



# BOSNIA AND HERZEGOVINA

## SELECTED ISSUES

October 2015

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October 9, 2015

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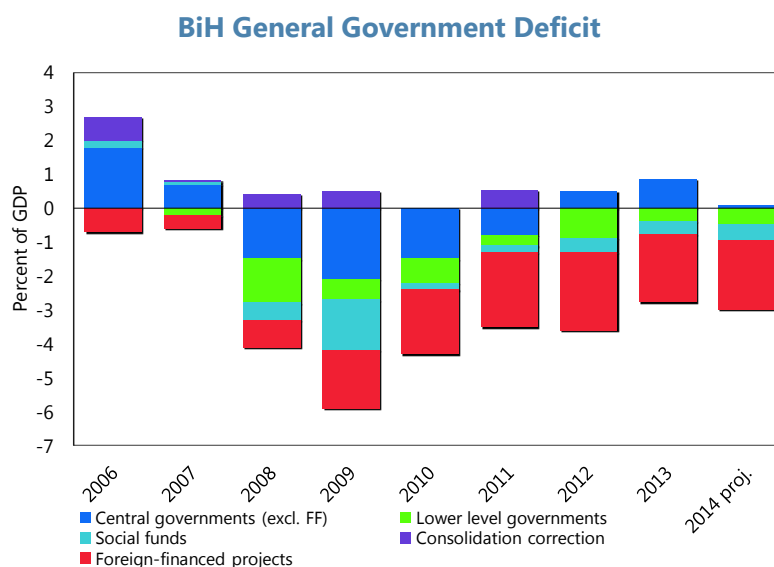
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# GOVERNMENT SPENDING IN BOSNIA AND HERZEGOVINA<sup>1</sup>

The size of the public sector in Bosnia and Herzegovina (BiH) is one of the largest in the region, mostly owing to a complex and highly decentralized governance structure. BiH spends a greater share of public resources on current spending items, notably on wages and social transfers. Moreover, poorly targeted social benefits generate adverse incentives with respect to informality and labor force participation. In order to enhance economic growth, BiH will need to refocus its spending and increase its efficiency, notably of spending on human and physical capital.

## A. Level of Government Spending

**1. BiH's fiscal consolidation in the aftermath of the global financial crisis has been largely accomplished through efforts at the central government level.** Prudent fiscal policies, supported by IMF arrangements, have resulted in a substantial narrowing of the overall budget deficit. From a peak deficit of around 6 percent of GDP in 2009, significant consolidation efforts successfully brought down the deficit to 2 percent of GDP in 2013. A major natural disaster caused an increase in the deficit to 3 percent of GDP in 2014. Nonetheless, these positive developments mask some worrying underlying trends: while central governments have managed to achieve budget surpluses in recent years, spending by lower level of governments and social funds, and on foreign-financed investment projects have persistently generated deficits and have contributed to increasing public debt levels.

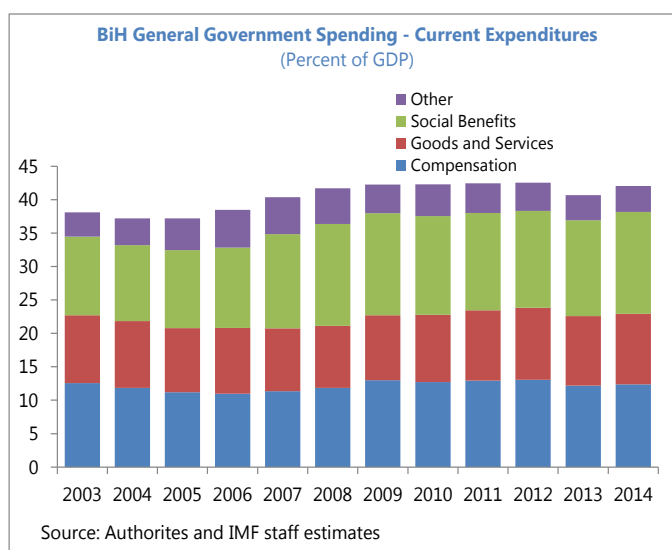


<sup>1</sup> Prepared by Dora Benedek and Ricardo Llaudes.

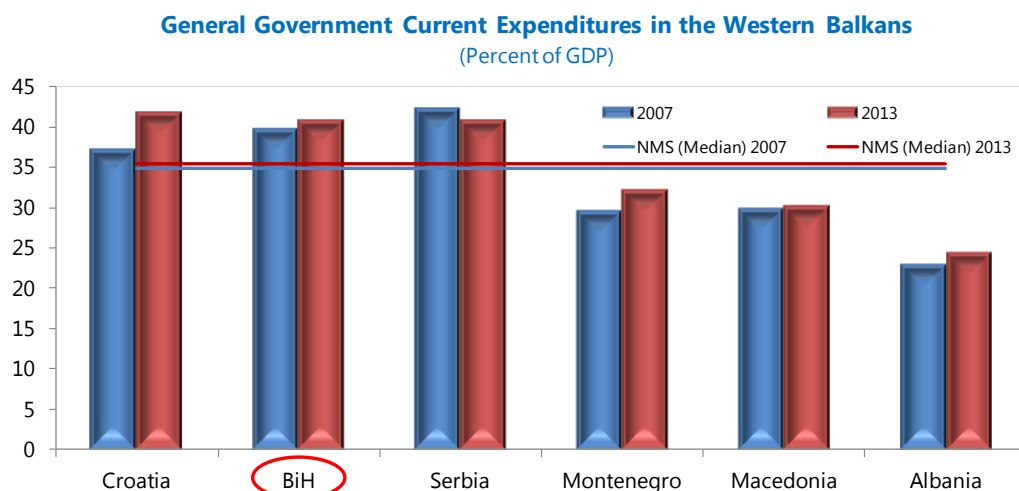
**2. Notably, increasing government outlays on recurrent expenditures have hindered the authorities' consolidation efforts.**

General government current expenditures rose sharply after 2005 following the introduction of a BiH-wide VAT in 2006 that provided a sizable and permanent increase in government revenues, and following the start of the privatization process in the Republika Sprska (RS) in 2006–07, which led to significant windfall for that government's coffers. Subsequently, the global financial crisis also led to additional government

spending to mitigate the impact of the shock. As a result, overall government current expenditures increased from an average of around 38.5 percent of GDP over 2000–05 to around 41.5 percent thereafter. Most of the increase in spending took the form of higher public sector wages and increased, and poorly targeted, social benefits, as well as higher spending on goods and services.

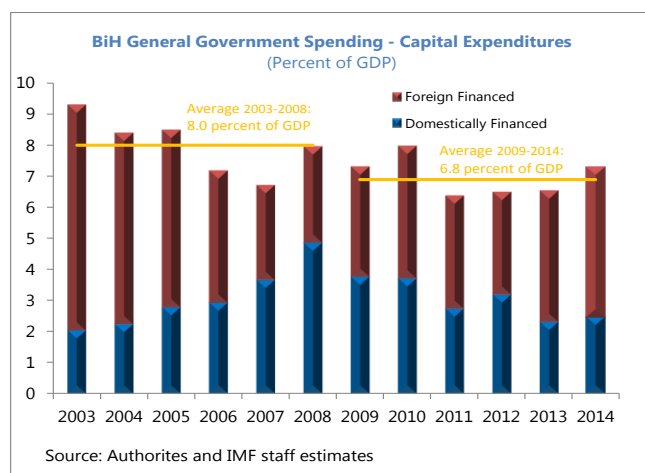


**3. As a result, BiH has one of the biggest government sectors in relation to its peers.** At over 41 percent of GDP, the size of BiH's public sector ranks second in the region, only behind Croatia's, and it is substantially larger than that of more advanced Emerging Europe economies.



**4. On the other hand, spending on public investment has been gradually declining.** BiH continues to face significant infrastructure needs, mainly road construction and energy generation. Investments in these areas would not only make BiH a more attractive place to invest, but would

also raise the country's growth potential. However, while sizable financial resources are still needed to fill this investment gap, the share of public capital spending has been decreasing over time, from around 8 percent of average in the pre-crisis period to less than 7 percent thereafter. Moreover, the financing of this public investment has gradually shifted from own resources to debt-generating foreign financing. The three governments have steadily been reducing capital spending in their central government budgets, while current spending continued to grow.

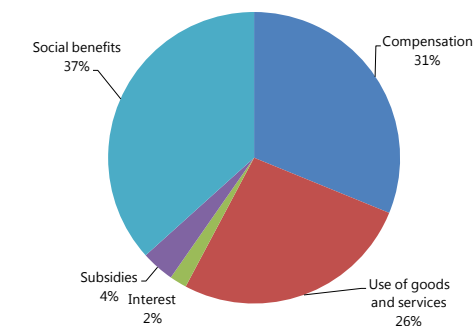


**5. BiH needs more investment in human and physical capital to accelerate real GDP growth.** Given limited fiscal space higher capital investment is only possible if current spending levels are reduced relative to their current level. While a public sector is critical for growth, efficiency of public spending is a key factor. The public sector in BiH is not only relatively large, but also not very efficient (see below). This is a reflection of the large size of public spending, but also of an inefficient structure of spending. Therefore, while the size of the public sector needs to be reduced, redeploying resources to invest in human and physical capital will also be critical in the years ahead.

## B. Structure and Efficiency of Government Spending

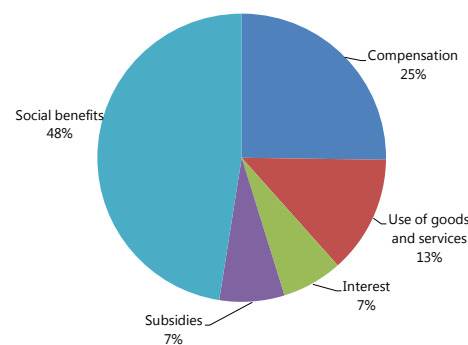
**6. Compared to regional peers, BiH spends substantially above average on public sector wages and goods and services.** Public spending on wages and consumption of goods and services accounts for over 55 percent of total current expenditures in BiH, considerably larger than the 38 percent spent on average by BiH's peers. Meanwhile, spending on social benefits is considerably lower in BiH than elsewhere in the region. This high spending on wages and public consumption complicates the country's efforts to streamline the size of the public sector.

