A low-wage, high-tax trap in the Western Balkans[1]

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ABSTRACT

The labour market performance of the Western Balkan region lags far behind the EU average. Although a good part of that lag can be explained by differences in GDP per capita and in the overall level of economic development, the rest can mostly be attributed to their suboptimal institutional configuration. We identify the labour taxation system as one of the most critical institutions and also as a field where most progress can be made. The taxation of labour income in the Western Balkans is skewed towards relatively high social security contributions, combined with a lower and relatively flat personal income tax. Low wage earners are particularly disadvantaged in the formal labour market in terms of their low net take home pay and the relatively high cost of hiring, with respect to medium or high wage earners. The implicit tax rate on labour (that is, the effective average labour tax burden) in Montenegro, Serbia and Bosnia and Herzegovina is among the highest in Europe. A major reform of the entire system of labour taxation and social insurance appears to be the most promising avenue for the revitalization of regional labour markets.

KEY WORDS: Labour costs, tax wedge, low-wage earners, Western Balkans

1. Introduction

In only two decades since the beginning of XXI century, labour evolved from an abundant to a relatively scarce resource in the Western Balkans. This development, driven by demographic trends and most directly manifested by the decline in the working age population in all economies except Kosovo (which probably also experienced a net decline if emigration were fully taken into account), was predictable a long time ago. Nevertheless, economic policy only recently and in most cases very belatedly changed the perception, formed at the start of transition, of unlimited supply of labour that could be put to work only by sufficiently flexibilizing the labour market, suppressing trade unions and appeasing the employers. Such an approach possibly helped reduce the unemployment rate, but was decisively unhelpful in creating good jobs and getting closer to escaping the middle income trap.

This contribution focuses on analysing institutional features that have been identified as the most likely direct causes for the poor performance of Western Balkan labour markets. The analysis is motivated by the need to reassess the structure of labour costs and the level and structure of labour taxes - understood

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broadly as the non-wage portion of total employee compensation - which was last studied comprehensively in a regional report over 10 years ago (Arandarenko and Vukojević 2008).

Section 2 analyses low wages and low-wage jobs, defined relatively as those that pay less than two-thirds of the national median or mean of gross hourly wages, in the Western Balkans. Two different sources of information are used. The first is the Structure of Earnings Survey (SES). However, since SES covers only a portion of the formal labour force, it tends to exclude large swathes of low-wage earners (as defined by its own threshold). Furthermore, there is some evidence that low-wage earners, especially those below the age of 30, tend to get stuck in a low-wage situation for prolonged periods of time (Aleksić 2020).

Sections 3 and 4 explore the features of the labour taxation systems in the region, applying the standard OECD methodology. This analysis identifies three countries in the region with a high effective labour tax burden, affecting not just employers but also low-wage workers. The analysis also shows that all countries rely predominantly on social security contributions (SSCs) as the main source of revenue from labour taxes.

Section 5 looks at policy options and obstacles to implementation of a thorough reform of the labour taxation system. Such reform is particularly necessary to counter the double disadvantage of low wages and low employment in high tax-wedge countries of the region. An alternative avenue – a gradual but persistent reduction in labour supply due to emigration and intensified natural population shrinking – is far less attractive.

2. Labour market performance and low wages in the Western Balkans

The shrinking of the working age population has been a distinctive feature of the region in the past decade. According to the Labour Force Survey data (LFS), between 2010 and 2019 working age population decreased by more than 1.1 million people or about 9%[2]. Kosovo was the only polity within the region that managed to increase population between 15 and 64 years by about 5%[3]. This is not a coincidence, since Kosovo has the highest birth rate and youngest population in the region. The magnitude of the reduction in other countries varied considerably, from a negligible 0.5% in North Macedonia to an astonishing 22% in Bosnia and Herzegovina. This trend can be explained mostly by the ageing of the population and strong emigration, the latter even not being fully accounted for (Arandarenko and Aleksić, 2020).

Moderate GDP growth in combination with the shrinking of the working age population contributed to the increase in activity rates. Although the activity rates (15-64) have increased since 2013 the region was still far behind the EU average in 2019 (61% vs 73.5%). The closest to the EU average are Albania with 69.6% and Serbia with 68.1%, while the gap is quite significant in Bosnia and Herzegovina (55.5%) and

[2] LFS data, National statistical offices.
[3] From 2012 instead of 2010.

Kosovo (40.5%). However, the wide gap between Albania and Kosovo is partially due to variations in their Labour Force Surveys, with Albania applying somewhat more relaxed classification criteria for activity and employment.

The low participation of women is one of the key factors behind the activity gap between the Western Balkans and the EU. Actually, the activity rates of women in the Western Balkans are among the lowest in Europe. While the gender activity gap in the EU in 2019 was 10.8 p.p., women in Western Balkans on average had almost 20 p.p. lower activity rates than men. It is indicative that the gender activity gap was highest in Kosovo (59.7% vs 21.1%) and Bosnia and Herzegovina (66.4% vs 41.8%), which are two countries that are also lagging the most behind the EU in the overall activity rate[4].

Relatively low participation of young people (15-24) also contributes to lower activity rates in the Western Balkans. More importantly, a large portion of inactive young people not in employment, education or training (NEET) indicates a difficult transition from school to work. In 2019 the NEET rate among young people in the Western Balkans was over 20%, more than twice the EU average[5].

After a sharp decline during the Great Recession, employment has risen since 2013. Up until 2019 about 700,000 jobs were created in the region. However, the employment rate of people between 20 and 64 years in the Western Balkans in 2020 (55%) remains far behind the EU (72.5%). More importantly, there are large variations in the employment rate across the region – from around 29% in Kosovo to 66% in Albania and Serbia. On the other hand, the unemployment rate decreased during the last decade, but in 2019 for the region as a whole it was still twice the EU average. In addition, the unemployment rates for women and young people in the Western Balkans are disproportionately higher than in the EU[6].

