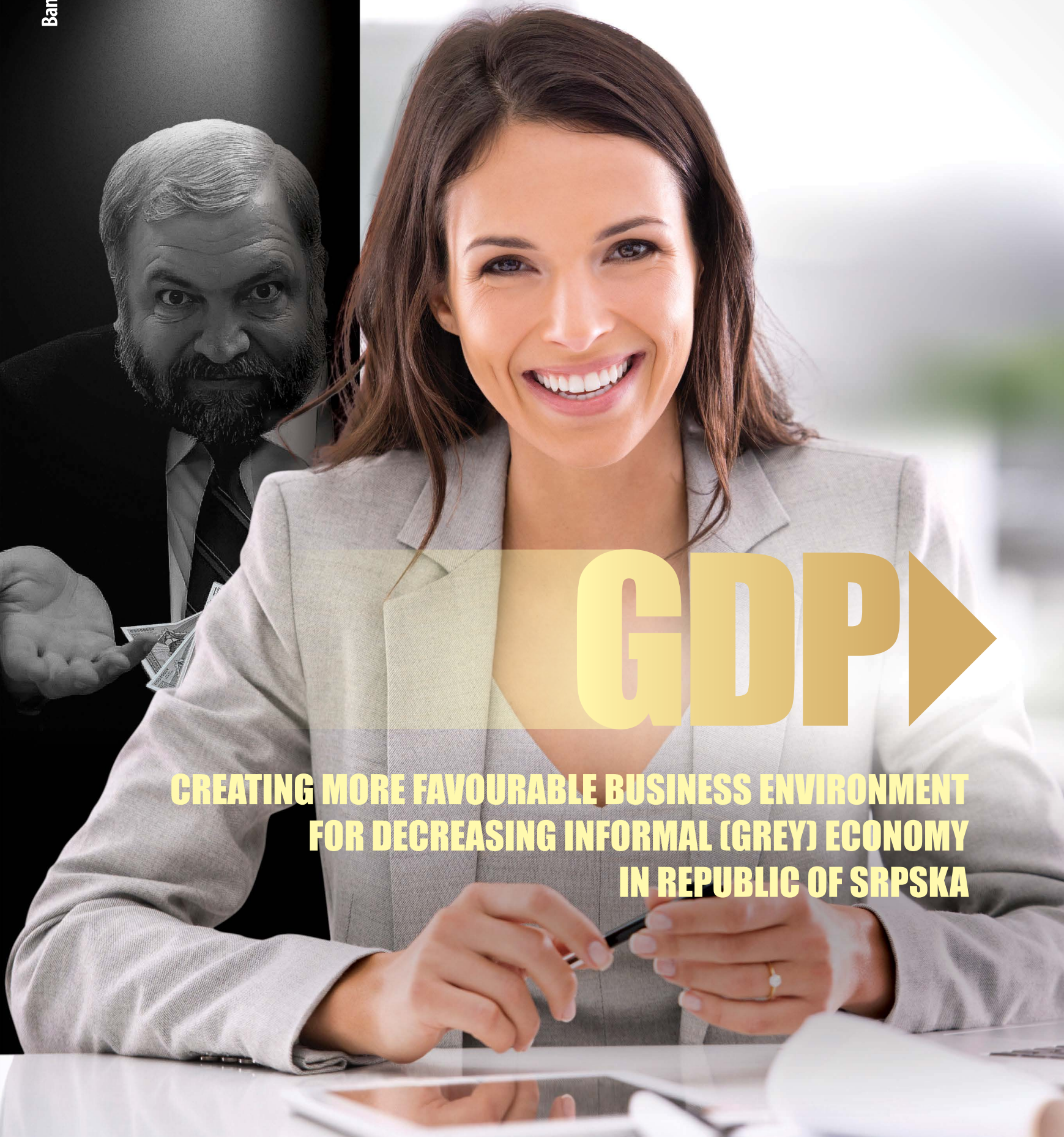


Banja Luka, october 2015



**UEARS**

Union of Employers' Associations of  
Republika Srpska



# GDP ▶

**CREATING MORE FAVOURABLE BUSINESS ENVIRONMENT  
FOR DECREASING INFORMAL (GREY) ECONOMY  
IN REPUBLIC OF SRPSKA**



International  
Labour  
Organization

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## List of abbreviations and acronyms

<b>ATM</b>	Automated Teller Machine
<b>GDP</b>	Gross Domestic Product
<b>BEEPS</b>	Business Environment and Enterprise Performance Survey
<b>BIH</b>	Bosnia and Herzegovina
<b>EBRD</b>	European Bank for Reconstruction and Development
<b>EESE</b>	Enabling Environment for Sustainable Enterprises
<b>EU</b>	European Union
<b>FBIH</b>	Federation of Bosnia and Herzegovina
<b>GCR</b>	Global Competitiveness Report
<b>MKO</b>	Microcredit organizations
<b>IMF</b>	International Monetary Fund
<b>ILO</b>	International Labour Organization
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>VAT</b>	Value Added Tax
<b>POS</b>	Point of sale terminal
<b>RS</b>	Republic of Srpska
<b>UNODC</b>	United Nations Office on Drugs and Crime
<b>UNHCR</b>	United Nations High Commissioner for Refugees
<b>UEARS</b>	Union of Associations of Employers of Republic of Srpska
<b>WDI</b>	World Development Indicators
<b>WEF</b>	World Economic Forum
<b>WGI</b>	Worldwide Governance Indicators





# Executive Summary

Findings of the research indicate that the grey economy is a profound and multidimensional problem for Republic of Srpska and BiH. It is a problem that affects employers, workers and the state at the same time. Thus all three parties in the social dialogue are interested in its resolution, the current efforts to combat the informal economy did not achieve some important results. One of the reasons for sure lies in the fact that these efforts were not the product of a comprehensive, harmonized and balanced approach, but more often a result of ad hoc activities and short-term measures. In this regard, identifying the main causes of grey economy, especially when it comes to the types of informal activities and reasons why employers and enterprises are turning to these activities, is very important so that measures and interventions for combating the grey economy are focused on the sources of the problem, i.e. to the very causes.

Where are the main causes of grey economy in Republic of Srpska? Results of the analysis show that there are a number of causes which act in synergy, mutual interaction. One of the key causes is certainly the high fiscal and quasi-fiscal pressure on companies and businesses operating in the formal sector. It is manifested through high taxation of labour, whereby enterprises are stimulated not to register workers or to record the salaries lower than actual, since they cannot bear the burden of labour costs and at the same time remain competitive in the market. This cause is only enhanced by the complex regulatory framework and expensive administration through numerous and complex business procedures that take time and money from employers and companies. The already complex regulatory framework is followed by the frequent changes to existing and adoption of new regulations, which creates an environment in which it is difficult to manage for employers, at least for those in the formal sector. Unlike them, in that environment, it is easier to manage for those that interpret and enforce it, a high perception of corruption of employees in public institutions, including the control and super-

visory authorities, thus only further undermining confidence in their work and general confidence in the state and the system.

Lack of trust in the system has a negative impact on the level of the financial discipline, tax morale and the ethics in the business of domestic companies. In such circumstances, there are no conditions of fair market competition, unfair competition grows and a vicious circle of cause and effect which only generates a gap between the formal and informal sectors is created. To make matters worse, relations between the partners in social dialogue are further complicated and the Economic and Social Council, as the main instrument of the tripartite dialogue, in practice functions rather poorly.

Recommendations given in this document are starting from the identified causes of the informal economy in Republic of Srpska. They are written as a reflection of the efforts to upgrade the recently adopted the *"Action Plan of the RS Government to combat the grey economy by improving the functioning of the control bodies"* with a series of incentive and systematic measures which would make business in the formal sector more attractive. In terms of general mistrust, increased activity of control bodies cannot in itself reduce the grey economy, as it does not eliminate its causes. Therefore, a balanced approach that includes measures to improve the business environment and the strengthening of trust in public institutions is required. So, how successful the decision-makers would be in combating the grey economy depends primarily on the manner in which it would be intervened by the next planned package of measures from the Action Plan on the key causes, primarily the high cost of doing business in the formal sector, perception of corruption in the public sector, and selective and inconsistent application of regulations. Thus, the functionality of the tripartite social dialogue is a *conditio sine qua non* in the fight against the grey economy.



# Recommendations

The findings of the research evidently show that the grey economy is deeply rooted problem in Republic of Srpska and BiH affecting employers, workers and the state at the same time. Therefore, solving this complex issue requires a comprehensive and multi-dimensional response. Identifying the main causes, especially when it comes to the reasons why employers and companies turn to informal activities, is important so as to make recommendations and measures for combating the grey economy aimed directly at the source of the problem.

This further means that comprehensiveness in tackling the informal economy requires harmonized, coordinated and balanced approach. Harmonized approach is necessary as a result of a joint agreement of key stakeholders, especially the social partners who represent and advocate the interests of those who are most affected by the informal economy. Past experiences show that the lack of consensus and one-sidedness in solving this problem leads into the trap of a spill-over of negative consequences of the grey economy from one to the other side, whether it is about the consequences to the detriment of the state, workers or employers. Therefore, it is necessary to reaffirm social dialogue in Republic of Srpska through the work of the Economic and Social Council, as well as through other institutional and non-institutional mechanisms as soon as possible, and as a starting point to take advantage of the fact that all three parties agree on the seriousness of the problem of the informal economy and sincere committed to finally tackle this issue.

Coordinated and integrated approach is necessary so that measures in combating the informal economy would not be carried out ad hoc and partially. Previous studies as well as comparative analysis done for the countries in the region indicate a certain

inelasticity of grey economy in relation to the individual factors of influence. Examples of countries such as Macedonia, which has made significant improvements when it comes to the business environment and ease of doing business (rank 30 according to the “Doing Business Report” for 2015) show that these developments have had only limited effects on the reduction of the shadow economy, because they lack other important factors such as the rule of law, fighting corruption, the efficiency of the judiciary system and so on.

Finally, a balanced approach entails systemic interventions that would encompass incentives and repressive measures. Incentive measures in order to enable and facilitate the transition from the informal to the formal sector, and repressive measures in order to raise the level of risk and reduce profitability of remaining in the informal economy at the same time. This should be emphasized in the context of the recently presented action plan for the fight against the grey economy, determined by the Government of RS which, among other things, provides for a more rigorous legal framework and the allocation of the major powers to the inspection authorities. It is, above all, on the set of repressive measures that need to be upgraded and those measures that will stimulate the transition from the informal to the formal economy. It has already been mentioned that insisting on stricter administrative requirements and tougher sanctions in the conditions when there is no trust in the work of public institutions can only further open up space for corruption and be counterproductive. Consequently, individual recommendations through a series of incentives listed below aim to balance the approach envisaged by the Action Plan.

In terms of good governance and the rule of law, it is necessary to intensify the work on raising public trust in government

institutions and public administration. Numerous analyses show that there is a very strong correlation between trust in government institutions and the size of the informal economy. This confidence is primarily acquired through the work efficiency, transparency and equal treatment of all. The rules laid down must apply equally to all, and discretionary decision-making power of government officials and elected officials about them is minimized. In this light, it is necessary to further simplify and speed up those business procedures that currently last the longest and cost the most (such as building permits) and are therefore fertile ground for taking/giving bribery, and generally for generating the grey economy. Furthermore, improved internal organization within institutions dealing with the control and supervision it is necessary to eliminate the possibility of a selective approach in the choice of companies to be subject to control, because it is one of the most common complaints of the business community in the work of the controlling authorities. Also, give subjects of control the opportunity to submit complaints to the inspectors' work.

Due to the cumbersome regulatory framework and its numerous and frequent changes, it is necessary to consider the possibility of establishing a single electronic register of regulations and all fiscal and quasi-fiscal fees for entrepreneurs and companies, which would be publicly available and free of charge. This would facilitate an insight into the regulatory framework in which companies operate and the obligations they are required to pay.

Small entrepreneurs and those who carry out their activities without permission should be given the first opportunity so as to build a bridge for crossing over into the formal economy. Experiences in many countries, including BiH, show that the survival rate of these "legalized" entrepreneurs is higher than among those who start their job without previous experience in the informal sector. Consequently, we should consider the possibility of providing technical and financial relief for those in the informal sector who opt for the first time to legalize their business (through the support of the RS Employment Bureau or through other programs). Also, one of the perks that already exist for those who have registered is small entrepreneur status, which facilitates their business in terms of meeting the administrative requirements, simpler tax and other business procedures (lump-sum payment of taxes, simply accounting, etc.). However, the limit established in the amount of KM 50.000 of annual turnover and three employees is set too low, and the majority of small entrepreneurs are motivated to "hide" the turnover or not to report more than three employees, so as not to lose the favourable status. Therefore, the possibility of raising the limit for the small entrepreneur status, based on the amount of annual turnover and in the number of employees should be considered. The limit for

the status of small entrepreneur should be aligned with the limit for compulsory registration in the VAT system.

In terms of sources of financing, solutions to combat the grey economy should be sought primarily in the improvement of the existing financial system, where in addition to the traditional (banking); other sources of financing for domestic companies and entrepreneurs would be developed. These intended resources should enable faster growth and development of small and micro enterprises. For those who are only considering the entrepreneurial ventures or are already engaged in highly productive activities, but are not registered, it is necessary to upgrade existing entrepreneurial infrastructure and support instruments through venture capital funds such as seed funds and venture capital funds, where the government in cooperation with many international donors could initiate the process and play a more active role. On the other hand, in order to reduce the informal sources of financing, in cooperation with the Banking Agency, the Central Bank, the Banks Association and other stakeholders should examine the possibility of reducing the cost of transfers, especially in light of the registration of remittances from the diaspora. For a direct impact on the reduction of the shadow economy, it is necessary to further promote and encourage non-cash payments, thus reducing the number of participants in the informal economy. It is preferable to give emphasis to the incentives that will encourage the use of non-cash transactions such as subsidies for the introduction of POS terminals to micro and small enterprises and possibly incentives for electronic payments.

When it comes to taxation, it is necessary to eliminate the most powerful cause of the informal economy – extremely high labour taxation. The Government of Republic of Srpska through more official documents announced moves in that direction. Reducing the tax burden on labour must not be symbolic, but a very important, if we want to change the status of Republic of Srpska in this sense at an international level and to discourage work "off the books" and salaries payment "hands on".

It is also necessary to fundamentally simplify the procedures of the Tax Administration of Republic of Srpska so as to facilitate and reduce the time necessary for their fulfilment to businesses in the formal sector. In general, it is necessary to systematically work on strengthening the confidence of businesses in the work of the tax authorities.

In regards to the VAT system, control authorities need to make further efforts in order to minimize the number of business subjects who avoid mandatory VAT registration and thereby constitute unfair competition. It is necessary to harmonize appropri-

ately the deadline for payment of invoiced VAT (performed by the company) with a deadline for payment of VAT refunds (performed by the Indirect Taxation Authority).

Until now, there was not much of a constructive dialogue between the social partners on the issue of the impact of existing labour legislation on the existence of the informal economy. According to employers, trust between the social partners is severely affected by non-compliance with the Agreement of the social partners from 2010. This practice must change, because it is only with the cooperation of social partners quality solutions can be created thus enabling a large number of unfairly treated workers to exercise their rights in labour relations by transition to the formal economy.

Unsatisfactory functioning of labour inspections need to be

improved, especially with regard to the elimination of non-registered entities from the market, independence from political interference and overlapping competencies of inspections from entity and local level.

Finally, in terms of education, training and lifelong learning is necessary to conduct an urgent reform of the education system, and also to support non-formal education in the form of professional education and training of workers. Such an intervention is necessary to help micro, small and medium enterprises which at this point have no real opportunities and capacities to build systems for staff training. It is also necessary to work on developing training market taking into account the demands of employers for the type and the specific elements of training so that it would be possible to recognize a direct benefit from investment in human resources and later to follow the same practice in the companies.







# Introduction and methodology

The term “informal economy” refers to all economic activities by workers and economic units which, in law or in practice, are not or are insufficiently covered by formal arrangements. Their activities are not included in the law, meaning that they work outside the formal reach of the law; or are not covered in practice, which means that, although they work under the formal reach of the law, the law is not applied or not implemented; or the law discourages its use because it is inappropriate, burdensome, or imposes excessive costs.

The forms in the informal economy are different. They include undeclared work (“moonlighting”), failure or partial reporting of trade in goods and services, the circulation of goods and services by a person who is not registered, salaries “in an envelope” to suppress the actual prices of goods and services, the conclusion of non-standard shapes of employment contract (contracts for copyrights work, temporary and occasional jobs, etc..) with the aim of avoiding labour relations, expressing unrealistically high amounts of invoices in order to avoid payment of VAT (in exports and related parties when the final company is intended to “suffer” effects of such business) and more.

This report was produced as part of a project that aims to help the Union of Associations of Employers of Republic of Srpska (UEARS) to identify the most important causes of the informal economy in Republic of Srpska and develop a set of quality and conductive recommendations for addressing this significant problem. The author of the report is the Centre for Research and Studies GEA Banja Luka. The report and the whole project are conducted on the basis of the methodology of the International Labour Organisation (ILO), which financed their design and implementation. A key element of this methodology is the Enabling Environment for Sustainable Enterprise Toolkit (ESEE toolkit), which is used to divide the business environment in 17 areas and has a developed questionnaire as a basis for assessing the situation in each area.

UEARS has, at the beginning of the project, and with the participation of GEA, organized four focus groups with its members in Banja Luka, East Sarajevo, Bijeljina and Trebinje, with the aim to extract a few key causes of informality from the perspective of UEARS for detailed research. Members of UEARS recognized the following six areas from the ESEE toolkit as the key ones: 1) favourable legal and regulatory environment, 2) competition, 3) access to sources of financing, 4) good governance and the rule of law, 5) social dialogue and 6) education, training and lifelong learning.

On the basis of the provided information, a questionnaire for conducting primary research (survey) on attitudes of employers in Republic of Srpska which covers the stated six fields was defined. Also, the structure of the target sample for the survey on the basis of the following criteria was determined: type of activity, type of ownership, geographical area and number of employees.<sup>[1]</sup> After UEARS conducted a survey, obtained information were processed and included in this report together with the findings of the secondary research, which is based on data and publications of the World Bank, the International Monetary Fund, the ILO and other international and local organizations and institutions. Serbia, Croatia, Macedonia and Austria were chosen as countries in the region with which the comparison was made on the situation in these areas. When using some of the international databases, for example, data about the easiness of business of the World Bank, no data were available for Republic of Srpska, so the data for Bosnia and Herzegovina were used. Given the possible differences in the situation in Republic of Srpska in relation to the entire Bosnia and Herzegovina in certain areas, the results of secondary research were correlated with the results of the primary research (as obtained from Republic of Srpska).

At the end of the analysis of each of the six areas the main findings for each area are summarized, while in Chapter 7 there are unified recommendations for all areas together.

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[1] Table with an overview of the structure of targeted sample of 200 respondents is attached at the end of this report.

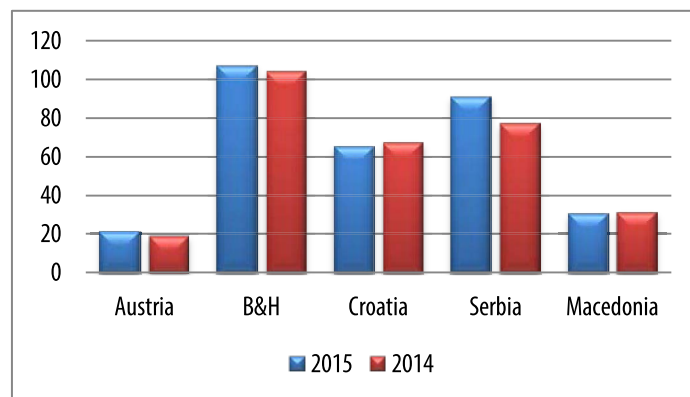
# 1. Favourable legal and regulatory environment



Legal and regulatory environment sets “the game rules” for all participants in the economic activities. These rules should minimize the kinds of behaviour with negative effects on other economic participants and the society in general and also to stimulate activities with positive effects such as employment, establishing new enterprises, etc. However, if these rules are complicated, expensive, irrational, or applied unequally, at least some number of economic participants would try to find a way to avoid them. Therefore, it is not hard to conclude that unfavourable legal and regulatory framework stimulates the growth of informal economy in relation to the formal.

