of public spending
- High budget deficit
- High public debt, and
- High current account deficit.

The main problem of the BiH economy is weak competitiveness of the domestic economy. Economic competitiveness in the global economy is an important prerequisite for long-term economic growth. The concept of competitiveness involves the development and entrepreneurship training for international competition, strengthening domestic export capacities and production, and creating conditions for the continuous increase in investment in competitive industries. Strengthening competitiveness is particularly important for a small transitional country and a potential member of the EU, such as Bosnia and Herzegovina.

According to the latest report on global competitiveness, **BiH is least competitive European country.** Together with other SEE countries it makes the most non-competitive region of Europe - Table 4. In addition, in the period after 2006, there is an evident trend of further decline in the competitiveness of the BiH economy and increasing the gap between the penultimate economy in Table of 12 least competitive European countries (Serbia) and BiH as the last, the least competitive economy.

Table 4



Source: World Economic Forum - Global Competitiveness Report 2011 – 2012

According to the Global Competitiveness Index of the World Economic Forum, ease of doing business index of the World Bank and the index of economic freedom, as the factors that most negatively affect the competitiveness of BiH, the following stand out:

- Availability of funds for entrepreneurship,
- **Amount of taxes and tax regulations,**
- Bureaucracy,
- Corruption and
- Poor infrastructure

In this paper we will analyze **how the tax reform could influence the improvement of business conditions and creating of a more competitive economy as a prerequisite for sustainable economic growth.**

## PROPOSAL OF THE TAX REFORM

According to the economic theory, the tax policy is a very important instrument at the disposal of the authorities in the conduct of macroeconomic policies and the creation of conditions for the growth of economic activities. The tax policy influences the changing of relative prices in the economy and the behaviour of economic agents. In this way, the tax policy can create the desired macro-economic conditions for business and performs a crucial influence on creating of the programmed macro-economic indicators.

In the previous period an extensive tax reform began that resulted in the introduction of value added tax (VAT) in 2006 and income tax in 2009. VAT system replaced sales tax (easier and more frequent tax evasion because this tax was paid in the final consumption), which often led to multiple taxation of the same value added, which burdened the smooth functioning of the economy.

With the amendments to the Law on Contributions, not only the salaries in the FBiH cannot be paid without payment of taxes and contributions, but also liabilities arising from labour taxes must be paid regularly at the end of each month, regardless of whether the salaries of the taxpayer were paid or not.

However, despite the significant changes that were made, the key thing was not done: the relief of the economy. Employers are burdened with high rates of taxation of labour, which is a disincentive for economic growth and attracting foreign investment.

It is clear that a sustainable model of economic growth will require a reduction in the trade deficit in the future. In order to achieve this it is necessary to increase the competitiveness of the BiH economy, which will create conditions for a more significant growth in exports. Given that due to the impact of the crisis the revenues from privatization are uncertain, when it comes to the method of financing current account deficit, rather than foreign borrowing, **the emphasis should be on**

**greenfield foreign direct investment.** How to attract foreign direct investment? The answer is simple, it is necessary to provide a stimulating business environment and political stability of the country.

By an analysis of macroeconomic indicators of the FBiH for the period 2004 - 2010, indicators of competitiveness of BiH economy, and activities provided for by all strategic and program documents adopted by the FBiH Government, we can conclude that the FBiH needs a tax reform that would significantly relieve the economy. Given that this is a deep crisis and a very poor state of the economy, solutions of small steps and symbolic improving the tax system will not or cannot bring the desired result. Therefore, when it comes to tax system reform, we advocate major procedures such as we propose in this document.

### **How the tax reform should stimulate economic growth and employment?**

Since contributions most participate in the total burden of labour, it is estimated that the reduction in the rate of social security contributions is the most appropriate way to reduce the fiscal burden on labour.

To achieve a positive impact of fiscal relief on economic growth, it is essential that a **significant part of the fiscal burden is retained in companies**, i.e. mostly not used to increase net earnings, although it is not bad because it will increase private consumption and on this basis the revenues from VAT. How will fiscal relief of labour be distributed between employees and employers depends on the unemployment rate, the power of trade unions, behaviour of the State that occurs as a regulator, but it mainly depends on the employers. Given the high unemployment rate in the FBiH and the relatively weak trade unions in the private sector of the economy, it is expected that a significant part of the fiscal relief will remain available to companies.

The question is, however: would the effects of fiscal relief be relevant in macroeconomic terms, or would they significantly contribute to economic growth and increased employment? The economic theory and practical experience say that the answer is yes, because a more significant **relieving of the economy in the first place would improve the liquidity of companies and contribute to the survival of the existing ones, and then through the growth of accumulation and investment it would contribute to the economic growth and new employment.**

What would such a relief mean for the solvency of the economy in a situation where employers have difficulties in receiving loans from banks (and if they do get them, interest rates are high), does not need much comment. Also, the FBiH economy would become more competitive in tax terms on the international market which would increase exports (reduced cost price of domestic products). A significant relieving of the economy would have a positive impact on foreign direct investment since the costs of doing business in the FBiH are significantly reduced.

Tables 5 - 10 give the data on the structure of tax revenues in BiH and the FBiH in the period from 2004 to 2010.

## DIRECT TAXES 2004 - 2010 - FBIH

Table 5

in mil KM

Name of income	2004.	2005.	2006.	2007.	2008.	2009.	2010.
<b>Direct taxes</b>	321,0	364,1	409,8	406,3	427,6	527,4	548,5
Payroll tax	161,4	173,0	196,1	229,0	285,0	258,5	266,2
Income tax	63,4	79,0	99,7	41,3	89,3	159,9	186,1
Taxes of citizens	80,0	89,4	90,6	115,0	29,3	83,0	68,2
Other taxes	16,1	22,7	23,4	21,0	24,0	26,0	28,0
<b>Other taxes, penalties and fees</b>	124,3	127,2	140,8	147,0	152,0	317,2	342,8
<b>Contributions</b>	1.452,0	1.545,6	1.774,2	2.107,0	2.327,0	2.395,9	2.570,6
PIO	801,0	849,9	980,2	1.154,0	1.280,0	1.344,5	1.447,4
Health care	572,2	614,3	699,5	841,0	924,0	942,3	1.008,5
Unemployment	78,8	81,4	94,5	112,0	123,0	109,1	114,7
<b>TOTAL (direct taxes + other taxes, penalties and fees + contributions)</b>	1.897,3	2.036,9	2.324,7	2.660,3	2.906,6	3.240,5	3.461,9
GDP	10.350,0	10.945,0	12.261,0	13.879,0	15.647,0	15.231,0	15.615,0
Contributions from the budget – health care + unemployment (consolidation)							390,7
Contributions from the budget – health care + unemployment + payroll tax (consolidation)							516,5