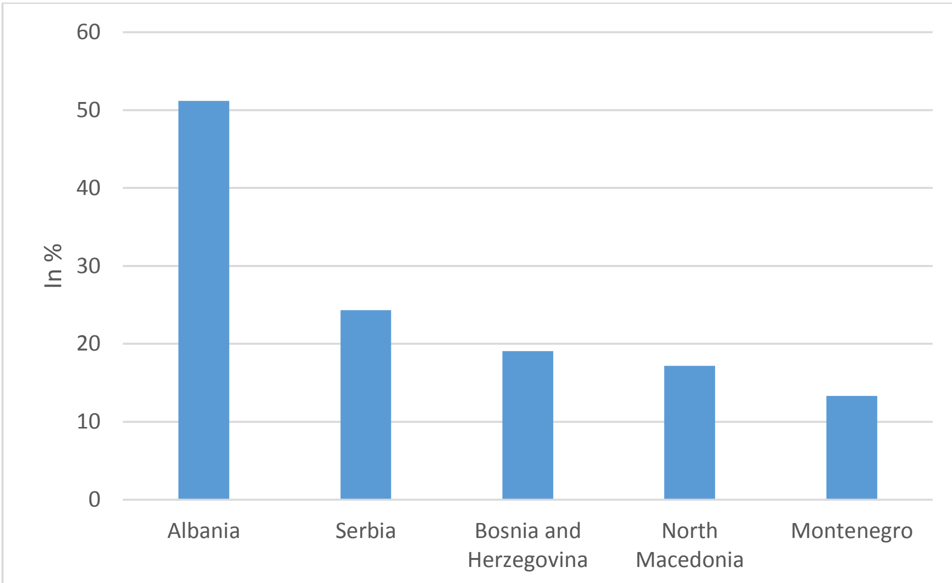
Another feature of the region is the relatively low quality of employment. Informality is widespread across the Western Balkans. According to the World Bank (World Bank 2021), the contribution of the informal sector to GDP was between 25% and 35% in the region, while in the EU informality averages 15-20% of GDP. Data on informal employment are directly available from LFS only for 3 Western Balkan countries - Albania, North Macedonia and Serbia. In 2019 the share of informal workers was highest in Albania (about 37%), while North Macedonia and Serbia had a similar share of around 16%[7]. The World Bank estimates suggest that the informal employment rate in 3 countries for which data are not available is closer to the level in Albania than in North Macedonia and Serbia.

Besides informal employment, the region is also characterized by vulnerable employment. Vulnerable employment is defined as a sum of self-employed and unpaid family members. In contrast to paid employment consisting of wage employees, vulnerable employment is usually associated with less job security and worse working conditions. The share of vulnerable employment in the region is higher than the EU average, but, as can be seen from Figure 1, it varies within the region. Moreover, the share of the most vulnerable group - unpaid family members - is far above the EU average. While there are not many

[4] Eurostat.
[5] Ibid.
[6] https://www.esap.online/social_scoreboard/?action=social_scoreboard
[7] LFS data, National statistical offices.

countries in the EU where the share of unpaid family members exceeds 1%, the share is almost double digit in some Western Balkan countries.

Figure 1 - The share of vulnerable employment in 2019



Source: ILO.

In contrast to the improvement of key labour market indicators over the past decade, the increase in wages is far less impressive. As a matter of fact, the real wages were mostly stagnant. In every country but Kosovo and Bosnia and Herzegovina annual real wages decreased at least in three years since 2012. However, between 2017 and 2019, real wages increased in every country but Montenegro. Recent real wage growth across the region can be explained by the combination of hikes in the minimum wage and the strong increase of wages in the public sector. Speaking in absolute terms, the gross average wage in the Western Balkans in 2019 was about EUR 650, with significant differences among countries. The lowest gross average wage was recorded in Albania (about EUR 440), while Montenegro had the highest gross average wage (about EUR 780)[8]. It should be borne in mind that the methodology for calculating the average wage varies between countries which leads to comparability issues (Arandarenko and Aleksić 2018). Compared with to the EU, the average EUR wages in the Western Balkans countries are 3 to 6 times lower. Of course, the difference is significantly smaller when wages are expressed in PPP dollars, because in the Western Balkans the costs of living are significantly lower than the EU average.

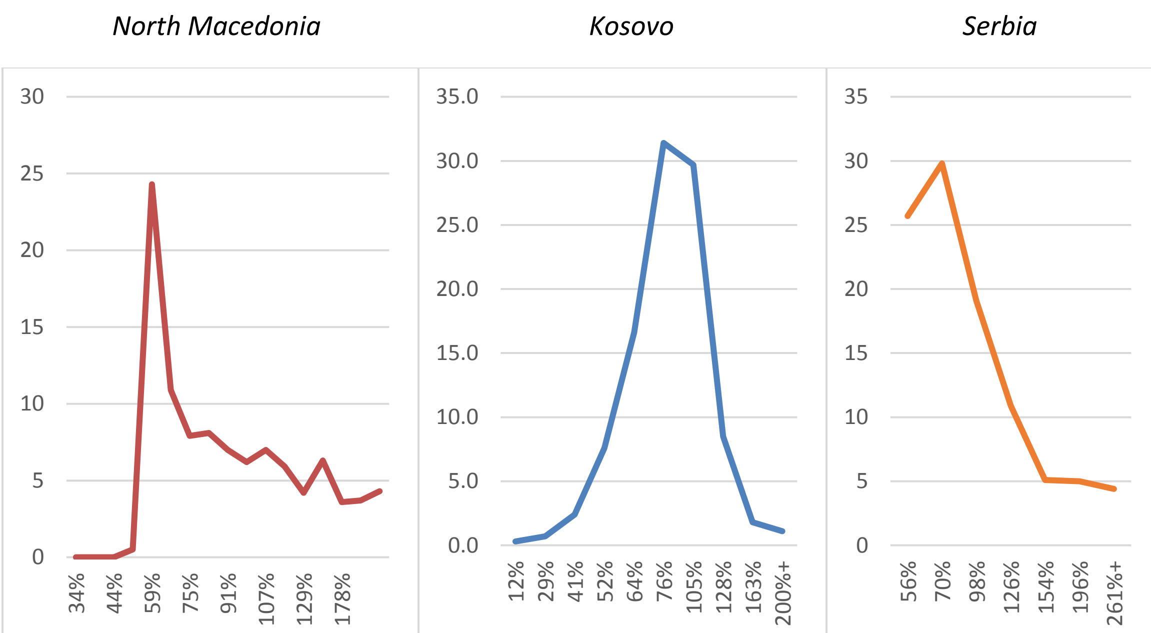
Since the Western Balkans is a region far less developed than the EU, the differences in average wages are not surprising and can mostly be explained by the differences in GDP per capita and the overall level of economic development. However, this explanation is largely irrelevant when it comes to the high prevalence of low-wage jobs, since they are defined in relation to national benchmarks. The Western

[8] SEE Jobs Gateway Database available at:
https://data.wiiw.ac.at/seejobsgateway-q-24700d30d110ea20eff4481b0.html

Balkan countries have a very pronounced right-skewed wage distribution, or the so-called positive-skew wage distribution. It is characterized by a long right tail and a mean far greater than median. The best way to get a hint of how the low wage jobs are spread in the Western Balkans would be to take a look at the complete wage distributions. Unfortunately, comparable wage distribution data are not publicly available.