Doing Business Report, published annually by the World Bank, ranked the countries in the world according to the easiness of doing business. The ranking is based on measuring and monitoring changes in 10 areas of legislation of importance for the business: starting a business, obtaining construction permits, connection to the electricity grid, registering property, access to financing, protection of minor investors, paying taxes, foreign trade, and contract implementation and resolving insolvency. In the report for 2015<sup>[2]</sup>, BIH ranks 107th position (out of 189 countries surveyed), which was the lowest place in relation to all other European countries and an additional decrease compared to 2014, when it was in 104th position.

**Figure 1. Ranking countries according to the Doing Business report**

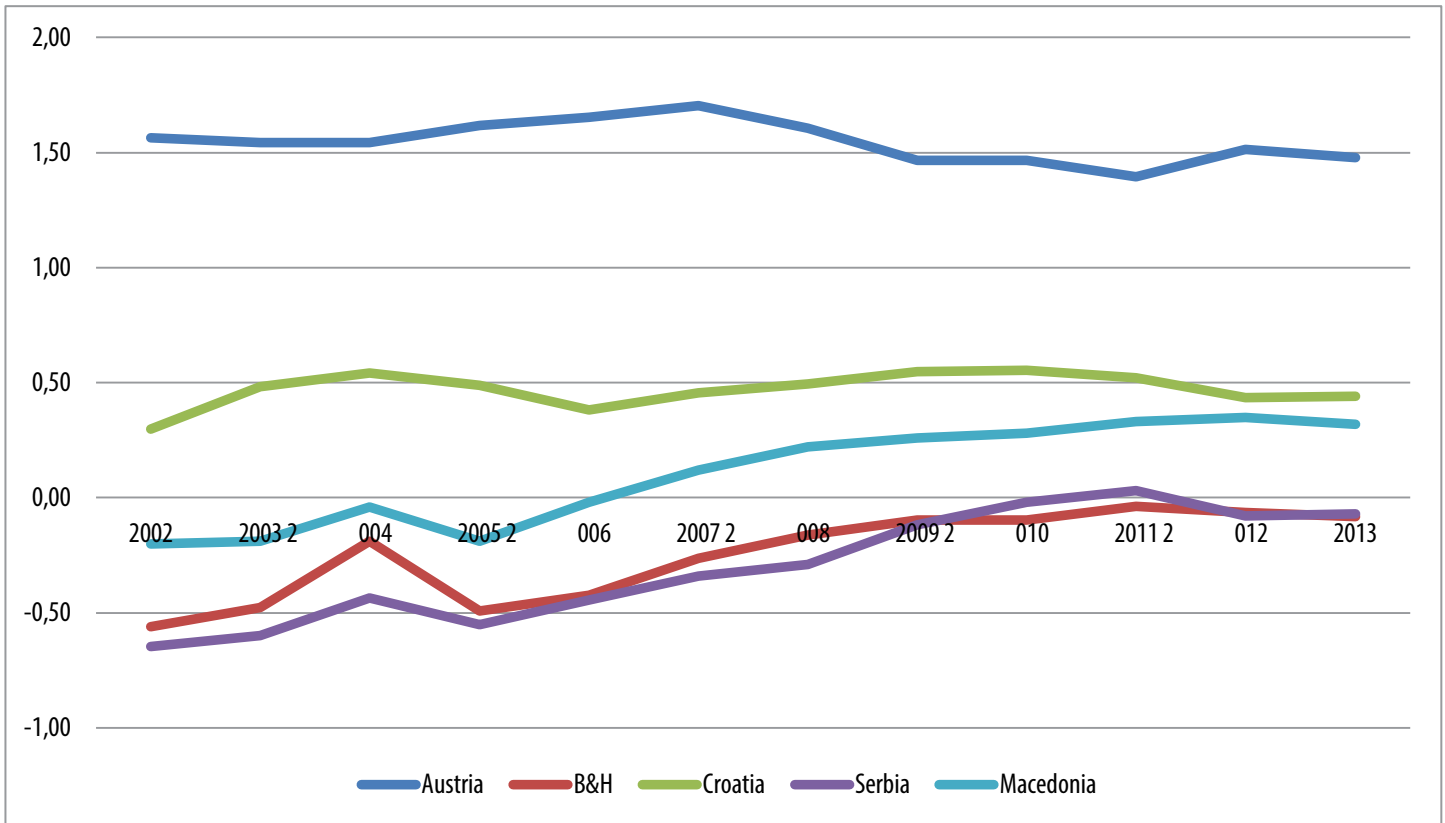


Source: [www.doingbusiness.org](http://www.doingbusiness.org)

Of the 10 areas of regulation that the report observes, in 2015 BIH had the worst standing in obtaining construction permits (182nd place) and in the connection to the electricity grid (163rd place), whereas the best standing was in resolving insolvency (34th place) and access to finance (36th place). Here we can observe a very large variation between positions in various fields. It tells us that BIH has still not implemented a comprehensive reform of business regulation, and that there is a significant disparity in the severity of fulfilling these obligations. These data suggest that an average company will have much greater incentive to weave regulation in the area of obtaining building permits than in the area of access to finance.

[2] Reports and data available at [www.doingbusiness.org](http://www.doingbusiness.org).

**Figure 2. Trends of Regulatory Quality Index**



Source: <http://info.worldbank.org/governance/wgi/index.aspx#home>.

Regulatory Quality Index is another indicator of the World Bank that focuses on measuring the ability of the government to formulate and implement sound public policies that enable and promote private sector development<sup>[3]</sup>. This index is constructed from a large number of individual variables for which data are collected from different sources. The range of the index ranges from -2.5 to +2.5, where a higher value indicates better performance. The value of this index for BiH in 2013 was -0.08, and -0.56 in 2002, from which it can be seen that a little progress was made in this period. The index value for Serbia moved a similar path, and in 2013 it amounted to -0.07, which is slightly better than in BiH.

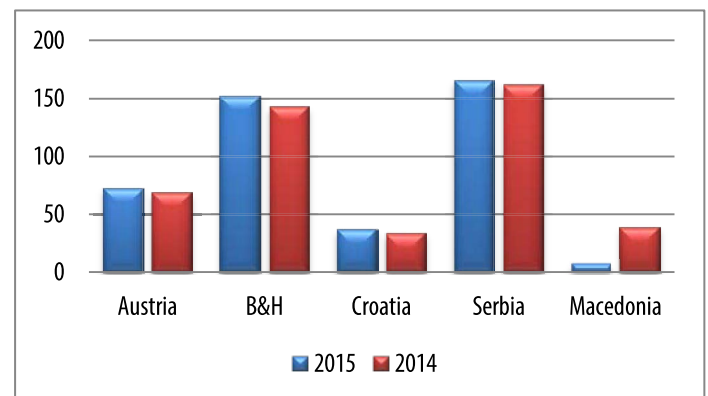
## Taxation

The main link between taxation and the informal economy is very direct. The higher the tax burden and tax payment procedures more demanding for businesses operating in the formal sector, the greater the financial and operating “profit” which can be realized by moving to the informal economy (if all other things remain unchanged). On the other hand, more rigorous penalties for tax evasion and stricter they are applied, the higher the expected “cost” of doing business in the informal economy. Of course, this calculation for each business unit includes other factors, such as the attitude of the owner and management towards the informal

economy, the overall level of social acceptability of this form of business, the size and the impact of competition from companies that operate in the informal economy, the type and relations of business partners and customers, the impact of employees, the existence of trade unions in the business unit, etc.

Report Doing Business ranks countries in the field of tax payments by measuring the size of the tax burden that a medium-sized company bears in a given year and the administrative burden faced when paying taxes. In 2015, BiH stood at 151st position in this area, which represented a decline compared to 2014 when it stood at 142nd position. Of all European countries, only Serbia was in a worse position than BiH – at 165th place.

**Figure 3. Ranking of countries in the areas of paying taxes, according to the Doing Business report**



Source: [www.doingbusiness.org](http://www.doingbusiness.org)

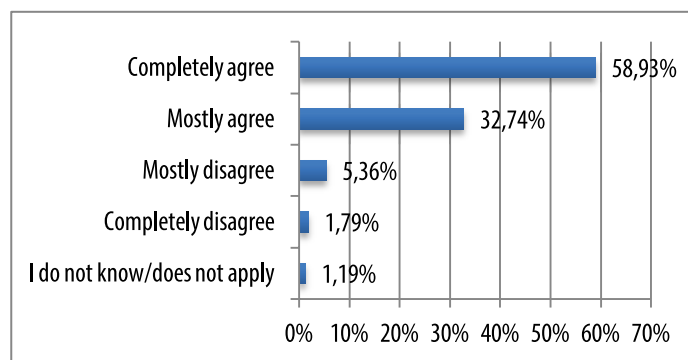
[3] Data and methodological notes available at <http://info.worldbank.org/governance/wgi/index.aspx#home>.

For enterprises that are formally registered, i.e. which at least partly work in the formal sector, we can speak of partial tax evasion. This means that companies that are evading their tax obligations do it mostly selectively, depending on the amount of certain taxes, ways of its collection and the type of business.

The results of primary research show that employers in Republic of Srpska see the amount of taxes and contributions on salaries as the biggest problem in the overall tax system for doing businesses in the formal sector. To the question: "In your opinion, which is the problem in the overall tax system that has the greatest impact on the creation of the informal economy?" (In the questionnaire there was a place to write a response as desired), more than half of respondents mentioned problems in connection with the amount of taxes and salary contributions. Problems that have also been highlighted in the responses are unequal access to tax authorities to taxpayers, as well as the lack of control of unregistered economic units.

Replies of employers on other questions in this area, also throw the problem of taxation of labour to the forefront. Even 91.67% of respondents either fully or mostly agree with the statement that the amounts of taxes and contributions on salaries are a significant cause of the existence of the informal economy.

**Figure 4. To what extent do you agree with the claim that "amount of taxes and salary contributions are a significant cause of the existence of the informal economy"?**



Source: Research of UEARS

Various international studies confirm that higher taxation of labour stimulates the growth of the informal economy<sup>[4]</sup>, which is manifested through the growth of the share of unregistered workers (the work "off the books") in the total number of employees. Some researches suggest that high taxation of low-paid jobs lead to their "exclusion" from the formal economy, i.e. work "off the books" for these employees is not a subject of choice<sup>[5]</sup>. Another important form of manifestation of the impact of high taxation on labour in the informal economy is the payment of a portion of the salaries of employees "hands on", thus making up for that part of the salary to avoid paying taxes and contributions.

**Table 1. Overview of the elements that determine the amount of the tax burden on labour in Republic of Srpska**

	2008	jan '09-feb '11.	feb '11-jan'14	feb'14-today	With suggested changes
non-taxable portion of income	250 KM*	300 KM	0 KM	200 KM	200 KM
Income tax	10 %*	10 %	10 %	10 %	10 %
Pension and Disability Insurance	24%*	17%	18%(18,5%)**	18,5%	18,5%
Health Insurance	15%*	11,5%	12,5%(12%)**	12%	11%
Unemployment Insurance	1%*	0,7%	1%	1%	0,7%
Child Protection	2%*	1,4%	1,5%	1,5%	1,4%
The total tax burden on labour (as% of gross salary)	32,7%	34,4%	39,7%	39,3%***	38,5%***

\* The amounts are shown in comparison to net salary.

\*\* Since 2013, the rate of pension and disability insurance increased from 18% to 18.5%, and the rate of health insurance decreased from 12.5% to 12%.

\*\*\* The calculation of the total tax burden for this period included the special contribution for solidarity, which is 3% of net salary (in force until December 31st 2015).

Извор: Анализа иницијативе за смањење стопе доприноса у Републици Српској, Огњен Ђукић, Центар за истраживања и студије ГЕА, април 2015.

[4] For instance Schneider, F. (2005) Shadow economies around the world: What do we really know? European Journal of Political Economy, pages 598–642.

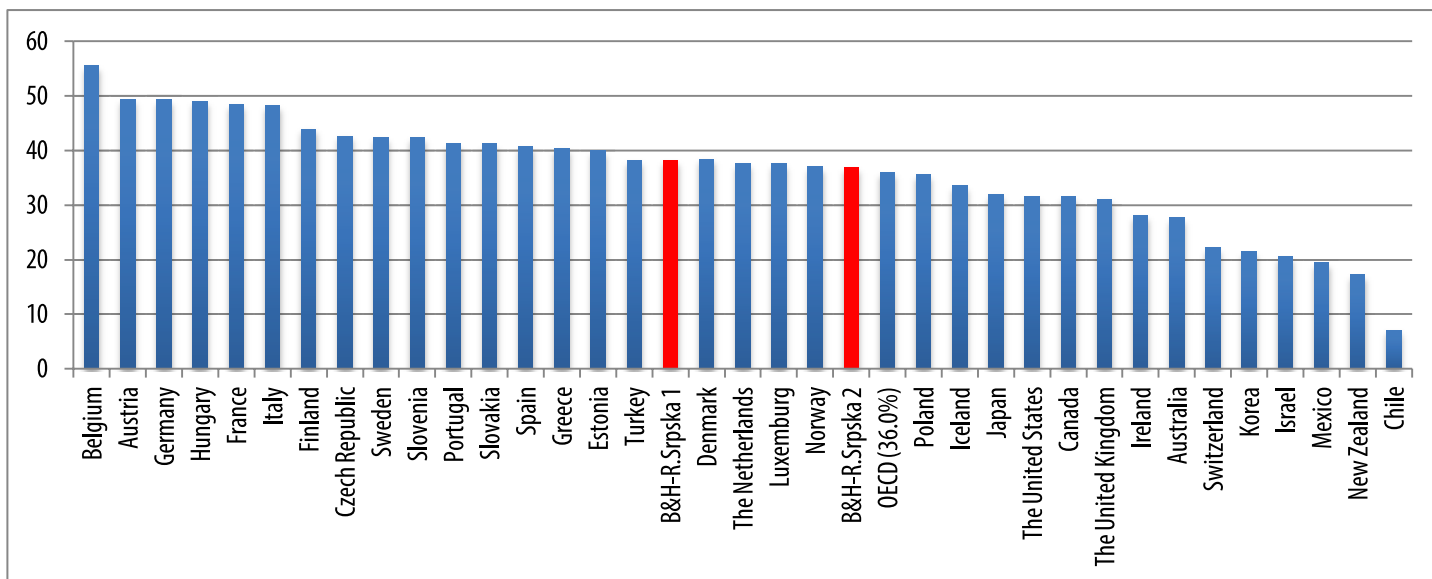
[5] For instance Anđelović, S., Žarković-Rakić L. (2012) Pобољшаванје радних подстицаја: Евалуација реформе пореске политике користећи SRMOD.



Analysis of the Centre for Research and Studies GEA<sup>[6]</sup> has found that in the 2011-2014 period in Republic of Srpska there were three changes to the amount of tax burden on labour and that the draft of the Law on Amendments to the Law on Contributions (adopted March 4th 2015 and submitted for a public discussion by the National Assembly of Republic of Srpska) provided the fourth amendment. The adoption of these amendments would mean that the tax burden on labour on average gross salaries would amount to 36.9%.

The same analysis indicated a relatively high level of taxation of labour in Republic of Srpska in relation to a number of countries. The reduction in taxes on labour at 36.9% of gross salary Republic of Srpska does not make a great progress and remains above the OECD average, which amounts 36%.

**Figure 5. Height of labour taxation in Republic of Srpska in comparison with OECD countries (% compared to the average gross salary)**



Source: Analysis of initiatives to reduce the contribution rate in Republic of Srpska, Ognjen Djukic, Centre for Research and Studies GEA April 2015. Note: "BIH - R. Srpska 1" indicates the height of the current tax wedge in RS, whereas "BIH - R. Srpska 2" indicates height of the tax wedge when the reduction in the contribution rate by 1.4 percentage points would be applied.

Within the primary survey, respondents were given information and a question was asked: "Participation of taxes and contributions in the average gross wage currently stands at 38.2%. In your opinion, how much would this share amount so to achieve that this possible causes of the informal economy is eliminated as substantially as possible?" (The questionnaire offered space for writing down the desired answers). The total average of all

responses that were given in quantitative terms is 24.6%<sup>[7]</sup>, which illustrates the attitude of respondents about the need for a significant reduction in labour taxation.

Other important documents dealing with economic reforms in Republic of Srpska and Bosnia and Herzegovina emphasize the need and announce reforms as a reduction in the payroll tax. The Economic Policy of the Government of Republic of Srpska for 2015 has announced the following: "Special attention will be devoted to finding optimal tax burden on labour (income tax and compulsory contributions)." Compact for Growth and Jobs, an initiative of the EU Delegation in BiH, which has formulated a package of priority socio-economic reforms, in the first place put the reducing taxes on labour. The Reform Agenda for BiH 2015-2018, a document adopted in July 2015 by the Government of Republic of Srpska, also states the taxation of labour as one of the priority areas for reform: "It is necessary to implement the reduction of burden on labour by reducing contributions for health insurance,

but also at the same time it is necessary to provide additional revenues of extra budgetary funds to cover the losses that will arise due to the reduction in the contribution rate."<sup>[8]</sup> Another problem in the field of direct taxation in Republic of Srpska, which is recognized as a cause of the informal economy is related to the degree of complexity of procedures of the Tax Administration of Republic

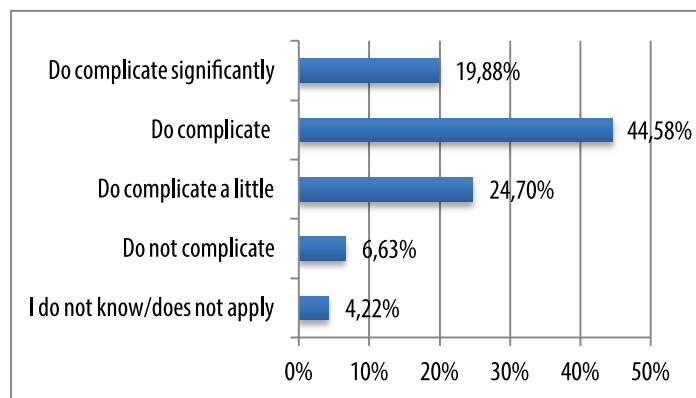
[6] Analysis of the initiative for lowering the contributions rate in Republic of Srpska, April 2015, available at <http://www.gea.ba/category/publikacije/>

[7] This information should be taken only as illustrative. Some respondents gave the descriptive answers and those answers are not taken into consideration when calculating the average. For quantitative answers that are given in the form of a range, average values are calculated (for example in the range of 25-30% the average is 27.5%).

[8] More information about the benefits of the lower tax burden on labor for all participants in the labor market in RS and FBiH, including both employed and unemployed, can be found in the study how to lower taxes on labor without harming public funds? Centre for Research and Studies GEA (available at <http://www.gea.ba/category/publikacije/>)

of Srpska. In fact, 44.58% of the surveyed employers believe that these procedures make it difficult, and 19.88 % that make business very difficult in the formal economy.