BiH - Current Expenditure Composition, 2013



Source: Authorities' data and IMF staff estimates

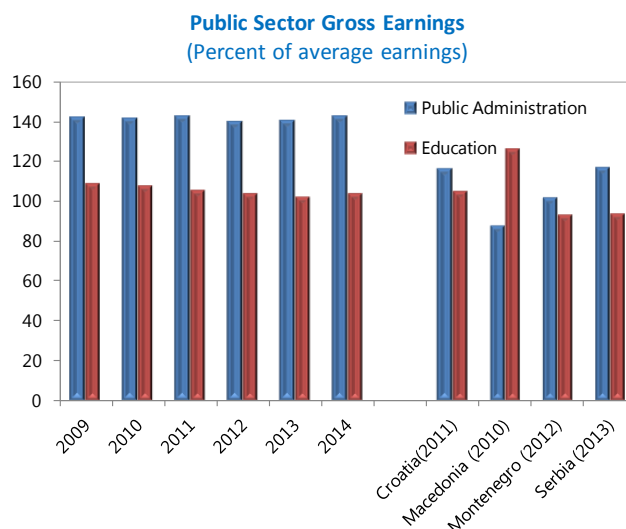
W. Balkans ex BiH - Current Expenditure Composition, 2013



Source: IMF's Government Finance Statistics

## 7. BiH also spends a greater share of GDP on compensation of public sector employees in relation to peers.

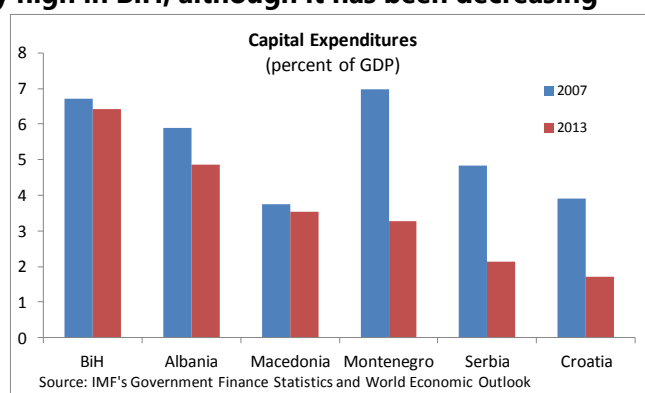
BiH spent over 12 percent of GDP on public sector wages in 2013, a substantially greater amount than countries such as Macedonia and Albania, which spent around 5 percent of GDP in the same year. Moreover, while many countries have managed to reduce public sector wages as a share of GDP in recent years, in BiH this ratio has increased considerably. Two factors explain these developments: (i) public sector payrolls have continued to increase, and (ii) wages in the public sector, and in public administration in particular, are very high compared to average pay levels in the economy. An undesirable outcome of these wage discrepancies in BiH is that public sector employment has become significantly more attractive than in the private sector, creating many economic distortions and stifling private sector development.



Source: BiH Agency for Statistics and International Labor Organization

## 8. The share of capital spending is relatively high in BiH, although it has been decreasing in last few years.

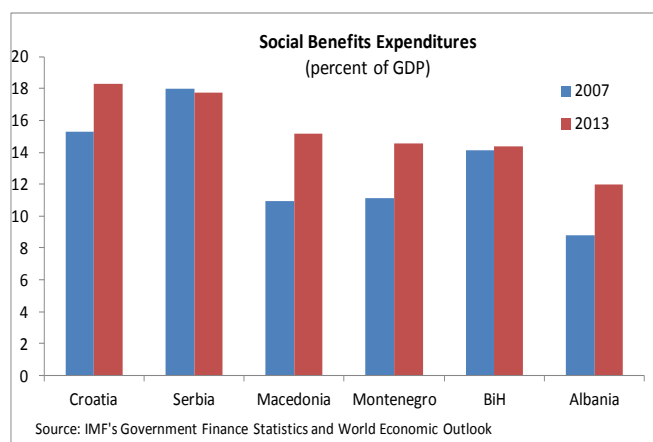
With large infrastructure needs, BiH's public sector spends more on capital investment as a share of GDP than its peers. However, a worrying trend has emerged in recent years and financing has relied ever more on foreign funds. Reversing this trend and boosting the amount of public sector resources allocated to infrastructure spending would support long-term growth and job creation.



Source: IMF's Government Finance Statistics and World Economic Outlook

## 9. Spending on social assistance, meanwhile, remains at the low end compared to elsewhere in the region, although this masks significant underlying differences.

Social benefits are those transfers in cash or in kind aimed at protecting the population against certain social risks. Social benefits include medical services, unemployment compensation, or social security pensions, and they vary across countries in their level and coverage. While total spending on social benefits in BiH is at the low end relative to peers, some significant underlying differences exist: while spending on

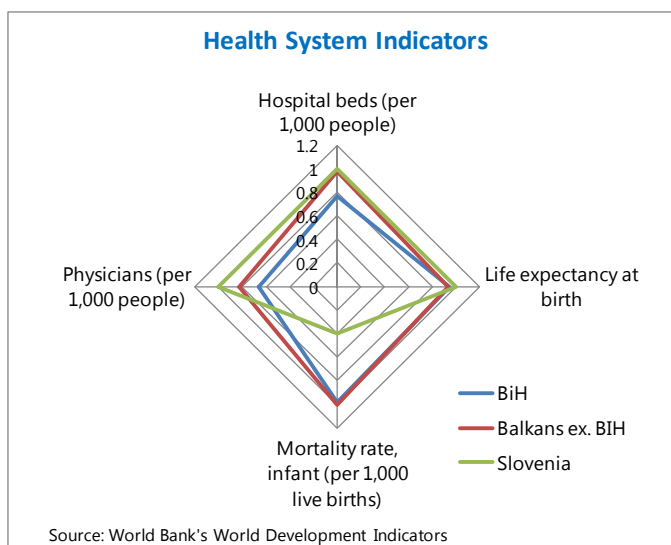


Source: IMF's Government Finance Statistics and World Economic Outlook

particular social benefits, such as health care or non-contributory social assistance, stands out in the region, spending in other areas, such as education, old-age pensions, and active labor market programs, are at or below the regional average.

**10. Large and increasing public health care expenditures in BiH also reflect a highly fragmented and inefficient system.** BiH's spending on public health in percent of GDP is now the highest in the region at over 7 percent of GDP. Moreover, while expenditures elsewhere have remained flat or even declined in recent years, public health spending in BiH has continued to increase. High health care spending in BiH is the result of the highly fragmented nature of the health systems in BiH, as entities are responsible for health regulation, organization, financing, and service delivery.<sup>2</sup> Moreover, the responsibility for health services in the FBiH has been further passed down to the cantons. Therefore, considering also the health systems in the RS and the Brcko District, BiH has a total of 13 ministries of health and an equal number of health insurance funds, all operating independently. This all leads to substantial duplication and inefficiencies, hindering coordination and savings within the overall health system. Moreover, since these high expenditure levels are mostly financed from social security contributions, contribution rates in both entities are the highest in the region.

**11. Nonetheless, BiH's health indicators are below average, confirming the need for structural improvements to raise the efficiency of public health spending.** Despite the large amount of financial resources devoted to health care, measures of efficiency and quality of health care indicate that BiH lags behind regional peers. Moreover, there are large discrepancies in efficiency and quality across the two entities and even across cantons, mostly explained by differences in spending levels. Despite large expenditures, the numbers of medical staff and hospital beds in BiH remain low in comparison to regional peers and more advanced Emerging Europe economies. On the other hand, the number of non-medical staff working in health care facilities is on the high end relative to peers.



**12. The education sector in BiH also suffers from fragmentation and inefficiencies, and does not provide the skills required in the labor market.** BiH spends about 5 percent of GDP on

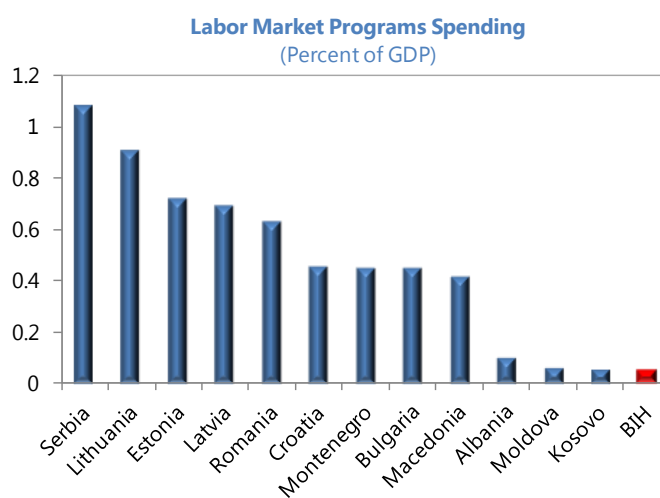
<sup>2</sup> See World Bank's Bosnia and Herzegovina Public Expenditure and Institutional Review (2012).



education, in line with comparable countries.<sup>3</sup> However, a complex governance and management structure holds back progress in the sector: there are 14 ministries of education in BiH (11 in the FBiH, 1 at the state level, and one each in the RS and Brcko District). As with health care, this system for education leads to substantial duplication and inefficiencies. Most of the education budget in BiH—around 80 percent—is spent on wages and not on system development or material resources. As regards educational outcomes, BiH's enrollment rates are relatively high for primary and lower secondary, compared to other countries in the region, but substantially below the regional average at the upper secondary and tertiary levels. This latter fact, coupled with declining levels of vocational and technical training, results in a widening mismatch between education and labor market skills required by businesses, adversely impacting the country's growth potential.

### 13. Meanwhile, labor market programs remain severely underfunded.

Structurally high unemployment remains one of the key challenges confronting BiH. Against this backdrop, active labor market programs aimed at boosting skills and enhancing the employment opportunities of the unemployed, including through training and education, can play a useful role in raising employment levels and bringing people back into the labor force. However, BiH allocates very little financial resources to labor market programs, a fraction of what is spent by regional peers such as Serbia, Croatia, Montenegro, and Macedonia.



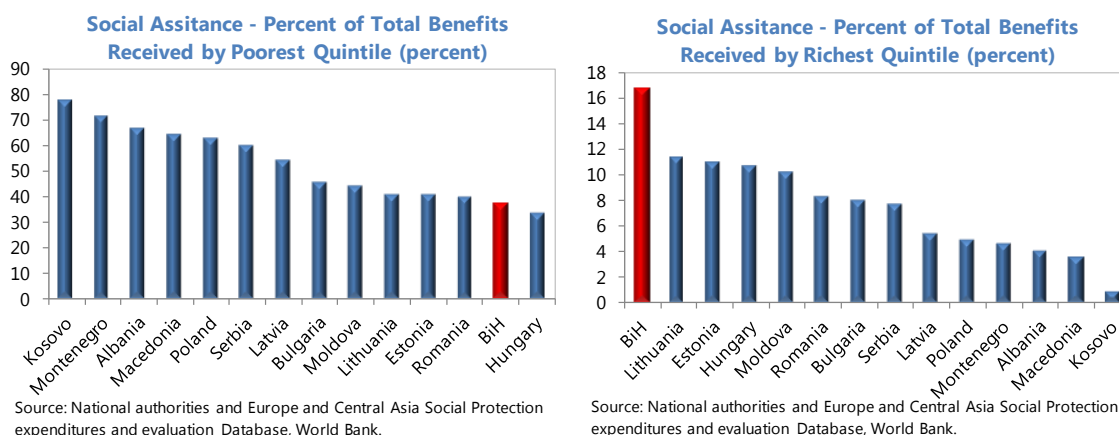
Source: National authorities and Europe and Central Asia Social Protection Expenditures and Evaluation Database, World Bank.

**14. Spending on non-contributory social assistance has long reached fiscally unsustainable levels in BiH.** BiH's spending on non-contributory social assistance<sup>4</sup> is by far the largest in the region and largest in Emerging Europe at close to 4 percent of GDP. Moreover, as indicated by World Bank analysis, this amount could be as high as 7 percent of GDP if spending by cantons and municipalities on their own non-contributory benefit programs is included. Spending on war veterans and disability benefits represent the bulk of social assistance transfers, while "civilian" programs are small and underfunded. Given the size and age profile of the veteran population, looming liabilities on account of veteran programs cast a large shadow over limited fiscal resources.

<sup>3</sup> See UNDP's "Progress towards the Realization of Millennium Development Goals in BiH" (2013).