Still, wage distribution data are obtainable for three countries - North Macedonia, Kosovo and Serbia. The distribution of net wages in 2019 for these countries is shown in the Figure below. It should be emphasized that the distributions are not completely comparable for several reasons. First, predetermined wage intervals vary by country, which is why the values on the horizontal axis differ. Second, while wages in Kosovo were obtained from the LFS, where respondents self-report their wages, wages in North Macedonia were obtained from the Establishment Survey (called TRUD) and in Serbia from the combination of the establishment survey (RAD) and tax administration data, where the data are taken from firms' or tax administration records. Despite all shortcomings, it can be concluded that all three countries have significant shares of low wage workers. More than half of workers in North Macedonia earned less than three quarters of the average wage, while the shares for Serbia and Kosovo were 57% and 59%, respectively.

Figure 2 - Net wage distribution in % of the average wage in selected Western Balkan countries (2019)

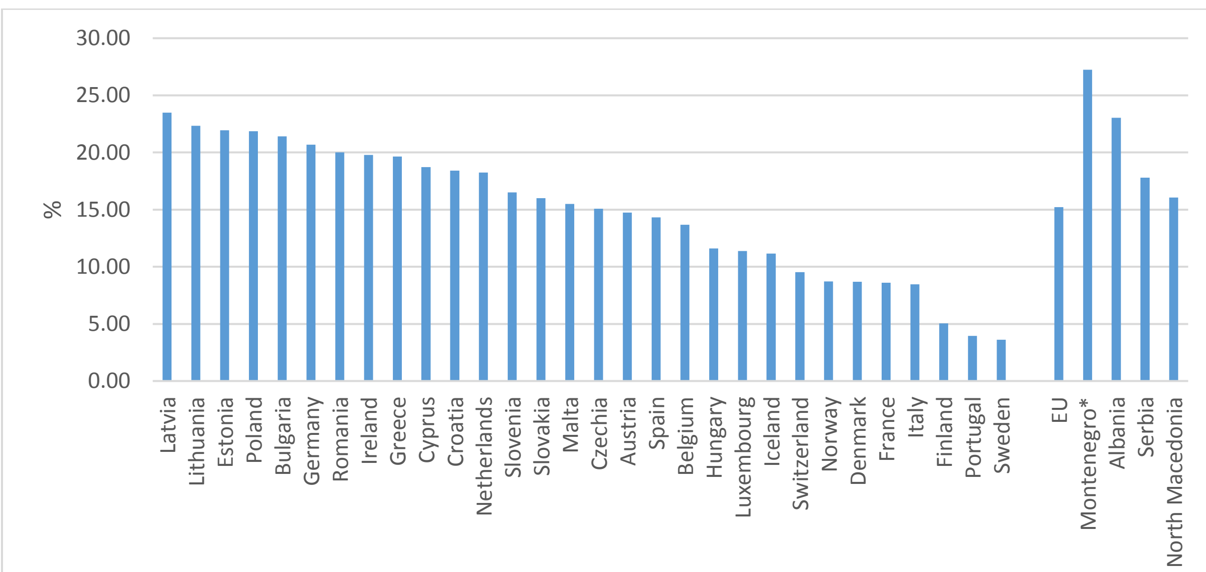


Source: TRUD for North Macedonia, RAD and Tax data for Serbia and LFS for Kosovo (only male wages).

In the rest of this section, our estimates of the share of low-wage earners are given, based on the Structure of Earnings Survey (SES) which is conducted every four years in the EU Member States and in some candidate countries. It is a high-quality employer-based individual wage dataset. The SES uses the standard definition of low wage earners developed by the OECD. It is a relative concept, where every worker who receives less than two thirds of the national median wage is considered as a low wage earner. This means that our analysis will focus not on the whole distribution, but at the point estimate – the percentage of low wage earners. The results are thus broadly comparable between the countries and over time.

North Macedonia was the first country in the region to conduct the SES in 2010. Montenegro and Serbia joined in the following wave, while the SES in Albania was for the first time implemented in 2018. The latest available data on low wage earners are presented in Figure 2. With a share of above 21% in 2018, the Western Balkans had a higher prevalence of low wage earners than the EU-28 and any neighbouring country except Bulgaria. However, the share of low wage earners significantly differs within the region. Closest to the EU average was North Macedonia with a share of 16.1%, while over 27% of workers earned low wages in Montenegro. Having in mind the overall trend, the share in Montenegro was probably somewhat lower in 2018, but data are not yet available. North Macedonia and Serbia were the two most successful countries when it comes to reducing the share of low wage earners from 2014 to 2018, by 9 p.p and 5 p.p, respectively. These results were achieved to a large degree due to significant increases in the minimum wage. A major minimum wage reform in North Macedonia in 2017 and significant increases of the minimum wage in Serbia in 2017 and 2018, after it was held frozen for 3 years, were the main factors behind the reduction in the share of low wage earners.