**Figure 6. In your opinion, to what extent the procedures of the Tax Administration of Republic of Srpska hinder business in the formal economy?**



Source: Research of UEARS

When it comes to value added tax (VAT), elements of the system for which respondents believe have the greatest influence on the existence of the informal economy are: unfair competition that operates outside the VAT system and the deadline for payment of invoiced VAT. The problem of competition that operates outside the VAT system is, of course, directly related to the issue of inadequate work of VAT/AIT inspectors who are often defined (3rd position) as having a high impact on the existence of the informal economy. The problem of the payment deadline for invoiced VAT stems from the fact that in practice it often happens that a company that has issued the invoice included VAT must pay the corresponding VAT before he managed to charge the very invoice.

## Labour Legislature

The role of labour legislation is manifold. Among other things, it should define employees' rights and ways to protect them, but also to facilitate the efficient functioning of labour market and labour relations. If a significant portion of the employees in an economy works in the sphere of the informal economy<sup>[9]</sup>, it means that there are obstacles to the efficient functioning of the formal sector and that they should be addressed.

[9] In primary research "work off books" was mostly cited as the main form of the gray economy in Republic of Srpska.

According to the Index of freedom in the field of labour<sup>[10]</sup>, which is a part of the Index of economic freedom, in 2015 BiH was in the middle of the ranking list of European countries in terms of freedom (or flexibility) allowed by labour legislation. It is worth noting that this index should be considered only as illustrative due to methodological problems associated with indices that attempt to measure various freedoms in the field of labour legislation<sup>[11]</sup>.

It should be borne in mind that in August 2015 in the Federation of BiH came into force a new law on labour, which brought solutions which in significant number of issues differ in comparison to Republic of Srpska and are considered more flexible for employers (for example longer duration of fixed-term employment contract, a different way of calculating severance pay, establishing the part of the salary based on performance, etc.). This results in a lack of balance in the current conditions in the area of labour law, which will affect the perception of employers about the ease of application of labour laws when the comparisons between the two entities are made.

The results of primary research indicates that employers in Republic of Srpska believe that the following components of labour legislation have the greatest impact on the existence of the informal economy: the cost of sick leave and maternity leave are borne by the employer (58.3% of respondents ranked this area as an area with a high degree of influence) and cancellation of employment contract (50.9% of respondents ranked this area as an area with a high degree of influence).

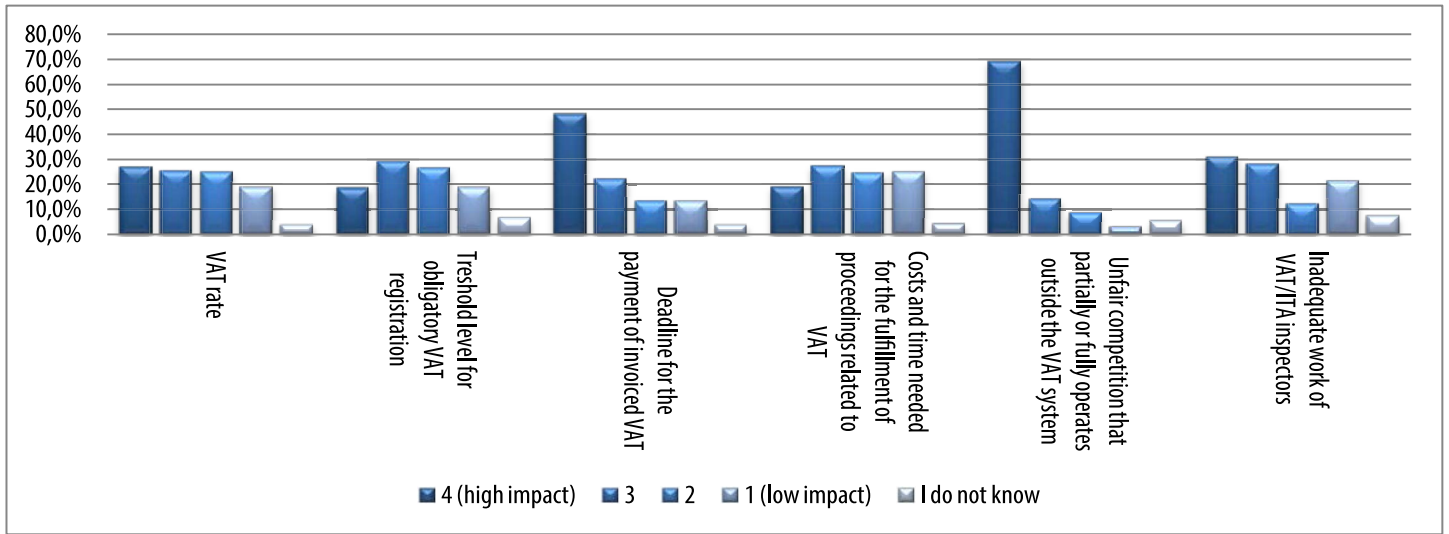
According to the International Labour Organization (ILO), there is no doubt that a suitable and effective response to the emergence and growth of the informal economy can only be made with the full involvement of the social partners<sup>[12]</sup>. In 2015 ILO adopted a new international standard in the form of a Recommendation to move from the informal to the formal economy, which, among other things, deals with the issues of the legal framework,

[10] Index is published by The Heritage Foundation. The ranking is based on quantifying six factors: the relationship between the minimum wage and average value added per worker, the barriers to hiring additional workers, the rigidity of working hours, the weight of firing unnecessary workers, the legal deadlines required for notice of cancellation and the amount of mandatory severance payments.

[11] More about problems of such indicators in connection with the methodology and the issue of one-sidedness in the measurement of labor regulations can be found in the publication of ILO Comparing indicators of labor market regulations across databases: A postscript to the employing workers debate, 2014.

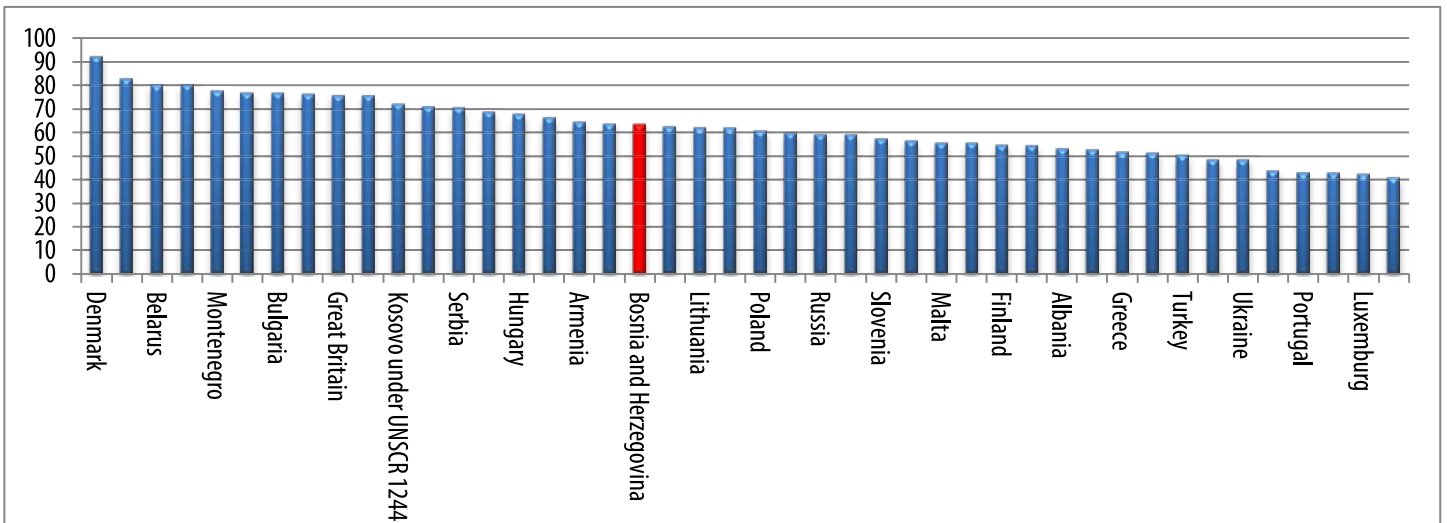
[12] Extending the Scope of Application of Labour Laws to the Informal Economy - Digest of comments of the ILO's supervisory bodies related to the informal economy, ILO, 2010.

**Figure 7. Please rank the degree of influence of the following elements of the VAT system to the existence of the Informal Economy in the scale from 1 to 4:**



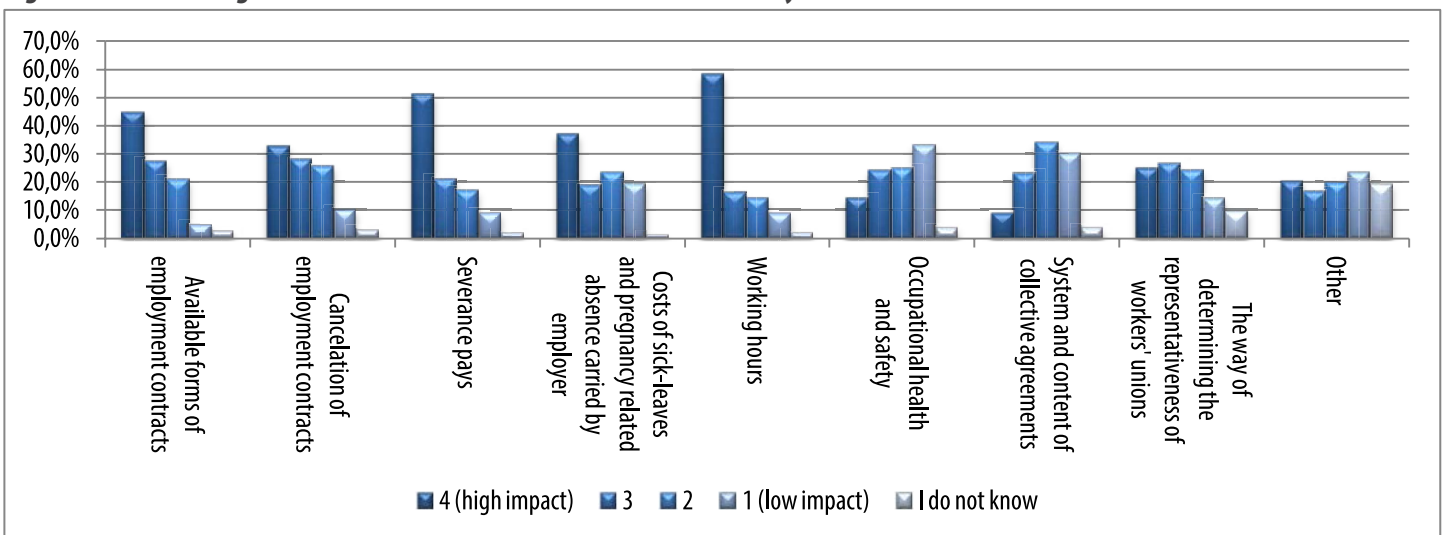
**Chart 8 Index of freedom in the field of labour for 2015 (index values range from 0 to 100, where higher value represents greater freedom)**

Source: Research of UEARS



**Figure 9. Please provide the rank in scale from 1 to 4 the degree of impact of the following areas of labour legislation on the existence of the informal economy:**

Source: www.heritage.org/index/



Source: Research of UEARS

employment policies, social protection, incentives, social dialogue and the role of employers 'and workers' organizations<sup>[13]</sup>.

The Government of Republic of Srpska in each annual economic policy since 2010 has envisaged adoption of the new labour law. Thus, the economic policy of Republic of Srpska for 2015 provided the adoption of the new labour law and the law on civil servants so as to enable „greater flexibility in the labour market, which will significantly increase the flexibility of labour in all areas.“

The Reform Agenda for BiH 2015-2018, which was signed by the Government of Republic of Srpska and supported by the IMF, World Bank and EU Delegation, it was noted that “the existing labour law to a great extent does not longer reflect the social and economic relations in BiH, and in certain provisions is in contradiction with other laws and even in some provisions is vague and insufficiently flexible. The culture of collective bargaining and social dialogue is underdeveloped and often burdened with unrealistic demands of the social partners.“

IMF mission to Bosnia and Herzegovina in 2015 concluded that it turned out to be “difficult to achieve a consensus between the social partners on a new labour law which would help in creating new jobs.”<sup>[14]</sup> However, the Reform Agenda for BiH 2015-2018 envisages that entity, cantonal and Brcko District governments “improve their drafts of labour laws, in consultation with the social partners, in order to increase flexibility of working conditions (including the possibility of employment on part-time basis) and allow for differential wage determination on the basis of skills, qualifications, experience level and performance. At the same time, entities, cantons and Brcko District will intensify their labour inspections and increase penalties for violation of labour laws and make best efforts to protect workers’ rights in accordance with the labour standards of the International Labour Organisation and the EU labour directives”. We can say that this conclusion is, to a certain extent, harmonized with the opinion of UEARS that a greater balance of rights and obligations of employers and workers is necessary so as to bring closer the level of responsibility in the execution of commitments.

[13] R204 - Transition from the Informal to the Formal Economy Recommendation, 2015 (No. 204)

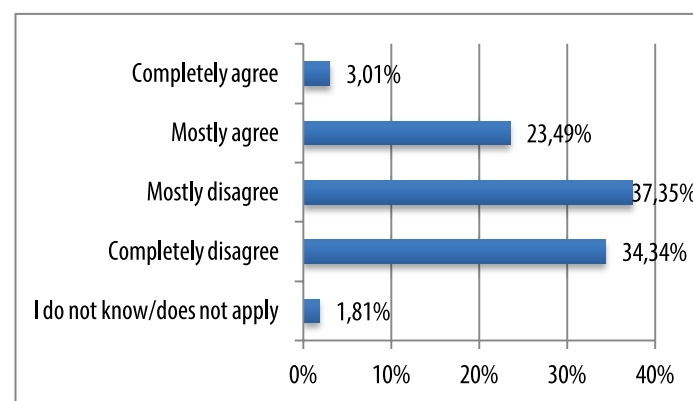
[14] The concluding statement of the Mission according to the Article IV, 12.05.2015

## Administration in the field of labour

The importance of administration in the field of labour for combating the informal economy and employment “off the books” is primarily reflected in its mission to provide a comprehensive and consistent application of labour legislation through various controls, preventive and punitive measures.

Conducted primary research indicates that employers do not have a high opinion of the work of inspections in the field of labour. Total 71.69% of respondents disagree with the statement that labour inspections are efficient and effective in their work (of which 37.35% disagrees in general, and 34.34% totally disagrees). One of the problems with which these results can be correlated is inadequate control of work of completely unregistered economic units. By the definition, all employees working in these units are workers “off the books”. This question was often stressed by employers during the focus groups, where a negative impact of this form of unfair competition was emphasized, especially in some sectors (for instance construction and transport).

**Figure 10. To which degree do you agree with the claim “labour inspections are efficient and effective in their work”?**

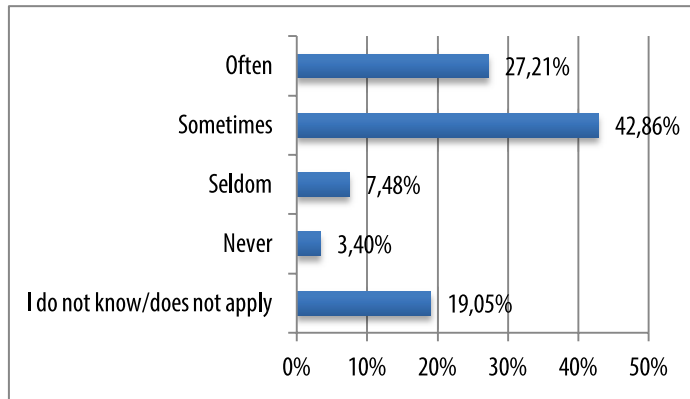


Source: Research of UEARS

Majority of the surveyed employers, also, think that labour inspection controls are sometimes (42.86% of respondents) or often (27.21% of respondents) politically motivated. This points to the existence of unequal treatment of all market players and the lack of independence of inspection bodies from political interference. This question is directly related to negative phenomena such as “political protectionism”, which have a very strong influence on the possibility of a healthy functioning of the entire economy.



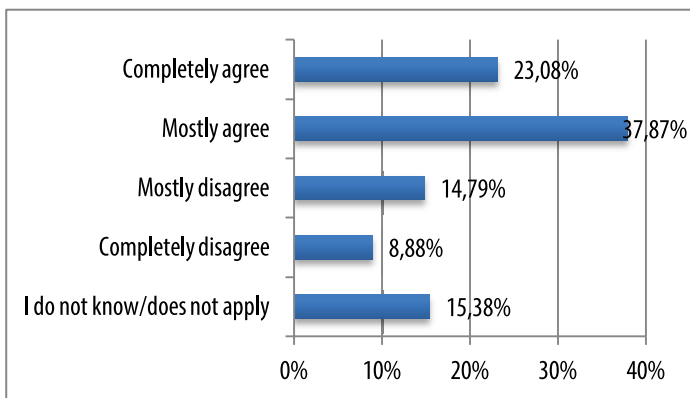
**Figure 11. In your opinion, are labour inspection controls politically motivated?**



Source: Research of UEARS

Most of the respondents also believe that there is a problem of unclearly defined competencies of labour inspections on entity and local level. Thus, 37.87% of respondents mainly agree with this statement, while 23.08% fully agree. According to statements of employers, in some cases this problem is reflected in the overlap of control and other inspection activities at different levels. In other cases, there is a lack of activities to combat the informal economy, for example in cases of completely unregistered enterprises and shops.

**Figure 12. To which degree do you agree with the claim “unclearly defined competencies of labour inspections on the entity and local level are a big problem”?**



Source: Research of UEARS

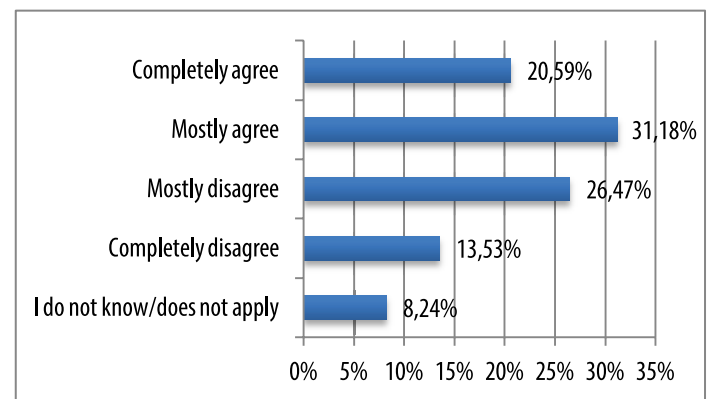
## Health and Safety at Work

The main objective of regulation in the field of health and safety at work is to ensure workplace safety and health protection and working capacity of workers. However, if these regulations are too complicated, then it can stimulate its avoidance through operating in the informal economy. Accordingly, there is a merger of two goals to one: to provide a safe and healthy work in any work-

place in a simple and easy way. The basic document in this field in Republic of Srpska is the Law on Safety at Work<sup>[15]</sup>, to which there are 22 bylaws, which all together represent a significant, but a very comprehensive regulatory content. Certain elements of this regulation in some cases caused a substantial increase in operating costs. For example, employers in this context often cite obligation of periodic drafting of the act on risk assessment for every workplace. It should be noted that for performing activities regarding safety and health at workplace a license issued by the Minister of Labour and Veterans is required.

Of the total number of surveyed employers, 31.18% mainly agreed, whereas 20.59% fully agrees with the statement that the legal standards and procedures related to health and safety in the workplace in Republic of Srpska are too demanding and thus stimulate the existence of the informal economy. On the other hand, there is inconsiderable number of employers that mainly disagree (26, 47%) or fully disagree with the same statement (13.53%). This finding supports the hypothesis that the views of employers on this issue vary depending on various factors such as the type of activity or size of the economic unit. For instance, the fulfilment of all conditions prescribed by legislation in the field of safety and health at work for a production company with a large number of employees is probably much more demanding than for a small company in the service sector.