<sup>4</sup> This includes: last-resort/minimum-income support social assistance, disability benefits for civilian disabled and civilian victims of war, family and child protection benefits, and benefits for war veterans and for members of families of fallen soldiers. See World Bank's Bosnia and Herzegovina Public Expenditure and Institutional Review (2012) for additional information.

**15. Moreover, spending on non-contributory benefits is also poorly targeted.** According to World Bank estimates, BiH social assistance is very poorly targeted by regional and Emerging Europe standards. The poorest 20 percent of the population receive only 36.8 percent of the total social assistance budget. On the other hand, regional peers such as Albania, Kosovo, Albania and Montenegro exhibit remarkable levels of social assistance targeting, with the poorest quintile receiving over 60 percent of total spending on social assistance. More worrying is that in BiH the richest quintile receives a disproportionately high share of social assistance benefits.



## C. Policy Recommendations

- A high degree of fiscal decentralization and proliferation of multiple institutions at the level of entities, cantons, and municipalities result in high and increasing level of public wages and public spending on goods and services. The institutional setting needs to be rationalized in order to reverse the excessive growth of the public sector and thus reduce current spending and increase its efficiency.
- The level of social spending is high but outcomes are poor. Expenditure consolidation measures along with structural reforms in the pension and health sector are needed in order to create fiscal space for reducing social security contributions, while improving targeting to ensure that the most vulnerably are supported.
- More efficient and streamlined education spending and greater resources allocated to active labor market programs can alleviate the existing skills mismatch problem and contribute to unemployment reduction.
- High and poorly targeted spending on non-contributory social assistance continues to drain scarce public resources. Additional reductions in veterans' benefits and improvements in the audit process are necessary to bring social assistance spending down to sustainable levels and eliminate labor market disincentives.

- The share of capital spending has been decreasing in recent years. Public expenditures will need to be shifted away from the present high share of non-productive current spending towards more productive expenditures to enhance economic growth.

## TOWARD A MORE BALANCED TAX SYSTEM IN BOSNIA AND HERZEGOVINA<sup>5</sup>

*Some of the key challenges faced by Bosnia and Herzegovina are a high rate of unemployment and a large informal sector. A high tax burden on labor provides disincentives for people to move from informal to formal employment and may prevent some even from entering the labor market. Meanwhile, an aging population and a shrinking labor force stretch the social security system. Lowering social security contribution rates, however, would need to be accompanied by offsetting revenue measures and spending cuts—including by better targeting social assistance—given the limited fiscal space.*

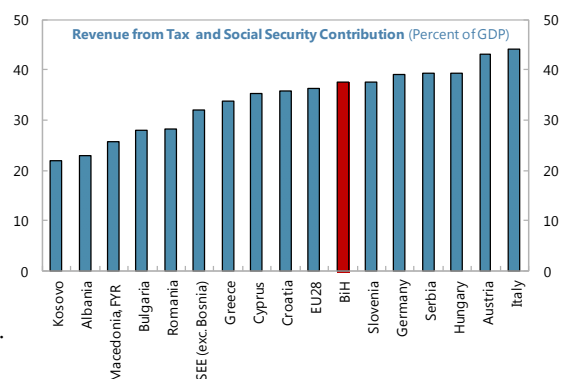
### A. Introduction

**1. Many economies face the challenge of mobilizing revenue in a growth-friendly way, including to provide space for social assistance and infrastructure improvement.** Raising revenues in an increasingly globalized economy requires simple and broad-based taxes and strong tax compliance. Revenue mobilization efforts should be guided by three principles: efficiency, fairness, and transparency.

**2. BiH has one of the highest tax revenue-to-GDP ratios in the South Eastern Europe (SEE) region.** Within total tax revenues, the share of social security contributions is also one of the highest. This puts a very high tax burden on labor, putting BiH at a disadvantage compared to its neighbors. While there is little fiscal space to reduce the overall level of revenues in BiH, a shift between different taxes might be warranted to lower the burden on wages. This paper presents the level and structure of tax revenues in BiH, relative also to neighboring countries; evaluates tax efficiency; and discusses potential areas for improving the efficiency of the tax system.

### B. Level and Structure of Tax Revenues in Bosnia and Herzegovina

**3. The level of total tax and social security contribution revenues in BiH, at 38 percent of GDP, is the one of the highest in the region, and**



Sources: IMF, Government Finance Statistics; IMF World Economic Outlook; Eurostat; European Commission; and country authorities.

<sup>5</sup> Prepared by Ruben Atoyan, Dora Benedek, and Irena Jankulov.

**slightly above the average of EU member countries.** While the overall revenue-to-GDP ratio in BiH has been rather stable in the last few years, the share of total taxes to GDP has been increasing (Table 1). Other revenues, including dividends from state-owned enterprises, for example, have been slowly declining. At the same time, the composition of revenues has been shifting toward an increasing share of social security contributions, while the contribution of indirect taxes has been decreasing.

#### **Box 1. General Recommendations on Revenue Mobilization 1/**

Although each tax system is different, some of the most effective recommendations for revenue mobilization are the following:

- Building administrations that limit incentives and opportunities for rent seeking and are capable of implementing the voluntary compliance needed to extend the tax base;
- Adopting and making readily available clear laws and regulations embodying strong taxpayer protection;
- Eliminating exemptions that forgo revenue to little useful end;
- Implementing a broad-based VAT with a fairly high threshold;
- Establishing a broad-based corporate income tax, at rates competitive by international standards;
- Extending the PIT base, and ensuring a coherent treatment of alternative forms of capital income;
- Levying excises on a few key items that address revenue needs and wider social concerns;
- Implementing simple but coherent regimes for taxing smaller businesses;
- Strengthening real estate taxes; and
- Developing capacity for tax expenditure and wider policy analysis.

1/ For a comprehensive discussion of issues and recommendations on revenue mobilization see International Monetary Fund, 2011, "Revenue Mobilization in Developing Countries," (Washington: International Monetary Fund).

#### **4. BiH relies more heavily on social security contributions (SSC) than its regional peers.**

The share of SSC within total tax and SSC revenues is over 40 percent, compared with a regional average of 31 percent and an EU average of 30.5 percent. On the other hand, the share of direct taxes, especially personal income tax (PIT), is very low compared to other countries. Direct taxes in BiH provide only 8 percent of revenues, out of which the PIT brings in about two-thirds. The regional average of direct taxes is 17.5 percent of revenues, with PIT at 11 percent. Indirect taxes provide about half of tax and SSC revenues both in BiH and in the region, which is substantially higher than the EU average of 38 percent. Revenues from property taxes are generally low in the region, well below the share in the EU member countries, but BiH collects even below regional average, only 1 percent of total tax revenues.

**Table 1. General Government Budgetary Operations, 2005–2014**

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	<i>(Percent of GDP)</i>									
Revenue	46.5	48.0	46.9	45.7	44.5	46.3	45.9	46.3	45.3	45.9
Total tax + social security contributions	36.1	38.8	37.9	37.7	36.7	38.2	38.7	38.8	37.7	38.1
Taxes	23.6	25.9	24.8	23.5	21.8	22.9	23.0	23.0	22.2	22.1
Direct taxes	3.5	3.4	3.3	3.8	3.5	3.6	3.5	3.6	3.6	3.4
Taxes on income, profits and capital gains	3.5	3.4	3.3	3.8	3.5	3.6	3.1	3.1	3.1	3.0
Individual income taxes	2.0	2.1	1.8	2.6	1.6	1.7	2.0	2.0	2.0	1.8
Corporate income tax	0.6	0.7	0.8	0.9	1.4	1.3	1.1	1.1	1.1	1.1
Other taxes on income, profit and capital gains	0.9	0.6	0.7	0.3	0.6	0.6	0.0	0.0	0.0	0.0
Taxes on payroll and workforce	...	...	...	...	...	...	0.1	0.1	0.1	0.1
Taxes on property	...	...	...	...	...	...	0.4	0.4	0.4	0.4
Indirect taxes	20.1	22.5	21.5	19.7	18.3	19.3	19.4	19.4	18.5	18.7
VAT	...	...	...	...	11.6	12.0	12.2	12.3	11.8	11.8
Excise	...	...	...	...	4.1	4.7	4.9	5.1	4.8	5.9
Trade taxes	...	...	...	...	1.4	1.2	1.1	0.8	0.8	0.9
other	...	...	...	...	1.1	1.4	1.3	1.2	1.2	0.1
Other taxes	...	...	...	...	0.0	0.0	0.1	0.0	0.1	0.0
Social security contributions	12.5	12.8	13.1	14.2	14.9	15.3	15.7	15.8	15.5	16.0
Other revenue	10.4	9.2	8.9	8.0	7.8	8.1	7.2	7.5	5.2	5.2
	<i>(Percent of total tax + social security contributions)</i>									
Total tax + social security contribution revenues	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Taxes	65.3	66.9	65.5	62.4	59.3	59.9	59.4	59.4	58.8	58.8
Direct taxes	9.7	8.9	8.7	10.0	9.6	9.4	9.1	9.2	9.5	9.5
Taxes on income, profits and capital gains	9.7	8.9	8.7	10.0	9.6	9.4	7.9	8.1	8.3	8.3
Individual income taxes	5.7	5.5	4.8	6.9	4.2	4.4	5.1	5.2	5.3	5.3
Corporate income tax	1.6	1.8	2.1	2.3	3.8	3.3	2.9	2.9	3.0	3.0
Other taxes on income, profit and capital gains	2.4	1.6	1.8	0.8	1.6	1.7	0.0	0.0	0.0	0.0
Taxes on payroll and workforce	...	...	...	...	...	...	0.2	0.2	0.2	0.2
Taxes on property	...	...	...	...	...	...	1.0	0.9	1.0	1.0
Indirect taxes	55.6	58.0	56.8	52.4	49.7	50.6	50.2	50.0	49.1	49.1
VAT	...	...	...	...	31.7	31.5	31.5	31.7	31.3	31.3
Excise	...	...	...	...	11.2	12.3	12.7	13.0	12.8	12.8
Trade taxes	...	...	...	...	3.9	3.1	2.7	2.2	2.1	2.1
other	...	...	...	...	3.0	3.6	3.3	3.0	2.9	2.9
Other taxes	...	...	...	...	0.0	0.0	0.2	0.1	0.2	0.2
Social security contributions	34.7	33.1	34.5	37.6	40.7	40.1	40.6	40.6	41.2	41.2
Nominal GDP (millions of KM)	17,198	19,426	21,896	24,984	24,307	24,879	25,772	25,734	26,282	26,779

Sources: Bosnia and Herzegovina authorities; and IMF staff calculations.