Figure 3 - Low wage earners in 2018



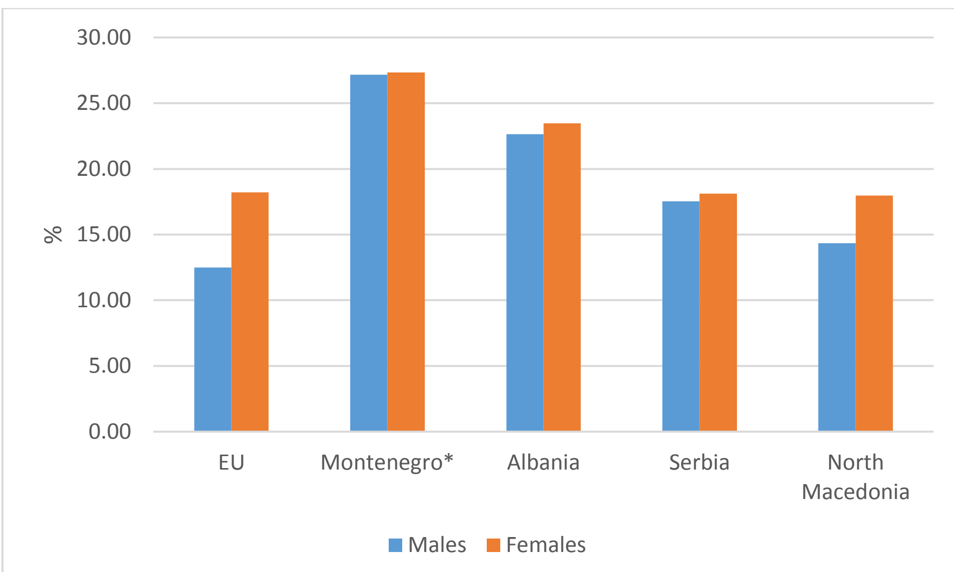
Source: Eurostat, SES. Note: * 2014 for Montenegro

It should be noted, however, that SES is less representative of the overall population of waged employees in the Western Balkans than in the EU countries. This is because the sub-population of wage earners not covered by the SES – that is, formal employees in micro firms and unincorporated businesses, as well as waged employees in informal businesses regardless of business size – makes up a larger share of the total wage-earner population in the Western Balkans than in most, if not all, EU countries.

Still, it is unclear whether the share of low-wage earners in the Western Balkans would rise further above the EU average if all waged employees were taken into account. This is because the inclusion of a large section of mostly low-wage workers outside the SES universe reduces both the median and the mean wage in uncertain – but possibly similar – proportions. However, if the threshold is kept at the level defined by the SES wage distribution, that share would clearly be much higher.

The probability of receiving low wages largely depends on the demographic characteristics of workers and the characteristics of jobs. Some groups that are traditionally considered as vulnerable in the labour market tend to have a higher share of low wage earners among them. However, this may not be true for every vulnerable group and every individual country. Interestingly, following the general pattern of gender inequalities in the Western Balkans, with the above-average employment gap and below-average pay gap, the gender gap for the low wage earners is lower compared with the EU average. With the exception of North Macedonia, it could be said that this gap barely exists. In contrast to the EU where the share of low wage workers among females was about 6 p.p. higher than among males, the corresponding gender gaps in Albania, Serbia and Montenegro were under 1 p.p. This is mostly due to the low labour force participation of women with low level of education. In a way, there is a trade-off between the large employment gender gap and low wage gender gap in the region (Avlijaš et al. 2012)

Figure 4 - Low wage earners by sex in 2018



Source: Eurostat, SES. Note: * 2014 for Montenegro

Similar to the vulnerability pattern for women, the second broad vulnerable group - young people (defined here as persons below the age of 30) - were not particularly exposed to low wages either. The share of young low wage earners in Albania in 2018 was similar to the one in the EU (about 26%), while Serbia and North Macedonia had noticeably lower shares (22.1% and 19.5%). The only outlier was Montenegro where the share of low wage earners among the young was highest in Europe with the value of 43.3%.

Unlike in the EU, where the share of low wage earners related to age had a “U” shape - with young and old having the highest share, the age-related share of low wage earners in the Western Balkans was monotonous - it decreased with age. This pattern can be partly explained by the existence of a mandatory wage premium on either total years of work experience or at least on tenure with the current employer.

As in the EU, higher education provides a strong shelter from low wages also in the Western Balkans. On the other hand, the low educated persons are disproportionately vulnerable in the Western Balkans. While the share of low wage earners among those with primary education in the EU amounted to 27% in 2018, the Western Balkans average was as high as 43%. Especially exposed were the low educated people in Montenegro (62%) and in Albania (46%). This is also due to the composition effect, with on average a higher share of low-skilled among the wage earners in the Western Balkans.

When it comes to the distribution of low wage earners across sectors of economic activity, the one in the Western Balkans largely overlaps with the EU. The highest probability of being a low wage earner was reserved for employees that worked in the Accommodation and food service activities and Administrative and support service activities, while the lowest share was observed for employees that worked in the Electricity, gas, steam and air conditioning supply.

3. Labour taxation

For well over a decade, the taxation of labour has been singled out as one of the most problematic institutional features of labour markets in the Western Balkans. Initially, emphasis was put on the presumed negative effects of high labour tax wedges on job creation and investment, especially in labour-intensive low-wage industries, and on disincentives for the formalization of informal employment (Arandarenko and Vukojević 2008). Koettl and Weber (2012) and Koettl (2012) emphasized the interaction between labour taxation and the social benefit system, and found a very high effective marginal tax rate at the point of formalization – typically around the minimum wage - in the region. Furthermore, Koettl (2012) singled out the rules regarding the minimum social contribution base as an impediment to the growth of formal part-time jobs and to improvements in the work-life balance, especially in view of the high gender employment gap. Labour taxation was highlighted as one of the main factors affecting job growth in the analysis conducted by Kovtun et al. (2014). More recently, the high inequality of disposable income in the region has been explained partly as a consequence of an apparent failure by labour taxation systems to reduce market income inequality (Arandarenko et al. 2017, Jusić 2018).

However, frequent changes in labour taxation rules within countries and the substantial differences found in those rules among the six Western Balkan economies call for a careful country-by-country analysis. While earlier analyses reported comparatively high tax wedges, more recently the variability in taxation rules and tax wedges across the region has increased.

Still, two important and long-standing features appear to be common or dominant (though not universal) across the region. The first is the reliance on social security contributions as the main component of labour taxes; they comprise the bulk of total revenue from labour taxation, while the personal income tax component remains marginal or modest, at best. The second, stemming to a significant degree from the first feature, is the low progressivity of labour taxation, as measured by the tax wedge differentials at various points of the wage distribution.

