

**Analysis of the initiative for decreasing the social contribution rate
in the Republic of Srpska**

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Introduction

The aim of this analysis is to provide information for public discussion on the initiative by the Government of the Republic of Srpska for a labor taxation decrease by 1.4% of the gross wage. This initiative has been included in the Draft law on changes and amendments to the law on social contributions adopted by the National Assembly of the Republic of Srpska on March 4, 2015, and put for public discussion.

According to the draft law, the total social contribution rate will decrease by 1.4 percentage points (health insurance rate by 1p.p., children's protection contribution by 0.1 p.p. and unemployment insurance rate by 0.3 p.p.). Thereby, the total tax burden on labor decreases to 36.9% in relation to the gross wage. In its explanation, the Government of RS states that the aim of this income tax decrease is to "create optimal tax burden and to support the expected growth of economy, increase of employment and economic development of the Republic". Will this step actually result in an optimal labor tax burden, and how much can it contribute to economic growth and an increase in employment?

1. Labor taxation tendencies in the Republic of Srpska

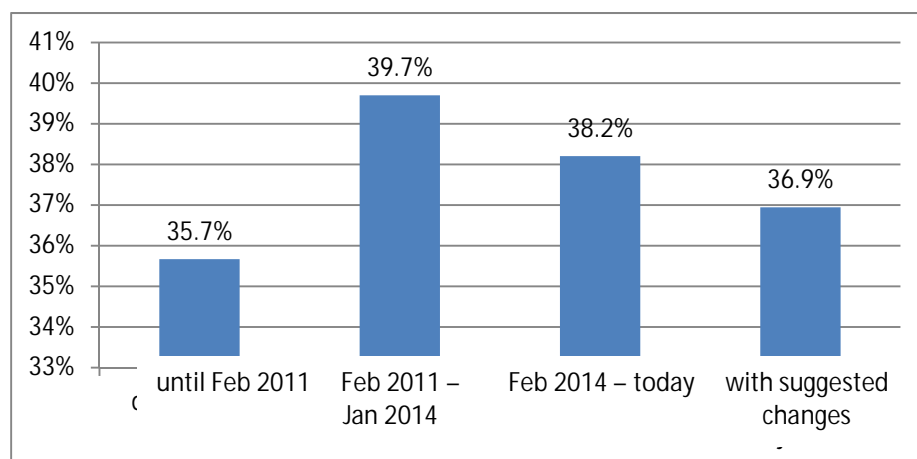
Should this initiative be adopted, that would be the fourth change in the amount of income tax burden ("tax wedge"¹) during the last five years. Remember, until February 2011 tax wedge was 35.7% of the average gross wage in the Republic of Srpska, when it jumped to the record-

¹ Tax wedge is the difference between the gross wage (wage including tax and social contributions) and net wage (wage amount after deducting tax and social contributions paid by the employer). In other words, tax wedge is the difference between the total wage cost paid by the employer for the engagement of the employee and the „take-home pay“ of the employee.

braking 39.7% and maintained at that level until February last year, when it decreased to 38.2%, the level that has remained still².

If applied, the suggested initiative would cause tax wedge decrease to 36.9%, which would still be 1.2 percentage points higher than before February 2011. Therefore, **in the 2011-2015 period we had one increase, followed by one decrease and now the announcement of another decrease of the tax wedge, which would lower it near, but still above the initial level.** This can be seen in the following graph:

Graph 1: Tendencies in the tax burden for the average gross wage (tax wedge) in the Republic of Srpska from 2010 to 2015.