**Table 2a. General Government: Tax Structure and Tax Levels for Selected European Countries**  
(Percent of GDP)

	Year	Total Revenue	Total Tax and Social Security Contributions Revenue	Tax Revenue	Taxes on Income, Profits, and Capital Gains					Taxes on Goods and Services					Social Security Contributions	Other Revenue
					of which:				Property Taxes	of which:						
					Total	Individual	Enterprises and Other	Unallocable		General Sales, Turnover, or VAT	Excises	Other				
Bosnia & Herzegovina	2013	45.1	37.6	22.1	3.1	2.0	1.1	0.0	0.4	18.5	11.8	4.8	1.9	0.1	15.5	7.5
Albania	2011	25.8	22.8	19.0	3.9	2.2	1.7	0.0	0.1	13.9	9.1	3.1	1.7	0.6	3.8	2.6
Bulgaria	2012	35.0	27.9	20.7	5.3	3.0	1.9	0.4	0.6	15.4	9.4	5.1	0.9	0.0	7.2	2.6
Croatia	2012	41.0	35.7	24.3	6.1	3.7	2.0	0.4	0.3	18.2	12.3	3.4	2.5	0.0	11.5	5.3
Hungary	2012	46.6	39.2	26.0	7.5	5.4	1.3	0.8	1.2	18.5	9.4	3.5	5.5	0.0	13.2	7.4
Kosovo, Republic of 1/	2013	27.5	21.8	21.8	3.4	1.7	1.2	0.4	0.3	19.2	10.9	5.9	2.4	-0.7	na.	5.7
Macedonia, FYR 2/	2012	29.0	25.6	16.7	3.1	2.1	0.8	0.2	0.0	12.0	8.4	3.6	0.0	1.6	8.9	3.4
Romania	2012	33.7	28.3	19.5	6.1	3.5	2.2	0.5	0.8	13.4	8.5	3.5	1.4	0.0	8.8	5.4
Serbia, Republic of	2012	43.7	39.2	25.9	6.6	4.9	1.6	0.0	0.7	17.5	11.0	5.4	1.1	1.9	13.3	4.5
Slovenia	2012	44.4	37.6	22.4	7.8	5.8	1.3	0.7	0.6	14.6	8.2	4.5	1.9	0.0	15.2	6.8
Unweighted Average of South East Europe (Exc. BiH)		36.5	32.0	21.8	5.5	3.6	1.6	0.4	0.5	15.8	9.7	4.2	1.9	0.4	10.2	4.9
Austria	2012	49.1	43.1	28.2	13.4	10.1	2.4	0.9	0.6	14.8	8.0	2.5	4.4	-0.1	14.9	6.0
Cyprus	2012	39.4	35.3	26.1	11.1	4.0	6.3	0.8	0.8	15.0	8.9	3.4	2.7	0.0	9.1	4.1
Germany	2012	44.8	39.1	23.6	12.1	8.8	2.7	0.6	0.9	11.4	7.3	2.5	1.7	0.0	15.6	5.7
Greece	2012	44.4	33.7	22.9	10.2	6.9	1.1	2.1	2.1	12.7	7.1	3.6	2.0	0.0	10.8	10.7
Italy	2012	47.7	44.0	30.4	15.2	12.2	2.3	0.8	2.6	15.2	6.1	2.4	6.7	0.0	13.5	3.7
Unweighted Average EU28	2012	45.4	36.3	25.2	11.3	7.8	2.6	0.9	1.4	13.9	7.9	3.2	2.8	0	11.1	9.1

Sources: IMF, Government Finance Statistics; IMF World Economic Outlook; Eurostat; EU

1/ Preliminary data. Negative "Other Taxes" reflects tax refunds. Social Security Contribution data not available.

2/ Central Government

**Table 2b. General Government: Tax Structure and Tax Levels for Selected European Countries**  
(Percent of total tax revenues and social security contributions)

	Year	Total Tax and Social Security Contributions Revenue	Tax Revenue	Taxes on Income, Profits, and Capital Gains					Taxes on Goods and Services					Social Security Contributions
				Total	Individual	Enterprises and Other	Unallocable	Property Taxes	Total	General Sales, Turnover, or VAT	Excises	Other	Other Taxes	
Bosnia & Herzegovina	2013	100.0	58.8	8.3	5.3	3.0	0.0	1.0	49.1	31.3	12.8	5.0	0.2	41.2
Albania	2011	100.0	83.3	17.1	9.6	7.5	0.0	0.4	61.0	39.9	13.6	7.5	2.5	16.7
Bulgaria	2012	100.0	74.2	18.8	10.6	6.8	1.4	2.0	55.3	33.8	18.4	3.1	0.0	25.8
Croatia	2012	100.0	67.9	17.1	10.3	5.6	1.2	0.9	50.8	34.4	9.5	6.9	0.0	32.1
Hungary	2012	100.0	66.2	19.2	13.8	3.3	2.1	3.1	47.1	23.9	9.0	14.1	0.0	33.8
Kosovo, Republic of 1/	2012	100.0	100.0	15.5	8.0	5.6	1.9	1.4	87.8	50.0	26.9	11.0	-3.3	n.a.
Macedonia, FYR 2/	2012	100.0	65.3	12.1	8.1	3.1	0.9	0.0	46.9	32.8	14.1	0.0	6.3	34.7
Romania	2012	100.0	68.8	21.6	12.3	7.6	1.6	2.8	47.2	30.1	12.4	4.8	0.0	31.2
Serbia, Republic of	2011	100.0	66.0	16.8	12.6	4.2	0.0	1.7	44.5	28.0	13.8	2.7	4.7	34.0
Slovenia	2012	100.0	59.5	20.8	15.6	3.4	1.9	1.7	38.8	21.8	12.1	5.0	0.0	40.5
Unweighted Average of South East Europe (Exc. BiH)			72.4	17.7	11.2	5.2	1.2	1.6	53.3	32.7	14.4	6.1	1.1	31.1
Austria	2012	100.0	65.4	31.1	23.5	5.5	2.2	1.3	34.4	18.6	5.8	10.1	0.0	34.6
Cyprus	2012	100.0	74.1	31.4	11.3	17.8	2.3	2.1	42.7	25.2	9.6	7.8	0.0	25.9
Germany	2012	100.0	60.2	31.0	22.5	6.9	1.6	2.3	29.2	18.6	6.3	4.3	0.0	39.8
Greece	2012	100.0	67.9	30.3	20.6	3.3	6.4	6.2	37.6	21.0	10.7	5.9	0.0	32.1
Italy	2012	100.0	69.2	34.7	27.8	5.1	1.7	5.9	34.5	13.9	5.4	15.3	0.0	30.8
Unweighted Average EU28	2012	100.0	69.5	31.3	21.6	7.2	2.5	3.8	38.4	21.8	8.8	7.8	0.0	30.5

Sources: IMF, Government Finance Statistics; IMF World Economic Outlook; Eurostat; EU

1/ Preliminary data. Negative "Other Taxes" reflects tax refunds. Social Security Contribution data not available.

2/ Central Government

## C. Tax Rate Structure

**5. The standard tax rates of all taxes in BiH are on the low side compared to other countries in the SEE region.** Both the FBiH and the RS have a PIT rate of 10 percent. While many countries in the region have low flat rate personal income tax systems, the 10 percent PIT rate is one of the lowest in the region. Similarly, the corporate income tax (CIT) rate of 10 percent in both entities is one of the lowest in the region, substantially below the regional average. The value added taxation (VAT) system has a single standard rate, with no reduced rates, which enhances efficiency of the VAT. While many countries have a higher standard VAT rate than BiH, they usually have a multiple rate structure. The VAT threshold on the other hand is one of the lowest in the region, which places a larger burden on tax administration by keeping many small and medium-sized taxpayers in the VAT net.

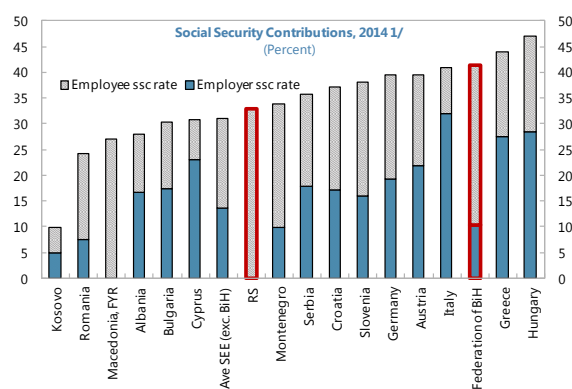
**Table 3. VAT, Corporate, and Individual Income Tax Rates for Selected European Countries, 2014**  
(Percent)

	GDP per Capita 2013 (US dollars)	VAT Thresholds (US dollars)	VAT Rates		Corporate Income Tax Rates	Top Individual Income Tax Rates
			Current Standard Rate	Other Positive Rates		
Bosnia and Herzegovina	4,598	33,557	17	N/A	10	10
Albania	4,610	47,335	20	N/A	15	23
Bulgaria	7,328	33,557	20	9	10	10
Croatia	13,562	39,792	25	5; 13	20	40
Hungary	13,405	21,066	27	5	19	16
Kosovo	3,717	65,789	16	N/A	10	10
Macedonia, FYR	4,944	42,918	18	5	10	10
Montenegro	7,026	24,660	19	7	9	9
Romania	8,910	47,950	24	5; 9	16	16
Serbia	5,907	93,897	20	10	15	15
Slovenia	22,756	65,789	22	9.5	17	50
Unweighted Average of South East Europe (Exc. BiH)	9,217	48,275	21.1		14.1	19.9
Austria	48,957	-	20	10	25	50
Cyprus	24,761	20,526	19	5; 9	12.5	35
Germany	44,999	23,026	19	7	15	45
Greece	21,857	-	23	6.5; 13	26	42
Italy	34,715	-	22	4; 10	27.5	43

Source: International Bureau of Fiscal Documentation

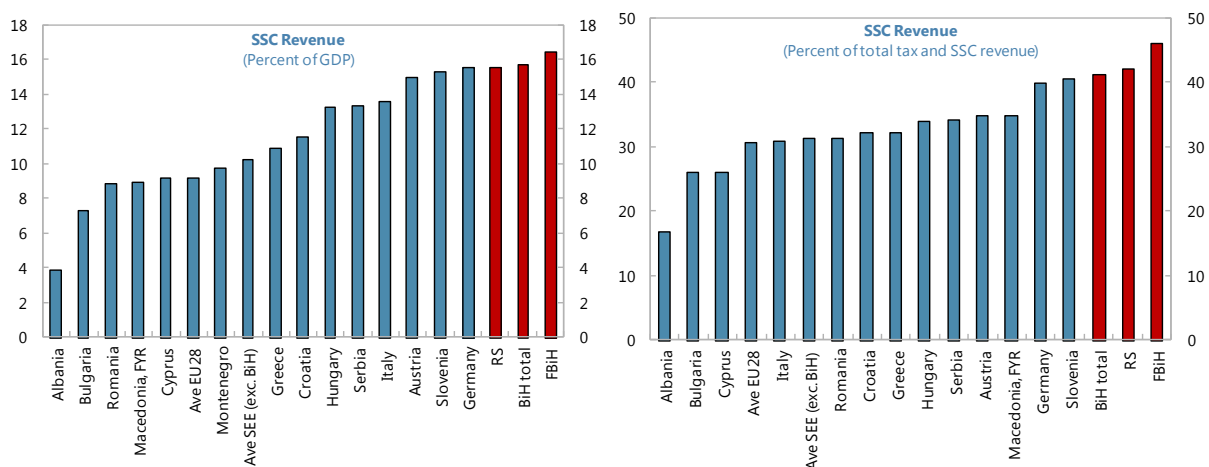
**6. While the PIT rate is low in BiH, SSC put a high burden on labor.** The SSC rate is high compared to neighboring countries, especially in the FBiH. The structure of SSC is different in the two entities: the RS collects all contributions from the employees, while the FBiH also collects some of the contributions from the employers.