The system of individual income taxation (where the unit of taxation is an individual rather than married couple) is applied in all countries of the Western Balkans. Almost every country in the region has a personal allowance which ensures some indirect progressivity of income tax schedules. The single exception is Montenegro in which, starting from the first earned euro, tax amounts to 9% of gross salary. The only country that has a family allowance is Bosnia and Herzegovina. The tax allowance for dependent spouse and/or children exists in both entities - Federation of Bosnia and Herzegovina and Republika Srpska.

The only two countries in the region that have at least two different marginal tax rates are Albania and Kosovo[9]. An increase of marginal tax rates with the increase of income provides direct progressivity to the labour taxation system. Besides the 0% tax rate, Albania has two and Kosovo has three marginal tax rates. However, the highest marginal tax rate in Kosovo is just 10%, which is the lowest maximal marginal tax rate among European countries that have progressive labour taxation. A somewhat higher maximal tax rate of 23% is observed in Albania. Still, compared with top marginal tax rates of other EU countries, it is well below average. Since the tax progressivity in only two countries that have a directly progressive labour taxation is moderate at best, adding up other countries that have only indirectly progressive labour taxation will only reduce the already low region's average level of taxation progressivity. Some type of pseudo-progressivity in Serbia is ensured by the existence of annual income tax consisting of two marginal tax rates. The annual income is not limited to labour income only, but also includes the income of other factors of production. However, it affects under 1% of all personal income taxpayers, so the contribution of annual income tax to overall progressivity is marginal. Furthermore, for labour income the total tax wedge becomes regressive once the annual income tax kicks in, because at that income level (effectively around five times the average salary) social contributions are no longer paid.

According to the tax base for the personal income tax, Western Balkan countries can be placed in two groups. The first consists of those countries in which personal income tax is levied on the gross wage after the deduction of the personal allowance. Albania, Kosovo, Serbia and Montenegro are following this approach, though in Montenegro the personal allowance does not exist so the base is the gross (market) wage. In the second group, the tax base for personal income tax is somewhat lower. The personal income tax is levied on the gross wage reduced not only by the personal allowance, but also by social security contributions. This type of calculation is practised in North Macedonia and Bosnia and Herzegovina. The

[9] Montenegro also has at least two marginal tax rates. Workers that have wages over 750 EUR are obliged to pay relatively more (11% vs 9%). However, a higher marginal tax rate was introduced as a crisis measure so it can be considered temporary (and it was indeed withdrawn in 2020). Another distinctive feature of labour taxation in Montenegro is the existence of surtax. The taxable base for surtax is personal income tax, while the surtax rate varies from 10 to 15%, depending on the region, and is specifically earmarked to provide revenue for local governments (i.e. surtax rate in Budva is 10%, 15% in Podgorica and Cetinje and 13% in other regions).

tax base in Bosnia and Herzegovina is even smaller since the gross wage is also reduced by the family allowance.

Social security contributions make the bulk of labour taxes in all Western Balkan countries. Another thing that is common for all countries in the region is the main components of social security contributions (SSCs). They are pensions, health and unemployment, listed by importance. However, there are some exemptions. For example, besides the standard contributions, Republika Srpska has an additional type of insurance - child care insurance. On the other hand, Kosovo does not have either unemployment insurance or health insurance. Actually, health contributions were introduced in 2017, but have not been implemented yet.

Although the main components of SSCs are more or less the same in all Western Balkan countries, there are significant variations across countries regarding the distribution of the SSCs burden on employers and employees. In one corner is Albania, where employers pay a higher portion of SSCs than employees. The opposite is observed in North Macedonia and Republika Srpska, where SSCs are entirely paid by employees. In the middle is Kosovo, where SSCs are split equally between employers and employees. Finally, Federation of Bosnia and Herzegovina, Montenegro and Serbia lean towards North Macedonia and Republika Srpska, since the larger part of SSCs is paid by employees.

In general, the rates, as well as the minimum and maximum base, of SSC that are in place for wage employees also apply to self-employed. However, Western Balkan countries do not have significant tax incentives for self-employed. As a result, the practice of false self-employment is not widespread in low-wage sectors, such as construction and manufacturing. Instead, false self-employment is more frequently encountered in high-wage sectors such as Information and Technology, Business and consulting etc. Since the regulations allow certain categories of self-employed to pay lump-sum taxes and contributions up to very high income thresholds, it can be observed that taxation of self-employment is even less progressive (and quite often outright regressive) than wage employment. A brief discussion about the taxation rules for self-employed persons in the selected Western Balkan countries is presented in the box below.

On the other hand, labour taxes for service contractors and workers on temporary employment contracts typically are equivalent to the ones for workers with standard employment contracts. Due to mandatory minimum bases for SSC, part-time workers may face higher tax wedges than their full-time peers. In Serbia, for example, casual student work faces a not-insignificant tax wedge of 29%, inclusive of a mandatory fixed service fee rate set by a cartel of service providers (so called student co-operatives), and both personal income tax and VAT. Students, on the other hand, do not have pension insurance and hardly any health benefits.

Overall, the increased share of temporary workers cannot be ascribed to a lighter taxation of atypical work. In some cases, this reflects the importance of seasonal work (e.g. in Montenegro), while it more generally represents a secular trend related to flexibilization of labour market institutions and waning trade union power. Simply, firms opt to employ workers on flexible contracts because they can pay them less and make them work harder.

Taxation of income from self-employment

ALBANIA - Small businesses that generate annual turnover of up to ALL 2 million are subject to a fixed tax obligation that varies according to the type of business activity and the location of the business. Self-employed that generate more than ALL 2 million are subject to tax at a rate of 10%. The tax base equals the difference between total gross income and total deductible expenses. The self-employed are liable to pay for themselves a mandatory SSC, made up of a social insurance contribution of no less than 23% of the monthly minimum salary and health insurance contribution of 3.4% on no less than the double minimum salary. As can be seen, health SSC for employees and self-employed persons is the same (3.4%), but pension and unemployment contributions are 1.5% p.p. lower for self-employed persons. Furthermore, SSCs minimum is the same, while maximum SSCs is also lower for self-employed.