Data source: personal calculations

Tendencies among basic elements determining the tax wedge are shown below:

Table 1. Overview of elements determining the tax wedge amount in the Republic of Srpska

	until Feb 2011	Feb 2011 – Jan 2014	Feb 2014. - today	with suggested changes
tax-free portion of income	250 BAM	0 BAM	200 BAM	200 BAM
income tax	10 %	10 %	10 %	10 %
pension and disability insurance	17%	18% (18,5%)*	18,5%	18,5%
health insurance	11,5%	12,5% (12%)*	12%	11%
unemployment insurance	0,7%	1%	1%	0,7%
children's protection	1,4%	1,5%	1,5%	1,4%
Tax wedge (in total as % of the gross wage)	35,7%	39,7%	38,2%	36,9%

*Note: since 2013 the rate of pension and disability insurance has increased from 18% to 18.5%, while the health insurance rate has dropped from 12.5% to 12%.

² This calculation does not include the contribution for solidarity, in the amount of 3% of the net wage, due to being temporary.

2. Why is high labor taxation bad?

Employment rate in the Republic of Srpska is 34.9%, meaning that almost every third person with work ability is employed³. To gain a better understanding of our position, it is useful to know that in the EU the same rate in 2013 was 64.1%⁴, while the EU 2020 strategy set the goal of achieving the rate of 75% before 2020 for the age groups of 20-65. Interesting fact is that in the Republic of Srpska only 47% of workforce is active, i.e. looking for employment. Therefore, **more than a half of the workforce population does not even look for a job, i.e. does not participate in the labor market.**

It is known that high labor taxation negatively affects active participation in the labor market and employment. This is directly caused by the fact that increased labor taxation creates bigger difference between the labor cost to the employer and the “take-home pay” of the employee. According to a research by the European Commission implemented in the EU, this negative effect is more present among population with lower level of education and women in households where one family member is already employed⁵.

High labor taxation also stimulates unreported employment. This effect is more present with low-paying jobs, meaning that this group has higher percentage of informal employment. Research suggest that high taxation of low-paying jobs leads to their “exclusion” from formal economy, i.e. that unreported employment is the only option for many employees.⁶ According to the Labor Force Survey from 2014, in the Republic of Srpska, 24.9% persons had some kind of employment, but were at the same time registered at the public employment bureau, meaning that at least every fourth person was employed without being reported. If we exclude public sector employees from the total number of employees, then the share of unreported employment increases significantly and we can conclude that more than every third person in the private sector works in grey economy.⁷

Situation is somewhat different with grey economy employees with higher level of education or persons with greater expertise in a certain field. According to an analysis performed in Poland, those who belong to this group and participate in grey economy much more often also have

³ Data from the Labor Force Survey for 2014 including unreported employment.

⁴ EUROSTAT data.

⁵ World Bank. (2012). *Bosnia and Herzegovina – tax policy challenges for economic growth and fiscal sustainability, report for 2012.*

⁶ See for example: Andjelovic, S., Zarkovic-Rakic J. (2012). *Poboljšavanje radnih podsticaja: Evaluacija reforme poreske politike koristeći SRMOD. (Improving incentives for work: Evaluation of the tax policy reform using SRMOD)*

⁷ World Bank. (2012). *Bosnia and Herzegovina – tax policy challenges for economic growth and fiscal sustainability, report for 2012.*

formal employment, but use this as an additional source of income. It is stated that this is caused by the lack of qualified workers in certain fields.⁸

An analysis by the World Bank in B&H finds that some developed countries can sustain higher level of the tax wedge due to low tax evasion, high degree of law implementation and general trust in the pension system, for which social contributions are paid. On the other hand, this kind of trust still has not been built in B&H, so tax evasion and informal employment are initiated on much lower labor taxation rates.⁹

The level of labor taxation influences international competitiveness of an economy's exports sectors. Tax wedge decrease will increase price competitiveness when this decrease of labor costs reflects in lower prices of exportation products and services. Advocates of this measure claim that its positive foreign trade effect should be greater in countries with fixed exchange rates (such as B&H), because after resulting changes in the demand for imported and exported products the currency exchange rate will remain unchanged and will not neutralize this price competitiveness.¹⁰ An alternative mechanism of increasing competitiveness is when tax wedge decrease enables increase of the net take-home pay of the employee without increasing the gross wage (total labor cost to the employer). In this case, international competitiveness increases because this enables an increase of productivity – through greater income for workers and employment of staff with better qualifications. Of course, a combination of these two mechanisms is possible when tax wedge decrease is used also for the decrease of gross wages and increase of net wages.

