



Bosnia and Herzegovina

Federation of Bosnia and Herzegovina

Government of the Federation of Bosnia and Herzegovina

Draft

PROPOSALS TO RELIEVE THE ECONOMY IN THE FEDERATION OF BiH

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Working Group

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INTRODUCTION

All strategic and operational documents in the Federation of BiH after the war pay a significant attention to the relieving of the economy as a prerequisite for economic growth and so desired employment growth.

Today there is no program of work of any political party in the FBiH (regardless of whether it is in a position or opposition) that gives not a prominent place to relieving the economy, hence there is a general consensus on the need to facilitate the position of the economy as a prerequisite for economic growth and increase in the standard of living of citizens.

In the Work Program of the FBiH Government for the term 2015 - 2018, the section S2) Reducing the burden on labour, explicitly expressed the commitment of the Government to increase the competitiveness of the domestic economy by reducing the obligations on the basis of labour.

Because of budget problems at almost all levels of government, today in BiH there is very little room for the development budgets and GDP growth supported by investments of the public sector and there is almost no chance for employment growth in the public sector. Therefore, the growth of the private sector, the growth of the private investment potential and the growth of employment in the private sector are extremely important.

However, a stimulating business environment should be provided for the growth of the private sector. For the first time after the war, the FBiH Government has clearly and unambiguously committed to improve the business environment and relieve the economy, which will, as economic principles tell us, lead to economic growth and employment growth.

The idea under consideration in this document is the idea of a revenue neutral relieving of the economy, with a significant reduction of direct taxes on labour with an increase in consumption tax and other taxes that do not burden the economy.

The economic theory suggests that a more efficient tax system would be established in this way. The idea of transferring the burden of taxation from direct to indirect taxes is not new. It has been present in theory for many years, but in our practice and in the public no one has seriously considered it so far.

In this document we present four proposals to relieve the economy in order to show that the reducing the labour taxation has influence on the employment growth and the growth of public revenues in the long term. We do not prejudge any of the considered proposals because we are aware that a consensus on the State and Entity levels must be reached on a more significant unburdening of the economy, which is necessary, considering the extremely low competitive position of the BiH economy. Theoretically speaking, there are many variants of the reduction of labour taxation and in consultations on horizontal and vertical level an entirely new proposal

can be reached. Consensus should be achieved even for individual taxes which are the responsibility of the Entities by which we would compensate for the lack of public revenues due to reduction in liabilities arising from labour. For example, if we used as compensation the tax on telecommunication services of mobile network or the tax on transactions of financial institutions (introduced in 9 EU countries), the telecom operators and financial institutions in the FBiH would be less competitive if these taxes would not be introduced across the BiH.

OBJECTIVE OF RELIEVING THE ECONOMY

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 of public spending. But the practice has shown that excessive taxation of capital (income tax) and labour (taxes and contributions on salaries) play a crucial role in the relocation of capital from one country to another, i.e. from countries with higher direct taxes to countries with lower direct taxes and based on this, the competitive position of national economies began to build, and the relieving of the economy by direct taxes began to be treated as a way to attract foreign direct investment.

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

The aim of this paper is to consider the proposals to relieve the economy as a precondition for increasing the economic competitiveness in domestic and foreign markets on the one hand and reducing the "shadow" economy on the other.

Slow job creation and generally low labour demand is the key problem of unemployment in BiH. There is no 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, along with Macedonia, the lowest employment rate of the labour force. Of the total number of the unemployed, 86.6% are long-term unemployed (over a year). Half of the unemployed (50.3%) have been unemployed for over five years.

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 the competitiveness is particularly important for a small transitional country and a potential member of the EU, such as Bosnia and Herzegovina is.

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. 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 out of 12 least competitive European countries.

The essence of this document is to reduce direct taxes that do not burden labour costs, by which we influence on the competitiveness of the domestic economy (liabilities for wages are the cost of companies), with an increase and the introduction of other taxes that do not affect competition, because they are not payable on exports and do not cost burden the economy.