KOSOVO - Self-employed with an annual gross income of EUR 50,000 or less are taxed at 3% (for activities such as trade, transport, agriculture and similar commercial activities) or 9% (for services, professional activities, entertainment, etc.). Self-employed with an annual gross income of up to 50,000 EUR and those who have voluntarily chosen to be taxed on real income, are taxed at the same progressive personal income tax rates as employees, only defined on an annual basis.

MONTENEGRO - According to the type of activity, self-employed are divided into four groups. Every group have a different predetermined lump sum deduction, ranging from 35% to 75%. Taxpayers in each of the four groups are further classified according to the amount of annual turnover, ultimately giving the total amount of fiscal liabilities.

NORTH MACEDONIA - The base for Personal Income Tax calculation for the income out of an independent activity is the net income (the difference between total income and total expenditures of the taxpayer) assessed in the Annual Tax Balance. The SSCs basis for self-employed cannot be lower than the average salary per employee in North Macedonia, while in case of employees the minimum is 50% of the national average salary. There are differences in the maximum base of SSCs also. In case of self-employed persons, the maximum is 1,200% of the average salary, while in case of employees it is 1,600% of the average salary.

SERBIA - Self-employed can choose one of three options. The first option - lump-sum taxation - implies a fixed monthly amount that is predetermined and unrelated to the actual income. It only depends on pre-assessed income, which is based on a variety of criteria like the sector of activity, location, etc. The threshold annual income for this option is some EUR 50,000. The tax rates are the same as for employees, except if a self-employed also holds a waged job, in which case he does not need to pay the health and unemployment insurance. The second option is self-taxation. In this case the self-employed pays the full amount of SSCs and personal income tax on actual income and thus needs to prepare balance sheets. The third option gives the self-employed the possibility of paying their personal earnings. Standard rates of SSCs and personal income tax are applied on those earnings, like for regular employees. However, self-employed that choose this option also need to pay 10% on income from self-employment (difference between actual income and actual costs).

In the past decade, numerous reforms of elements of labour taxes can be observed in almost all tax jurisdictions in the region; but hardly any of them could be said to have brought about a profound change, even if they have formally involved a shift from flat to progressive taxation (or vice versa). The most important changes are presented below, country by country. A more detailed discussion of the motivation for and limitations of these reforms, as well as of the underlying policy strategies regarding the tax-benefit systems in the region, will be presented in Section 5.

Albania

In 2014, the taxation of employment income changed from a flat-rate tax regime of 10% to a progressive tax scale. Monthly employment income of up to 30,000 Albanian lek (ALL) is exempt from taxation; income of between ALL 30,000 and ALL 130,000 (approx. EUR 215 and EUR 930) is taxed at 13%; and any income above ALL 130,000 is taxed at 23 %. The first ALL 30,000 of employment income is thus income tax exempt. It is interesting to note that under the previous tax regime, the tax-exempt amount was the same; however, employees earning more than ALL 30,000 per month were taxed at 10 % on their entire wage, resulting in a marginal effective tax rate of well over 100% immediately above that threshold point. In 2019, the lower threshold for the highest tax rate was increased from ALL 130,000 to ALL 150,000. Finally, in January 2021, the minimum and maximum salary for social and health contributions purposes increased. The new minimum salary is ALL 30,000, whereas the new maximum salary is ALL 132,312.

Bosnia and Herzegovina

In the past 10 years, there have been several labour taxation changes in Republika Srpska, while the labour taxation regime has remained practically unchanged in the Federation of Bosnia and Herzegovina. In 2011, Republika Srpska increased its headline personal income tax rate from 8% to 10% and its SSC rates from 30.6% to 33%. In 2012, a minor tax-wedge and revenue-neutral correction of SSC rates was introduced, with the pension contribution rate rising from 18% to 18.5%, and a corresponding decrease in the health insurance contribution from 12.5 to 12%. Between 2014 and 2016, there was a “solidarity contribution” of 0.4% on wages and pensions above 500 convertible marks (BAM), to help alleviate the consequences of the 2014 floods. In September 2018, the personal tax-free allowance was increased by 150%, from BAM 200 to BAM 500, resulting in an increase in nominal wages. In 2021, the personal tax-free allowance was further increased to BAM 700. At the same time, the family allowance for every dependent family member was increased from BAM 75 to BAM 150. Unlike in the Republika Srpska, the personal tax-free allowance in the Federation of Bosnia and Herzegovina has not changed for years. Finally, the 0.2 p.p. of unemployment insurance in Republika Srpska were reallocated to contributions for child protection (increased from 1.5% to 1.7%). Unemployment insurance was further reduced to 0.6% in 2020.

Kosovo

In 2009, personal income tax rates within the then moderately progressive tax system were slashed: wage income of up to EUR 80 per month is not taxed; for income between EUR 80 and EUR 250 the tax rate was reduced from 5% to 4%; for income of between EUR 250 and EUR 450, it was reduced from 10% to 8%; and for income of above EUR 450, it was cut from 20% to 10%. As of July 2017, health contribution rates have been introduced, with a combined employer–employee rate of 7% of the gross wage (though this has not yet been implemented). Pension contribution rates have remained unchanged, with a mandatory contribution rate of 10% (5% each for employee and employer) and with the possibility of contributing up to 30% of the gross wage on a voluntary basis.

Montenegro

Montenegro introduced a flat tax reform in 2007, with a headline rate of 15 % and the aim of gradually reducing it to 9%. By 2010, that goal had been achieved. However, in early 2013 fiscal hurdles brought about the introduction of a so-called "crisis" tax, when a higher personal income tax rate of 15% was introduced on net monthly wages exceeding EUR 480 (about the average wage level). This "crisis" tax has been gradually reduced, but has not been revoked. In 2018, it stood at 11% of monthly gross wages above EUR 750 (roughly the average wage). In the middle of 2019, the Government announced a reduction of the health contribution paid by employers from 4.3% to 2.3%. A major reform package is planned for 2022. It will include the introduction of the personal allowance of EUR 700, progressive taxation of wages over EUR 1,000 and the abolition of health insurance. Early estimations suggest that the tax burden will be hugely reduced, from 40% to 21%. In addition to tax changes, the minimum wage will be doubled from around EUR 220 EUR to EUR 450.