Source: FBIH Tax Administration

## DIRECT TAXES 2004 - 2010 – FBIH

Table 6

% GDP

Name of income	2004.	2005.	2006.	2007.	2008.	2009.	2010.
<b>Direct taxes</b>	3,10	3,33	3,34	2,93	2,73	3,46	3,51
Payroll tax	1,56	1,58	1,60	1,65	1,82	1,70	1,70
Income tax	0,61	0,72	0,81	0,30	0,57	1,05	1,19
Taxes of citizens	0,77	0,82	0,74	0,83	0,19	0,54	0,44
Other taxes	0,16	0,21	0,19	0,15	0,15	0,17	0,18
<b>Other taxes, penalties and fees</b>	1,20	1,16	1,15	1,06	0,97	2,08	2,20
<b>Contributions</b>	14,03	14,12	14,47	15,18	14,88	15,74	16,46
PIO	7,74	7,77	7,99	8,31	8,18	8,83	9,27
Health care	5,53	5,61	5,71	6,06	5,91	6,19	6,46
Unemployment	0,76	0,74	0,77	0,81	0,79	0,72	0,73
<b>Total</b> (direct taxes+other taxes, penalties and fees+contributions)	18,33	18,61	18,96	19,17	18,58	21,27	22,17
Contributions from the budget – health care + unemployment (consolidation)							2,50
Contributions from the budget – health care + unemployment + payroll tax (consolidation)							3,31

**INDIRECT TAXES 2005 - 2010 - BIH**

Table 7

in mil KM

	2005.	2006.	2007.	2008.	2009.	2010.
VAT	1.812	2.349	2.705	3.118	2.810	2.915
Customs	616	557	655	651	347	302
Excises	798	861	917	937	997	1.172
Tolls	177	177	187	189	250	307
Total	3403	3944	4464	4895	4404	4696
GDP	17.157	19.272	21.778	24.717	24.004	24.486

Source: BiH Indirect Taxation Authority

**INDIRECT TAXES 2005 - 2010 - BIH**

Table 8

% BDP

	2005.	2006.	2007.	2008.	2009.	2010.
VAT	10,56	12,19	12,42	12,61	11,71	11,90
Customs	3,59	2,89	3,01	2,63	1,45	1,23
Excises	4,65	4,47	4,21	3,79	4,15	4,79
Tolls	1,03	0,92	0,86	0,76	1,04	1,25
Total	19,83	20,46	20,50	19,80	18,35	19,18

**INDIRECT TAXES 2005 - 2010 - FBIH**

Table 9

u mil KM

	2005.	2006.	2007.	2008.	2009.	2010.
VAT	1.150	1.492	1.717	1.979	1.784	1.850
Customs	391	353	416	413	220	192
Excises	507	547	582	595	633	744
Tolls	112	112	119	120	159	195
Total	2160	2504	2834	3107	2796	2981
VAT	10.945	12.261	13.879	15.647	15.231	15.615

**INDIRECT TAXES 2005 - 2010 - FBIH**

Table 10

%BDP

	2005.	2006.	2007.	2008.	2009.	2010.
VAT	10,51	12,17	12,37	12,65	11,71	11,85
Customs	3,57	2,88	3,00	2,64	1,44	1,23
Excises	4,63	4,46	4,19	3,80	4,16	4,76
Tolls	1,02	0,91	0,86	0,77	1,04	1,25
Total	19,74	20,42	20,42	19,86	18,36	19,09

Total tax revenues in the FBiH in the amount of 41.26% of GDP in 2010 are above the average of the European Union – EU 27 (2007 - 40.7%, 2008 - 40.5% and 2009 - 39.7 %). Revenue from **taxation of consumption** (VAT, customs and excise duties) amounted to **19.09% of GDP**, while revenues from **taxation on labour** (income tax, corporate income tax, social contributions, etc.) amounted to **22.17% of GDP**.

These data clearly show that the taxation of labour is much more involved (over 3% of GDP) in the financing of public expenditure in relation to the taxation of consumption. It is a really worrying data that clearly speaks about the business environment in which the business entities operate.

From Table 5, it can be concluded that the **revenues from tax from citizens in 2010 (property taxes, etc.) are at a very low level**. Considering to the proclaimed equality of the working class of the socialist system as we had before the war, the real estate tax had no real function and this practice continued today. As one of the important measures of tax reform, we advocate **introducing the tax on immovable property** as taxes on immovable property are a significant source of income in developed European countries. The objective of this tax is that tax is paid most in proportion by the rich layers of society and thus more prosperous participate in the financing of public expenditure than the poor categories of the community. This gives full contribution to the realization of the principles of Adam Smith in which the citizens are obliged to pay taxes in accordance with their capabilities.

Social contributions are an extremely important item of public revenues (significant burden on labour costs and in total direct taxes account for close to 75%) and deserve a more detailed analysis.

The public health care system is financed through contributions for health care, with the payers of these contributions being entitled to use health care services in case of need. By an analysis of the health system it can be concluded that health **insurance beneficiaries do not exercise the right in proportion to the funds paid** (it may be that workers pay contributions to health insurance for the entire service life, and never use health care services), and also certain vulnerable segments of society are enabled to access to health care without payment of contributions. That is why it is right to raise the question of selection of the method of financing health care, i.e. **is it more appropriate to finance the health insurance system through contributions or through taxes?**

According to World Bank data, total spending on health care in BiH is growing at an unsustainable rate. Over 50% of users of medical services covered by health insurance (pensioners, invalids, veterans, unemployed) are exempt from payment of contributions, so that the financial sustainability of the health care system us a serious problem. It is estimated that the ratio of those who work and pay their contributions and those who are entitled to health care is 1:5. The outstanding problems of the health care sector are unjustifiably large number of non-medical staff (estimate 30%), and continued funding based on inputs rather than on the needs of the population and health care objectives.

According to the World Bank's data, public and private expenditures on health care in BiH and F BiH grow, while private expenditure (own resources of users of health insurance) account for over 40% of total health care spending.

Bearing in mind the significant benefits of Beveridge model, in the 20th century a significant number of European countries opted for the model of financing health care through taxes, such as **the United Kingdom since 1946, Ireland, Norway, Sweden, Denmark and Finland since the seventies, and Italy, Spain, Portugal and Greece since the eighties**. Mindful of the increasingly difficult financial situation in the health care sector, in this material we advocate the Beveridge model of health care because we think it is most appropriate in a situation aggravated financing of public spending due to the economic crisis, because it allows better control of resources spent and more cost-effective administration. On the other hand, this model would provide "health for all" because the entire population would be covered by health insurance, which would lead to an improvement in the overall health status of the population.

Unemployment contributions finance the workers' compensation in case of layoff. The experience with the phenomenon and the emergence of the economic crisis has taught us that it is not possible to accurately predict the location, time and frequency of occurrence of crisis. Therefore, in difficult and fateful times for each economy, it is **very difficult to predict the number and timing of workers who lose their jobs to make the system more balanced** and to have adequate compensations for workers who lose their jobs funded by contribution for the unemployed. By analyzing the current system of unemployment insurance it can be concluded that the benefits paid to workers who lose their jobs in the F BiH are not enough to cover the basic needs of workers. The risks of losing their jobs depend on many factors (internal factors of the company, external factors resulting from inadequate economic system of the country, external factors outside the country, such as economic and political crises in the region and beyond) and are not isolated nor independent so that, bearing in mind the way and the concept of financing the protection of workers from unemployment through contributions, the same **does not meet the criteria necessary to have the character of insurance**.

This is why we propose to change the current way of financing the benefits to workers who lose their jobs and to pay benefits from the budget by tax revenues in the future.