Since the public sector loses part of income due to relieving of the economy, it is necessary to compensate for the same in order to avoid disturbances in public spending.

Compensation for missing public revenues (neutral character of reduction in levies on the economy) due to the reduction of direct taxes could be made by selecting the measures as follows:

- Savings in the public sector,
- Introduction of other, in terms 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, 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, tax on pollution),
- Increasing the excise tax on high-tariff goods, and finally, as a last resort,
- Increasing the VAT rate, if necessary.

These types of compensation of funds to the public sector could be combined with the introduction of progressive taxation of salaries (salary grades), taxation of benefits based on labour (food, transport, recovery 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 solutions that we propose in this paper are entirely in line with current regional and European trends, fully following the economic logic, the experience of the global economy and the opinions, views, analyses and studies of famous European and world economists.

IMPACT OF RELIEVING THE ECONOMY

In the long term, conditions are created for new investment and employment (the obligations of the company are reducing and the accumulation is increasing), which influence on the growth of companies, and thus the overall growth of the economy.

Relieve the economy will have a positive impact on the public sector in the long term, because there will be growth and a 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, excise duties).

The interest of citizens will also be satisfied in the long term because the economic logic says that there will be a significant increase in employment (lower cost of labour affects the increasing demand for labour). There is no greater interest to the citizens than the increased employment because only citizens who work and regularly receive salary have a chance to meet basic needs and not to be poor.

We should especially bear in mind that companies make profit in which all the other economic entities "embed". Therefore, with the relief of the economy and thus increasing the competitiveness, 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.

In the short term (one year), the effect of relieving the economy to the public sector is neutral because the revenues will not change.

PAYROLL TAX RATES IN THE FBiH

Table 1

	Gross salary base	Net salary base
PIO	23,0%	36,06%
Health care	16,5%	25,87%
Unemployment	2,0%	3,13%
Protection from accidents	-	0,50%
Personal income tax 10% *	3,53%	5,39%
TOTAL	45,03%	70,95%

*The income tax base is the net salary with accrued income tax, net of personal deduction

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%.

Table 2 The tax wedge in the OECD countries, the rates of taxes and contributions in% (contribution base gross salary)

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

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

The table shows the total tax wedge in some OECD countries in 2014. It is obvious that the FBiH is just behind Belgium by the tax burden on labour (before Austria) with the productivity of the FBiH not even close to the productivity of Belgium or Austria.

By tax competitiveness, the most competitive OECD countries are the United States, Canada, England, Ireland and Israel.

PROPOSALS FOR RELIEVING THE ECONOMY

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 (see the studies Johansson, 2008; Arnold, 2008; Myles, 2009), 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 method of relieving the economy in this document 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 more efficient taxation of consumption and other types of taxes that do not burden the economy.

Table 3 Ranking tax forms - the criterion of efficiency

OECD RECOMMENDATION		SITUATION IN BiH and 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. Relieving the economy on this basis and increasing the taxation of consumption and property, we would change the current practice and thus provide a better business environment for entrepreneurs.

Since the contributions take the most part of total load 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.

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 improved the liquidity of the company 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.

It is essential to relieve the economy as to ensure fiscal sustainability and we just do so by a neutral principle because we compensate the lack of public revenues due to reducing taxes on labour in full by the savings in the public sector, additional taxation of consumption and other taxes that do not affect the economy.

In a complex situation like today in BiH, the only sustainable macroeconomic relieve of the economy is the one by which the share of public revenues in GDP does not

change in the short term and which leads to a moderate increase in public revenues in the long term. The reduction of liabilities based on labour 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 lead to an increase in public debt, which is the more likely option.

Table 4 Proposals of rates after relieving - net salary base

Aggregate rate - net salary base %	0 70,95	I 62,48	II 57,09	III 44,23	IV 36,06
Lack of public revenues in mil. KM	0	185	302	583	761

The above review shows that the relief of variant I creates savings in economy in the amount of about 185 mil. KM, in variant II around 302 mil. KM, in variant III savings are about 583 mil. KM, and in variant IV the amount of savings in the economy is about 761 mil. KM. The missing public revenues are consolidated (net) for liabilities arising from wages by the public sector (ministries, administrative bodies, agencies, institutions, etc.) that will not be payable due to the reduction of taxes on labour and will remain in the budget.