**Figure13. To which extent do you agree with the claim “legal standards and procedures related to health and safety in the workplace in Republic of Srpska are too demanding and thus stimulate the existence of the informal economy”?**



Source: Research of UEARS

## Main Findings

Legal and regulatory business environment in Republic of Srpska is still unfavourable and stimulates the existence of the informal economy. Doing Business report of the World Bank for

[15] Official Gazette of Republic of Srpska 01/08 and 13/10



2015 ranked BiH at 107th position for the ease of doing business, which is the worst of all European countries. Extremely high variations between positions in 10 different fields observed by this report indicate that we did not have a comprehensive approach in implementing reforms of the regulatory environment for business.

Surveyed employers identified high tax, fiscal and quasi-fiscal levies as the main cause of the informal economy in Republic of Srpska. In Doing Business report, BiH is ranked 151st in the field of paying taxes, which is the penultimate place among all the countries of Europe.

Employers have been very consistent in the view that within the whole tax system a high taxation of labour has the greatest impact on the creation of the informal economy. Current height of the tax burden of the average wage is higher than the average in OECD countries. Due to the high taxes on the salary paid, employers often choose not to report their employees or to have a part of the salary payment “hands on”. The surveyed employers had the view that the tax burden on labour should be significantly reduced. All important documents dealing with economic policy in Republic of Srpska in the future, also, emphasize the importance of lower income taxes to revitalize the economy and stimulate employment. It is important to note that the revenue neutral reform (reducing taxes on labour while increasing one or more other tax) can have positive effects in this regard<sup>[16]</sup>.

In regards to VAT, unfair competition operating outside the VAT system and the deadline for payment of invoiced VAT are recognized as elements of this system mostly stimulating the informal economy.

In labour legislation, employers surveyed agreed that the following components of labour legislation have the greatest impact on the existence of the informal economy: the cost of sick leave and maternity leave borne by the employer and the termination of employment contract. The economic policy of the Government of Republic of Srpska for 2015 and Reform Agenda for BiH 2015-2018 provides the adoption of a new labour law to increase flexibility in the labour market. Full participation of the social partners is essential to complete a quality response to the informal economy in a society.

This study points to serious problems in the functioning of labour inspections, resulting in the creation of unfair competition. Particularly interesting are the lack of control of non-registered players on the market, the inspectors’ work under the political influence and overlapping of responsibilities of the inspections from the entity and local level.

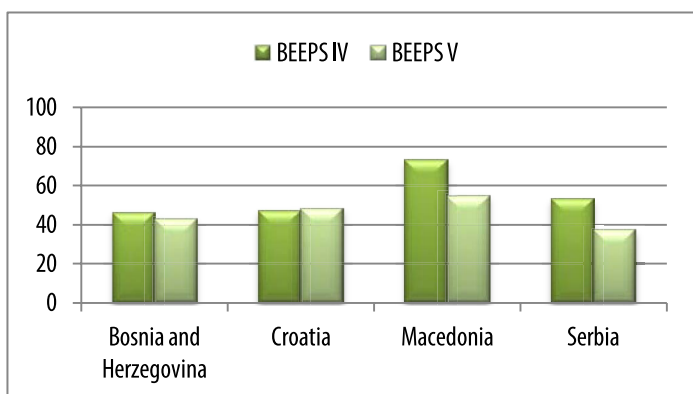
Employers have had relatively divided opinions on how the existing legislation in the field of health and safety at work stimulate the informal economy. Our assumption is that attitudes of employers vary depending on factors which determine the amount of costs and weight of such legislation, such as the type of business or number of jobs.

[16] See Kako do nižeg oporezivanja rada bez štete za javne fondove? – How to reach lower labour taxation without harming public funds?, Centre for Research and Studies GEA, 2013

## 2. Competition

According to the findings of BEEPS (Business Environment and Enterprise Performance Survey) conducted by the European Bank for Reconstruction and Development in cooperation with the World Bank, the effect of unfair competition, which operates in the informal economy is one of the three key barriers faced by employers in countries in transition and almost a third of them finds this to be the biggest obstacle. This is an inquiry which is carried out continuously for more than 15 years in 29 different countries and covering more than 15,000 companies with five or more employees. Bosnia and Herzegovina is one of the countries included in this research, where it is also stated that the informal economy represents a major obstacle to the business of domestic business entities. More than 40 per cent of the managers surveyed in Bosnia and Herzegovina through this research indicated that they face competition operating in the sphere of the informal economy. Seen in the regional context, the situation is similar in Croatia and Serbia, but in Serbia some progress has been made

**Figure 14. Percentage of enterprises facing competition from informal economy**

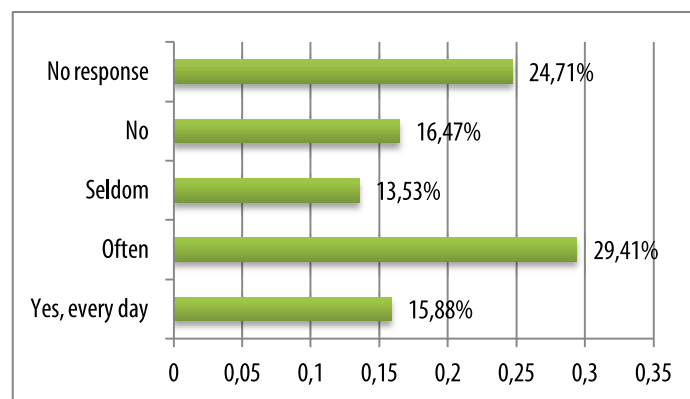


Source: BEEPS (Business Environment and Enterprise Performance Survey)

compared to the previous survey which was carried out in 2010. Even greater progress has been made in Macedonia, where in the previous survey more than 70 per cent of the managers surveyed indicated that they had a problem with unfair competition which operates in the sphere of the informal economy.

The data obtained through research of EBRD and the World Bank was almost completely confirmed by the survey results conducted by UEARS in Republic of Srpska.

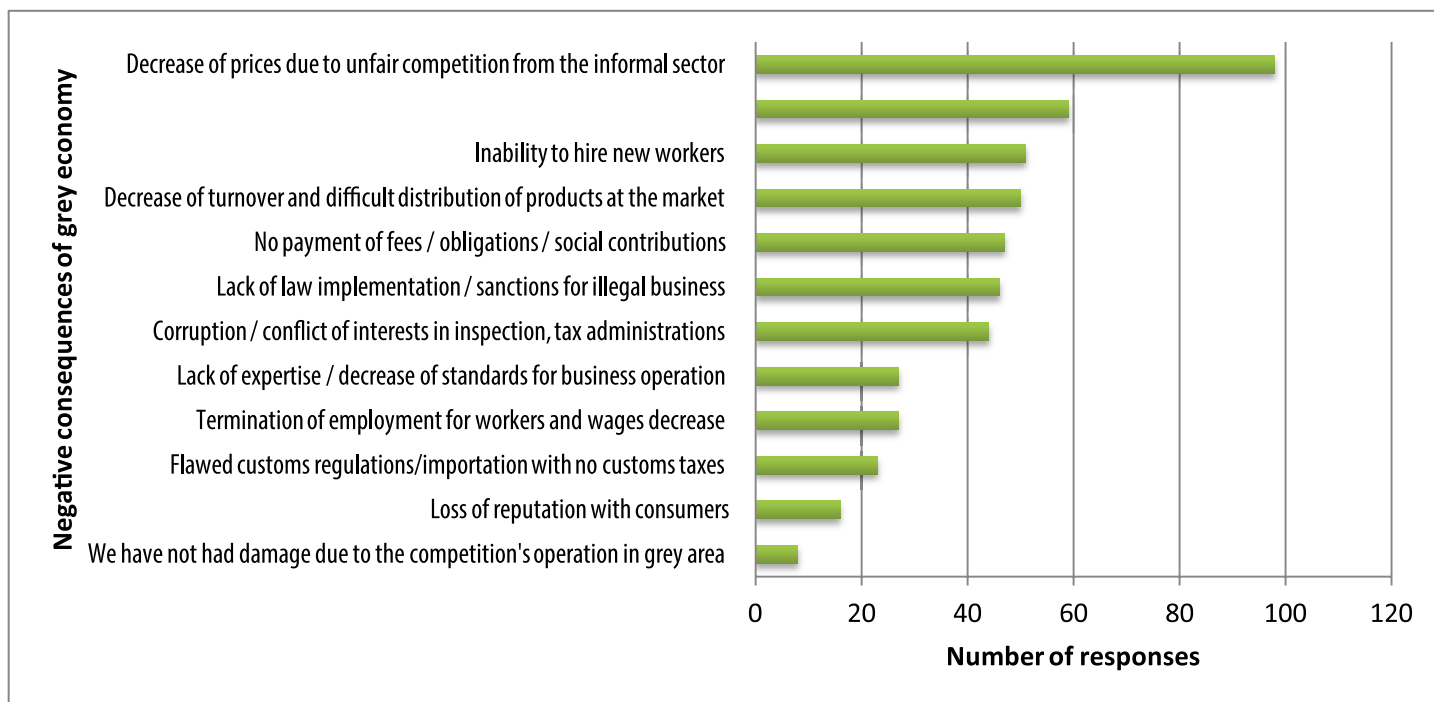
**Figure 15. Does your enterprise face unfair competition for businesses operating in the informal (grey) economy?**



Source: Research of UEARS

The data obtained in this study shows that more than 45 per cent of the companies in Republic of Srpska almost daily or often suffer damage due to unfair competition operating in the informal economy. In their view, the damage suffered because of the informal economy is mostly manifested in the fact that they are forced to strike down the prices of their products and services due to unfair competition, and do not have the possibility of investing in technological development and recruitment of new workers.

**Figure 16. Negative consequences of the grey economy on the activities of your enterprise?**

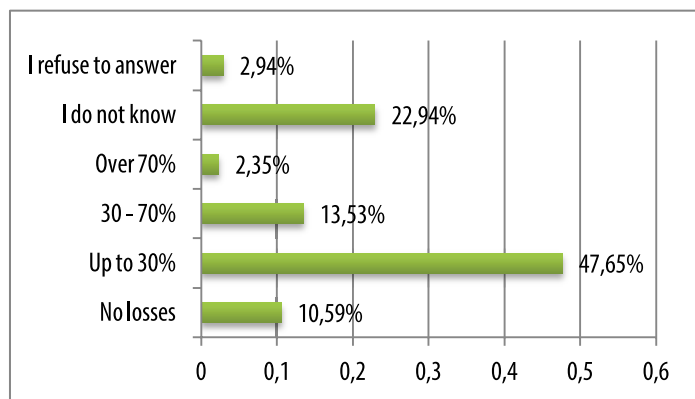


Source: Research of UEARS

The negative consequences that employers feel are difficult to accurately quantify and document. However, most respondents estimated that their annual income is reduced by at least 30% due to unfair competition and business of competitive enterprises in the grey economy.

least 30% due to the competition operating in the sphere of the informal economy.

**Figure 17. Can you estimate how much of annual revenues of your company decreased due to the activities of companies that operate in the grey area?**



Source: Research of UEARS

It is interesting to note that similar data were obtained through primary research among employers and business entities in the Federation of BiH, which was conducted in the same period. More than 45 per cent of the respondents indicated to faces competition from the informal economy on a daily bases or often. Also, majority feel that their total annual income decreased for at

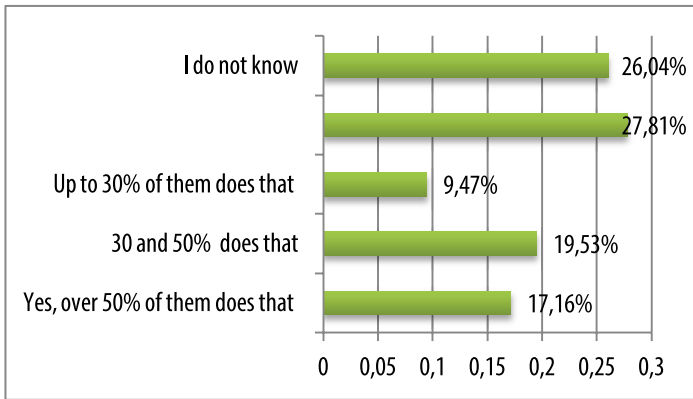
## Salaries

When we talk about business in the sphere of the informal economy here are usually a few typical phenomena: business activities for which the company is not registered or sale of products and services without a license, failure to declare traffic, failure to register employees, paying part of the salaries in an envelope in order to reduce the base for tax and contributions, failure to report the import of goods, etc. Employers in Republic of Srpska believe that all these phenomena are not equally represented or, that the practice of not reporting workers or not reporting full wages is higher in comparison to, for example, suppress the actual prices of goods and services.

These phenomena, of course, are not equally typical for all sectors. There are different forms of activities in the informal economy, if we view the construction industry, trade and catering. UEARS research shows that more than 45 per cent of respondents believe that there is a practice of payment of salaries in envelopes in their sector, while 17 per cent of respondents believe that more than half of their competitors do that.



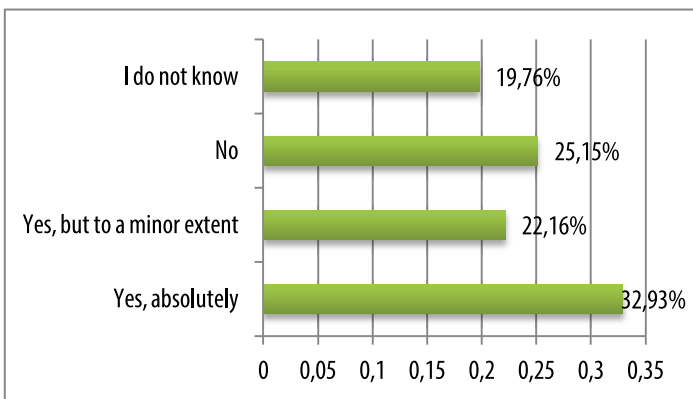
**Figure 18. Do you think that in your sector there is a practice that a part of the salary is paid “off the books” (in cash) and, in your opinion, what is the percentage of those who pay wages in that way?**



Source: Research of UEARS

It is clear that this way of doing business jeopardizes the competitive position of those who register their workers and pay salaries in full amount. Depending on the activity, size of the company and market position, this emergent form of informal economy enterprises feel to a greater or lesser extent. A quarter of respondents considers that their competitive position is not compromised by the practice of not reporting work, and almost the same percentage believe that the effect exists, but to a lesser extent. On the other hand, more than 30 per cent of respondents believe that the practice of not reporting workers and non-payment of full wages absolutely jeopardizes their position in the market.

**Figure 19. Do you believe that your competitive position is endangered by the practice of not reporting full salary in your sector?**

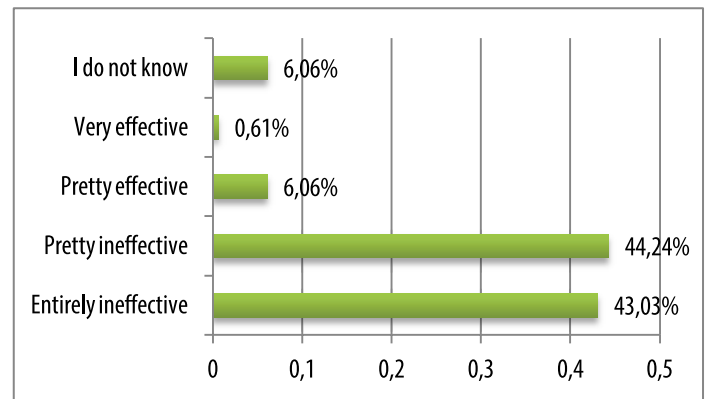


Source: Research of UEARS

From the above stated we can conclude that the negative impact of the informal economy to the competitive position of domestic companies is multifaceted and that undeclared work is one of its typical shapes. In such circumstances, the role of the state in combating the grey economy is crucial. Through other sections of this document it is much said about how important the efficiency, transparency and consistency of public administration is in the implementation of the legal framework and how important is the

work of control and judicial institutions in order to gain the trust of the business community in the political institutions. Unfortunately, employers included in the UEARS survey do not believe much in the success of previous efforts of public institutions in Republic of Srpska towards eliminating the negative impacts of the grey economy and the fight against unfair competition. Namely, 87 per cent of respondents believe that the existing legal solutions in force against unfair competition are inefficient.

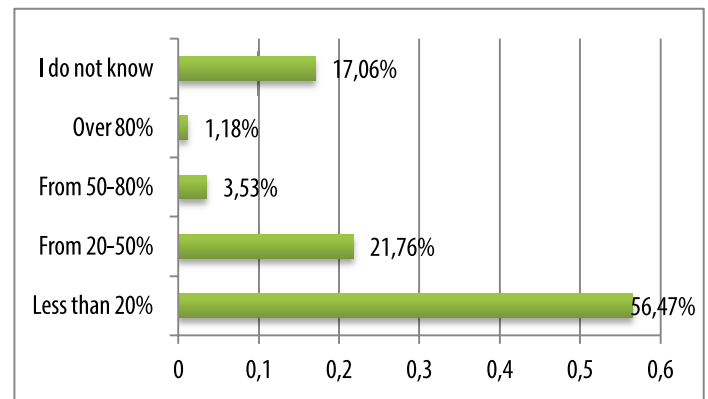
**Figure 20. In your opinion, how effective are legal solutions in force against the unfair competition?**



Source: Research of UEARS

In addition, confidence in the operation of the control bodies that need to sanction the appearance of unfair competition is very low.

**Figure 21. The probability that an enterprise operating in a grey zone to be discovered and punished**

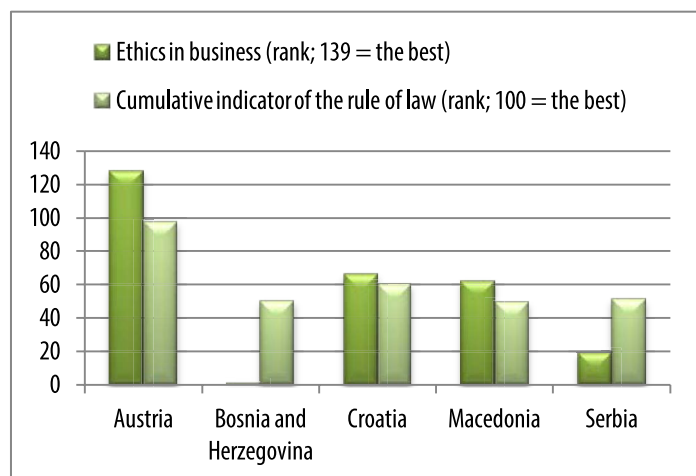


Source: Research of UEARS

Majority of respondents believe that there is a little probability that a company operating in the grey zone will be discovered and punished. These data fit into the general picture of lack of confidence in the work of government institutions, which will be discussed further in the section relating to good governance and the rule of law. In addition, it is important to emphasize that lack of confidence in the work of public institutions at the same time make the atmosphere of general mistrust in the domestic market, contribute to poor ethics of a company in business and to low tax morality. Comparative data from the research that evaluate the

rule of law and ethics of business operations in Austria, BiH, Croatia, Macedonia and Serbia confirm that in a way.