We have already pointed out that a long-term sustainable growth model in BiH must be characterized by a higher level of investment (especially greenfield FDI), greater number of employees, reducing the trade deficit and a lower level of consumption. How could the tax policy influence the achievement of those objectives? As the tax policy (height and dispersion of taxes) change the relationships in relative prices in the economy, it is necessary to implement such a tax reform that will **increase the cost of consumption and imports, and reduce the burden of production and exports**.

Since, according to the economic theory, **taxes of citizens** (real estate tax, tax on winnings from games of chance, tax on foreign financial transactions, tax on car registration services, tax on luxury cars, the tax on telecommunications services using the cellular network, tax on uncultivated agricultural land, tax on unused entrepreneurial real estate, tax on undeveloped building land) do not burden the economy, **excise duty and VAT** (also, they do not burden the economy) **represent** a consumption tax and are

not calculated while exporting, their increase is imposed as a logical choice.

Taxes of citizens and indirect taxes do not affect the competitiveness of the economy either in a positive or in a negative way because they are not paid on the export of domestic goods. The only direct taxes that tax labour and capital affect the competitiveness of the economy and with the large relief of the economy that we advocate, we help our economy to be more competitive in the domestic, regional and global markets.

Thus, the new forms of taxes that do not burden labour and capital and the increase of existing indirect taxes, could finance (compensate) the abolition of the contributions for health care and unemployment (even income tax), which would reduce the fiscal burden of salaries and **method of financing the social security (except PIO) would be transferred from contributions to taxes.**

At first sight, abolition of the contributions could reverberate as an earthquake in the system of financing public spending. However, when you think about it, change of financing the health care and unemployment protection could be carried out without major problems. Employment bureaus could easily be integrated into the budget, so that the payment of compensation in case of workers out of work would become another right which is financed from the budget.

Initially, in the interim period, health care institutes could operate as separate institutions, and instead of directly as so far, be financed by payments from the budget. Later, health care institutes would be integrated into the budgets in the true sense of the word. In addition, the financing of the health care sector from the budget, not only would achieve a better and more direct control of the health care system by the FBiH Government, but could **equalize the rights to health insurance by cantons, which are now very different.**

The proposed reform is fully in line with the recommendations of the World Bank contained in the document "BiH - Challenges and Recommendations for Reforms – An Overview of Public Expenditure and Institutions" of February 2012, according to which it is necessary to reduce the amount of taxes on labour, focusing, primarily on changing the rates of social contributions. This document points out that it is crucial that this is done in a way that ensures fiscal sustainability and we just do that by a neutral character of the reform as lack of public revenues by labour tax relief, we fully compensate by the savings in the public sector, additional taxation of consumption and other taxes that do not burden the economy.

In a complex situation like today in BiH, the only viable macroeconomic tax reform is the one which does not change the share of public revenue in GDP, or that leads to a moderate increase in public revenues. Tax reform that would lead to a significant reduction in public revenues in relation to GDP, would either reduce the quality and availability of public services, or would lead to an increase in public debt, which is a more likely option.

## PROPOSED RATES OF PAYROLL TAX

In order to significantly lower the cost of labour by reducing the rate of taxation of salaries, we suggest two alternatives rates of taxation of salaries:

### 1. AGGREGATE RATE 44.23% ON NET SALARY

In the first version, we suggest that during taxation of salaries **the tax (10%) and contribution to the PIO (23%) remain at current rates, which in the total percentage of the net salary amounts to 44.23%.**

The contribution of health insurance (16.5% or 25.87% of net salary) and unemployment contribution (2% or 3.13% of net salary) would be abolished and financed by other types of taxes that do not burden the economy.

After examining the tables 5 and 6, we can notice that revenues from social security contributions in 2010 amounted to 16.46% of GDP, with the PIO contribution of 9.27%, the contribution for health care 6,46% and the contribution in the case of unemployment 0.73% of GDP. Thus, the abolition of health care contributions and contributions for unemployment would cause a loss of public revenues in the amount of 7.19% of GDP, or 1,123.2 million KM. As in the process of consolidation it is necessary to reduce this amount by the payment of contributions by the State (administrative bodies, agencies, institutions, etc.), which now remain in the budget (390.7 million or 2.5% of GDP), **the actual loss of public revenues would amount to 732.5 million or 4.70% of GDP<sup>1</sup>.**

### 2. AGGREGATE RATE 36.06% ON NET SALARIES

According to the second variant, **only the contribution to PIO (23%) would be financed by taxing labour, so that salaries would be taxed at a rate of 36.06% on net salary.**

Other charges (tax on salaries, contributions for health care and unemployment contribution) would be abolished and financed by other types of taxes that do not burden the economy.

By abolishing the payroll tax, the health insurance contribution and the unemployment contribution, the public revenues would decrease by 8.89% of GDP, or 1,389.4 million KM (Tables 5 and 6). Because of consolidation, this amount needs to be reduced by 516.5 million or 3.31% of GDP, which means that the **actual loss is 872.9 million or 5.59% of GDP.**

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<sup>1</sup> The consolidated amount (contributions from the budget) was calculated based on the number of employees in the public sector in the FBiH (2010) - 122,354, the average salary in the public sector in the FBiH in the amount of 933.79 KM and the applicable rates of payroll taxation.

The compensation for the lost revenues due to the reduced rate of payroll taxation will be discussed in the next section "Order and method of implementation of the tax reform," and in this section we provide an analysis of how the change in the VAT rate affects the public revenue, not preferring any single VAT rate, even not preferring any increase in the VAT rate, which does not have to come if the lack of public revenues due to reduction of rates of payroll tax is compensated by savings in the public sector, the increase of excise duties and the introduction of new taxes that do not affect the economy, as we advocate in this document.

#### **VARIANT I**

- a) 44,23% net salary tax rate  
**20% s VAT rate**
- b) 36,06% net salary tax rate  
**21% s VAT rate**

According to this variant of the VAT rate, **the resources lack to fully cover** income for health care and unemployment in the amount of **a) KM 322 million or 2.0% of GDP**, and for health care, unemployment and income tax in the amount of **b) KM 325.9 million or 2.1% of GDP**.

#### **VARIANT II**

- a) 44,23% net salary tax rate  
**21% VAT rate**
- b) 36,06% net salary tax rate  
**22% VAT rate**

According to this variant of the VAT rate, **the resources lack to fully cover** income for health care and unemployment in the amount of **a) KM 187.8 million or 1.20% of GDP** and for health care, unemployment and income tax in the amount of **b) KM 191.7 million or 1.23% of GDP**.

#### **VARIANT III**

- a) 44,23% net salary tax rate  
**22,5% VAT rate**
- b) 36,06% net salary tax rate  
**23,5% VAT rate**

According to this variant of the VAT rate, **the revenues that would be missed by reducing the rate of payroll taxation, would be fully compensated for by an increase in the VAT rate**.