3. International comparison

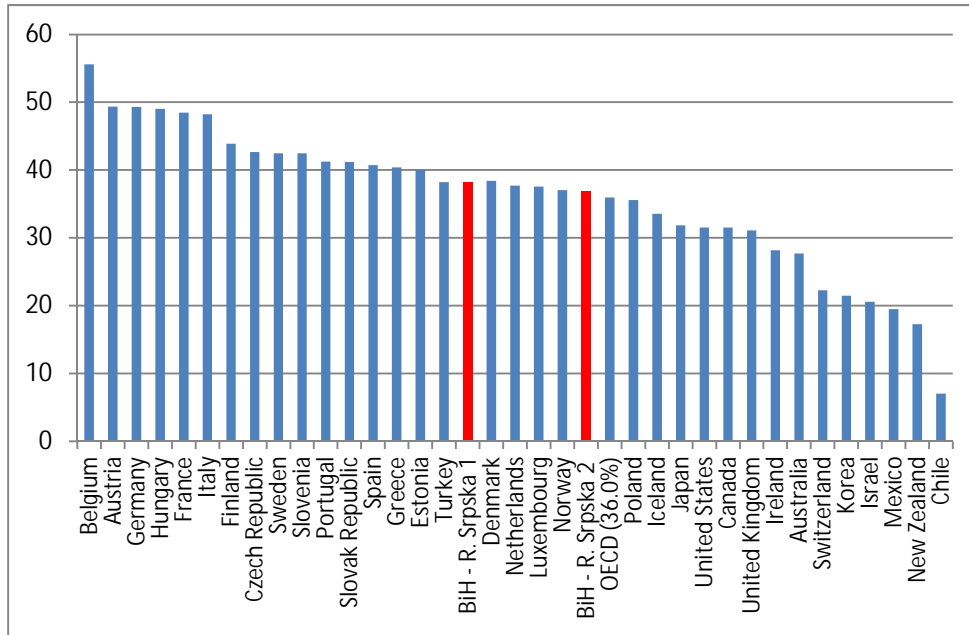
By comparing the tax wedge level in the Republic of Srpska with OECD countries, we can see that the tax wedge in the Republic of Srpska (present, as well as after the suggested decrease) is above the OECD average, which is 36% (see graph below). Among OECD countries the tax wedge ranges from even 55.6% in Belgium to only 7% in Chile. This overview is a very good illustration of all the existing differences in the approach to labor taxation policies in the world. Therefore, it is not difficult to conclude that **the suggested contribution rate decrease by 1.4% cannot change the international status of the Republic of Srpska in terms of the level of labor taxation.** It is interesting to see that almost all OECD countries whose tax wedge is below average have low unemployment rates (for example Chile 6.5%, New Zealand 6%, Mexico 4.9%, Korea 3.5%, Israel 5.7%, Switzerland 4%).

⁸ Walewski, M. (2008). *How to beat shadow employment in Poland?* Center for Social and Economic Research.

⁹ World Bank. (2012). *Bosnia and Herzegovina – tax policy challenges for economic growth and fiscal sustainability, report for 2012.*

¹⁰ Vidi de Mooij, R., Keen, M. (2012). „*Fiscal devaluation“ and fiscal consolidation: VAT in hard times.* National Bureau for Economic research, Cambridge.