**Figure 22. Rule of the law and the ethics in business of companies**



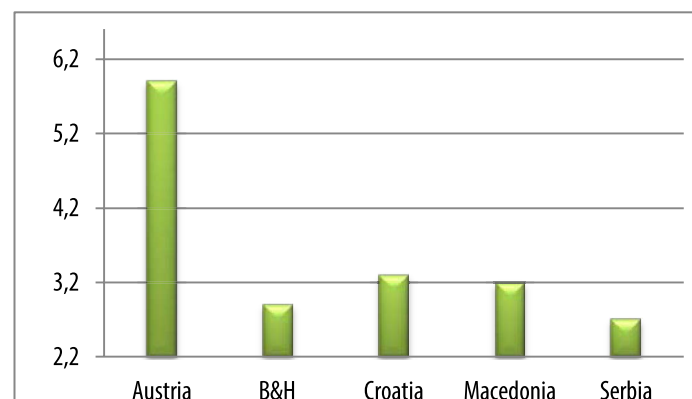
Source: *Global Competitiveness Report 2010/11 u (WGI) - World Bank, 2013*

## Main Findings

Unfair competition operating in the informal economy is one of the three key barriers faced by employers in Bosnia and Herzegovina. More than 40 per cent of surveyed employers and enterprises, both in Republic of Srpska and in the Federation of BiH, through primary research indicated that they are facing this problem.

Damage that companies in Republic of Srpska suffer because of the informal economy is manifold. Due to unfair competition, companies are forced to strike down the prices of their products and services, do not have the possibility of investing in technological development, are more difficult to decide on the recruitment of new workers, lose their reputation among consumers, lower quality standards, lack of expertise prevails, etc. On the other hand, as the most common forms of the informal economy that unfair competition use as a competitive advantage is work "off the books" and failure to report full salaries, carrying out activities without a license, failure to declare traffic and sales without a receipt. Effect of unfair competition is very typical for those sectors with low productivity and a high share of labour costs, but also generally for the economy as a whole.

**Figure 23. The degree of complexity of the production process (1 = labour-intensive production; 7 = technologically advanced manufacturing)**



Source: *Global Competitiveness Report 2010/11*

It is the practice of unregistered employment or full salary particularly widespread, especially with those dealing with individual activity and micro and small enterprises. In conditions of low purchasing power of the domestic market and a general mistrust in the political institutions distorted motives operate and the companies (especially small businesses and entrepreneurs) are forced to fight for customers with low prices at the expense of quality of products and services. This causes them to defend their competitiveness by low labour costs, so the workers are not registered or are registered for lower wages than real, and the rest is paid in an envelope to minimize the base for taxes and contributions. According to data from the Tax Administration of the RS and the Fund for Pension and Disability Insurance RS for 2015, even 47, 52% of those engaged in independent business activity are reported on the minimum wage and pay taxes and contributions to that wage. Also, if we look at the average wage on the basis of contributions paid for pension and disability insurance, then we can notice that the average wage of those who are engaged in self-employed business amounted to 463.84 KM versus 1077.08 KM of those who work in joint stock companies (the typical form of organization for medium and large companies). This further illustrates the pressure the economic entities are subjected to in RS, especially small entrepreneurs. State, unfortunately, by its activities fails to remedy the situation. On the contrary, additional taxes, especially taxes on labour, deepen the already large gap between the rate of income tax (10%) and taxes and contributions on salaries (over 60% of the average net salary in RS), which stimulates entrepreneurs and owners of small businesses to pay the difference in salaries in cash from retained earnings. This combined with other adverse factors that prevent fair competition only accelerates the movement along the negative spiral, where the first target is public funds, and long-term all.

# 3. Financing

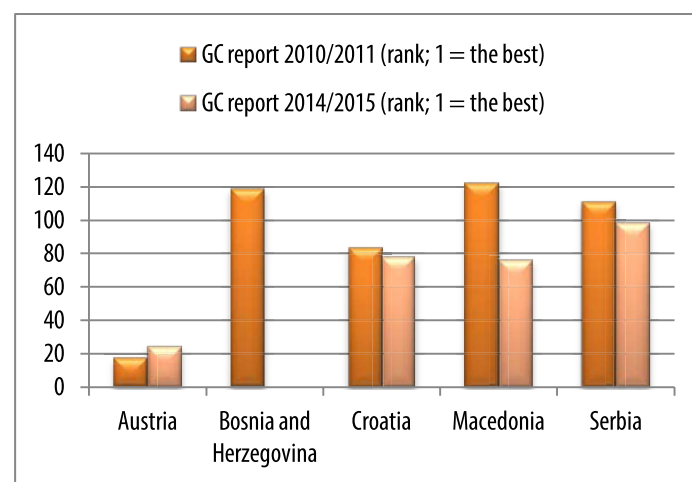
It is known that regulation of the financial market plays a significant role in creating a favourable business environment for enterprises. An efficient financial system allocates resources of citizens, public institutions and funds coming from abroad to the economy and businesses that use them most productively. Thus, resources are focused on those entrepreneurial or investment projects of whom we expect the highest rate of return and pay-back. A well-functioning financial market is crucial for the growth and development of domestic companies, their productivity and competitiveness. Developed economies therefore develop sophisticated and advanced financial markets able to provide the capital to be quickly available for investment in the private sector, thus promoting their growth and development. In doing so, important are presuppositions to the successful operation of domestic financial market, developed market capital and a reliable and transparent banking sector.

## Access to finance

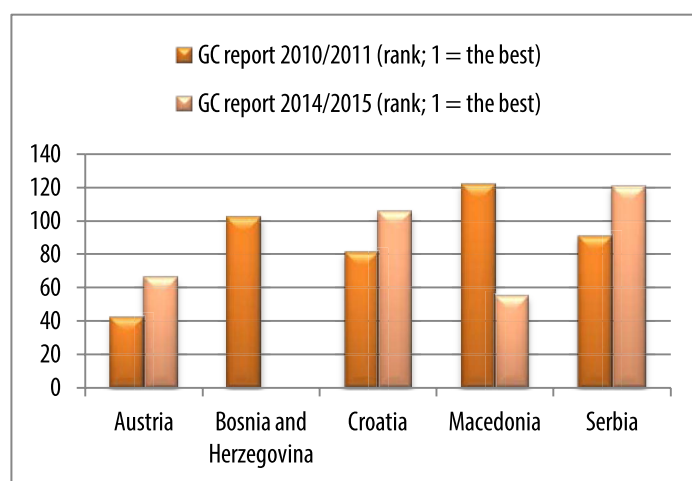
The banking sector in RS and BiH, according to numerous national and international analyses, is evaluated as reliable, and the way it is arranged is mentioned as one of the best examples in BiH. Reports of competent banking agencies also state that generally seen, the banking sectors both in Republic of Srpska and the Federation of BiH is stable. However, if we look at the role of the banking sector in creating a favourable environment and creating conditions for the growth and development of domestic companies then things are not so good. According to comparative indicators of the Global Competitiveness Report, published by the World Economic Forum, Bosnia and Herzegovina is very poorly ranked

when we look at the availability of financial services for companies, and the level of ease in which companies receive loans.

**Figure 24: Availability of financial services**



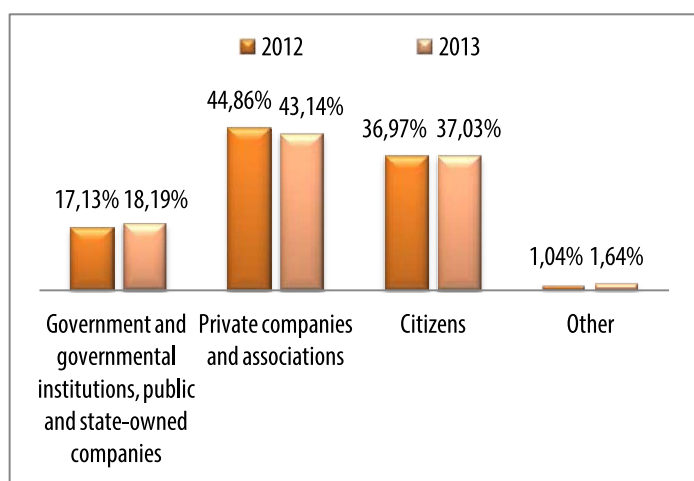
**Figure 25: The ease of obtaining loans for economic entities**



Source: WEF - Global Competitiveness Report (2010/11 - 014/15)

This is partially confirmed by the reports of competent institutions in the banking sector, where we can observe that the loan placements to enterprises in RS and FBiH have a slight decline compared to the overall structure of placements. Based on the report of the Banking Agency of RS, the share of loans to private companies fell from 44.86 per cent in 2012 to 43.14% in 2013, and such a trend was continued in 2014. At the same time, the share of loans to government institutions, public and state enterprises are growing. It was a consequence of a general commitment of banks to invest more in the public sector, where the risks are estimated lower, and at the expense of the economy. On the other hand, the constant growth of deposits and savings accounts of natural and legal persons shows that citizens and companies in Bosnia and Herzegovina seem to believe banks more than the banks believe them.

**Figure 26. Structure of total lending in the Republic of Srpska in 2012 and 2013**



Source: Banking Agency of Republic of Srpska, calculations of the author – NEMAM GRAFIKON

Moreover, unlike banks, which to some extent still have a choice in deciding where to place the credit funds, in the search for external sources of funding enterprises in Republic of Srpska and BiH are still predominantly dependent on the banking sector. Indicators of the World Bank on the percentage of enterprises using bank loans, based on the survey, indicate that entrepreneurs and businesses in BiH are much more focused on banks in financing investment or working capital needs in comparison to companies in the region.

Furthermore, despite the fact that in the banking sector, there is a considerable competition (in the market of Republic of Srpska currently operates nine banks headquartered in the RS and seven banks from the FBiH), it did not bring special benefits to businesses, especially when it comes to the cost of banking services. Most employers and companies surveyed by research of UEARS, more

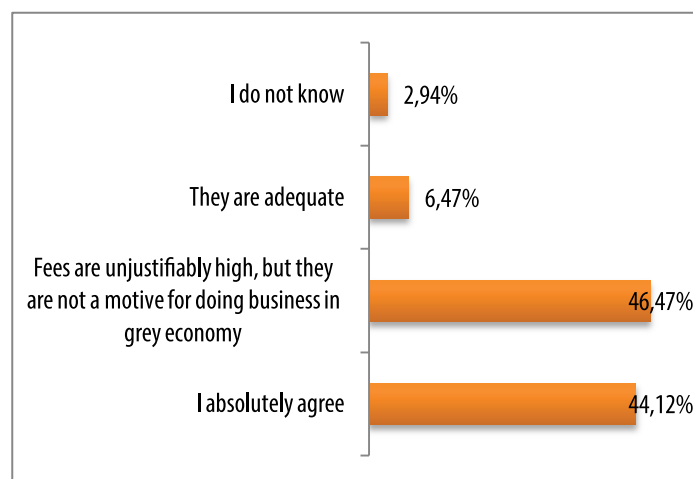
**Table number 2: A World Bank survey on the percentage of companies using bank loans**

	BiH	CRO	MCD	SRB
Percentage of surveyed companies using bank loans to finance work capital	47%	38%	38%	38%
Percentage of surveyed companies using bank loans to finance investments	38%	27%	21%	27%

Source World Bank – World Development Indicators, 2013

than 90 per cent, believe that the costs of banking services are unreasonable. In this regards, they think the costs of commissions, fees, guarantees, etc. Most of them (44 per cent) even believe that the high costs of banking services in Republic of Srpska simultaneously motivate business in the informal economy, where companies and entrepreneurs try to minimize traffic carried over transaction accounts so as not to be exposed to the high costs of banking services.

**Figure 27. Do you agree with the statement that the costs of banking services in Republic of Srpska are unreasonably high and constitute a motive for doing business in the informal economy?**

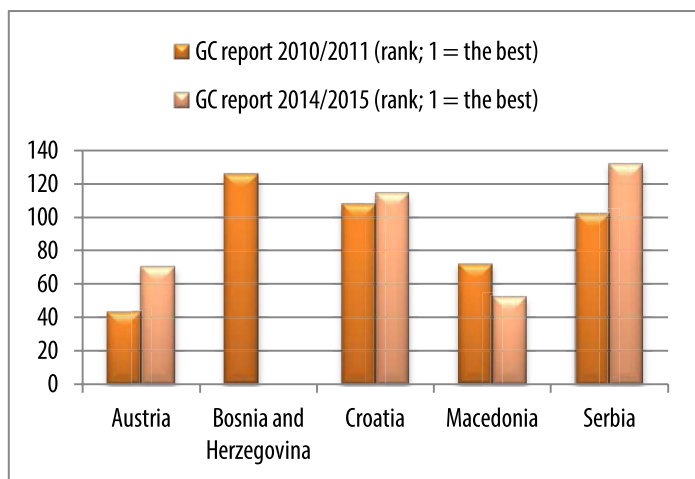


Source: Research of UEARS

One of the main reasons why this is so is the fact that alternative sources of financing for enterprises in BiH are rather undeveloped and in the search for external sources of financing companies mainly address to banks. After all, this is confirmed by the following indicators of the Global Competitiveness Report of the World Economic Forum, in which BH was ranked lower compared to other observed countries when it comes to the availability of venture capital funds.



**Figure 28. Availability of venture capital funds**



Source: WEF - Global Competitiveness Report (2010/11 - 2014/15)

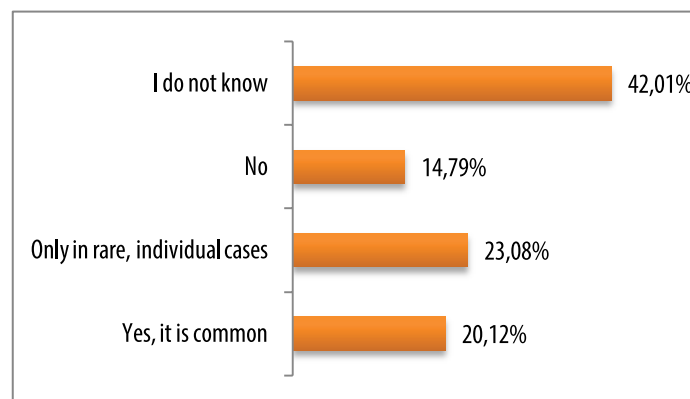
This information is all the more important due to the fact that alternative sources of funding through the so-called seed funds, venture capital funds, business angels network, etc., are generally more focused on young companies, start-ups and those who are not formally registered or do not have a credit history that would be acceptable for banks. Venture capital funds are particularly fond of sectors with high growth potential and productivity, such as IT services, software development, etc. At the same time, in the domestic market it often happens that the start-ups in these sectors spend the incubation period by operating in the informal economy.

Those who are engaged in less productive sectors and operate in sectors typical for the informal economy, such as trade, catering, agriculture, services, construction and alike, due to the inability to meet the stringent requirements of banks for loans, are sent to other financial institutions, namely microcredit companies and foundations. The target groups of these organizations are mostly small entrepreneurs and citizens with lower incomes, because they, as a rule, tend to get loans from banks because they are not able to provide the required documentation and meet more stringent collateral requirements. However, the conditions under which they borrow from microcredit organizations are worse than the bank loans so the weighted average effective interest rate on an annual basis for loans to these organizations amounted to over 21%!<sup>[17]</sup> It is evident that this is about the sources of funding that do not allow significant growth and development for entrepreneurs and economic entities and thus discourage the step from the informal to the formal economy.

[17] The report on the situation in the banking system of Republic of Srpska for the period 01.01.2013 – 31.12.2013, the weighted average interest rate MCO with headquarters in RS amounted to 21.33%, and those based in the FBiH 26.5%.

Finally, another form of financing of businesses in RS refers to informal sources that are completely in the sphere of grey economy, whether it is about unrecorded remittances, financial investments of relatives, friends or other, and sometimes illegal financial arrangements. Research of UEARS shows that one-fifth of the surveyed entrepreneurs and enterprises from Republic of Srpska believes that this is a common occurrence in their branch, while 23 per cent of them believe that such a practice exists, but it is not so common.

**Figure 29. Do you think that in your branch there is a practice of financing business activities from informal and / or illegal sources?**



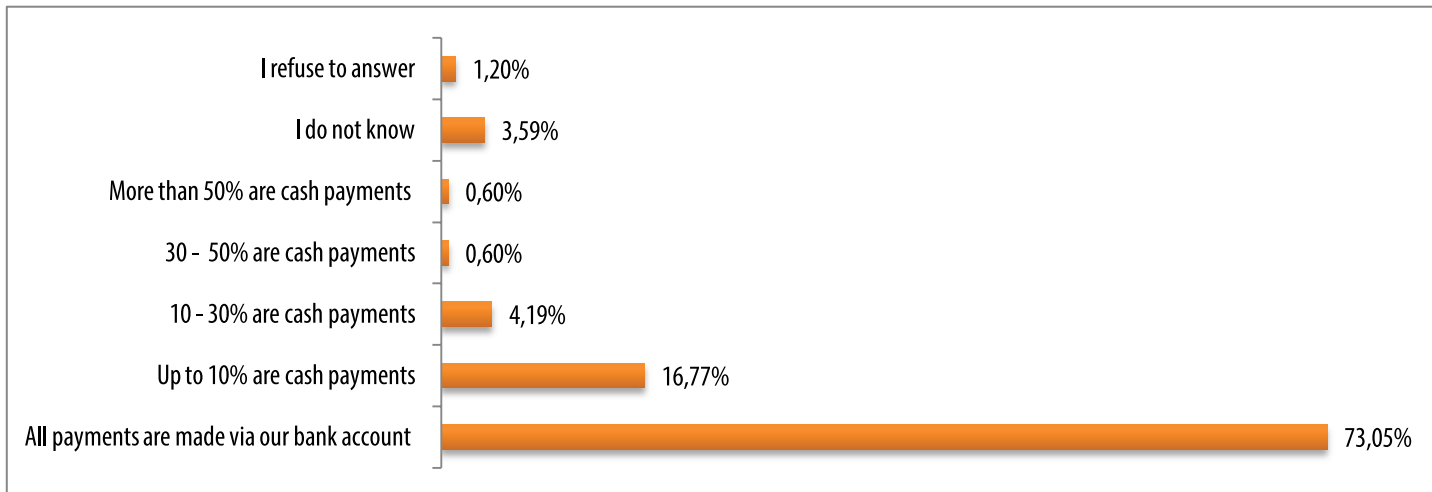
Source: Research of UEARS

## Financing of the informal economy

Another important aspect that we want to observe within this chapter is the way in which enterprises and business entities are financing the activities in the sphere of the informal economy. Bearing in mind that this is about those activities which are not fully covered by the legal framework or formally registered, the cash will be seen as the “motor fuel of grey economy” (Schneider, F) because it is difficult to have an insight into its progress<sup>[18]</sup>. Cash transactions in a certain way open the door to facilitate access to the informal economy. Sectors and activities where cash is dominant form of payment (such as trade, catering, agriculture and services) are at the same time recognized by a significant share in the informal economy. This means the fewer transactions in cash the narrower space for the grey economy. Research on the shadow economy in the EU countries, led by one of the leading experts in this field prof. Schneider, documents a strong correlation between the numbers of electronic transactions in a country with the scope of the grey economy. For example, countries with a high

[18] Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries, Friedrich Schneider, 2013

**Figure 30. Can you estimate what percentage of payments in your company is carried via the bank account and what in cash?**



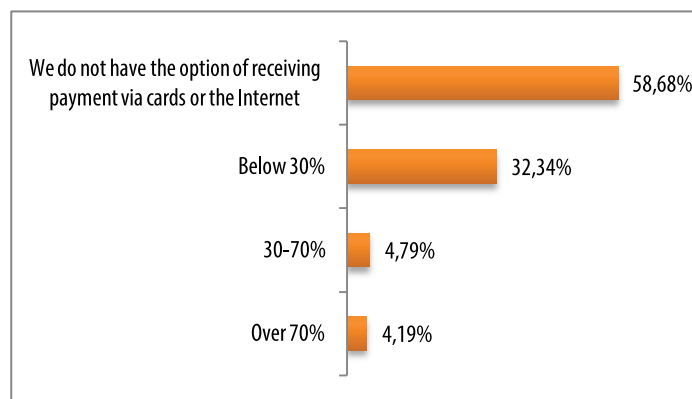
Source: Research of UEARS

share of electronic payments in all your transactions have significantly lower proportion of grey economy in GDP compared to other countries where the system of electronic payments is not so developed. Prof. Schneider goes a step further and in his research argues that an increase in the volume of electronic payments for 10% over a period of four years may reduce the grey economy by about 5%.