## OVERVIEW OF VARIANTS

Table 11

	VARIANT 0	VARIANT I	VARIANT II	VARIANT III
Salary rate %	44,23	44,23	44,23	44,23
VAT rate %	17	20	21	22,5
Uncovered % of GDP	4,70	2,0	1,20	-
Salary rate %	36,06	36,06	36,06	36,06
VAT rate %	17	21	22	23,5
Uncovered % of GDP	5,59	2,1	1,23	-

## ORDER AND METHOD OF IMPLEMENTATION OF TAX REFORM

In the previous text, we pointed out that the tax reform which has a neutral character is desirable. Therefore, it is necessary to compensate to the public sector all tax revenues "lost" due to the relieving the economy.

In Table 11 we have listed 6 variants of VAT rates as "coverage" for decreased public revenues due to lower payroll taxation rates in order to show what the changes in the VAT rate mean for the public revenues.

However, in practice, **the implementation of tax reform should go in an entirely different, opposite direction.** As the relieving the economy significantly reduces public revenues, it is necessary to find a way of compensation because the tax reform that we suggest has a neutral character. Compensation of public revenues should go as follows and by the following sequence of actions:

### a) the responsibility of the Entities

1. Savings in the public sector (budget and off-budget spending)
2. Introduction of the tax on real property (residential space over 25 m<sup>2</sup> per family member, weekend houses, etc.)
3. Introduction of tax on transactions of financial institutions (banks, stock exchanges, investment funds, insurance companies) and international payments
4. Introduction of tax on car registration services
5. Introduction of a special tax on luxury cars (according to cc)
6. Introduction of tax on telecommunications services using the mobile network
7. Introduction of tax on winnings from games of chance
8. Introduction of tax on uncultivated agricultural land
9. Introduction of tax on unused entrepreneurial real estate.

## a) the responsibility of Bosnia and Herzegovina

10. Increasing the excise tax on high-tariff goods

11. Increasing the VAT rate

The first step that we think we need to make are the savings in the public sector, not only in budget spending, which the Federal Government is already doing, but in total public spending with an emphasis on off-budget spending (75% of direct taxes relate to the financing of off-budget spending - PIO, health care, unemployment). In the analysis it is necessary to specify in detail how much could be saved in this way.

Given that the real estate tax is the most efficient tax from the standpoint of long-term economic growth and that in developed countries it significantly participates in the financing of public spending, we should seriously consider the introduction of this tax and do analyses of how many the funds on this basis could be used to finance public spending. With the aim of further taxing on the wealthier segments of society, games of chance, stimulating the development of agriculture, encouraging entrepreneurship and construction, discouraging imports, we could consider the introduction of a tax on winnings from games of chance, tax on transactions of financial institutions and international payments, tax on car registration services, tax on luxury cars, tax on telecommunications services using the cellular network, tax on uncultivated agricultural land, tax on unused entrepreneurial real estate and tax on unused construction land and do an analysis of what these taxes mean as a contribution to the financing of public spending. Since the prices of coffee, cigarettes and alcoholic beverages in BiH are among the lowest in Europe, the next step would be thinking about increasing excises and estimating how much money for public consumption could be provided in this way.

Only when we do **accurate assessments of how much the funds to finance public spending could provide savings in the public sector, excise duties and taxes which do not burden the economy** (11 previously described actions and measures), as the last, 12th option would be to change the VAT rate, but **only for a difference** that cannot be provided within the previous 11 steps.

**Theoretically it can happen (very unlikely) that the VAT rate does not change at all**, if the analyses showed that the "lost" public revenues due to relieving the economy can be compensated with the first 11 actions (steps) that are discussed in this section (12th step - change in the VAT rate is not required then). Thus, we suggest a change in the VAT rate only in exceptional circumstances and as a last resort, with the aim of providing the domestic economy and foreign capital, in tax terms, the most competitive business environment with the lowest cost of labour force in the region and the EU.

How to perform a precise compensation in the public sector depends on the calculation of how much the funds could be provided by the above measures and political will to make its decision on the selection of the type of tax.

As a stimulus for discussion and easier decision-making, here are a few variants of compensation for "lost" revenues due to relieving the economy. We believe that the example we present is very realistic and socially sensitive.

## COMPENSATION OF PUBLIC REVENUES

Table 12

in mil. KM

PROPOSED MEASURES	PROPOSAL 1			PROPOSAL 2		
	rate 44,23%			rate 36,06%		
	Variant I	Variant II	Variant III	Variant I	Variant II	Variant III
1. Savings in public spending	150	150	150	150	150	150
2. Tax on immovable property	10	10	10	10	10	10
3. Tax on transactions between financial institutions and international payments	60	60	60	60	60	60
4. Tax on car registration services	5	5	5	5	5	5
5. Special tax on luxury cars (according to cc)	10	10	10	10	10	10
6. Tax on telecommunication services using the mobile network	5	5	5	5	5	5
7. Taxation on winnings from games of chance	60	60	60	60	60	60
8. Tax on uncultivated agricultural land	2	2	2	2	2	2
9. Tax on unused entrepreneurial real estate	2	2	2	2	2	2
10. Tax on non-built construction land	1	1	1	1	1	1
Total 1 - 10	305	305	305	305	305	305
11. Increasing excise on high-tariff goods by	157 (20%)	226 (28%)	292 (37%)	167 (21%)	236 (30%)	297 (37%)
12. VAT rate increase	268 (19%)	199 (18,5%)	133 (18%)	398 (20%)	329 (19,5%)	268 (19%)
TOTAL 1 - 12	730	730	730	870	870	870

Estimate of the amount of revenues that will be realized from taxes 2-12, made by FZZPR.

## DIRECT TAXES 2004 and 2010 - FBiH

Table 13

	2004		2010		GROWTH %	
	mil KM	% GDP	mil KM	% GDP	Rate	
	1	2	3	4	5 (3/1)	6 (4/2)
Personal income tax	161,4	1,56	266,2	1,70	64,9	9,0
Corporate income tax	63,4	0,61	186,1	1,19	193,5	95,1
PIO	801,0	7,74	1447,4	9,27	80,7	19,8
Health care	572,2	5,53	1008,5	6,46	76,2	16,8
Unemployment	78,8	0,76	114,4	0,73	45,6	-4,0
<b>GDP</b>	<b>10.350,0</b>		<b>15.615,0</b>		<b>50,9</b>	

Table 13 shows why the first action in the implementation of the tax reform should be the savings in the public sector, not only in budget spending, but also in extra-budgetary funds.

In the period from 2004 to 2010, in terms of GDP, the revenues on the basis of income tax, profit tax, PIO contributions and health insurance contributions grew significantly faster.

Revenues based on income tax increased by as much as 3 times and had doubled share in GDP in 2010 compared to 2004. All other public revenues also recorded a much higher growth compared to the GDP growth (50.9%) - income tax 64.9%, PIO 87.7%, health care 76.2%.

Since after the war, year after year, all former governments spent more than the new value (GDP) created by the economy, each successive government after the war found the condition that is much harder than the previous one. We think that it is high time that this practice ceases. There is a great danger that, because of social and political pressures, the current "populist" model be accepted which, always after a short time, gets the FBiH into an even greater and deeper crisis.

What would happen if this practice continues is well illustrated by the famous Italian philosopher, economist and historian of the 18th century, Pietro Verri: "Taxation can lead to deterioration of a nation in two ways. One way, if the amount of tax exceeds the power of the nation and is not proportionate to the general wealth. Second way, if the amount of tax, although proportional to the overall power of the nation, is not well distributed".

