Open Society Fund Bosnia & Herzegovina

Taxing labour in BH

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What makes labour taxation a relevant policy issue?

With increasing globalization the competition for foreign investment intensifies, where country in order to secure more international financing keep labour costs low as possible. Labour costs are relevant not only for attracting foreign investments but also for domestic firms which export their product to states with higher labour costs. However, in transition economies including BH, foreign direct investments (FDI) are seen as a primary vehicle for new job creation[1]. Employment level in BH remain low, around 30% in 2008, two times lower than EU average *(64.8% for EU15 and 66.2% in EU25 in 2006%[2])* and are among the lowest in the region[3] *(Serbia 44,75%, Montenegro 42,7%, Albania 56,4%, Croatia 44,1%, Macedonia 44,1%).* In addition, more than half of working age population is inactive. Unfortunately BH has not much benefited from FDI inflows having the lowest FDI stock among transition economies (UNCTAD[4]) mostly linked to privatization of inefficient public companies with tendency of job destruction. According to EBRD data, in period 1989-2007 BH attracted some 1.348 USD[5] per capita of FDI *(only Macedonia with 1.117 USD and Albania 830 USD show lower FDI inflows per capita than BH)*. BH economy is labour intensive and current level of labour costs are considered as obstacle for new investments and more employment.

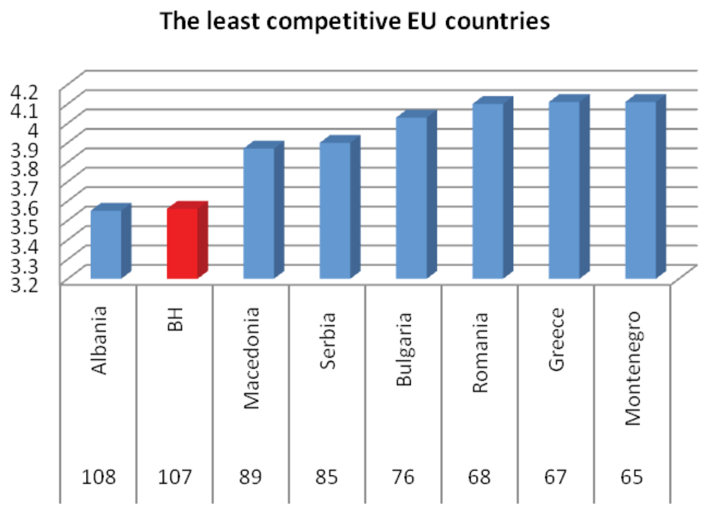
[1] Source: World Bank (2004). Building LM institutions in SEE; Broadman, Bergsman, Drebentsov 2000; World Bank 2003a

[2] EUROSTAT 2006

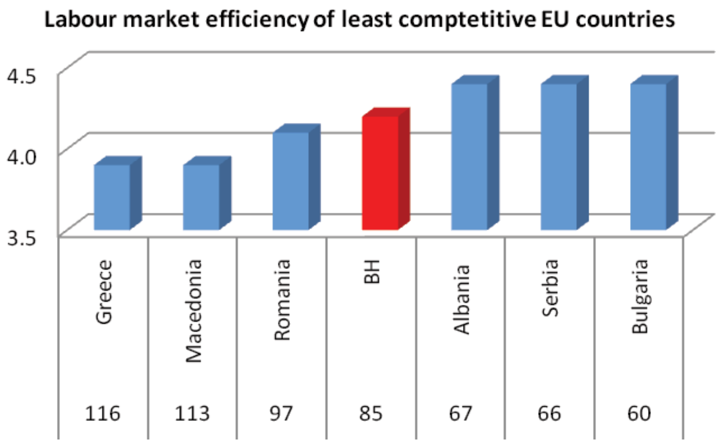
[3] International Labour Organization (ILO). (2007)

[4] Source: United nations conference on trade and development (UNCTAD). FDI online statistics available at http://stats.unctad.org/fdi/

[5] Source: EBRD - Transition report statistics. http://www.ebrd.com/country/sector/econo/stats/index.htm