As in all variants of relieving the economy the public revenues are reduced, it is necessary to make compensation. Compensation of public revenues could be done as follows:

a) the responsibility of the Entities

- Savings in the public sector (budget and off-budget spending)
- Introduction of the tax on real property (residential space over 25 m² per family member, weekend houses, etc.)
- Introduction of tax on transactions of financial institutions (banks, stock exchanges, investment funds, insurance companies)
- Introduction of tax on car registration services
- Introduction of a special tax on luxury cars (according to cc)
- Introduction of tax on telecommunications services using the mobile network
- Introduction of tax on winnings from games of chance
- Introduction of tax on uncultivated agricultural land
- Introduction of tax on unused entrepreneurial real estate
- Introduction of tax for pollution.

b) the responsibility of Bosnia and Herzegovina

- Increasing the excise tax on high-tariff goods and, if necessary, for the missing difference
- Increasing the VAT rate.

EFFECTS OF RELIEVING THE ECONOMY

Employment

Economic and market logics dictates that a reduction in labour costs leads to an increased accumulation and tax competitiveness of the economy, increases the demand for labour and thus causes the increasing in the number of employees and reducing long-term unemployment. Relieving the economy would have a positive effect on domestic and foreign investments, which would certainly reduce the number of unemployed.

Shadow economy

The key feature of the tax system in BiH is a strong reliance on labour taxes (in the financing of public spending in the FBiH, direct taxes account for 3.14% of GDP, more than indirect taxes), which makes difficult the position of the economy and results 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 the FBiH the tax burden on employees with low incomes is among the highest in Europe.

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 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 on 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 say 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.

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 GDP¹, 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 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

Relieving the economy would reduce 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.

Tax competitiveness is one of the most important determinants of the overall competitiveness determinants of a country. Tax competitiveness is, in fact, a 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.

^{4 1} Dinka Antić, 2008, „Barijere u sistemu PDV-a i tržišna konkurentnost“ ("Barriers in the VAT system and market competitiveness")

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 theory of economic growth suggest that the taxation of consumption and property of citizens is economically more efficient than the taxation of factors of production, which is another argument in favour of reducing the taxation of labour.

Based on the above we can conclude that the relieving of the economy would have positive effects on the business environment and economic growth, BiH export competitiveness and employment level, thereby causing no significant negative effects.

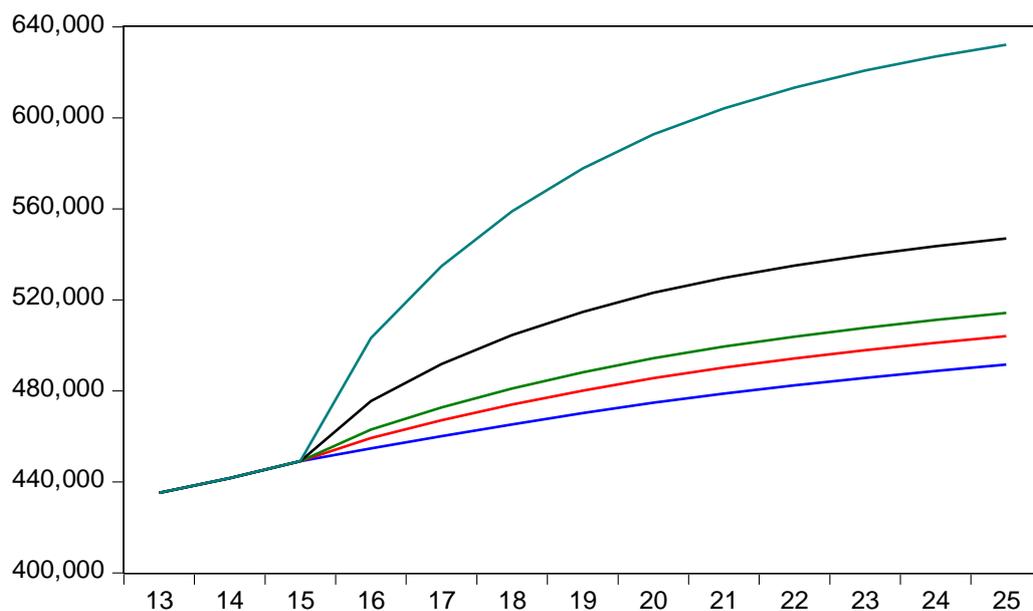
IMPACT OF REDUCING THE RATES BASED ON SALARIES ON EMPLOYMENT AND PUBLIC REVENUES