In this context, it is interesting to look at the data collected through the survey research about the percentage of payments done in cash and credit card payments or via an Internet service. A significant majority of surveyed employers and businesses, more than 70 per cent, stated that all payments are exclusively performed via bank / transaction accounts, while there are less than 1 per cent of them with a predominant payment in cash.

In a sense these responses are a reflection of the sample structure where are predominantly companies not engaged in retailing and thus have no direct contact with cash. The second question shows whether interviewed enterprises have introduced card payment or payments through the Internet, and what percentage of the turnover is realized in such a way.

**Figure 31. If your customers have the option of credit card payment (payment by credit or debit card), or Internet payments, what percentage of revenue is being charged in this way?**



Source: Research of UEARS

Based on the answers, we can conclude that more than 90 per cent of the respondents in general do not have the possibility of card payment, or even if they have it, less than 30 per cent of turnover is realized in this way. When we speak about the credit card business what is encouraging is the data of the Central Bank of BiH for 2013, at the macro level, indicating a positive trend when it comes to cashless payment and card business. According to this data, 2.27 milliard of BAM was realized on POS terminals in BiH, or 32% of the total value of all transactions carried out via the cards<sup>[19]</sup>. This is an improvement compared to earlier periods, including 2012, when the share of transactions through POS terminals amounted to 27%.

[19] Transactions performed via ATM or POS devices.

## Main Findings

Even though facilitated access to finance for enterprises operating in the zone of the formal economy should be their competitive advantage, in Bosnia and Herzegovina and Republic of Srpska the advantage is relative. Lack of alternative sources of financing, underdeveloped capital market and the commitment of banks to issue loans to the public sector and the population at the expense of the economy affected that Bosnia and Herzegovina is very poorly ranked in comparison to other countries when we see the availability of financial services to businesses, and the level of ease in which companies receive loans. The limited availability of financial services and rigorous conditions for obtaining a loan at a time when companies have no other sources of external financing, except commercial banks, impede their ability to stronger growth and development. Without money to invest in new technologies and additional employment, their productivity is stagnant and competitive position is weak, which leads them to even more unfavourable position regarding ability of obtaining credits from banks. Companies are thus forced to look for internal reserves to fund business activities, which are often found in the informal economy, through savings on labour costs and different forms of tax evasion. In the light of the informal economy a particular problem is the lack of financial support instruments for small companies as well as for start-ups who are already working but are not registered. Without adequate financial support, those who operate in the so-called “grey zone” have no other option but to

stay there. In this way they avoid relatively high costs of banking services, which is only one of the limiting factors for doing business in the sphere of the formal economy.

Accordingly, solutions to combat the grey economy should be sought primarily in the construction of a more robust and efficient financial system, where in addition to the traditional (banking), other sources of financing for domestic companies and entrepreneurs would be developed. These sources, except the title and declaratory purpose, for small businesses and start-ups should include conditions that enable the development of the business and the transition from the grey zone in the formal economy. For those who are just thinking about entrepreneurial ventures or deal with highly productive activities, but are not registered, there should be developed systems of support through venture capital funds such as seed funds, venture capital funds, crowd funding platforms, etc.

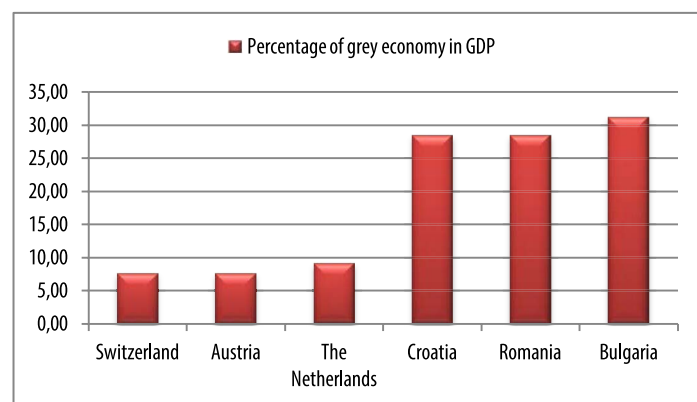
Finally, given the positive correlation between the volume of electronic transactions and reduction of grey economy, the positive trend should be continued and the non-cash payments in retail should be promoted, especially in sectors with traditionally expressed preference towards the informal economy, such as trade, catering and services.

# 4. Good governance and the Rule of Law



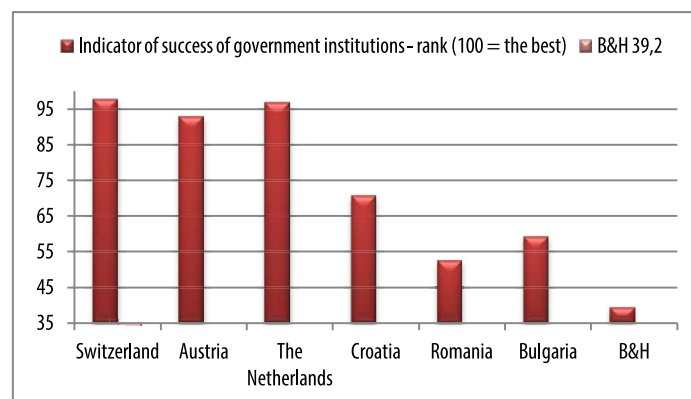
The way in which public institutions do their job and the degree of confidence in them significantly influence on the decision and commitment of business entities to operate in the field of formal or informal economy (Aghion, 2010; Torgler and Schneider, 2007; Johnson, 1999; Lackó, 2006; Kuehn, 2010). This means that there is a strong correlation between the degree of trust in public institutions and participation of grey economy in GDP of a country. Countries with the lowest share of the grey economy in GDP are also characterized by good indicators of the effectiveness and efficiency of governmental institutions and vice versa. The graphs below illustrate the relationship by comparing EU Member States with the highest and the lowest share of the grey economy in GDP, according to the indicators of effectiveness of the public institutions.

**Figure 32 EU member states with the highest and lowest share of the grey economy in GDP, 2013<sup>[20]</sup>**



Source: *Worldwide Governance Indicators (WGI) - World Bank, 2013.*

**Figure 33. Cumulative indicator of the effectiveness of governmental institutions**



Source: *Worldwide Governance Indicators (WGI) - World Bank, 2013.*

At the same time, when we talk about the index of effectiveness of public institutions, following should be born in mind: how the business community and the public perceive the quality of services provided by state / public institutions, the extent to which these services are provided independently of political influence, the quality of adoption and implementation of public policies, and to what extent it is possible to trust that state implements such policies. It is, therefore, a number of indicators from different sources which are, according to the methodology of the World Bank, compiled in the aggregate index. Of course, in addition to the above, there are many other factors that influence the perception of the quality of public services and trust in their work. In further text the subject of special attention will be those areas in the work of public services which might pose direct incentives for the grey economy. These are, above all, the tendency of public officials to taking bribery, as well as public spending and public procurement.

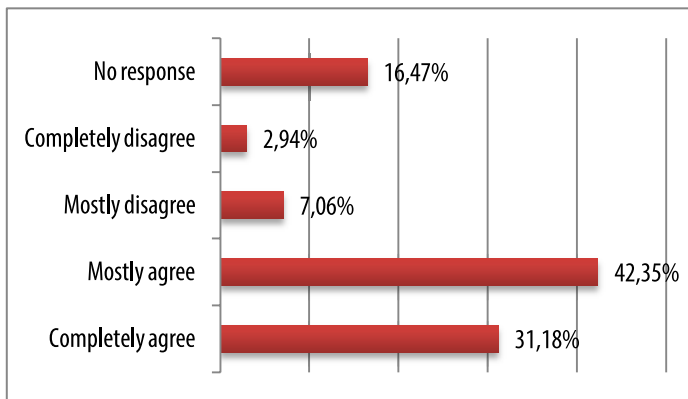
[20] Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries, Friedrich Schneider, 2013



# Bribery

The tendency of public officials to take bribery and lack of transparency in public spending and implementation of public procurement procedures are the direct incentives to employers and business entities in Bosnia and Herzegovina and Republic of Srpska that operate in the informal economy. Primary research, conducted among employers of Republic of Srpska by UEARS, speaks in favour of it. More than 70 per cent of the respondents agree with the claim that the high susceptibility to bribery of supervisory authority allows the existence of various forms of informal economy in Republic of Srpska.

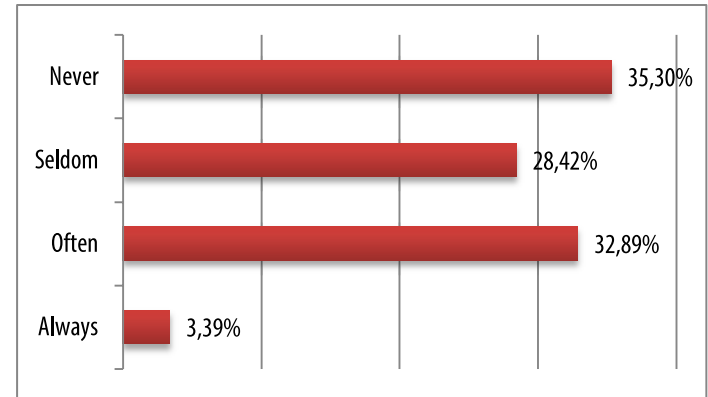
**Figure 34. To what degree do you agree with the statement “high susceptibility to bribery of supervisory authority allows the existence of various forms of informal economy in Republic of Srpska”?**



Source: Research of UEARS

Also, the majority of respondents stated that officials of public institutions, while performing control within its competence, exercise direct or indirect pressure on companies to offer bribery.

**Figure 35. How often do officials of public institutions, while performing control within its competence, exercise direct or indirect pressure on companies to offer bribery?**



Source: Research of UEARS

If we compare and analyse the responses to the previous question by the institutions that monitor enterprises, then we can see a relatively high percentage of respondents who did not want to give an answer to this question, which is indicative in itself, if we consider it in the context of confidence in the public service.

The data provided by survey research among employers in RS also confirm other similar reports and studies conducted in BiH. The United Nations Office on Drugs and Crime (UNODC) in 2013 published a report on the impact of bribery and crime to private companies in BiH based on research that included nearly 2.000 private companies in BiH. The report, among other things, states that a significant number of companies pay bribery to public officials and several times during a year, with higher levels of bribery in the Federation of BiH than in Republic of Srpska. Public servants with the highest risk of bribery in dealings with companies are authorities of medical institutions, police officers, customs officers and judges and prosecutors. Also, the presence of bribery is significantly higher in small (10 to 49 employees) enterprises than with micro, medium or large enterprises. The report notes that the most common purpose of paying bribery are “to accelerate

**Table 3. How often officials from the following institutions exercise direct or indirect pressure on companies to offer bribery?**

	Tax Administration of RS	Indirect Taxation Authority of BiH	Republic Inspectorate	City or Municipal Inspection	Police
Always	2,41%	1,21%	1,20%	2,41%	3,97%
Often	19,88%	13,33%	16,87%	23,49%	33,77%
Rarely	16,87%	20,00%	19,88%	15,06%	17,22%
Never	20,48%	24,24%	19,28%	22,89%	25,17%
I do not know/ Do not want to answer	40,36%	41,21%	42,77%	36,14%	19,87%

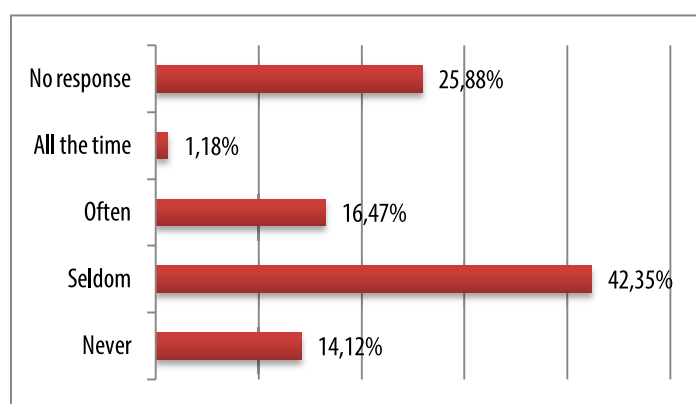
Source: Research of UEARS

business procedures" (29.1% of all payments of bribery), "enable the completion of the procedures" (17.4%) and "provide better treatment" (14.4%). At the same time in 8.6% of cases the bribery is given without specific direct benefit to companies that pay it, assuming that these "incentives" in future interactions would induce public officials to conduct proceedings in the interests of the company. These impressive results show the following: bribery, which aims to streamline business procedures, is an example and an indicator of administrative procedures in the public sector often last too long. On the other hand, bribery aimed at facilitating the completion of administrative procedures, establishing better treatments or obtaining information, show a lack of professionalism among public servants who act outside the prescribed standards and procedures as well as the lack of transparency in public institutions.

## Public spending and procurement

It is the lack of transparency in the work of public institutions, especially in the process of conducting public procurement, something that employers in Republic of Srpska often point when it comes to trust in the work of public institutions. The survey was conducted among employers of Republic of Srpska says that the majority of respondents believes that the business through a public procurement procedure cannot be obtained without bribery and payment to officials responsible for the tender or other related parties.

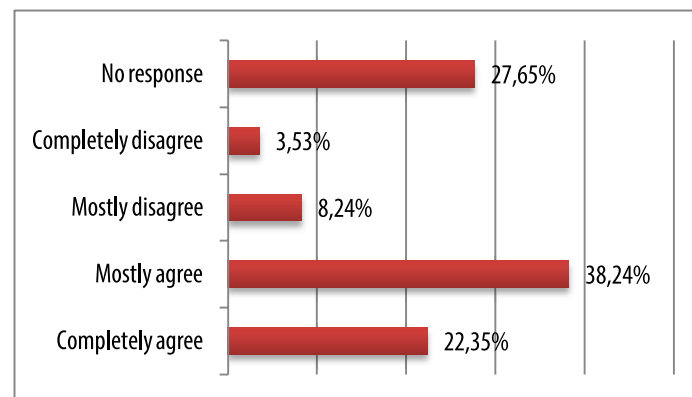
**Figure 36. How often the public tender may be won by the best supplier, without exercising illicit payments to officials accountable for tender or other related parties?**



Source: Research of UEARS

Their attitude is clear when it comes to the grey economy, where more than 60 per cent of respondents believe that the existing practices in public procurement contribute to the existence of the informal economy.

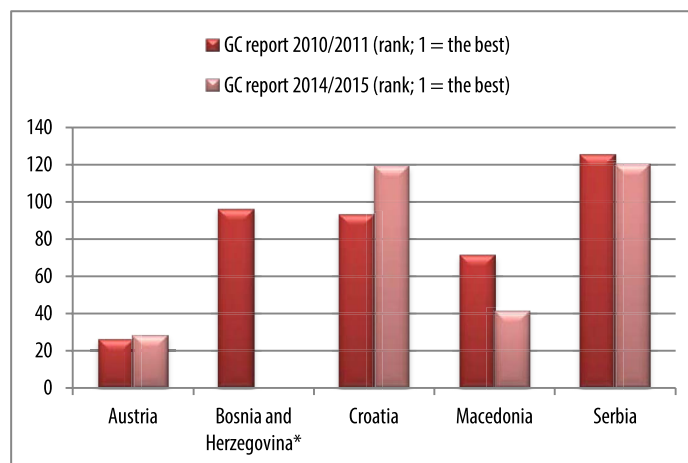
**Figure 37. To what extent do you agree with the statement "the existing practices in public procurement in Republic of Srpska contribute to the existence of the informal economy"?**



Source: Research of UEARS

Responses through this research on a relatively small sample have the confirmation through the results of researches of other institutions and relevant international organizations. One of them is the research of the World Economic Forum on global competitiveness, whose results are published in annual reports (GCR – Global Competitiveness Report). The Global Competitiveness Report 2014/2015 includes an overview of the competitiveness of 144 economies, providing a comprehensive assessment of this kind. It contains a detailed profile of each economy and data tables with global rankings on over 100 indicators. One of the pillars of this research, which has developed a set of internationally comparable indicators, is also institutional environment within a country, including the views of the business community about the work of public institutions. Among other, indicators from this research are related to the degree to which government servants and officials favour certain companies or individuals when making decisions about public policy or contract award. From the following graph, it is evident that this is a relatively common occurrence in BiH and the neighbouring countries, Serbia and Croatia.

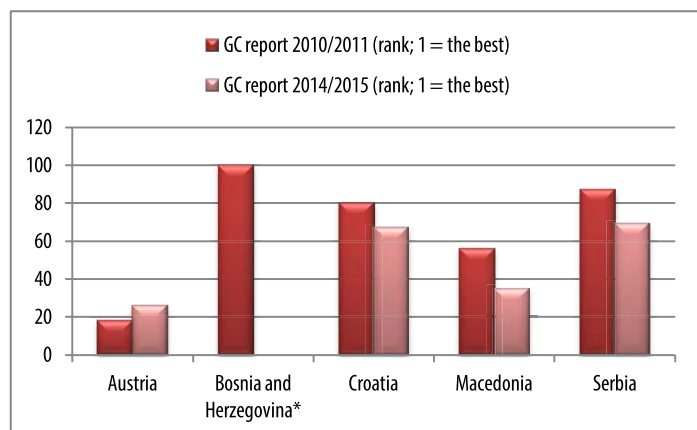
**Figure 38. Favouring companies and individuals by government officials when making public policies or contract award**



\* Data for BiH for the year 2014/2015 lack;  
Source: Global Competitiveness Report (2011-2015)

Another interesting indicator in this report points to the existence of the practice of giving bribery and irregular payments by enterprises, whether it is about imports or exports; utilities; payment of taxes; obtaining contracts and licences from public institutions; obtaining a favourable court rulings. According to the indicator of the existence of practice of bribery and improper payments, Bosnia and Herzegovina is the worst ranked in relation to other observed countries.

**Figure 39. The existence of the practice of irregular payments and bribery**



\* Data for BiH for the year 2014/2015 lack;  
Source: Global Competitiveness Report (2011-2015)

It should be noted that Bosnia and Herzegovina, meanwhile, has made some progress in the position of global competitiveness (from 102nd to 87th position in 2013), but it is not included in the Report of the World Economic Forum for 2014/2015 due to a high level of inconsistency of data and consideration of the results obtained in the last four years was noticed, respectively, later checking has shown that some of the indicators presented in the report were not supported by the real trends. Therefore, in this review the data for BiH from the Report for 2010/2011 were taken as the last valid.