Graph 1: Tax wedge in the Republic of Srpska in comparison with OECD countries



Data source: OECD and personal calculations

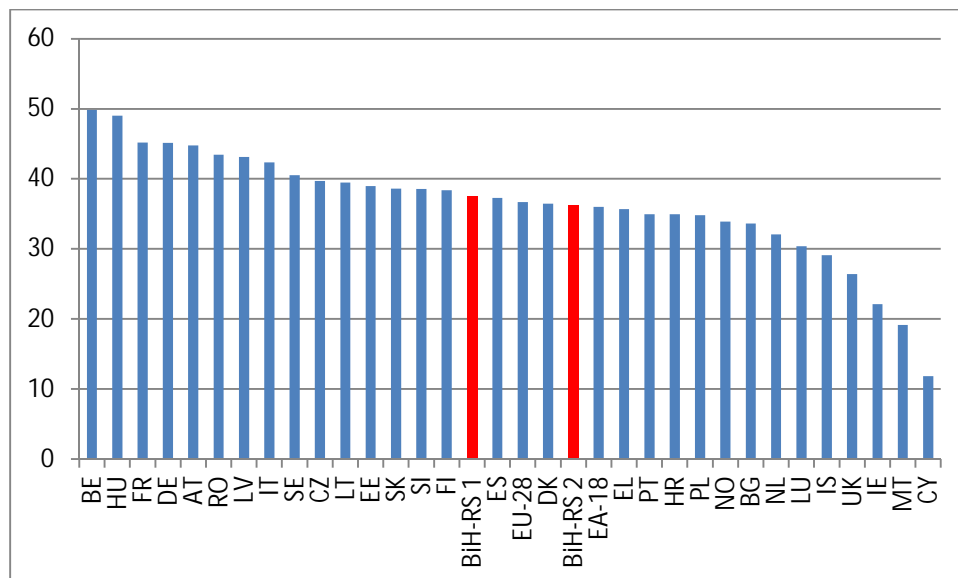
Note: „BiH - R. Srpska 1“ marks the level of the current tax wedge in the RS, while „BiH - R. Srpska 2“ marks the level of the tax wedge after applying the 1.4 percentage points decrease to the contribution rate.

Next comparison was done with EU countries, but in such manner that the comparison was done for tax wedges on a wage amount equal to 67% of the average wage in each country. Thereby, we obtained information on a relative burden on low-paying jobs. The tax wedge on such wage (67% of the average wage) in the Republic of Srpska equals to 37.5%, which is above the EU average (36.7%). With the proposed decrease, this tax wedge in the Republic of Srpska would be 36.2%, which would be slightly below the EU average, but still above the eurozone countries average (36%). Graph below shows that the range of this tax wedge in the EU is wide and that it goes from 49.9% in Belgium to 11.9% in Cyprus. We notice that only a limited number of countries has the tax wedge below 30%. In most countries that are below the average, the tax wedge ranges from 30% to 35%. Therefore, countries in the middle or at the bottom of this range can be grouped as countries with significantly lower tax wedge in relation to the EU average.

Previous analyses have confirmed that B&H is characterized by a low level of progressiveness in labor taxation, meaning that there is no significant difference between the taxation of low and

high-paying jobs.¹¹ As already said, tax wedge level has the biggest influence on labor market results in the segment of low-paying jobs.

Graph 2: Tax wedge in the Republic of Srpska in comparison with EU countries



Data source: EUROSTAT and personal calculations

Note: „BiH - R. Srpska 1“ marks the level of the current tax wedge in the RS, while „BiH - R. Srpska 2“ marks the level of the tax wedge after applying the 1.4 percentage points decrease to the contribution rate.

4. Conclusion and recommendations

In this analysis we determined that current labor taxation in the Republic of Srpska is above OECD and EU average. In the event of contribution rate decrease of 1.4%, the tax wedge would still remain above the level it was in February 2011 and there would be no significant change in this position in relation to compared countries.

Previous research determined that high labor taxation has negative influence on the participation in the labor market, stimulates unreported employment and limits the possibilities of exportation sectors to increase their competitiveness. Low-paying jobs in the Republic of Srpska are also subjected to high taxes and social contribution rates, which represents a serious problem for the employment of persons with lower level of education, especially in the formal sector.