A simulation of reducing the rates of taxation of labour in the FBiH and its impact on employment growth and public revenues, in the framework of the EU Twinning Project, was prepared by the Institute for Advanced Studies Vienna according to the model of Dr Klaus Weyerstraß which is adapted to our circumstances.

The table below clearly shows that, according to the findings of the Institute in Vienna, the number of employees in the ten-year period (2025) would rise to 49.970, without any reforms.

With the relieving of the economy of 8.47% on net salary in variant I (5.5% on gross salary) in 2025 the number of employees would increase by approximately 12,500 (an annual average of about 1,250), with a relief of 13.86% in variant II (9.00% on gross salary) the number of employees would increase by about 22,700 (an annual average of about 2,270), with a relief of 29.27% in variant III (19% on gross salary) the number of employees would increase by around 55,400 (an annual average of about 5,540) and a relief of the economy of 34.66% in variant IV (22.53% on gross wages) would bring employment growth according to the findings of the Institute in Vienna by around 140,500 (an annual average of about 14,050), which means that the total number of employees in this variant at the end of 2025 would increase by about 190,000.

Projekcija broja zaposlenih u FBiH do 2025



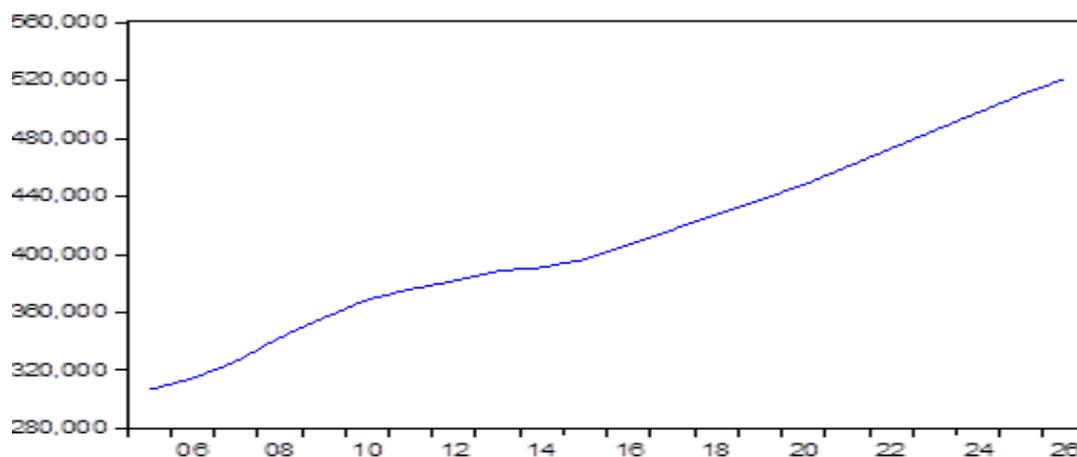
Izvor: Model Instituta za napredne studije Bec, obrada FZZPR



According to the estimate made by the Institute for Advanced Studies in Vienna, in variant IV of the economy relief by 34.66% on net salary (22.53% on gross salary), at the end of 2025, budget revenues in FBiH would increase by approximately 880 mil. KM, PIO revenues by about 320 mil. KM and revenues of the health care sector by around 220 mil. KM. Thus, the total public revenues in this variant would be increased at the end of 2025 by about 1,400 mil. KM.