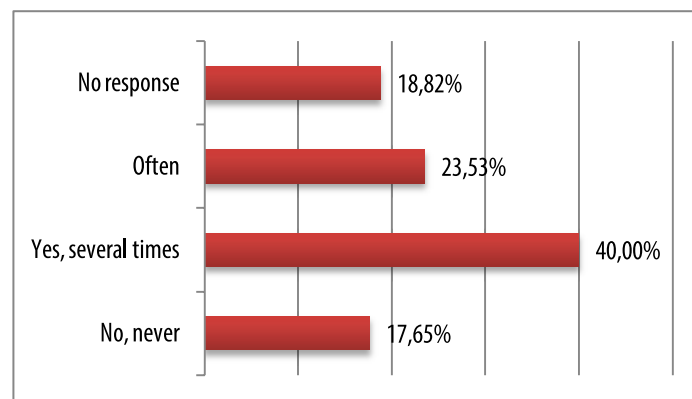
## The rule of law

Another important aspect of gaining confidence in the work of public institutions is the rule of law through effective legislation and its implementation. The work of control and judicial authorities here distinguishes especially, which is the foundation for trust in public institutions. For entrepreneurs and enterprises it is particularly important that within the system institutions the legal framework is applied consistently, and that the court proceed-

ings initiated before the commercial courts, are ended as quickly as possible. Efficient commercial courts inspire confidence to businesses that they can rely on them in the event that, for example, the buyer does not settle its debts, or that they are deprived of any other economic rights.

Unfortunately, employers and business entities in Republic of Srpska who were involved in primary research most cited negative experiences, especially regarding the selective application of the law.

**Figure 40. Have you had any negative experiences with regard to selective or inconsistent application of the law in your business?**

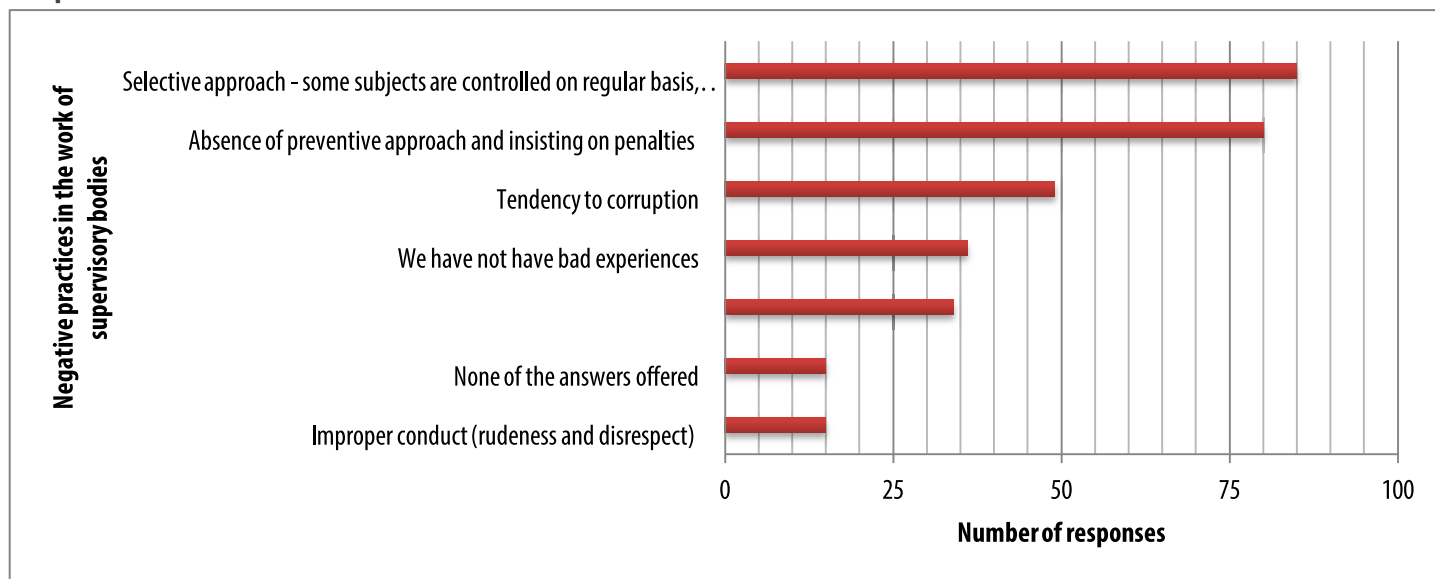


Source: Research of UEARS

Most of them complained that the control authorities in their work have a selective approach, where certain enterprises are subject to constant controls, while others are not. Also, the control authorities are criticized for insisting on imposing fines at any cost and the lack of preventive approach and measures, as well as advisory assistance before sanctions.

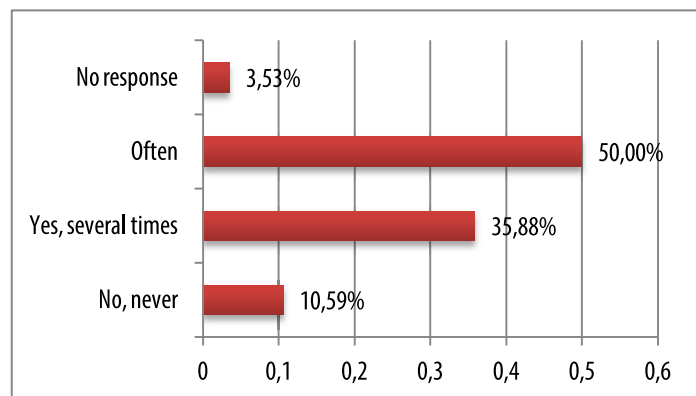
In addition, the vast majority of respondents stated that one of the most common problems faced is mismanagement of contracts and contractual provisions by customers and business partners (see the following Figure). More than 80 per cent of surveyed employers indicated that there is just such a problem, and often these are the provisions relating to the terms and conditions of payment, which are forcing companies either to take other goods in compensation or to seek solutions through the courts. In terms of the general lack of liquidity in the domestic market, any delay in the judicial process is a serious blow to their already exert financial position.

**Figure 41. The most common negative situations in the control / supervisory bodies in the opinion of the surveyed employers and companies:**



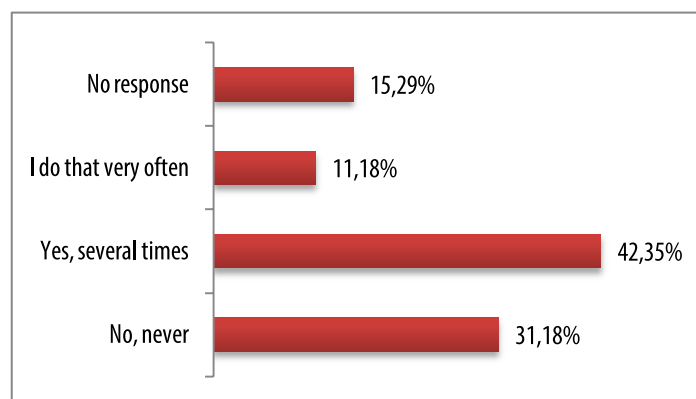
Source: Research of UEARS

**Figure 42. Did you in your business have any negative experience for contempt of contracts (including the provisions relating to payment) by your business partners and customers?**



Source: Research of UEARS

**Figure 43. Have you ever been forced to take other goods or services for compensation and enter the area of the informal economy due to the problems of debt collection?**



Source: Research of UEARS

The previous figure shows that more than half of the surveyed employers and enterprise were forced to take other goods or

services in compensation due to problems in collection of receivables. Although this does not necessarily mean that it is about the informal economy, because of this enterprises are often forced to deal with matters outside its activities, to sell goods and services without the bill, or to initiate a process of compensation due to the insolvency problem, etc.

The Government of Republic of Srpska, also aware of this problem, adopted the Law on the unified system of multilateral compensation and cession ("Official Gazette of Republic of Srpska" No. 20 of 19.03.2014) with the aim to increase liquidity and reduce domestic debt. The law prescribed obligatory multilateral compensation, as well as the possibility of conducting bilateral and multilateral cessions and sale of receivables via the system that Banja Luka Stock Exchange would keep record of.

Also, earlier this year the Government has prepared a draft Law on the limitation of terms of payment, which stipulates that companies among themselves cannot agree on a payment period longer than 60 days. In the case that a contract does not define the deadline, the debtor is required to pay its obligations within 30 days. This law applies to state institutions, non-budgetary funds, public institutions, bodies and public companies which are jointly referred to as "public law entities", provided that the Government gave these institutions significantly "larger space" for the payment of obligations than to private enterprises, so the overdue payments between enterprises and public law entities is 90 days. Following the model of neighbouring countries, the law aims to contribute to solving the problems of poor financial discipline in Republic of Srpska, but it will also be a serious test for the Govern-



**Table 4. Overview of procedures, time and cost of execution of a contract in Bosnia and Herzegovina**

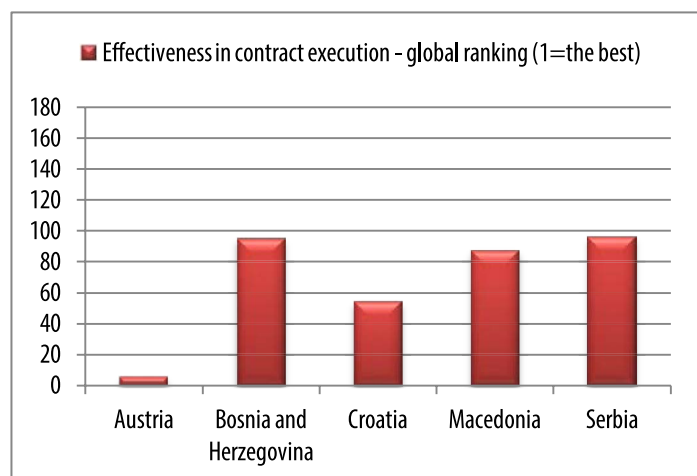
Indicator	BiH	Austria	Croatia	Macedonia	Serbia
Time (number)	595	397	572	321	635
- Filing a lawsuit and services	30				
- The trial and verdict	385				
- Execution of the verdict	180				
Cost (% of the receivables)	34.0	15	13.8	9.7	34
Lawyer fees (%of the receivables)	25.0				
- Court fees (%of the receivables)	6.0				
- Execution fees (%of the receivables)	3.0				
Procedures (number of procedures)	37	25	38	26	36

Source World Bank, „Doing Business Report“, 2015

ment and public institutions, which have multi-year unpaid debts towards private enterprises. On the other hand, it should relieve the commercial courts which are swamped with disputes for unpaid claims, which considerably slows down their work.

It is the efficiency of the judicial system in resolving commercial disputes before national courts one of the key indicators of global World Bank report “Doing Business”. This indicator analyses data relating to time, cost and complexity of procedures in resolving complaints before the commercial/competent courts. Seen in a global framework, Bosnia and Herzegovina is on the 95th position out of 189 economies according to this indicator.

**Figure 44. Global indicators of efficiency in the execution of contracts**



Source: World Bank „Doing Business Report“, 2015

However, it is important to know that this is an indicator based on a number of specific procedural steps that are required in resolving standardized business disputes through the courts.

Procedures, time and costs needed for their completion have been identified by studying the Law on Civil Procedure and other court regulations as well as through researches and surveys of local litigation attorneys. Ease rank of performance of the contract is the average of the following components: procedures, time and costs of a dispute. According to data for 2015, the execution of contracts in BiH takes on average 595 days, costs 34.0% of the value of the receivables and requires 37 procedures.

While analysing those indicators, it should be borne in mind that these are data for BiH methodologically sampled on examples from the capital, in this case Sarajevo. In this sense, there may be certain discrepancies and differences in relation to the situation in Republic of Srpska. It should be emphasized that the RS recognized this problem in 2012 and by the Law on Courts of Republic of Srpska (RS Official Gazette No. 37/12) singled out the work of commercial courts, i.e. district commercial courts as the first instance and the Higher Commercial Court of RS as the second instance. However, by examining the reports on the work of the Higher Commercial Court substantial improvements in work compared to the previous period cannot be concluded, and therefore data for BiH can serve as a frame of reference.

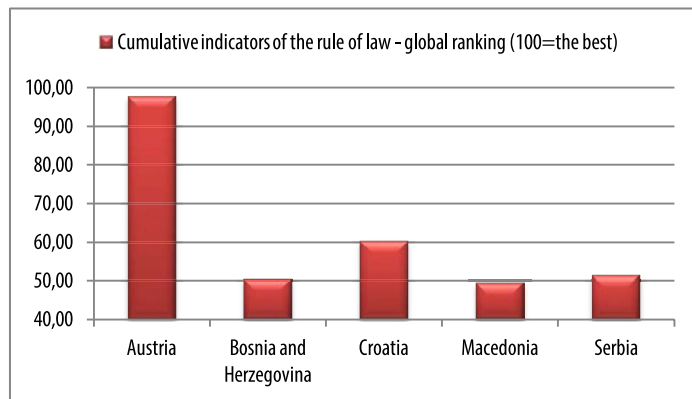
From the above it is clear that the business community in particular suffers from low efficiency of the judiciary, and micro and small enterprises are particularly affected because they have no possibility to initiate court proceedings for unpaid claims when such actions are costly for them, too long and the outcome uncertain. In such circumstances, they are often forced to work under the conditions imposed by the “large-scaled” ones and to compensate the damages by operating in the informal economy.

# Main Findings

It is evident that lack of confidence in the work of public institutions gives a motive for employers and businesses to operate in the informal economy. On the other hand, public institutions gain confidence by improved efficiency, effectiveness, transparency, accountability in their work, and equal treatment for all, without discrimination. Research results and reports for Republic of Srpska and Bosnia and Herzegovina indicate that the level of confidence of the business community in the work of local institutions is low, there is a tendency of supervisory authorities to take bribery, that public procurement procedures are not transparent and that there is favouring of certain companies or individuals by public servants and officials when making decisions or awarding contracts.

In addition, judicial institutions do not contribute to the confidence in the work of public institutions. The costs of starting legal proceedings before the commercial courts are high, and the processes are too long. These are all reasons why Bosnia and Herzegovina (including Republic of Srpska) is in a series of international reports ranked very poorly when it comes to rule of law and the efficiency of work of the judicial authorities.

**Figure 45. Cumulative indicators of the rule of law**



Source: *Worldwide Governance Indicators (WGI) - World Bank, 2013.*

Accordingly, as long as the administrative procedures in the public sector are complicated, whether being too long, expensive or unclear so that public officials have discretionary power to decide on them, a fertile ground for corruption would be created and the confidence in the work of government institutions would not grow. The analysis shows that due to it the greatest damage is suffered by small businesses and entrepreneurs, the most represented ones in the structure of the domestic economy. In the conditions of disordered market, global exposure, poor competitiveness and inefficiency of the judicial system, small businesses and entrepreneurs often lack the capacity and capabilities (financial, human, technical) to meet all the administrative requirements. Therefore, they are often forced to operate in the grey economy, not to achieve an extra profit, but merely to survive.

In this regard it is important that future measures to combat the grey economy in Republic of Srpska are the result of a combined and balanced approach that will have as its primary goal enabling businesses transition from the informal to the formal economy, and not reducing the informal economy at any cost. This applies in particular to the Action Plan for the fight against the grey economy, which has recently been introduced and established the RS Government and which, among other things, provides for a more rigorous legal framework and the allocation of higher powers to the inspection authorities. In insisting on additional administrative requirements and tougher sanctions in the conditions when there is no confidence in the work of public institutions one should be very careful, since it can open up extra space for corruption and thus cause more damage than benefit.

## 5. Social dialogue

The preceding chapters were about the typical forms of the informal economy in Republic of Srpska. Certainly one of the most common is undeclared work, be it for employment, which is not officially recorded or payment of part of the salary in an envelope and the reduction of the base for payment of taxes and contributions. There are various assessments about the number of workers who work illegally and they vary in a wide range from 30,000 up to 90,000<sup>[21]</sup>. Such significant differences in the estimates primarily appear due to the lack of a unified and coordinated approach to the study of undeclared work, which would be implemented in continuity. However, regardless of the differences in the estimates, it is clear that this is a serious problem whose solution requires joint participation and involvement of all stakeholders, notably through coordinated and harmonized policies of the partners in the social dialogue. In this regard social dialogue as one of the key mechanisms of good governance and democratic decision-making represents an extremely important lever in combating the grey economy.

It could be said that the social dialogue in Republic of Srpska is institutionalized through the Economic and Social Council as a tripartite body, established for encouraging and developing of collective bargaining and harmonizing interests of employees, employers and the executive power. Bearing in mind the importance of the Economic and Social Council and the need for participation of representatives of workers and employers in the decision making processes on issues of importance to the status of employees and the business community, in 1997 a special agreement of the social partners the Economic and Social Council of Republic of Srpska was established. At first the existence of the Council has been regulated through the former law on labour, while due to the extreme importance of this body, as an institution of social di-

alogue, the Government of Republic of Srpska in cooperation with the social partners arranged the work of the Council through a special law - the Law on the Economic and Social Council ("Official Gazette of Republic of Srpska" No. 110/08). In this way, composition, competences, mode of operation, financing and other issues relevant to the work of the Council were defined. Accordingly to this law, the Council considers and takes positions on issues of development and improvement of collective bargaining, the impact of economic policy and measures for its implementation on social development and stability of employment, wages and prices, and so on. The Council shall consist of nine members, including three representatives of the Government, the Union of Employers' Association of RS, as the representative association of employers in Republic of Srpska and RS Federation of trade unions, as the representative trade union.

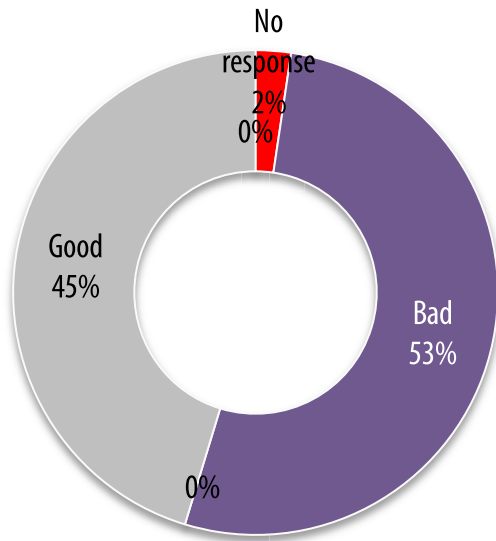
Despite the importance the Economic and Social Council has for the social dialogue, the work of this body in the previous period, especially in the last few months has been largely dysfunctional. That is perhaps best evidenced by the fact that since the beginning of 2015, several Council meeting were adjourned for lack of quorum. What is more concerning is the trend of poor relations and mistrust between the social partners that is present for a long time, where employers state breach of the Agreement of the social partners in Republic of Srpska from 2010 as a key objection. Without intention to go deeper into the reasons why this is so, it is clear that the absence of dialogue between the social partners, particularly between employers and workers, has long-term negative consequences for both.

Negative atmosphere in the relations between social partners in Republic of Srpska has been recognized by representatives of the business subjects involved in primary in the research of UEARS. The majority of them find relationships between employers and workers to be poor, and nearly 20 per cent of them even very poor.

[21] Estimates of the RS Employment Institute; ILO report "Global Employment Trends for 2013"

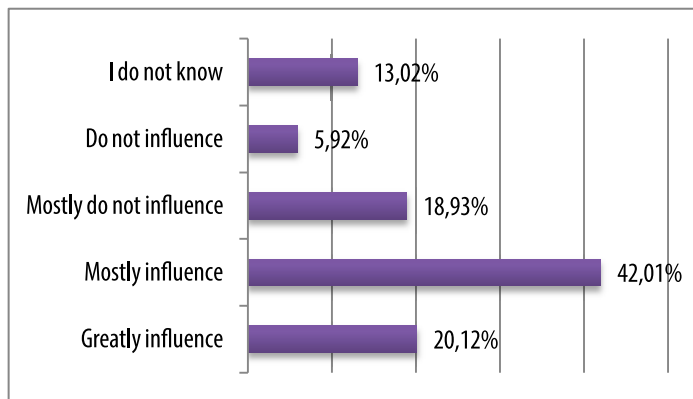
In addition, more than 62 per cent of respondents believe that poor relations of employers and workers affect negatively the level of the informal economy, which somehow just confirms earlier thesis about the importance of social dialogue on combating the informal economy.