In the period 2004 - 2010, only the income from unemployment insurance grew more slowly than GDP because the rate was reduced in the past period.

In all variants we propose, the special fee for protection against natural and other disasters (0.5%) would be removed.

Pressed by the crisis, many European countries used restrictive measures to limit public spending (Croatia in 2012 to 500 million Euros, Germany in 2012 to 80 billion Euros and the release of 10,000 employees in the public sector, France until 2016 to 65 billion Euros, Italy to 128.9 billion Euros).

All the solutions proposed in this document enable a **revenue-neutral tax reform**. In the next section we will show how the proposed reform would lead to an economically more efficient tax system and a more competitive economy.

## IMPACT OF TAX REFORM ON THE OVERALL ECONOMIC AND SOCIAL DEVELOPMENTS

Historically, reforms always have a long term character and impact on the wider social community. A similar situation is with the tax reform that will have long-term consequences for the economy and economic trends, but on the other hand, for the social developments as a whole. This is particularly true in the reduction of poverty, because with the reform we anticipate a significant increase in employment, which should ultimately have a positive effect on the increase in living standards of citizens.

In this part of the material we will discuss the short analyses of the economic effects of the proposed tax reform through the impact on increasing employment levels, reducing the shadow economy, increasing competitiveness of the economy, reducing the trade deficit and the long-term economic growth.

### FISCAL BURDEN ON SALARIES – FBIH

Table 14

Current burden	On 100 KM net salary	73,73
Proposal I	On 100 KM net salary	44,23
Proposal II	On 100 KM net salary	36,06

### Employment

The proposed tax reform would lead to a reduction of the fiscal burden on earnings, which currently amounts to 73.73 KM on 100 KM in net earnings, to 36.06 or 44.23 KM on 100 KM net earnings, depending on the variant chosen.

Economic and market logics dictates that a **reduction in labour costs**, leading to an increased accumulation and tax competitiveness of the economy, should **increase the demand for labour** and thus cause the **increasing in the number of employees and reducing long-term unemployment**. The new tax rate of payroll taxation would have a positive effect on domestic and foreign investments, which would certainly reduce the number of unemployed.

The assumption is that the from the total amount of relief, the economy will invest 50%, which is quite realistic, and that the other half will be used to pay employees, dividends, short-term liabilities of companies and the reserve fund of the company. This means that the FBIH economy will annually invest their own funds in the amount

of **366 million KM** (the first proposal - the rate of 44.23% on net salary) and **435 million KM** (second proposal - rate of 36.06% on net salary).

What this means in a situation of difficult access to already expensive credit resources of banks, needs no explanation. The funds set aside by companies for a reserve fund and dividends, at some point in the near or distant future, can also be converted into investments of business entities or citizens, and payment of short-term obligations of the economy and a rise in salaries will increase the liquidity of the economy and private consumption, which will lead to the increase in revenues from VAT. All this will contribute to increased domestic investments, which directly leads to an increase in employment.

## **Shadow economy**

The key feature of the tax system in BiH is a **strong reliance on labour taxes**, making difficult the position of the economy and resulting in a large number of employees in the informal sector (shadow economy). The direct connection between the fiscal burden and the shadow economy can be seen from the fact that the highest rate of informal employment is in case of farmers and workers with low wages. In FBiH the tax burden on employees with low incomes is among the highest in Europe.

Shadow or unregistered economy, which has resulted in, among other things, tax evasion, is present in a greater or lesser extent in all countries of the world. Estimates of the shadow economy in the OECD countries range from about 9% (the USA) to 28% of GDP (Greece)<sup>2</sup>. However, the shadow economy is far more present in European countries in transition, such as BiH, for which estimates say that the share of the gray economy is about 36% of GDP<sup>3</sup>. It is quite clear that unregistered economy adversely affects the economic development and resource allocation, as economic entities that make tax evasion are so-called unfair competition to economic entities operating in accordance with legal regulations. In this sense, it is necessary to ensure that the "rules of the game" in the market apply to all equally, and as one of the ways to achieve this we see the tax reform that we propose.

The experience teaches us that it is most difficult to carry out the **tax evasion in part of taxes of citizens that do not burden the economy** (it is easier to get to the data on the assets for tax apportionment and the collection is simplified) **and in the system of indirect taxes** where it is necessary to organize a tax evasion system throughout the chain (from production and import to retail). Detection of tax evasion at any stage of production or marketing would lead to tax collection for the entire value added in the previous stages. The VAT system is a self-controlling system to a large extent because

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<sup>2</sup> F. SCHNEIDER: The size and development of the shadow economy and the workforce in the shadow economy in 22 transition countries and 21 countries of the OECD.

<sup>3</sup> Federal Development Planning Institution 2008 - Unregistered (shadow) economy (NOE) in the FBiH - analysis (evaluation was performed for the FBiH in 2008, but we think that it may relate to the entire BiH and that it is appropriate even today).

everyone in the chain from production to final consumption is interested in receiving a procurement invoice that will allow them to recover the input VAT. VAT is a multi-stage tax paid by everyone in the chain to their share of added value, so it is quite logical that it is hardest to make the tax evasion in the VAT system. This means that for the completion of tax evasion, the tax evasion must be made at all stages, which is quite difficult. Economic analysts believe that, in the world today, from the viewpoint of billing and collection, VAT is the most reliable tax.

Also, there are a lot of opportunities for the efficient collection of taxes from citizens (fee when registering vehicles, through phone bills, electricity bills, when issuing identity documents, etc.).

On the other hand, the experience of Eastern Europe and the former Yugoslavian countries show that **the shadow economy is most present in the field of labour**. In the economic life of BiH and the FBiH, there are three ways of tax evasion in the field of labour. The first way is when employers do not register workers ("moonlighting"). In this case, these are the evasions of the entire amount of obligations based on salaries paid. Another way is when employers register workers with legally minimum wages, and the difference to full wages is paid "at hands" ("shadow work"). The third method of evasion in the field of labour is the most benign and consists in "lowering salaries" with a maximum statutory increase in allowances other than wages (meals, transportation costs, etc.) that are not taxed.

Considering the incentive rates of taxation of labour that we propose, it can be expected that a significant number of businessmen will have no need to conceal the payment of wages, and thus the obligations based on wages. We may presume that a significant reduction in burden on wages would result in an **increase in tax discipline** which would further reduce the shadow economy and result in additional government revenues.

When we analyze the table 13, we saw that a realistic and properly defined level of tax rate as is the case with the income tax (10%) contributes to the growth of public revenues. Revenues from income tax increased in 2010 compared to 2004, even 3 times. Compared to the period before 2000, when the tax rate was 30%, public revenues on this basis increased much more.