North Macedonia

North Macedonia had a major labour tax overhaul in 2007–2008, introducing a flat tax with a low headline rate of 10% and reducing the tax wedge. The early effects of that reform on employment have been assessed favourably by Mojsoska-Blaževski (2012). In 2019, the Government introduced progressive taxation with the adoption of the new Law on Personal Income Tax. According to the original design, a higher tax rate of 1% was levelled on monthly incomes of over MKD 90,000 (about EUR 1,460). However, the effects of this change were mild at best – the Ministry of Finance has stated that the threshold was selected because it only affects the highest-earning 1% of the total population. In mid-2019, the Government decided to roll back the progressive taxation mainly because of two factors. First, there was a minor improvement in inequality of income distribution, namely just under 1% reduction. Second, tax avoidance was high. According to one assessment real tax revenue collected from progressive taxation in the first 6 months in 2019 was 51.2% lower than potential[10]. The progressive tax rate on individual income will be postponed until at least 31 December 2022. In accordance with the newest reforms, mandatory contributions for pensions and health insurance were also increased – by 0.8 p.p and 0.2 p.p., respectively.

Serbia

Serbia introduced a flat tax reform in 2001, with a headline personal income tax rate of 14% and no tax-free allowance. A tax-free allowance was introduced in 2007 to compensate for changes in the personal income tax and SSC rates. This allowance is adjusted annually – either to reflect real wage trends or to rebalance the tax wedge in a revenue-neutral and distribution-neutral fashion. The personal income tax rate stood at 12% between 2007 and 2012; since 2013 it has been 10%. In 2013, to compensate for the reduction in the personal income tax rate, the employee pension contribution rate was raised by 2

[10] https://finance.gov.mk/mk/node/8323

percentage points, thus increasing the total SSC rate to 37.8% of the gross wage. The pension contribution rate was increased by an additional 2 percentage points in 2014, but at the same time the health contribution rate was reduced by the same rate, leaving the tax burden unchanged. In order to accept the increase in the minimum wage, the Government bribed employers by reducing the labour costs in 2019 and 2020. This was done by abolition of contributions for unemployment paid by the employers firstly and then by lowering the pension and disability contribution paid by the employers from 12% to 11.5%.

4. The size and structure of labour tax burden in the Western Balkans

The total labour costs to an employer of a waged employee can be expressed as the sum of what the worker gets in terms of take-home pay and all the labour taxes paid in relation to the worker's net wage (most notably, personal tax on wage income and social security contributions). The ratio of labour taxes to total labour costs is known as the "tax wedge". In other words, the tax wedge measures the proportional difference between the cost of a worker to his/her employer and the employee's net take-home wage. It therefore measures both the incentive to work (labour supply side) and to hire employees (labour demand side). Put differently, the higher the tax wedge, the greater is both the disincentive for someone to work and the disincentive for an employer to hire a worker.

However, in most modern jurisdictions, not all workers face the same (absolute or relative) tax burden. Typically, lower wages are taxed less than higher wages. Furthermore, having a spouse and dependent children often reduces the tax base, thanks to family allowances. In some countries, there are additional tax reliefs.

Since workers at various wage levels and with various family statuses face different tax wedges - not to mention further potential variations in the tax treatment of an individual within a country - it becomes complicated to make an international comparison of the labour tax burden. To make such a comparison meaningful, one or more representative individuals or families may be used for each country. The OECD, the top authority in the field, uses eight such hypothetical family types in its flagship publication (OECD, 2018). The model family types vary by marital status, number of children and economic status: a single taxpayer, without children, earning 67%, 100%, and 167% of the average wage (AW); a single parent, with two children, earning 67% of the AW; a single-earner couple at the AW level, with two children; a two-earner couple at 133% and 167% of the AW, with two children; and a two-earner couple, without children, at 133% of the AW.

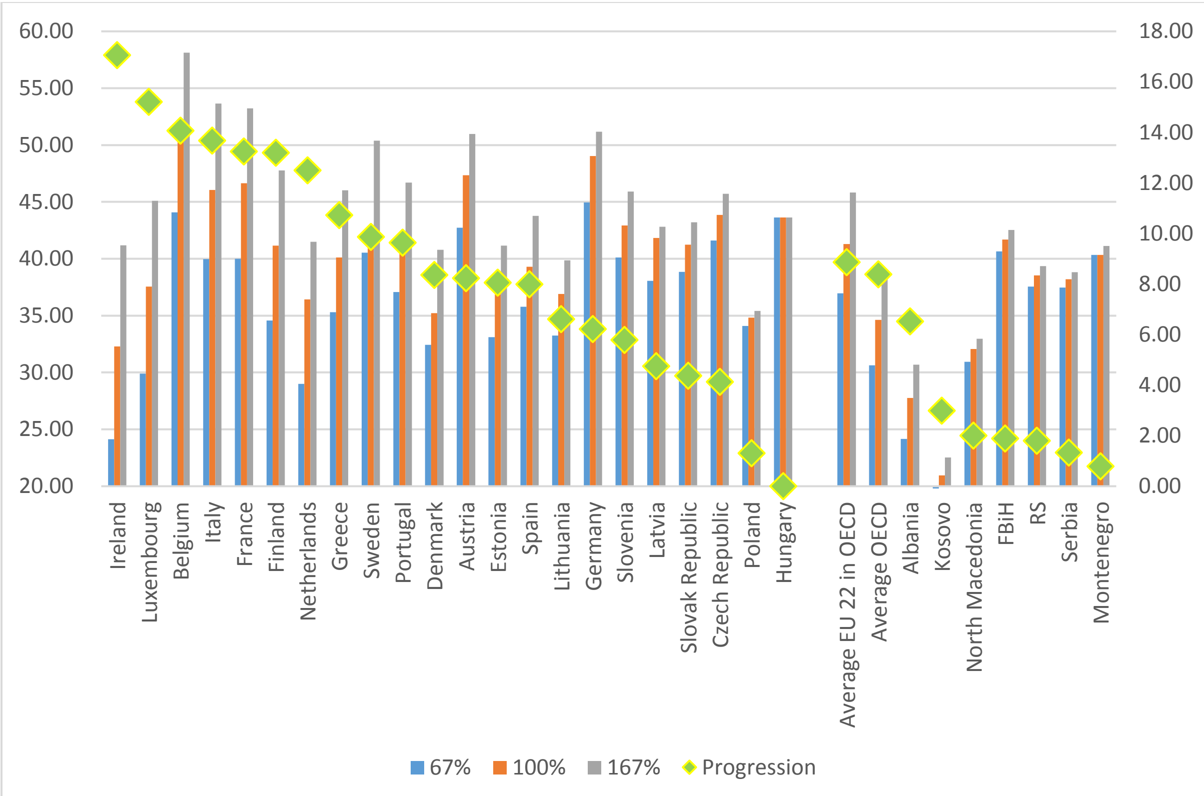
The main advantage of the OECD approach is its simplicity. Instead of calculating the actual average (or median) tax burden on labour in the economy – most likely, a complicated and imprecise endeavour – the statutory tax burden on a hypothetical ("representative") worker earning the exact average wage is calculated, and the exact tax wedge for such a worker is easily obtained. In fact, the tax wedge for a representative single worker without children at 100% of the average wage is often used as a sufficient proxy for international comparisons of the tax burden on labour. However, in case of the Western Balkan countries, characterized by very low progressivity in the taxation of labour, such a practice could be seriously misleading.