**Figure 46. How do you evaluate the relations between representatives of employers and trade unions in RS?**



Source: Research of UEARS

**Figure 47. To what extent do you believe that the relationships between employers' and workers' representatives affect the amount of the informal economy?**

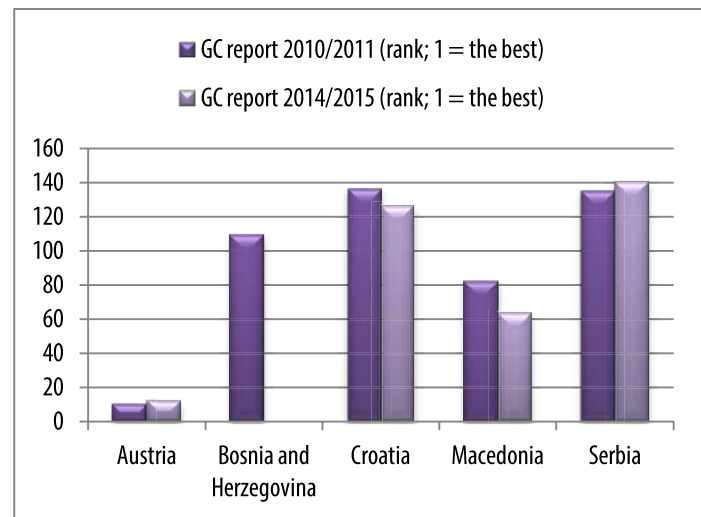


Source: Research of UEARS

If the attitudes of employers and business subjects in the survey research are compared with the results of other secondary researches and placed in an international context, we can see that poor relations between workers and employers are not specific only to RS and BiH, but also for neighbouring countries, primarily Serbia and Croatia. However, what is common for all three countries, and what certainly plays a role in the relations between social partners, is a relatively high proportion of employment in

public administration in relation to the total number of employees. All these countries have above-average percentage of those who work in public administration in relation to the total number of employees, as documented in data from Eurostat, Laborstat and some earlier researches<sup>[22]</sup>. It is necessary to keep this in mind when examining the attitude and understanding of the attitudes of key partners in social dialogue. Representative trade unions in BiH and the neighbouring countries have a strong base in the public sector, as opposed to employers who represent only the interests of the real sector, while the government appears in a double role, as a mediator between the employers and workers and at the same time as the employer for the public administration sector. In such a specific relationships and activities from different perspectives, dialogue among social partners is often marked by misunderstanding and sharply opposing views, which has negative repercussions on the labour market, but also on the overall business environment. Negative repercussions primarily reflect through the creation of a dual labour market, where a deeper gap between jobs in the public administration and those in the real sector is created in Republic of Srpska. Regardless of the unique labour legislation, in practice, working conditions differ significantly in all key parameters, making work in the public administration much more attractive. This creates pressure on employers and business subjects in the real sector, especially in micro and small enterprises, which are unable to compete with the public administration, especially in terms of wages. On the other hand, workers in the real economy are exposed to additional pressure to preserve jobs in the state of huge unemployment. In such circumstances it is not surprising that relations between workers and employers at the enterprise level are not on a very high level.

**Figure 48 Indicators of relations between employers and workers (from cooperation to conflicting positions)**



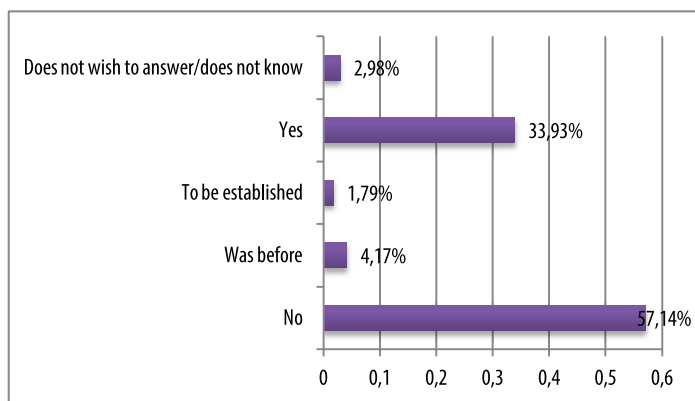
Source: Global Competitiveness Report (2010/11 - 2014/15)

[22] Ekonomski monitor: "Neophodne reforme zapošljavanja i utvrđivanja plata u javnom sektoru RS – što prije to bolje"; GEA - Center for Research and Studies, 2011



In addition, data from the primary research show that in more than 50 per cent of surveyed business entities workers are not organized in trade unions, because there is no trade union. With a number of other, it raises the question of the position of workers in the real sector and the ways in which their interests are represented in the social dialogue.

**Figure 49. Is there a trade union at the level of your enterprise?**



Source: Research of UEARS

## Main Findings

Poor communication and relationships of mistrust between the partners in social dialogue and labour market institutions, neither solve the problem of undeclared work in Republic of Srpska, but are an incentive for the informal economy. Tripartite dialogue in Republic of Srpska is marked by the specific relations of the social partners that operate from different perspectives, with opposing views, which have extremely negative effects on the labour market. These effects are primarily manifested through creating a duality in the labour market between the public and private sectors and increasing the difference between jobs in the public administration and the real sector. The greatest damage is suffered by micro and small enterprises and workers in the real sector, especially those who work without being registered.

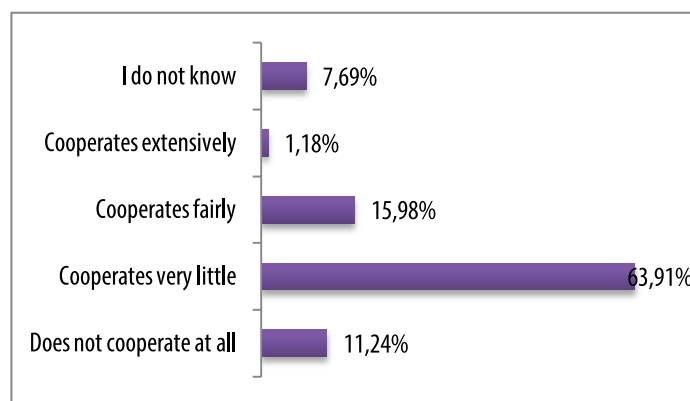
Workers who are not registered have no status and rights arising from labour legislation, nor enjoy any kind of protection. Their interests are not represented in the dialogue between the social partners, and in terms of the huge unemployment are exposed to additional pressure to preserve jobs. Because they do not have a

choice, nor do they believe in the political institutions and public funds, they are more likely to accept informal contracts for the sake of somewhat higher net wages.

Reflection of poor relations of the social partners in the labour market is felt by small entrepreneurs, micro and small enterprises in Republic of Srpska. It is hard to obtain adequate staff, because they are not able to deal with the public administration as a competition, particularly in the area of wages. In such circumstances, they are motivated to offer employees informal engagements and go into the zone of grey economy so as to keep its competitive position to some extent. In relation to the representatives of medium and large enterprises their voice in social dialogue is much less audible.

At the end, if we look at the role of the Government in the tripartite dialogue, it is interesting to note that the vast majority of employers and representatives of business subjects involved in primary research, more than 75 per cent, believe that the government has rather low or no close cooperation with its partners in the social dialogue in order to combat the informal economy. Accordingly, the Government is expected due to its specific position to take a more active role in the revitalization of social dialogue, primarily through the work of the Economic and Social Council, in order to improve the position of those who are most affected by the informal economy in Republic of Srpska.

**Figure 50. How the Government cooperates with its partners in the social dialogue (employers' associations and trade unions) in order to reduce the informal economy in Republic of Srpska?**



Source: Research of UEARS

## 6. Education, training and lifelong learning

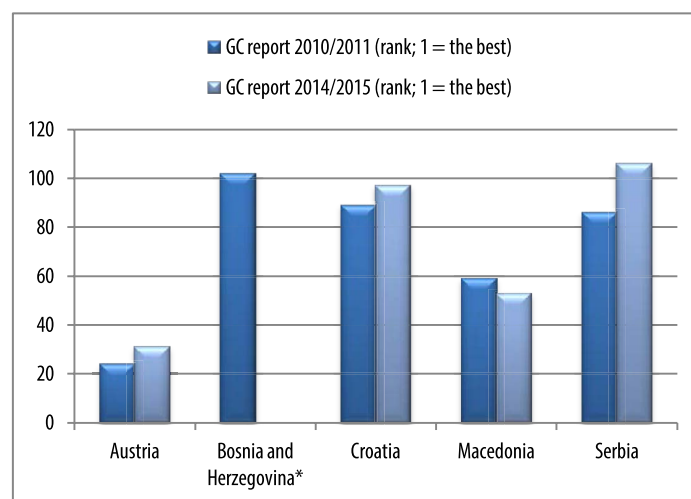


Investing in human capital is an essential prerequisite for increasing the competitiveness of economic operators and the economy as a whole. Investing in human capital is important, because it also develops other factors of production, encouraging innovation in companies and the adoption of new technologies. On the other hand, the strengthening of human capital is a demanding and long-term process that requires a lot of time, resources and the proper management approach, which is often lacking in micro, small and medium-sized enterprises, especially those operating in the informal economy. With all the previously mentioned negative consequences, the informal economy has particularly adverse impact because it significantly reduces the possibility for the development of human capital and thus limits the company to be competitive in domestic and international markets.

In Bosnia and Herzegovina, poorly educated and skilled workforce is one of the serious obstacles faced by entrepreneurs and companies. Employers often point out objections that the current education system in BiH is not in a position to offer and profile workforce that can respond to the current needs of the economy. Usually this argument is supported by data from the labour market, where the conditions of huge unemployment and labour supply, vacancies for specific occupations remain unfilled for several months and even years (benders, welders, medical professionals, IT specialists, etc.). If we observe the regional context, it seems that employers and business entities in Bosnia and Herzegovina are particularly dissatisfied with the quality of the education system in terms of its ability to meet the demands and needs of the economy. According to research by the World Economic Forum and according to the Global Competitiveness Report, Bosnia and

Herzegovina was the worst ranked country when it comes to the quality of the education system. It is important to note that these are the attitudes of managers and owners of companies that were included in survey research.

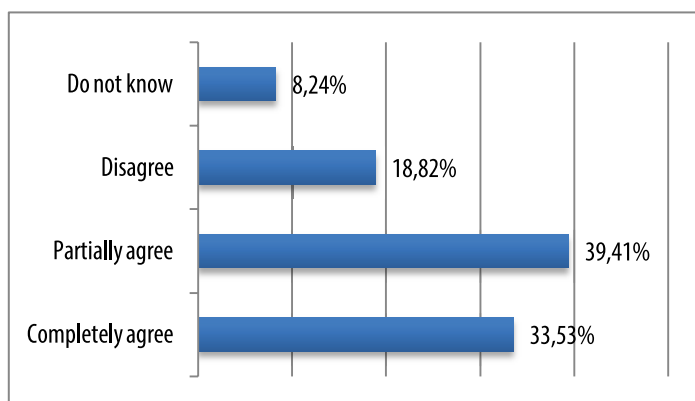
**Figure 51. To what extent does the education system meet the requirements of a competitive economy - the attitudes of directors and company owners?**



\* Data for BiH for the year 2014/2015 lack;  
Source: Global Competitiveness Report (2011-2015)

Furthermore, employers see a direct incentive for the informal economy in the non-compliance of the education system with the labour market needs. Those who were covered by the survey research of UEARS mostly believe that the failure of compliance of the educational system with the needs of the market affects the informal economy.

**Figure 52. Does the inability of the education system to produce profiles of employees in accordance with labour market needs is a motive for the informal economy (work off the books)?**

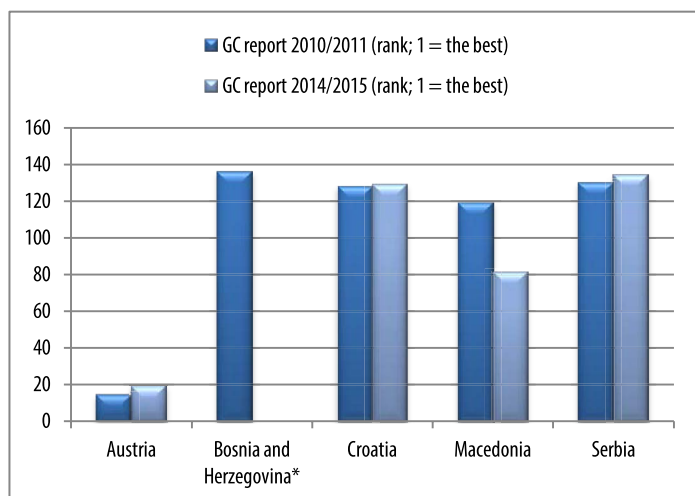


Source: Research of UEARS

Slightly less than 40 per cent of them think that it is a factor that has only a partial effect, while 33 per cent of them indicated that this is a very serious impact. This influence is reflected primarily in the fact that workers without qualifications or those with lower qualifications apply for jobs that are low productive and where the practice of work off the books and unregistered employment are more common.

However, despite recognizing the problem of insufficient training of the workforce, it seems that BiH companies are not prepared to further invest in professional development and training of employees to correct deficiencies in the education system. Results of the already mentioned research of the World Economic Forum show that the companies from BiH were at least willing to invest in their employees through training programs and trainings in relation to others in the region.

**Figure 53. Readiness of companies to invest in education of their employees**



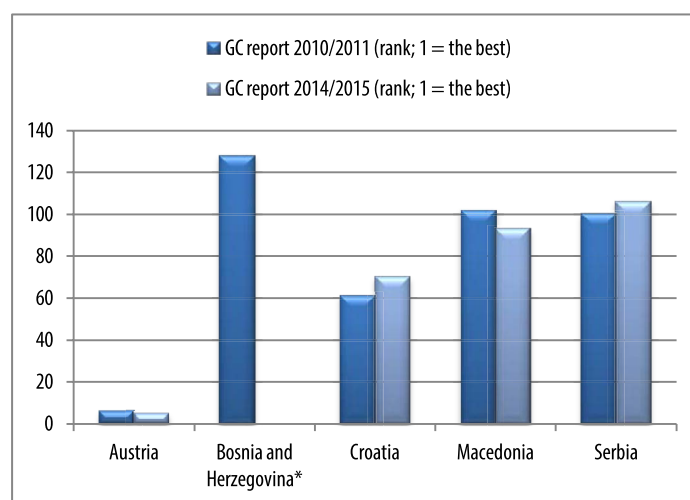
\* Data for BiH for the year 2014/2015 lack;  
Source: Global Competitiveness Report (2011-2015)

Also, all countries in the region according to the survey are ranked much lower in comparison to Austria, which is among the top 20 in the world by the willingness of companies to invest in training of their employees.

It should be noted that the situation is much worse especially if we separate those companies that operate in the informal economy. The companies that do not register their workers or apply them for a minimum wage are not ready to invest in the training of their workers. In the development of human capital they do not see the possibility for strengthening the competitive position, but see professional development and training of employees as an unnecessary expense or, at best, as something that does not bring harm, but makes no use. The owners of these companies often have the attitude that good workers cannot be sent to training because they are necessary in the workplace, and that it makes no sense to invest in the poor workers anyway.

Another reason why in BiH and RS it is little invested in employee training is the fact that the local market has no developed offer of high-quality, specialized and practical training programs employers and managers of enterprises recognize as relevant and meaningful. Data from the previously mentioned research of the World Economic Forum confirm this due to the fact that Bosnia and Herzegovina is significantly worse ranked compared to other observed countries, in particular compared to Austria.

**Figure 54: Availability of high-quality and specialized training programmes**



\* Data for BiH for the year 2014/2015 lack;  
Source: Global Competitiveness Report (2011-2015)

Finally, an important factor that significantly affects the reluctance of domestic companies to invest long-term in labour force is more pronounced fluctuation in the labour force. This phenomenon is especially characteristic of workers in the real economy who are trying at all costs to find work either in public administra-

tion or to go abroad in some of the developed European countries, where they are able to obtain better working conditions. According to the data of UNHCR and the Union for sustainable return it is estimated that only in the past two years BiH left more than 60,000 people, mostly working-age population. Domestic companies simply do not have mechanisms to retain employees long-term and to ensure that after trainings employees would remain faithful to the company. This only creates a vicious circle in which the company due to the weakness of the education system cannot reach the quality of the workforce in the labour market, and due to its position it is unable to invest their own resources in training of employees. This makes them less competitive in the market, which weakens their position further and makes them even less attractive for workers looking for work, and for those who are only educated for future careers.

## Main findings

A number of indicators presented in the Report indicate that human capital is one of the key constraints to the development of entrepreneurship and economy in BiH and Republic of Srpska. Numerous studies emphasize the development of human capital as the basic prerequisite for raising the competitiveness of economic subjects and the economy as a whole. Investing in human capital is also a long-term process which at the moment poses a serious challenge to employers in RS and BiH.

The education system is unable to provide the labour force in accordance with the requirements of the economy, and, unfortunately, the majority of companies are unable to invest their own resources in training and development of workers. It is something especially faced by micro, small and medium enterprises, where labour productivity is relatively low, or that operate in the informal economy. In such circumstances, companies are trying to pre-

serve its position by cutting costs and reducing to a minimum investment, including investment in the workforce. Although doing business in this way companies manage to survive, in the global competition position of the majority of them in the long run is seriously compromised.

What additionally complicates the situation is the fact that Republic of Srpska and Bosnia and Herzegovina are affected by the mass departure of the workforce in developed countries, which is why companies fail in the long run to retain skilled and lacking workers, which further threatens their competitive position.

Great damage is suffered by workers as well, especially those with low qualifications or no qualifications. Due to the lack of necessary knowledge and skills they are not able to integrate into the labour market, nor do they have the opportunity to obtain legal work abroad, which is why they are forced to accept low-paid jobs in the informal sector. Additional concern is the fact that among them is a significant number of young people.

Bearing in mind that this is a systemic problem, the state role in its overcoming is the key one. This implies, first of all, an urgent reform of the education system and its harmonization with the requirements of the labour market, but also a support to non-formal education in the form of professional education and training of workers. Intervention is necessary so that micro, small and medium enterprises without real possibilities and capacities to keep the lacking workforce. It is also necessary to work on developing training market, taking into account the requirements of employers for a specific type and amenities, so that they would recognize a direct benefit from these training programs and later follow the same practice in their companies



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# Annex

Overview of the structure of the target sample for the survey conducted among employers in Republic of Srpska.

STRUCTURE OF THE TARGET SAMPLE	
<b>By type of activity *</b>	
Agriculture	5,2%
Mining	3,2%
Processing industry	30,4%
Production of electricity	4,7%
Water supply, municipal services and waste management	3,0%
Construction	6,8%
Trade	26,1%
Traffic	7,1%
Catering	6,9%
Information technology and communication	3,2%
Financial services and mediation	3,5%
TOTAL	100,0%
<b>By type of ownership *</b>	
Public	30,5%
Private	52,5%
Mixed (including cooperatives)	17,0%
TOTAL	100,0%
<b>By areas *</b>	
City of Banja Luka	52,1%
City of Prijedor	10,8%
City of Doboј	10,5%
City of Bijeljina	16,8%
City of East Sarajevo	3,4%
City of Trebinje	6,5%
TOTAL	100,0%
<b>By size **</b>	
Micro and small (0-49 employees)	94,0%
Medium (50-249 employees)	5,1%
Large (more than 250 employees)	0,9%
TOTAL	100,0%

\* The structure based upon data on number of employees in 2014

\*\* The structure based upon data on total number of enterprises in Republic of Srpska in 2013



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