Source: WEF 2008-2009. GCI Index



Source: WEF 2008-2009. GCI Index

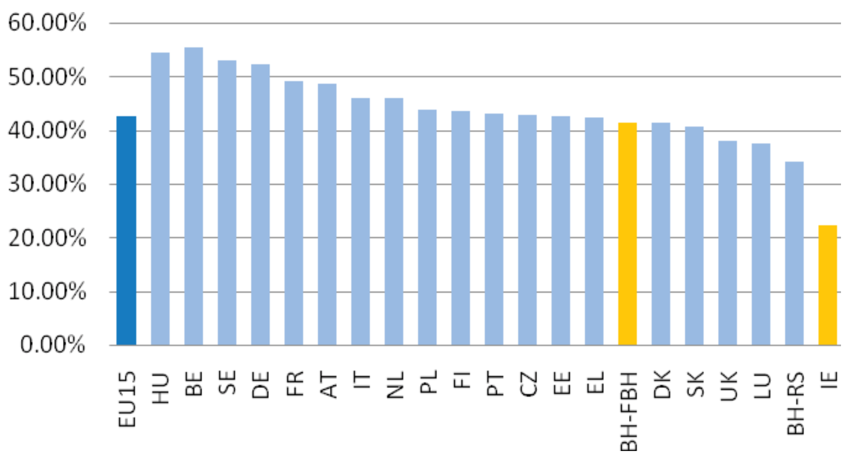
According to Global competitiveness index (GCI[6]) index, BH economy was ranked 107th in 2008 *(out of 134 countries)* as the least competitive country in Europe (only Albania is scored lower). The reasons are numerous. One of the factors contributing to low competitiveness is labour market efficiency (85the place) with "pay and productivity" being among the lowest scored component.

The obstacles in doing business is rather linked to tax regulation (GCI score 5.0) than to tax rates (GCI score 3.6). Further, the EU integration process requires, within Copenhagen criteria, for countries to have functional and competitive economy. Especially enlargement process of Eastern European countries fortified the importance of labour cost issue in EU.

High taxation of labour has been traditionally accused for inability of labour market to generate jobs. So, entrepreneurs view high labour costs *(in particular high social security contributions)* as an obstacle for development of private sector, especially SME *(World Bank, 2002)*. Therefore, advises coming from international community *(EC, World Bank, IMF)* were directed at reducing tax burden on labour in BH by broadening the tax base, a policy accepted by FBH government and outlined in government program 2008-2010. Further, international empirical evidence found in large body of literature *(Daveri and Tabellini, 2000; Haltiwanger et al., 2003; Nickel, 2003; Bassanini and Duval, 2006)*, showed detrimental effects of tax wedge (component of labour costs) on employment with different magnitude for different groups of workers and with similar levels of elasticity. Tax wedge, difference between labour costs incurred on employer and employees take home wage, can significantly affects labor market outcomes *(Researchers of the Centre for Social and Economic Research – CASE)* especially for low-skilled labour. A 10% pts reduction in tax wedge would

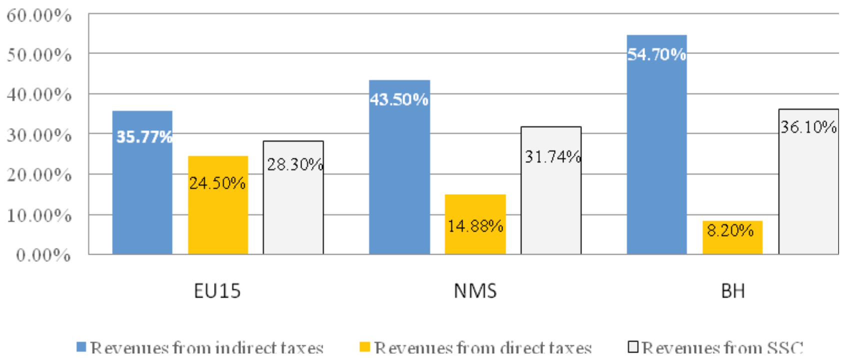
[6] World Economic Forum. 2008. The Global Competitiveness Report 2008-2009

Tax wedge across EU



Source: OECD, taxation of wages (2007) for EU countries, data for FBH and RS based on author's calculations

Revenues from taxes and social security contributions in EU, new member states (NMS) and BH



Source: MTEF for BH/FBH/RS 2008-2010 and 2009-2011, OECD Tax revenues statistics for 2006 be associated with a drop in the unemployment rate by 2.8 percentage points *(Bassanini and Duval 2006)* or a 10 % pts rise in the tax wedge *(Nickell, 2004)* reduces labor input by somewhere between 1-3% of the population of working age. Cross country regression *(Arandarenko, 2008)* for Western Balkan countries yield a short run labour demand elasticity of - 0.21% meaning that 10% increase in labour costs would, in a short term result in a decrease in employment of 2.1%.