**7. Consequently, BiH raises a higher share in SSC revenues both in percent of GDP and in percent of total tax revenues compared with other countries in the region.** SSC revenues are also above those collected by some of the more advanced European countries with extensive social safety nets. While both entities are at the top of the range, SSC collection in the FBiH is higher than in the RS.



Source: International Bureau of Fiscal Documentation.  
1/ Total level of social security contributions in the FBiH, RS and Selected European countries.

### Social security contribution revenue in percent of GDP and Total tax revenue, Selected European Countries, 2012



Sources: IMF, *World Economic Outlook*; IMF, *Government Finance Statistics*; Eurostat; and country authorities.

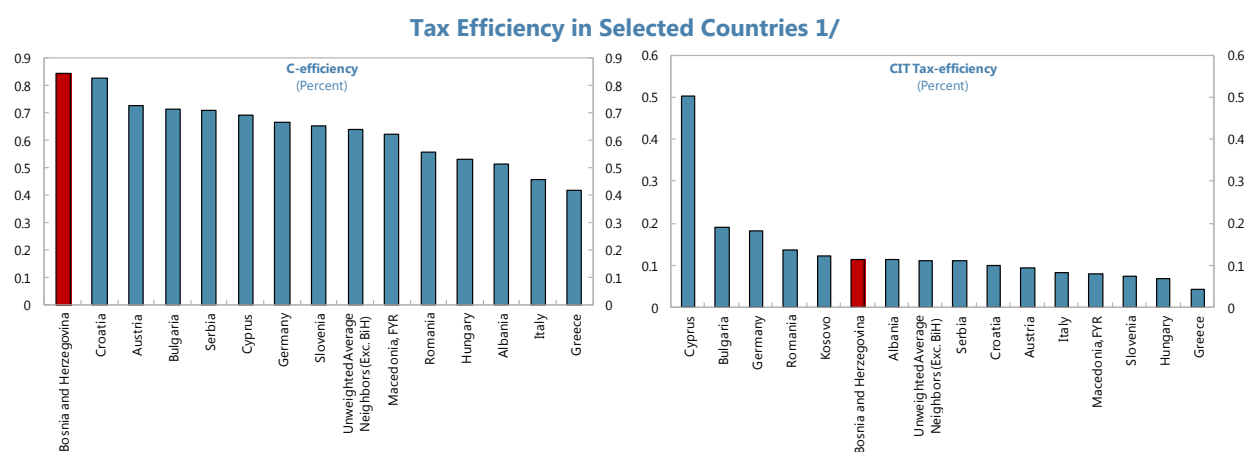
**8. The property tax systems are different in the two entities.** In the FBiH, property tax is levied at the cantonal level and the allocation of revenues between cantons and municipalities are defined by cantonal laws. Most cantons impose a property tax on buildings for recreation and parking spaces, but the overall revenue take from recurrent taxes on immovable property is very low. A property transfer tax is also collected in the FBiH. The RS, on the other hand, introduced a comprehensive recurrent property tax system in 2012. The central government defines the range for the property tax rate with upper and lower limits, currently at 0.05%–0.5%, and each municipality decides its own rate within this range. The tax base is the estimated market value of the property. Property taxes are administered and levied by the central government for the benefit of the local governments. The RS tax administration maintains a real estate cadastre. With the introduction of the recurrent property tax, the property transfer tax was abolished in the RS.



## D. Tax Efficiency

**9. Tax efficiency measures the share of tax revenue in percent of GDP relative to the statutory tax rate.** It compares the actual collection of a tax type with a theoretical maximum defined by the statutory rate. Improving tax efficiency to raise tax revenues has two components. The “policy gap” is the difference between collections under current law and those obtained if all exemptions not consistent with best practice and all reduced rates were eliminated. The policy gap can be reduced by broadening the tax bases. The “compliance gap” is the difference between current tax collections and those that would be obtained if the existing tax law was perfectly enforced. The compliance gap can be reduced by revenue administration reforms.

**10. VAT efficiency is very high in BiH, due to the low policy gap.** There are few exemptions in the VAT system, no reduced rate, and a zero VAT rate is limited to very few items (e.g., exports and diplomats). Altogether this makes the VAT system in BiH more efficient than in countries with multiple rates and extensive exemptions. Efficiency of the CIT is around the average of the region. CIT efficiency could be improved through both policy and administration measures. Tax incentives and exemptions should be reviewed, with a view to their elimination. Tax administration reform efforts should aim to improve compliance. Tax administration measures, however, usually take time before they show significant results.



Sources: IMF, *World Economic Outlook*; IMF, *Government Finance Statistics*; International Bureau of Fiscal Documentation; and IMF staff calculations.  
 1/ Tax efficiency is measured as tax revenue in percent of GDP divided by the statutory tax rate. C-efficiency is tax efficiency of VAT calculated based on consumption.

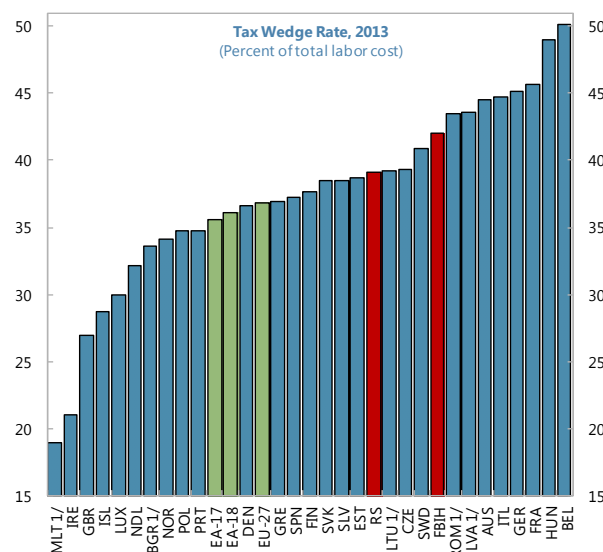
## E. Total Tax Wedge

### 11. The tax burden on labor is high in BiH.

The tax wedge—consisting of PIT and SSC—differs between the entities given the decentralized structure of the country. For a single average wage earner, the tax wedge amounts to 42 percent of the gross wage in the FBiH and slightly over 39 percent in the RS, with most of the burden coming from SSC.

### 12. The labor tax wedge in BiH is also relatively high compared with other countries.

The current BiH rates are more in line with advanced EU countries than many emerging economies. Moreover, in 2013 the tax wedge in both entities was notably higher than the EU or Euro Area averages.



Sources: Eurostat and IMF staff calculations.  
1/ Data for tax wedge refers to 2012.

**Table 4. Labor Income Taxation**  
(Percent of November 2014 gross wage)

		FBiH	RS
Gross wage 1/	A	100.0	100.0
Income tax 2/	B	4.5	5.2
Contributions 3/	C	41.5	33.9
Pension		23.0	18.0
Employee	D	17.0	18.0
Employer		6.0	...
Health		16.5	12.5
Employee	E	12.5	12.5
Employer		4.0	...
Unemployment		2.0	1.0
Employee	F	1.5	1.0
Employer		0.5	...
Child protection		...	1.5
Employee	G	...	1.5
Employer		...	...
Floods	H	...	0.9
Fees paid by employer	I	0.6	...
Net wage	J = A – B – D – E – F – G – H	64.5	60.9
Labor cost to employer 1/	K = J + B + C + I	111.1	100.0
Tax wedge (percent of labor cost) 1	L = (1 - J / K) * 100	<b>41.9</b>	<b>39.1</b>

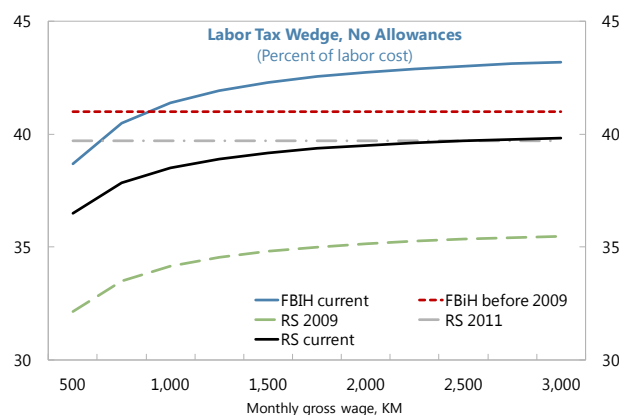
Source: IMF staff calculation.

1/ Gross wage = Net Wage + Taxes + Employee Contributions; Labor Cost = Gross Wage + Contributions, Employer + Other Fees; Tax wedge = Net Wage / Labor cost

2/ Effective rates for gross average wage paid in November 2014. Taxable base = gross wage minus employee contributions minus personal exemption. Personal exemption is KM 300 in the Federation and KM 200 in RS. Statutory tax rate 10% in Federation, and 10% in RS on net wage.

3/ RS introduced temporary flood related contribution of 1.5 percent on net wage (0.9 percent on gross wage).

**13. The tax treatment of allowances is not harmonized across the two entities, creating distortions and adding to administrative burden for businesses operating in both entities.** Besides wages, employees in BiH often receive meal, holiday, and transportation allowances as part of their remuneration. In the RS, these allowances are treated as part of the overall compensation and subject to taxation. In contrast, in the FBiH these allowances are tax-free. This means that the effective labor tax wedge in the FBiH is lower if these allowances are included in the calculations. The tax free allowances can be viewed as an increase in tax deduction for PIT purposes.



Source: IMF staff calculations.

**14. High labor taxation undermines cost competitiveness and contributes to the high share of informal employment in BiH.** In order to increase overall employment—and employment in the formal sector in particular—and to improve competitiveness of the economy to attract foreign investment the labor tax wedge will need to be reduced.

## F. Conclusion

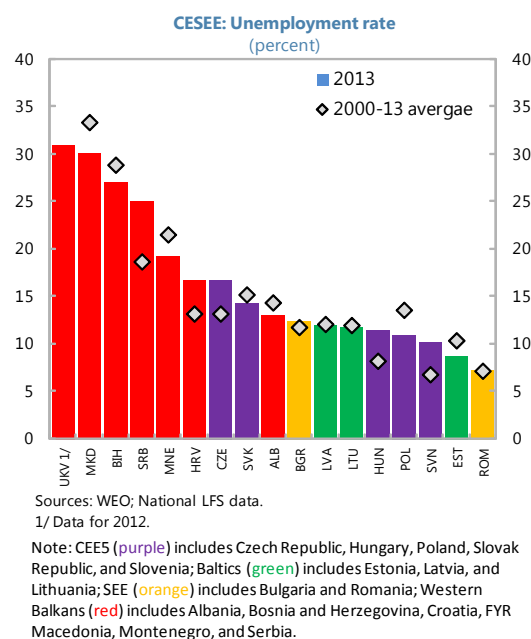
- Lowering SSC rates is necessary to improve labor market incentives. A reduction will need to be accompanied by offsetting revenue measures, including base broadening and improving compliance, and/or spending cuts.
- A review of the tax system is necessary to identify measures to broaden the tax base of all major taxes, by capturing tax-free allowances and curtailing tax exemptions and incentives. Tax rates also need to be reviewed to identify options to mobilize revenues from other taxes than SSC. Similarly, property taxes could be expanded, notably in the FBiH.