The system of indirect taxes is so arranged that it is much more difficult to cover up the obligations on this basis and in practice there was no case of an employer that regularly registers all workers and pays in full all the obligations arising from the payment of salaries, and on the other hand performs tax evasion in the VAT system. There are many reversed cases, i.e. the companies regularly pay their indirect taxes, and conceal the direct taxes on labour. The above shows that tax evasion is considerably higher in the field of direct taxation which tax salaries than in the field of indirect taxes. According to some estimates, annual VAT evasion in the EU amounts to 2-2.5% of GDP<sup>4</sup>, which is significantly lower than evasion in the field of labour. It is therefore quite clear and logical that the **reduced taxation in the fields where tax evasion is most represented** (direct

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<sup>4</sup> Dinka Antić, 2008, „Barijere u sistemu PDV-a i tržišna konkurentnost“ ("Barriers in the VAT system and market competitiveness")

taxes that burden the labour) **and increased taxation on the fields where the shadow economy is least present** (taxes on citizens, excise and VAT), **would automatically reduce the scope of shadow economy in BiH and the FBiH.**

## **Long-term economic growth, competitiveness and trade deficit**

Taxes on citizens and indirect taxes do not affect exports and investment, so that the introduction of or increase in these taxes with significantly relieving the economy would decrease labour costs which would have a positive impact on the growth of economic activities and production, and an increase in the competitiveness of BiH economy on the international market.

The reform that we propose would lower the prices of export goods which would contribute to **increasing the price competitiveness of the BiH economy.** In this way, the creation of conditions for **increasing exports** is directly influenced, and thereby **reducing the trade deficit**, which is now very pronounced in BiH. Studies show that the growth of exports, or sales in foreign markets, provides two times more jobs than the same sales quantity of domestic market.

A significant effect of the tax reform is stimulation of the production of tradable goods as the burden of production would reduce (as a rule, production branches are more labour intensive than services) and the burden would be largely transferred to services that capture a significant share in GDP (in recent years services have recorded constant growth in share in GDP).

With a positive impact on the tradable goods sector which is in direct regional and wider competition, we would directly help the BiH economy to cope with intense competition from outside.

Tax competitiveness is one of the most important determinants of the overall competitiveness of a country. Tax competitiveness is, in fact, competition among countries to attract foreign direct investment by tax instruments and incentives, which is a crucial influence on **the commercial and overall economic growth.**

That is why, in the last two decades, a significant increase in indirect taxes (VAT, excise duty, customs duty) and a reduction of direct taxes relating to the taxation of labour and capital are present in the EU.

In this way, the international competitiveness of the economy is increasing because the costs of companies are reduced, the accumulation increased and conditions for investment growth and employment created, which in turn contributes to the growth of economic activities and GDP.

Direct taxes that burden the economy are inversely proportional to the competitiveness of the economy. **Higher direct taxes** cause higher costs of companies resulting in **lower competitiveness**, and vice versa, **lower direct taxes** contribute to **increasing the competitiveness of the economy.**

The taxation of factors of production, labour or capital, directly discourages production. On the other hand, taxing consumption directly discourages consumption, while indirect effects include stimulation of savings and discouraging of economic activities. However, the differences between the taxation of consumption and production factors in particular come to the fore in the inter-temporal context - in the long run. Namely, the taxation of

consumption does not affect the inter-temporal allocation of consumption, while the taxation of factors of production in presence has a negative impact on inter-temporal allocation of resources in the future. Hence **the theory of economic growth suggest that the taxation of consumption and taxation of property of citizens is economically more efficient than the taxation of factors of production**, which is another argument in favour of the proposed tax reform. We can conclude that **the proposed reform would have positive effects on the business environment and economic growth**, BiH export competitiveness and employment levels, thereby causing no significant negative effects<sup>5</sup>.

Lowering the rate of taxes and contributions on salaries from the current 73.73% (net salary base) to 36.06% or 44.23%, is extremely encouraging for doing business, for attracting foreign investment, with **the lowest such a rate not only in region but also beyond in the European scale**.

#### FISCAL BURDEN ON EARNINGS IN THE EU COUNTRIES AND GENERAL VAT RATE

Table 15.

	Burden on net earnings %	VAT rate %
Belgium	98,2	21
Germany	84,7	19
France	80,1	22
Austria	77,9	20
Italy	74,0	21
FBiH	73,7	17
Hungary	72,3	27
Sweden	71,9	25
Romania	71,8	24
Slovenia	69,2	20
Lithuania	68,9	21
Latvia	68,9	22
Czech R.	67,0	20
Serbia	64,0	18
Croatia	64,0	25
Estonia	63,1	20
Turkey	62,6	18
Denmark	60,5	25
Finland	59,4	23
The Netherlands	58,6	19
Poland	57,1	23
Spain	56,3	18
Slovakia	54,3	20
Norway	51,0	25
Greece	50,2	23
Portugal	48,8	23
Bulgaria	47,7	20
FBiH – proposal I	44,2	Up to 19
England	42,7	20
FBiH – proposal II	36,1	Up to 20

Ireland	29,1	23
FBiH – consolidated rate I	33,4	Up to 19
FBiH – consolidated rate II	27,3	Up to 20

Source: Eurostat 2010.

<sup>5</sup> Altiparmakov, 2010.

Analyzing Table 15, it is clear that in both variants the total rate of taxation of labour would be more stimulating compared to all countries in the EU and region, with the exception of Ireland which has an aggregate rate as the percentage of 29.1% on net salary. Compared to all the other countries of Europe, developed or countries in transition, BiH and the FBiH would have much lower labour cost, which is extremely favourable for the growth of business activities, an improvement of the investment cycle and a strong economic growth. However, if we equalize the bases since all personal incomes in the EU are taxable, and we do not tax costs of hot meals and transport, the actual rate in the FBiH would not be 36.06%, but 27.3% for the same, in mass realized revenue from taxation of wages. This means that in this case the rate of taxation of labour in the FBiH would be more stimulating even in relation to Ireland, meaning the lowest and most stimulating one in Europe.

On the other hand, the possible increase in the VAT rate is in line with the trend of developments in the EU and the European practice (average general VAT rate in the European countries is 20% in 2010, 21% in 2011 and 22% in 2012). To illustrate this, today in the European Union, Sweden, Denmark and Norway have the general VAT rate as a percentage of 25%, and Hungary has recently increased the VAT rate to 27%.

Since it is expected that in the period **after the introduction of new rates of tax on salaries, there would be a significant increase in employment, and therefore a large increase in consumption**, following the implementation of tax revenues, the VAT rate can be reduced (applies only to the last option, if it is necessary to increase the VAT rate) **for as much as revenues from indirect taxes grow beyond growth as a result of the increase in the VAT rate**. Employment growth will cause a significant increase in revenues derived from VAT due to a significant increase in private consumption.

According to our estimation, provided the solution of the political crisis in BiH and the debt crisis in the Euro zone and the global financial crisis, with a very stimulating rate of taxation of labour, as is proposed, in the FBiH economy **we can expect double the number of employees in the manufacturing activities in ten years**, and thus a large increase in private consumption. This means, if the VAT rate increased, during and after ten years the VAT rate could be significantly reduced (or even returned to the current 17%), and the rate of taxation of labour would remain at the same, lowered level. This would achieve about the same effects with the new significantly lower rate (36.06% or 44.23% depending on the selected solution), as before the reform with the aggregate rate of labour taxes as a percentage of 73.73%.