Labour costs in BH is high

Considering latest policy change in labour taxation, employing a worker at average wage level (ca. 750 KM monthly) cost the employer in FBH some 1.283 KM. If fringe benefits, such as hot meal allowance, transport costs, etc., are taken into account then, labour becomes even more expensive (app. 1.526 KM). For the same level of wage, employer in RS would pay 1.161 KM monthly. The net wage makes 58% of total labour costs. The levels of personal income tax are moderate and more in line with EU levels, where SSC rates are above the EU levels. The tax wedge, which stands for difference between labour costs incurred on employer and employee take home wage can significantly affect the labour market. However, the tax wedge in FBH, although higher than in RS, still in line with EU15 and below NMS levels.

However, high labour costs still do not provide decent social security standards

Governments in BH increasingly relies on revenues from indirect taxes (*account for more than 54.7% of total tax revenues*[7]*)* on one hand, and revenues from social security contributions *(SSC*) as a predominant form of wage taxation on the other hand *(general government data, revenue from SSC: 36.1% total tax revenues in 2008*[8]*).*

Around 14% of GDP (2006) in revenues was collected from SSC in BH *(IMF 2007)*. Only FBH collected 14.8% GDP in SSC revenues in 2006[9]. These levels of revenues are in line with international standards *(13.8% GDP for EU15 and 13.7% GDP for EU27 in 2006*[10]*)* but not at the per capita levels. In addition these level of revenues do not provide sufficient level of benefits. The expenditure on health care, 8.9% GDP[11] (mainly influenced through high out-of-pocket expenditure and low public expenditure), is in line with EU levels, but low in per capita levels of expenditure. The tax bases financing the health care sector is low; the ratio is 1:4.8 where one contributor to health care system is financing 4.8 beneficiaries. Pension system is challenged with providing decent standard of living of retired persons. Some 51% of pensioniers in FBH were receiving minimum pension, 296 KM monthly, in 2008. The average pension was 348.5 KM in 2008. Considering the level of poverty line in BH in 2007, 238.11 KM monthly, large share of this population lives in poor condition confronted with poverty. The system dependency ratio shows extremely low levels where one contributor to pension system is financing 1.46 pensionier. However, only 44.3% of all pension beneficiaries (including old age, surivor and early retirement pension) are old age pension beneficiaries. The total social security contribution rates amount 41.5% in Federation BH and 30.6% in RS making in average 95%[12] of fund's revenues *(pension, health and unemployment insurance funds in for both entities)* and were subject to reduction in recent years.

The policy study examines whether the reduction of labour costs is justified or better say should FBH governmnent (which is the focus of this study) should rush into reduction of labour taxes? From perspective of competitivenes it would be desired policy option. But taking into consideration the benefits structure of social security funds it makes us rethink. Reductions in social security contribution undertaken in recent period, does not show any improvements in labour market outcomes. The study provides recommendations focusing rather on instituttional necessary preconditions which should be provided if policy of labour taxation should be based on evidence. The recomdations follow:

1. More detailed analyses of potential fiscal space that could finance the reduction in labour cost, is needed

[7] Ministry of finance and treasury BH (2008)

[8] Ministry of finance BH/FBH/RS (2008)

[9] Ministry of finance BH/FBH/RS (2008)

[10] European Commission (2007b)

[11] WHOSIS

[12] Author's calculations using data from MTEF FBH, RS 2008-2010

Mirela Ibrahimagić was born in Tuzla on June, 19th 1972. After she completed her education in Austria, where she obtained a Master's Degree in Business Administration in 2002, she continued her professional education in the field of Professional Accounting in the USA. In 2003, she started to work on issues of economic development where she at first worked in the Office of the PRSP Coodinator and after that in Economic Policy Planning Unit (EPPU) on monitoring of macroeconomic and structural reforms. Today she is employed in Directorate for Economic Planning as the Head of the Office for the Analysis of Social Inclusion.

2. Detailed analyses of expected results in light of labour cost reduction on employment levels is needed
3. Harmonization of PIT rates between entities with considering further introduction of progressivity in income tax
4. Continue with development of labour cost index and labour cost survey by BH statistic institutes in line with Eurostat methodology in future period
5. Reduction and harmonization entity's social security contribution rates
6. Continue with reforms in area of pension and health insurance but consider the minimum standards set by European Code on Social Security

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