# DIRE STATE OF LABOR MARKETS CALLS FOR BROAD-BASED REFORMS<sup>1</sup>

Labor market outcomes in the Bosnia and Herzegovina are among the worst in emerging Europe. The long-standing persistency of high unemployment and low employment rates in the region points at predominately structural reasons. Thus, poor labor market outcomes are likely to persist even as economic growth picks up. Only a simultaneous and comprehensive reform effort—aimed at retooling the economic growth model, improving the business and investment climate, strengthening labor market institutions, and reducing rigidities of the labor markets—is likely to produce the desired outcome.

## A. Worrisome Labor Market Trends

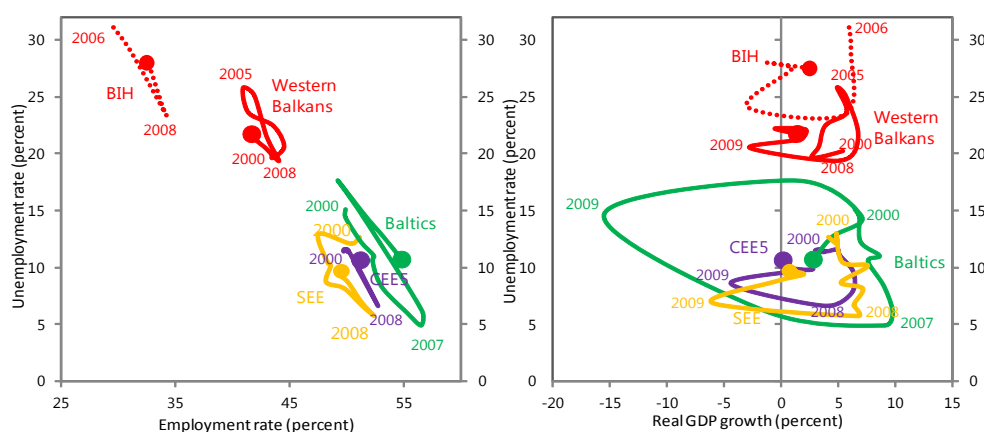
**1. The labor market in Bosnia and Herzegovina is characterized by notably worse outcomes than those in most other countries in emerging Europe, including many countries in the Western Balkans.** In 2013, the unemployment rate—as measured by the labor force survey—in Bosnia and Herzegovina (BiH) reached 27½ percent, higher than 23 percent average among the Western Balkan countries and in sharp contrast with about 11 percent and 5 percent averages among Central European and CIS countries, respectively. This is a key social concern but also implies significant economic challenges in terms of lost potential output and additional fiscal costs.



**2. Bosnia and Herzegovina's inferior labor market trends predate the global financial crisis.** While Central and Southern European countries—and even more so the Baltics—also experienced large cyclical swings of both employment and unemployment during the 2000s, these swings took place within a qualitatively different space of markedly lower unemployment and higher employment. In contrast, labor markets in BiH failed to significantly benefit from employment gains during the boom years while still registering significant job losses in the aftermath of the crisis.

<sup>1</sup> Prepared by Ruben Atoyan and Irena Jankulov.

Labor market trends, 2000-2013

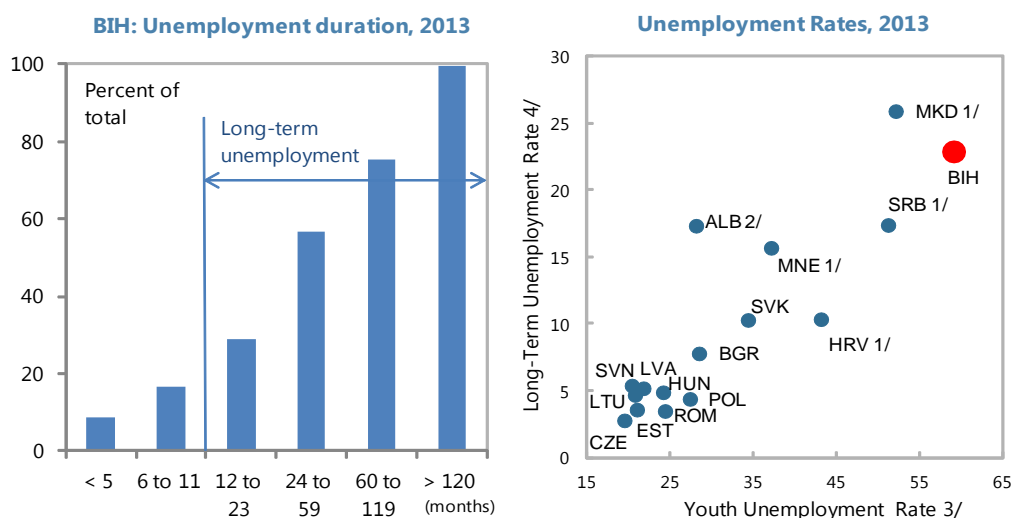


Source: WEO.

Note: CEE5 (purple) includes Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia; Baltics (green) includes Estonia, Latvia, and Lithuania; SEE (orange) includes Bulgaria and Romania; Western Balkans (red) includes Albania, Croatia, FYR Macedonia, Montenegro, and Serbia.

### 3. High youth unemployment and long-term unemployment are particularly worrisome.

The unemployment rate for the youth (aged 15–24 years) exceeded 59 percent in 2013, while over 34 percent of the next potentially productive group (aged 24–34 years) is also unemployed. This situation is further complicated by high rate of long-term unemployment where over 80 percent of unemployed have not been able to find a job for more than 12 months.



Sources: Country authorities; OECD; Haver; Eurostat; CEA; and IMF staff calculations.

1/ 2012 data used in place of 2013 data.

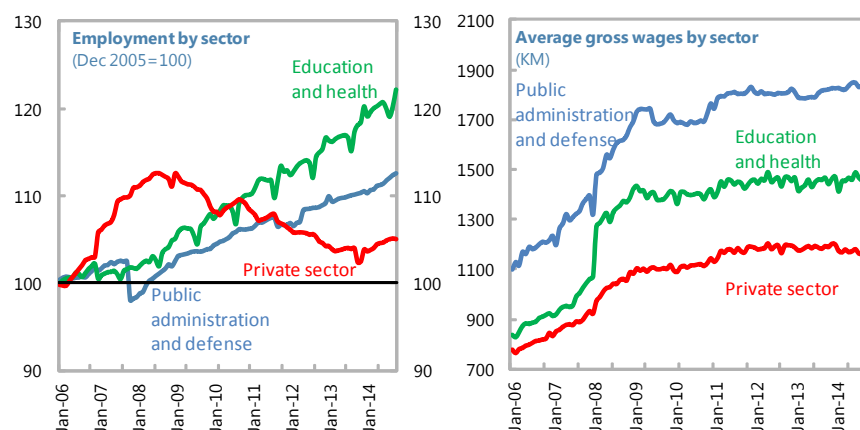
2/ Balkan average used for long-term unemployment rate. due to missing data.

3/ Unemployed (15-24) as a percent of active population (15-24).

### 4. The public sector continues to be the main source of jobs in Bosnia and Herzegovina.

Employment trends by sector highlight that much of private sector job gains of the boom years have been lost in the aftermath of the global financial crisis. These job losses were somewhat masked by a continued expansion of the employment in the broader public sector. Indeed, during

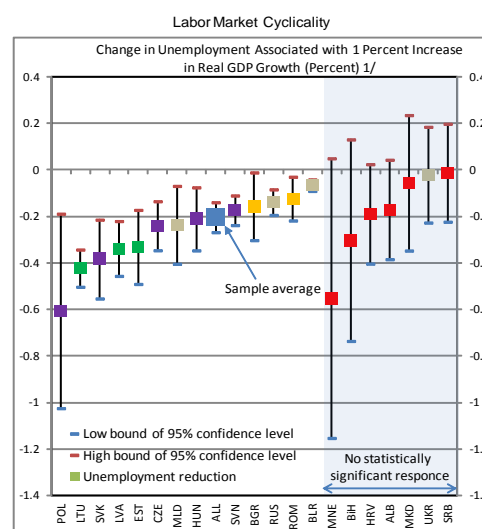
the past decade, the number of public administration and defense jobs has increased by nearly 13 percent, while employment in education and health sectors has increased by over 22 percent. These trends are hardly surprising in the face of weak private activity and considering that, in addition to higher job security, public sector jobs enjoy high wage premium relative to the private sector employment. With high wages and large public sector employment, BiH is spending a greater share of GDP on compensation of public sector employees than its peers.



Source: BiH Agency for statistics, and IMF staff calculations.

1/ Private sector employment includes workers employed by a number of state-owned enterprises.

**5. Unemployment is likely to persist even as economic growth picks up in the aftermath of the crisis.** Indeed, smaller and statistically insignificant responses of labor market outcomes to swings in economic cycles—gauged by the size of Okun’s coefficient measuring the contemporaneous response of unemployment rate to changes in economic growth—suggest that unemployment in BiH—as well as in all other Western Balkan countries—is unlikely to drop radically once economic growth recovers in the future. This is in sharp contrast with larger and statistically significant response coefficients found in most Central European and Baltic economies.<sup>2</sup>



Source: IMF staff estimates.

1/ Values of the response coefficient of unemployment to one percent increase in economic growth estimated over country-level data from the period of 1993–2013.

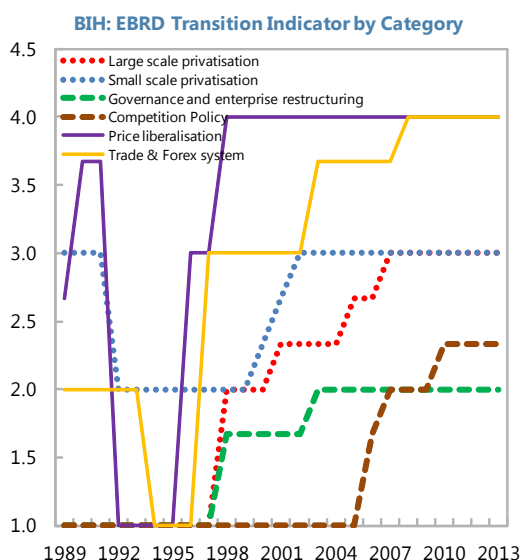
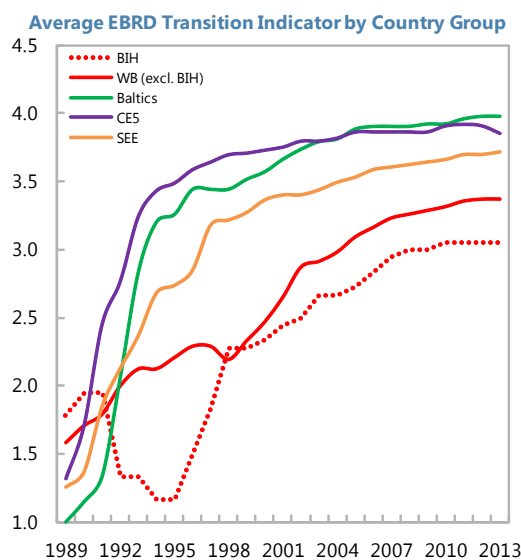
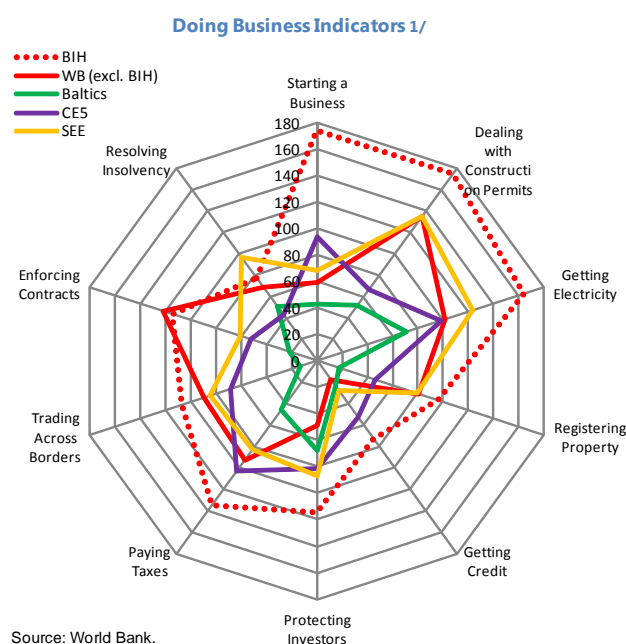
<sup>2</sup> In post crisis environment, sluggish responsiveness of job creation to growth is likely aggravated by weakened balance sheets affecting financing conditions (ILO, 2013). Also, job creation is impaired by a need for firms to build up new collateral to finance their activities (Calvo et. al., 2012), while concurrently fiscal consolidation could have depressed aggregate demand (ILO, 2014).