## OECD RECOMMENDATIONS

The series of recently published OECD studies, based on theoretical and empirical indicators, established the ranking of tax forms according to economic efficiency. Recurrent **taxes on (immovable) property are ranked as the most economically efficient form of taxation**, while **the second is the taxation of consumption**. Labour taxation is ranked as third, while the taxation of capital occupies the last place, as a form of taxation that has the most negative impact on economic growth (Johansson, 2008; Arnold, 2008; Myles, 2009)<sup>6</sup>, because increasing the burden on economy through taxation of labour and capital reduces the opportunities for the economy for new investment and new jobs.

Thus, **the proposed reform is in line with the OECD recommendations** and knowledge of economic theory aimed at establishing a more efficient tax system in which **the taxation of labour is replaced by economically efficient taxation of consumption and other types of taxes that do not burden the economy**.

### RANKING OF TAX FORMS - EFFICIENCY CRITERIA

Table 16

	OECD RECOMMENDATION		SITUATION IN BiH and the FBiH
1.	Tax on immovable property	1.	Taxing wages
2.	Tax on consumption	2.	Tax on consumption
3.	Taxing wages	3.	Tax on capital
4.	Tax on capital	4.	There is no tax on immovable property

In the total public expenditure of BiH, taxing of labour takes most part and we want to change this in order to provide entrepreneurs with a better business environment. Also, with the tax reform we propose introducing a tax on immovable property suggested by the economic theory as the most efficient tax from the point of economic growth.

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<sup>6</sup> Altiparmakov, 2010.

## EUROPEAN AND REGIONAL TRENDS OF MOVEMENT OF TAX POLICY

Academic studies in the EU over the last 20 years have shown that a desirable tax system is the one that encourages economic growth, investment, savings and employment, implies a shift from taxes on labour and capital to taxing consumption (excise and VAT), property and environmental taxes. Also, in light of the global tax initiatives by which the tax system would give full contribution to fiscal consolidation, the IMF is committed to the reform of the tax systems towards a higher share of taxation of consumption in relation to the taxation of labour and capital, considering consumption a less variable tax base in relation to salaries and profits, which affects more stable public revenues.

Such a trend of tax policy movements in the EU has been present in recent years. It can be noted that the expansion of the EU in the last twenty years has led to greater mobility of capital and labour. The mobility of capital has caused debates in European countries about keeping the tax policy and optimizing the direct and indirect taxes in the interest of sustainable economic development. Analyzing the tax policy in the EU in the last 20 years, it is obvious that the European countries have chosen a simple and logical solution.

In the nineties of the 20th century, there is a visible tendency to decrease the tax burden on capital in the EU countries, and since 2000 the reducing of labour taxation is noticeable. In this way, by giving tax concessions to capital through the reduction of tax rates on profits and dividends, and reducing the tax burden on earnings, the EU countries made decisions with the primary aim to attract foreign capital and to increase the competitiveness of the economy. This practice is especially visible in the region of Eastern Europe.

Looking at Table on the 17, it is clear that in the period after 1980, in almost all EU countries there is a noticeable trend of constant VAT growth, which created the possibility for relieving the economy by reducing direct taxes on labour and capital.

Putting the emphasis on increased taxation of consumption, the highest number of countries was increasing the VAT rate, although the increases in excise duties are not insignificant.

In the period after the onset of the global financial crisis, Estonia, Latvia, Lithuania, Hungary and Ireland increased VAT rates. The Czech Republic and Bulgaria decreased the income tax and contributions during the crisis to further strengthen the competitiveness of their national economies. Taking into account the competitiveness of the economy, most of the EU countries in the selection of tax forms to increase revenues for financing of public spending, have selected the indirect taxes.

Even today, a number of EU countries are conducting the activities to increase the VAT rate (Finland from 23% to 25%, Italy from 21% to 23%, Lithuania from 21% to 23%).

## MOVEMENTS IN GENERAL VAT RATES IN THE EU 1980-2012

Table 17

	1980	1990	2000	2010	2012	Changes in progress
Belgium	16	19	21	21	21	
Germany	13	14	16	19	19	
France	17,6	17,6	19,6	19,6	22	
Austria	18	20	20	20	20	
Italy	15	19	20	20	21	23
Hungary	-	25	25	25	27	
Sweden	23,5	25	25	25	25	
Romania	-	18	19	24	24	
Slovenia	-	-	19	20	20	
Lithuania	-	-	18	18	21	23
Latvia	-	-	18	18	22	
Czech R.	-	-	22	20	20	
Serbia	-	-	-	18	18	
Croatia	-	-	22	22	25	
Estonia	-	10	18	20	20	
Turkey	-	18	18	18	18	
Denmark	20	22	25	25	25	
Finland	-	-	22	23	23	25
The Netherlands	18	18,5	17,5	17,5	19	
Poland	-	-	22	22	23	
Spain	-	12	16	18	18	
Slovakia	-	-	23	20	20	
Norway	-	-	-	25	25	
Greece	-	18	18	21	23	
Portugal	-	-	17	21	23	
Bulgaria	-	-	20	-	20	
England	15	17,5	17,5	20	20	
Ireland	25	23	-	-	23	

Source: European Commission, 2012.

## POSSIBLE NEGATIVE PUBLIC PERCEPTION CONCERNING THE POSSIBLE INCREASE IN VAT RATE

According to the European practice, the EU directives and the existing solutions in the Law on VAT in BiH, the obligation to pay VAT arises on the basis of billed realization. Due to the expressed illiquidity of the economy of BiH and the FBiH and late payments between business entities which lasts for several months, VAT payers would be more suited to VAT paid on the collected and not on invoiced realization. Therefore, in a number of businessmen and part of the public might think that increasing the VAT rate would increase illiquidity of the economy.

Bearing in mind that the legal solutions of indirect taxes in BiH were made in full compliance with the European regulation (VAT payable on invoiced realization), and that most of the economies of European countries do not suffer from lack of liquidity, it is clear that **the problem in BiH is not and cannot be the method of calculation and payment of VAT**, and that VAT cannot significantly affect the illiquidity of the economy that **has causes of a completely different nature**. In addition, radical relieving of the economy will directly increase the liquidity of companies, considering that we suggest more than twice a cut in labour cost. This means that **companies have a benefit from relieving the economy (greater reduction in wage costs) much greater than it is a negative effect based on the VAT growth, if the same went at the expense of business entities without increasing the prices**.

Another issue that may arise in the public is whether the VAT increase may cause an increase in inflation. We think that in a situation of great relief of the economy by a significant reduction in labour costs, there will be a huge number of entrepreneurs (especially in labour-intensive industries) which will not increase the prices due to the possible increase in the VAT rate because they have no reason to do so. But if the VAT rate increases in the implementation of the tax reform, only one time price increase can happen. The current system of calculation and payment of VAT cannot cause any additional long-term pressure on inflation. Thus, **an increase in VAT rate cannot affect the inflationary cycle in the long term**.

Another concern that could appear in public is that a possible increase in VAT further impoverishes the citizens and adversely affects the standard of living.

The thesis according to which **the VAT rate** (17% - among the lowest in the EU), **is untouchable and should not be changed at all** because allegedly every increase impoverishes citizens, is false, absolutely **economically unjustified** and conservative. If citizens do not work and do not have salary, they will not purchase goods easily even if there was no VAT. In theory, if we abolished VAT entirely, it would not significantly ease the position of citizens and would not significantly affect the increase in living standards. Only if the **citizens are employed and receive regular salaries** they can **meet basic needs**, and even buy basic foodstuffs and household items necessary for life. Hence, the essence of the tax reform is to create conditions for investment growth, employment growth and overall economic growth, which in the long run means a better standard of living for citizens.