¹¹ E.g. World Bank. (2012). *Bosnia and Herzegovina – tax policy challenges for economic growth and fiscal sustainability, report for 2012.*

Obviously, we need achieve greater labor tax burden decrease, but a question emerges how great should it be and how to realize it, having in mind the current fiscal position and income needs of the public sector.

These are the basic recommendations:

- **Decrease the tax wedge level by an amount that would change the international status of the Republic of Srpska in terms of labor taxation** (the same recommendation could be implemented in the Federation of B&H). The initiative “Compact for Growth and Jobs” suggests that the tax wedge should be lowered to 35%, which is the average in new EU member states. However, an overview of international data suggests that targeted tax wedge should not be above 33%, if the Republic of Srpska was to be categorized as a region with significantly more favorable labor taxation rate in relation to the EU average. To achieve this, the social contribution rate should be decreased by 5.8%.
- **Additionally decrease the tax wedge on low-paying jobs, e.g. through increasing the tax-free income portion.** It is necessary to target low-paying jobs, because it has proved that labor market results for this group are more sensitive to changes in labor taxation than high-paying jobs. Thereby, the progressiveness of taxation in the Republic of Srpska would increase. In the selection of a concrete measure for implementing this recommendation, it is necessary to pay special attention to its applicability, having in mind the tax system capacity. For example, the introduction of several tax categories with tax rates increasing from the bottom up demands a great capacity for control, since it additionally stimulates tax evasion.
- **Implement a coordinated initiative that would secure that the all (or a portion) of the lost revenues compensate through the increase of consumption taxes.** Difficult fiscal position must not be an obstacle to the needed decrease of labor taxation. Even a revenue-neutral reform by which the fall of revenues would be compensated through higher taxing of consumption has its advantages, because it is directed towards the creation of a tax structure more favorable for economic growth and employment. It is important to remind that here we would have a short-term fall of revenues from labor taxation, while in mid-term we could expect faster growth due to stimulation effect by the lower tax wedge on the tax basis growth. Therefore, the European Commission has recommended such tax restructuring in the EU countries. A concrete example of this kind of an income-neutral reform in the Republic of Srpska and the Federation of B&H was demonstrated in the study called “How to achieve

lower income taxes without harming public funds?”¹² Since such reform is necessary in both entities, it should be possible to reach an agreement on changes in indirect taxation policies at the level of B&H. The Government of the Republic of Srpska has already launched an initiative to introduce differential VAT rate, specific excise tax on cigarettes and additional excise tax on beer. Here, we have to emphasize the great danger of the suggestion for several VAT rates, because this would lead to greater complexity of the VAT system, which would open doors for tax evasion increase.¹³

- **At the same time, it is necessary to make a firm decision on bringing the relation of public expenses and VAT in the Republic of Srpska to a long-term sustainable level.** This would create basic presumptions for improving the fiscal position of the Republic of Srpska, so it could be possible to use one portion of released revenues to compensate for the lack of direct revenues (due to lower labor taxation). In that case, total tax burden on the economy of the Republic of Srpska would decrease. The tax burden is currently much higher than the average of new EU members. This reform, which demands a comprehensive approach, cannot be implemented in a year, but it is important to have firm political decision determined by law or clearly defined in another way. For example, it is possible to determine a targeted annual ratio of public expenses and VAT, with an end aim of achieving the average of new EU members by 2020. Large space for decreasing public revenues lies in high administrative costs. It has to be remembered that wage-related expenses make 45% of total budget expenses in the Budget of the Republic of Srpska.

¹² Djukic O., Tomic M. (2013). *How to achieve lower income taxes without harming public funds?* Banja Luka: Center for Research and Studies GEA. The Study is available at <http://www.gea.ba/how-to-achieve-lower-income-taxes-without-harming-public-funds-2>.

¹³ A brief analysis of this issue can be found at <http://www.gea.ba/introduction-of-differential-vat-rate-a-move-in-a-wrong-direction>.