## B. Diagnostics of Structural Impediments

### 6. Persistent labor market problems signal the presence of deep structural problems, likely going far beyond labor markets.

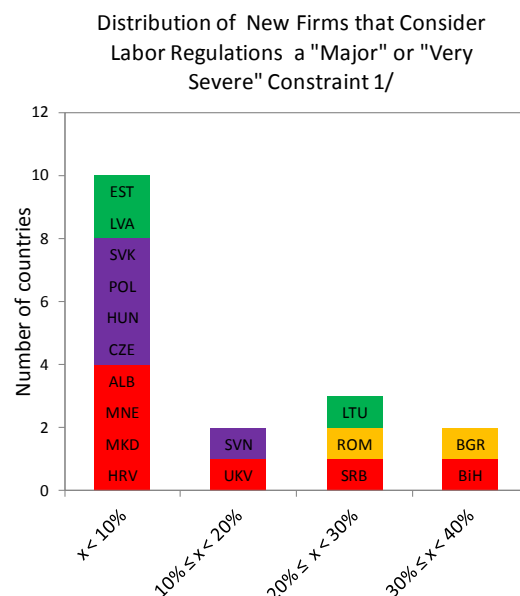
One reason is BiH is a latecomer to the transition process, even by Western Balkan standards. Core structural reforms such as enterprise restructuring, competition policy improvements, and privatization are drastically less advanced in BiH than in other more dynamic peer countries. Furthermore, the country's business environment indicators lag far behind the region and indeed most of the countries in the world, particularly in areas of ease of starting businesses, obtaining construction permits, connecting to electricity, paying taxes, and investor protection. This has held back FDI inflows, diversification from traditional

sectors, and private sector job creation. At the same time, the country has experienced very large emigration and a brain drain—particularly among the better educated layers of population—likely contributing to labor shortages at the better-educated segment of the labor market. While high remittances inflows provide a welcome safety net for the poor and elderly (filling in significant gaps in the government-provided social assistance programs), they also could raise reservation wages, hamper external competitiveness, and contribute to the long unemployment duration.



## 7. Institutional rigidity of the labor markets compounds the impact of structural problems.

Business surveys show that—even before the global financial crisis—up to 40 percent of younger and more vibrant firms in BiH considered existing labor market regulations as a major or very severe impediment for their economic activity and growth, the bottleneck that is likely to significantly constrain development of new industries with more sophisticated and better paid jobs. This is in sharp contrast with most CEE5 and Baltic countries where labor regulations were not considered to be an important constraint.



## 8. Private (non-financial) sector companies view the BiH labor market legislation as inadequate.

According to a recent study conducted by the FBIH employers association, more than  $\frac{3}{4}$  of companies are dissatisfied with the current labor legislation as it fails to promote entrepreneurship and positive attitude towards labor.<sup>3</sup> Under the current economic conditions, about  $\frac{1}{3}$  of companies are unable to comply with provisions from the general collective agreements.

## 9. Indefinite duration of collective bargaining agreements poses a number of challenges for BiH labor markets and the broader economy's ability to adjust to economic shocks:

- *It fosters job loss and results in higher occurrences of bankruptcies* as stiff constraints on employers to renegotiate wages and benefits limit the space for firms' responses to cyclical swings and economic shocks.
- It fosters informal economy as employers would favor easily adjustable and cheaper illegal workers over inflexible and costly formal employment.
- It leads to a higher wage premium in the public sector over the private sector as it benefits the negotiating position of heavily unionized public sector employees compared with a weaker bargaining position of less organized private sector workers (less than 10 percent of private sector workers belonging to a trade union).
- It encourages lengthy and costly litigations and piles up fiscal costs. Unenforceable labor contracts, overly rigid redundancy procedures, economically unjustified wages and allowances encourage labor-related lawsuits, largely arising from the public sector employees.<sup>4</sup>

<sup>3</sup> FBIH Employers Association, 2015.

<sup>4</sup> In 2013 and only in FBIH, the total value of all lodged legal challenges was over KM 500 million (about 2 percent of GDP), pointing to unsustainability of the current legal framework and requiring urgent changes.



Ultimately, these challenges resulted in a creation of a dual labor market of “insiders”—mainly public sector workers, including SOE; and “outsiders”—mainly private sector workers and informal workers.

**10. In line with ILO findings and positions, longer durations of collective agreements entail larger risks to the workers.**<sup>5</sup> In most countries in the region, collective agreements are limited in duration, with limits ranging from 1 to 5 years. BIH is the only country in the region with indefinite duration of collective agreements.

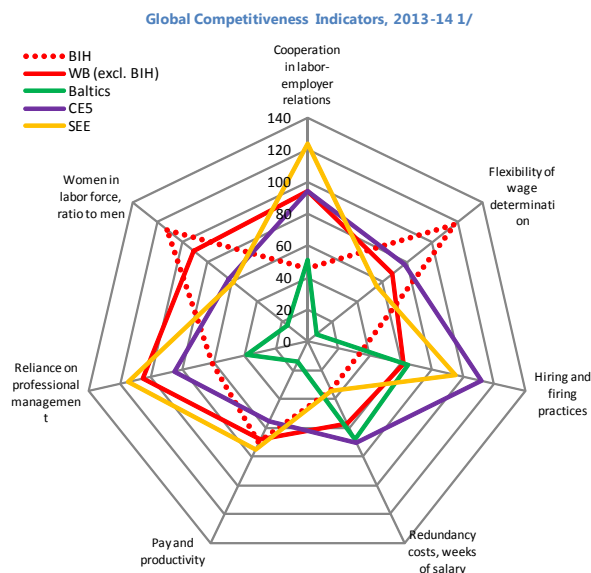
#### Duration of Collective Agreements

1 year	Austria, Germany, Great Britain, Ireland, Latvia, Lithuania, Netherlands, Slovenia.
2 years	Belgium, Cyprus, Hungary, Montenegro, Romania.
3 years	Denmark, Finland, Greece, Luxemburg, Serbia, Sweden.
5 years	Croatia.
Indefinite	BiH.

Source: <https://www.worker-participation.eu>

**11. The BIH labor market was shaped by the particular legacy of the “self-management” system for enterprises, and the existence of the so-called social ownership.**<sup>6</sup>

As in other Western Balkan countries, this led to a high level of job protection for the “insiders” and to overall rigidity. As witnessed by the country’s poor standing in the Global Competitiveness Indicators, Bosnia and Herzegovina is characterized by extremely rigid wage determination—rigidly regulated by collective agreements for job complexity groupings and by education and tenure of an employee—and coupled with a feeble link between work compensation and labor productivity. Similarly, the country stands out in terms of the dragging effect of taxation on incentives to work and extremely low women participation in the labor force. While BIH ranks surprisingly favorably in terms of overall hiring-firing practices and redundancy costs, these results need to be interpreted carefully as indices do not always agree with the public consensus within the country that identifies these areas as problematic. Moreover, a large share of the BIH labor market—capturing jobs in the civil service, public sector, and state-owned enterprises—is subject to strict



Source: World Economic Forum Global Competitiveness Indicator database, 2013-14 edition.

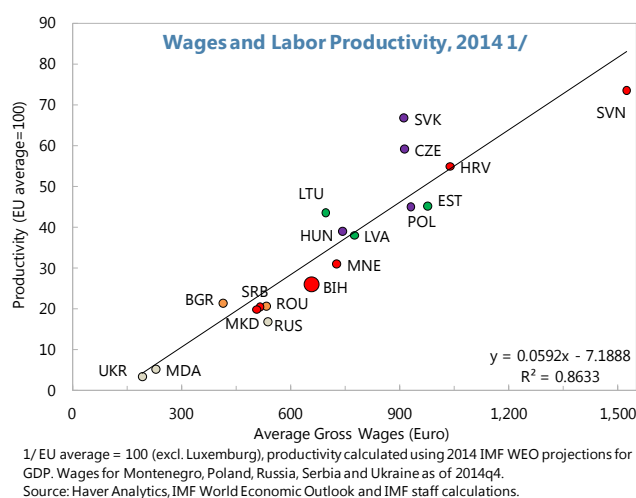
1/ The number corresponds to a global rank of a country. Lower rank means better competitiveness.

<sup>5</sup> ILO, 2006.

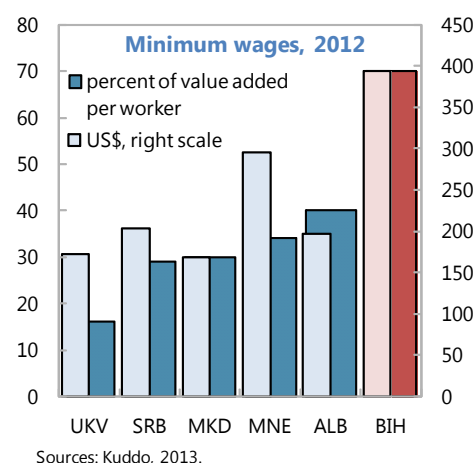
<sup>6</sup> See Kuddo, 2013.

rules for terminating the employment and generous severance payments guided by civil service regulations.

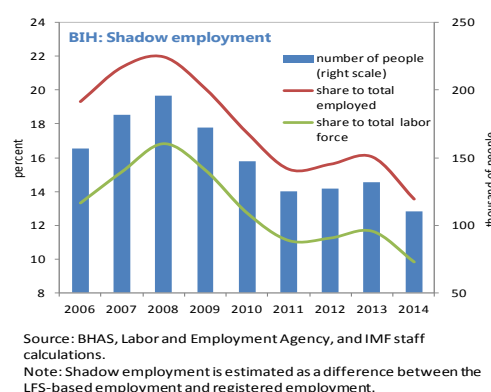
**12. Average gross wages in BIH—while low in absolute level—are somewhat higher than labor productivity.** However, these averages need to be interpreted with caution when making an overall assessment of BIH external cost competitiveness, as they are likely to be significantly inflated by high wages in the broader public sector, a dominant employer in the economy. At the same time, labor productivity is quite low by regional standards, amounting to just over 25 percent of average productivity in EU countries.