In variant IV, in 2020 there would be a surplus in the federal budget as a percentage of 2.7% of GDP and this trend would be continued in the future period. It is estimated that in 2025 the surplus of the federal budget would be stabilized at around 1.4% of GDP, which is extremely important from the standpoint of ensuring the development budget and an increase in public investments.

The projection of the number of pensioners in 2025 in the FBiH



Source: Model of the Institute for Advanced Studies in Vienna, processed by FZZPR

Bosnia and Herzegovina and the FBiH are faced with the process of aging population, and increasing the share of elderly in the total population. The average number of pensioners in 2012 amounted to 377,975, in 2013 385,181, while at the end of 2014 it stood at 392,265. In the period 2008 - 2013 the number of pensioners was continuously growing at an average rate of 2.9% per year. Projections of growth in the number of pensioners tell us that in 2025 we will have more than 500,000 pensioners, which means that, without reforms, the ratio of the number of pensioners and workers would be 1: 0.9. For example, with variant IV of relieving the economy, this ratio would be 1:1.25. Only a long-term and stable increase in employment can contribute to the stabilization of the pension fund and an increase in average pensions.

Projections of growth in the number of pensioners call for urgent reform steps. Relieving the labour and increasing the number of jobs is the most rational reform and the largest contribution to the stabilization of the pension fund. Such an approach would also represent a basis for the sustainability strategy, and with additional measures, it would ensure a long-term stability of the PIO Fund. Also, in this way it is possible to reduce the risk of poverty in old age, and increase the efficiency in the collection (less labour load means greater opportunity cost of avoiding payment).

Institute for Advanced Studies in Vienna

Dr. Klaus Weyerstraß

IMPACT OF REDUCING THE RATES BASED ON SALARIES ON EMPLOYMENT 2025

S/N	Variant	Rate reduction %		VAT %	Aggregate net rate %	Number of employees	Increase/ 2014 441.554	Increase/ Without reforms 491.524
		Gross	Net					
1.	Existing situation without reforms	-	-	17	70,95	491.524	49.970	-

2.	Contributions - part	5,5	8,47	20	62,48	504.034	62.480	12.510
3.	Contributions - part	9	13,86	22	57,09	514.256	72.702	22.732
4.	Contributions – 3 yr phases	19	29,27	18	44,23	533.199	91.645	41.675
5.	Contributions – one-off	19	29,27	18	44,23	546.914	105.360	55.390
6.	Contributions + Tax (10%) –3 yr phases	22,53	34,66	19	36,06	606.136	164.582	114.612
7.	Contributions + Tax (10%) – one-off	22,53	34,66	19	36,06	632.048	190.494	140.524
8.	Contributions + Tax (10%) – one-off	22,53	34,66	21,5	36,06	623.178	181.624	131.654

Institute for Advanced Studies in Vienna
Dr. Klaus Weyerstraß – Simulation

Macroeconomic indicators – effects

1	Number of employees		Level of employees	Growth of public revenues				Federal Budget Balance % GDP
	2	3		4	5	6	7	
	without reform	Variant IV 36,06%		Reform in total	Budgets	Healthcare	PIO	
2014.	441.554	441.554	26,6					-
2016.	454.633	458.031	27,9	222	137,2	34,6	50,2	-
2017.	460.046	469.048	28,8	335	207,2	52,3	75,7	
2018.	465.260	495.078	30,6	462	285,7	72,1	104,4	
2019.	470.209	530.754	33,1	684	423,0	106,7	154,6	
2020.	474.847	574.675	36,1	990	612,2	154,4	223,7	+2,7%
2021.	478.798	604.182	38,4	1.100	680,2	171,6	248,6	
2022.	482.377	613.326	39,4	1.192	737,1	186,0	269,4	
2023.	485.686	620.778	40,3	1.270	784,9	198,1	287,0	
2024.	488.732	626.922	41,2	1.380	853,4	215,3	311,9	
2025.	491.523	632.048	42,0	1.426	881,8	222,5	322,3	+1,4%