In the chapter "The impact of the reform on the economy, public sector and citizens", we have shown that the tax reform is in long-term interest of all economic entities and social groups in BiH and the FBiH.

We have already responded to the opinions, rather the media speculations, in a small part of the public that the tax reform affects the reducing of the competitiveness of the economy, and there is no need for further explanation.

We will just repeat that the introduction of new taxes that we propose and the increase in the existing taxes that we propose (excise tax and possibly VAT), have no influence on the reduction of competitiveness because they are not borne by companies and are not payable when exporting.

When it comes to the "transitional" period until full implementation of the tax reform, we note that the proposal advocated in this document has a neutral character (public revenues are neither increased nor decreased, only sources of revenues are changed), and that there cannot be any possible, unforeseen reduction in income for health insurance and unemployment insurance, which would cause a disruption in the financing of health care and workers who lost their jobs. Only the structure and sources of income will change. Until the moment of the introduction of the tax reform, the unemployment and health care funds will receive funds directly from business entities (the existing regulations), and after the introduction of the tax reform, the identical assets will be received from the budget. In the period after the possible introduction of a new VAT rate, it is easy to solve technically the question of the transitional period and **there is no fear that there may be unforeseen decline in public revenues** necessary for the functioning of the health care system and unemployment insurance, **nor can there be any disturbances in the functioning of public spending system**. In addition, the experience of some developed countries shows that, in periods of announcing the VAT rate growth, revenues on this basis grew before the decision was formally adopted (psychological effect in citizens).

## PROBLEMS IN PRESENTATION, ADOPTION AND IMPLEMENTATION OF THE DOCUMENT

Any problems in the adoption of the tax reform can occur due to **various constitutional competences** of direct taxes (Entities) and indirect taxes - VAT and excise duties (State level). This means that if it is decided that it is necessary to modify the rates of indirect taxes, the consensus should be reached at the state level, in both BiH Entities. Our opinion is that this should not be a big problem, considering that the relief of the economy and creation of conditions for the growth of economic activities, investment, employment and overall economic growth are the interest of the entire BiH public.

During the presentation of the document, which was organized by the FBiH Chamber of Commerce and cantonal chambers of commerce, there was a problem due to **insufficient and incorrect media interpretation of the document** in some influential media. Some media, although they did not report on the document and specific solutions of the tax reform, insisted on something that is not the essence of the document, so that **citizens do not get the true picture of the objectives and proposals of the tax reform**. The essence of the document is radical relieving of the economy with a proposal to introduce **the lowest rate of taxation of labour across Europe**, which means the best tax conditions for domestic and foreign capital, increase in investments, employment, production and exports. Should there be a change of indirect tax rates in the implementation of the tax reform, this would not be done for "patching holes" in the budget as some media already reported, but with the aim of relieving the economy and creating, in tax terms, the most competitive economy in Europe, as an assumption for overall economic growth and rising living standards for citizens. The VAT rate as a percentage of 17% (among the lowest in Europe) is the most powerful economic tool in the hands of government and it is extremely important to use such a trump card in the proper way. Our opinion is that there is no better way than a direct impact on the increase in the competitiveness of the domestic economy, which is in an extremely bad condition.

Because of the potential price increase (unlikely) and the negative impact on the poor segments of the population, the implementation of this document should be followed by **social programs** for the most vulnerable categories of the population, and the funds for the programs could be included into calculations by the tax reform.

In the debates in the cantons the formation of the Fund for the poor was proposed as a form of guarantee that in the implementation the poorest population will be taken care of. Funds for the establishment of the Fund for the poor can also be easily included into calculations by the tax reform, if a decision is taken in this regard.

In the public debate on the document, which was organized by the Chambers of Commerce of the FBiH and of the cantons, **businessmen and academic community** (the largest number of professors and doctors from economic and other faculties in the FBiH) **positively assessed the document and expressed strong support for the tax reform** as a development opportunity for the country.

## CONCLUSION

Tax solutions in the document "Tax Reform for the Purpose of Investments and Employment" are **revenue-neutral**. The proposal is to compensate for the revenues that the public sector "lost" due to reducing the direct taxes that burden labour costs, by introducing new taxes which do not burden the economy and an increase in indirect taxes (excise and possibly VAT).

The aim and essence of the document is a **radical relieving of the economy** by reducing the rate of taxation of wages from the current 74% on net salary, to **44%** (I variant), or **36%** (II variant). This significant relieving of the position of the economy would be achieved by the abolition of the contributions for health care and unemployment (rate 44%) and the abolition of income tax, contributions for health care and unemployment (rate 36%).

As a compensation to the public sector for the reduced public revenues due to the reduction of direct taxes that burden labour, we suggested several possibilities: savings in the public sector (especially in off-budget spending), introducing a tax on immovable property, tax on winnings from games of chance, tax on transactions of financial institutions and international payments, tax on car registration services, tax on luxury cars, tax on telecommunications services using the cellular network, tax on uncultivated agricultural land, tax on unused entrepreneurial real estate, tax on undeveloped building land, increase in excise duties, and at the end as the last solution, an increase in the VAT rate, but only for a difference that cannot be "covered" by the previous taxes and savings in the public sector.

**Strengthening the so-called tax competitiveness** by radical relieving of the economy, we would provide for a significant inflow of foreign direct investment which would increase employment and living standards. For countries in transition, and those that are lagging behind significantly in terms of technology, the tax competitiveness is a key instrument for strengthening the competitiveness of the economy. Significant relieving of the economy would create conditions for increasing domestic investment which would also significantly increase the number of employees.

Furthermore, the proposed tax reform would, first of all mean discouraging consumption and imports, stimulating production and exports, and reducing the tax "evasion", because the tax burden would be transferred from the areas with the largest shadow economy (labour) to the area where tax evasion (taxes of citizens and indirect taxes) is most difficult to carry out.

The current system relies significantly on taxes and contributions on salaries, which strongly encourages employers and workers to leave the formal sector and thus avoid paying taxes. This is difficult to do for foreign investors and potential exporters, and therefore they bear, generally, a disproportionate share of levies based on the labour tax. This affects foreign direct investment, reduces the competitiveness of the economy and has the negative impact on economic growth.

**Reducing the shadow economy** would mean to allow more equal competition to all market participants. This would protect economic agents operating within legal

frameworks against unfair competition prone to tax evasion, and in particular the foreign investors would be protected, which in today's time of recession is one of the most important goals of tax policy.

The tax reform would eventually influence to **reducing the imbalance present in BiH economy**, which is reflected in a **high trade deficit, high unemployment rate, high public spending level and low level of investments**.

Abolition of contributions for health and unemployment would enable a **more economical structure of the state apparatus and a simpler system of public revenues collection**. Also, empirical experience of the past few decades suggests that **health systems funded from taxes have been more successful in controlling public expenditure on health care, compared to systems that are financed from contributions** (Van der Zee i Kroneman, 2007)<sup>7</sup>.

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<sup>7</sup> Altiparmakov, 2010.

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