**13. Minimum wages are significantly higher in BIH than elsewhere in the region.** This holds irrespective whether minimum wages are expressed in US dollars or as a share of the average value added per worker (a proxy for average earnings in a cross-country comparison). Faced by higher minimum wages, businesses are less likely to hire less experienced workers and workers who have been out of the workforce for some time. High minimum wages may also induce disincentive to higher the youth and depress formal employment, especially in low-paid sectors and poorer regions. The relatively high level of minimum wages in BIH also suggests that economic factors—such economic growth, productivity improvements, and the current state of the labor market—are insufficiently taken into account. Notwithstanding these findings, discussions with employer associations in both entities did not indicate that an elevated minimum wage level poses significant impediment to job creation.



**14. The BIH labor market is also characterized by a large share of informal employment.** While inevitably the precise size of the shadow employment is subject to significant uncertainty, available estimates seem to suggest that nearly 15 percent of the country's employment (or about 10 percent of the labor force) in 2014 is engaged in activities in the informal economy. And these figures were even higher during the boom years preceding the global financial crisis—likely because



employers found it easier to shed illegal workers whose rights were not adequately protected—and the shadow employment is likely to increase again as economic growth picks up. Aside from obvious problems of tax evasion and unpaid social contributions, workers engaged in informal employment do not enjoy adequate level of employment protection available to officially employed peers and are subject to higher risk of employment violations.

**15. The decentralized political structure of Bosnia and Herzegovina imposes additional challenges to businesses operating in the country.** Indeed, differences in labor regulations across the entities and inconsistent court interpretations of legal provisions add administrative hurdles and costs to companies that work in the whole country.<sup>7</sup> Most common problems are related to calculating the past service, sick leave payment, compensation and refunds by health insurance funds, and maternity leave payments. Furthermore, a special problem is related to different interpretation of legal solutions—collision of collective agreements with the Law on Personal Income Tax and the Law on Social Security Contributions—resulting in different court rulings related to the same legal matter, adding to a high degree of uncertainty for both employers and employees. More generally, businesses perceive the judiciary system as slow and inefficient, with a negative impact on the labor market and employer-workers relations.<sup>8</sup>

### C. Making BiH a more Conducive Place for Job Creation

**16. To sustainably bring down unemployment from its current high levels and to improve labor market participation, Bosnia and Herzegovina needs to become a more attractive place to invest and create jobs.** This task is far from simple and favorable results cannot be achieved overnight. Nevertheless, several priorities emerge. First, there is a need to address remaining structural impediments to growth and job creation. Maintaining macro-financial and political stability is a key pre-condition, but robust economic growth will ultimately hinge on cultivating more competitive product and factor markets and deeper trade integration, both within the region and more globally. These, in turn, are not possible without decisive efforts aimed at improving business and investment climate to attract foreign investors, stimulate entrepreneurship, improve productivity, and create more and—importantly—better jobs, including for younger workers and women. This is the overarching challenge facing the country. That said, specific reforms to labor markets can also make a contribution to stronger growth, especially in the formal sector.

**17. Second, strong labor market institutions are key to generating productive employment and addressing duality between “insiders” and “outsiders” in the labor market.** This balance is difficult to achieve, but updating the labor market legal framework to make it more conducive to job creation should play an important role (Boxes 1 and 2). Most critically, the indefinite collective agreements have become a drag on private, formal-sector employment creation

<sup>7</sup> White Book 2012/13, Foreign Investors Council BiH.

<sup>8</sup> FBIH Employers Association, 2015.

and the new labor laws should introduce a limit on their duration so that these could be adjusted regularly to reflect rapidly changing economic realities. Collective agreements that are limited in duration and apply only to those enterprises and workers that want to be part of the agreement will help ensure that the process of collective bargaining—currently stalled due to unwillingness of some social partners to revisit outdated agreements—can function effectively. Equally important, the new laws should enhance flexibility of wage determination frameworks and facilitate better linkage between work compensation and labor productivity by promoting differentiated wage setting based on skills, qualifications, experience, and performance. Finally, the legal framework governing employment in the civil service need to be updated to facilitate public administration reform, including by increasing the scope for reallocating staff within the administration and adjusting staffing and wage levels, and channel labor market resources to the private sector.

**18. Third, sustained employment growth requires improving cost competitiveness.**

Legislations governing minimum wages and redundancy costs would need to be reviewed, while strengthening the general system for unemployment insurance, to avoid creating disincentives for hiring new workers in the first place and placing a sizable burden exclusively on enterprises when they are forced to downsize at a time they can ill afford this. Introducing a separate minimum wage for young workers may be useful to facilitate youth unemployment. Also, containing current expenditure of the governments and broadening the tax base by addressing tax evasion are also needed to create fiscal space to lower the tax burden on labor and reduce the informal economy.

**19. Fourth, welfare reforms aimed at better targeting of social assistance and incentivizing labor market participation for all groups are needed, as is boosting skills and adaptability of workers through improved training and education.** In this context, active labor market programs such as job matching services, career counseling and training for both pre-redundancy workers and the unemployed, employer subsidies targeting disadvantaged job seekers, and self-employment support are of critical importance. These efforts need to be supported by stepped up labor inspections and increased penalties for labor law violations to help protect workers' rights—consistent with ILO labor standards and EC labor directives—and reduce the informal economy.

**20. Finally, completing the labor market transition in an environment of slow post-crisis recovery will inevitably have wide-ranging social consequences.** Social cohesion should be achieved through extensive consultation between all social parties, including those that are currently out of work. The adjustment must be seen as fair, and as involving labor not just in the production sector, but also in the services and financial sectors. It is also important to have a well-targeted social safety net in place to protect the most vulnerable and make fiscal space for critical social and infrastructure spending.

### Box 1. The Region Is Moving On

#### A number of countries in the region have recently reformed their labor market frameworks.

In 2014, **Serbia** adopted amendments to the labor law which are aimed at removing disincentives for hiring and making wage bargaining and employment procedures more flexible. Specifically, the reform limited severance payments by linking them to service with current employer rather than life-time employment, extended the maximum length of temporary contracts from one year to two years, clarified and simplified separation rules, and tightened the rules for extensions of collective agreements to all firms in the sector. The authorities also envisage wider use of job supporting programs such as job matching services, career counseling and training for both pre-redundancy workers and the unemployed, employer subsidies targeting disadvantaged job seekers, and self-employment support.

Also in 2014, **Croatia** adopted the new labor code with the aim to increase employment, decrease informal employment, introduce more flexible business operations, and adequately safeguard workers' rights. Specifically, the reform envisaged support to different labor contracts including work through employment agencies, relaxation of working hours and part-time employment, and simplifying redundancy and lay-off procedures.

Over 2007–12, **Macedonia** implemented a number of legislative reforms focused on clarifying provisions governing part- and fixed-term contracts, allowing greater flexibility for overtime work, simplifying redundancy procedures to make compliance easier and less costly, and revamping the collective bargaining framework (including by limiting duration of collective agreements).

## Box 2. Modernizing Labor Laws in Bosnia and Herzegovina

Labor laws in Bosnia and Herzegovina are outdated and do not create an environment conducive to job creation in the formal sector.<sup>1</sup> Labor markets could benefit from aligning labor legislations to ILO labor standards and EC labor directives, particularly in areas of labor market flexibility, protection of workers, and the role of the governments.

### **Labor market flexibility**

**Duration of collective agreements.** The general collective agreement is mandatory for all employers and regulates the minimum rights of workers. It regulates the minimum wage, calculation of the basic wage, as well as the right and the amount of severance payment, meal, transportation, and vacation allowances. Although legislation allows for collective agreements with definitive and indefinite duration, in practice the general collective agreements date many years back, no longer reflect economic realities, and resulted in numerous failed negotiations. These agreements are seen as an obstacle to formal sector employment creation in a rapidly changing economic environment and give a rise to a large number of court proceedings—mainly involving workers in the public sector—due to the failure to implement collective agreements. Labor laws should set a limit on the duration of the collective agreements to ensure that the process of collective bargaining can function.

**Fixed-term contracts.** Although fixed-term contracts are allowed, the current framework sets an overly restrictive time limit (up to two years) on their duration. This may be insufficient for longer infrastructure projects, resulting in higher employee turnover and inadequate worker right protection. Also, a less rigid regime would benefit employment of vulnerable groups of workers as fixed-term contracts typically are held by younger people and other market entrants. Thus, they can provide a step forward to regular employment and an opportunity to gain skills and experience. New laws should allow duration of fixed-term contracts, with or without renewals, for up to five years. With these considerations in mind, however, careful attention needs to be given to avoid a situation where short term contracts are offered as a substitute to permanent contracts as this could damage job prospects for new labor market entrants, and particularly the youth.

**Temporary employment agencies.** A legal framework for operations of temporary employment agencies does not exist and needs to be established. Clear defining legal and operational status of employment agencies would help bringing temporary jobs into official economy and protect rights of workers.

### **Workers' rights**

**Overtime activities.** The current framework is overly restrictive in regulating overtime activities as it sets strict time limits on daily, weekly, and annual overtime hours. This not only constrains employer's capacity to react quickly to temporary fluctuations in the economic activity, but also undermines workers' ability to earn extra income. Legislation should permit greater flexibility in overtime activities, allowing employers and employees a possibility to negotiate specific overtime terms in collective agreements or individual contracts.

**Probationary period.** The current legal framework sets a fixed limit (six months) on the duration of probation period. However, some degree of differentiation might be warranted with longer trial periods for employees in managerial positions and shorter periods for unskilled workers.

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<sup>1</sup> The current labor law in the FBiH was approved in 1999 and amended in 2000 and 2003. The current labor law in the RS was approved in 2000 and amended in 2000, 2002, 2003, and 2007.

### Box 2. Modernizing Labor Laws in Bosnia and Herzegovina (concluded)

**Leave.** Family-related and sick-leave arrangements are fairly generous, based on international standards. While maternity leave is an important public policy measure to protect the health of mothers and children, long maternity leave can reduce women's attachment to the labor market, erode skills, and result in employer's discrimination against women of child-bearing age due to the associated indirect costs. Family-related and sick-leave arrangements are particularly costly for small and medium enterprises and some flexibility may be warranted to allow these to be covered by employee's annual leave or unpaid leave entitlements. Furthermore, maternity leave arrangements differ between the entities—and even between the cantons in the FBiH—and greater degree of harmonization may be warranted.

#### **Role of the Government**

**Minimum wages.** The level of minimum wage is relatively high in Bosnia and Herzegovina compared with the average productivity per worker and relative to the minimum wages in neighboring countries. The lack of a separate minimum wage for young workers may have also contributed to extremely high youth unemployment. The governments should consider taking a more active role in regulating the levels and differentiation of the minimum wage.

**Severance entitlements.** Current legal solutions overprotect the insiders, at the expense of lack of opportunities for those currently without the work. While the unemployment benefits are low, burden of income support is placed on employer through severance payments. This hinders job creation, creates disincentives for hiring new workers, and leads to informality and stagnant unemployment pool. The focus should be shifted from protection of jobs to helping the job transition via strengthening active labor market policies and an unemployment benefit system.

**Penalties.** It is important to ensure that penalties for the labor laws are sufficiently high to help protect worker's rights and reduce the size of informal economy.

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