Tax wedges for a single worker without dependents

Figure 4 shows that there is quite a diversity of tax burdens within the region. High tax wedges at the average wage level are found in Montenegro (40.3%), Serbia (38.2%), and Bosnia and Herzegovina (Federation of Bosnia and Herzegovina – 41.7%; Republika Srpska – 38.5%). These figures are close to the average of EU22 that are members of OECD (41.3%) and are above the OECD average of 34.6%, taking into account that the highest labour tax wedges worldwide are to be found in the European Union. Furthermore, whereas labour taxes in these three countries are on average at higher wage levels, they are high at lower wage levels, due to the low progressivity of the income tax regimes. North Macedonia has a moderate tax wedge (32%), while Albania and Kosovo have low to moderate tax wedges (27.8% and 20.9%, respectively). These regional differences between high and low tax-wedge countries are driven not by the level of personal income tax rates or by the divide between the flat and progressive personal income tax systems, but by the difference in SSC rates.

Another key finding, largely stemming from the low personal income tax rates, is that in five of the six Western Balkan countries (except Albania), workers face small increases in their average tax burden as they progress to higher wage levels. While the average increase in the tax wedge between 67% and 167% of the average wage is 8.9 percentage points in the EU22 and 8.4 percentage points in the OECD, in those five Western Balkan countries the increase is between 0.8 and 3 percentage points. Only in Albania does it come close to the international averages, with 6.5 percentage points.

Figure 5 - Labour tax wedges in Western Balkans for a single worker at 67%, 100%, and 167% of average wage, in a comparative perspective

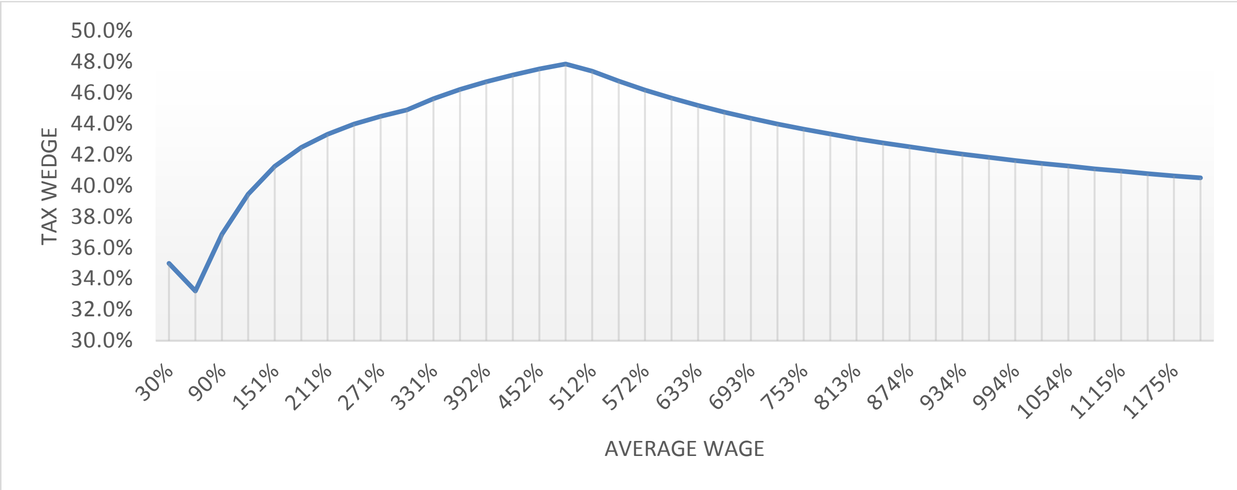


Source: Authors' calculations for Western Balkan countries; OECD for others.

Not only do the Western Balkan countries have less than average tax progressivity between the 67% and 167% of the average wage, but areas of regressivity can also be found if the whole distribution is observed. Take Serbia as an example. As can be seen in Figure 5, the tax wedge decreases two times across the wage distribution, both times because of the tax schedule of SSCs. The minimum SSCs base results in a higher tax burden for workers earning 30% of the average wage compared with workers who earn up to 90% of the average wage. However, since the national minimum wage is set at about 50% of the average wage, this applies only to low wage workers who work on part-time jobs. Some researchers pointed out that the minimum base is one of the biggest obstacles to the expansion of part-time jobs (Kovačević et al. 2017).

On the other hand, the maximum base set at 500% of the average wage continuously reduces the tax burden as the wage increases. The inclusion of annual income tax paid by not more than 1% of taxpayers will moderately slow the drop in the tax wedge for higher wages, but the regressive character of labour taxation will not disappear. Even after accounting for annual income tax, instead of 23%, the tax wedge is 29% for the salary equal to twelve times the average salary in Serbia. In other words, the annual income tax does not have the potential to overcome the existence of a ceiling for the SSCs.

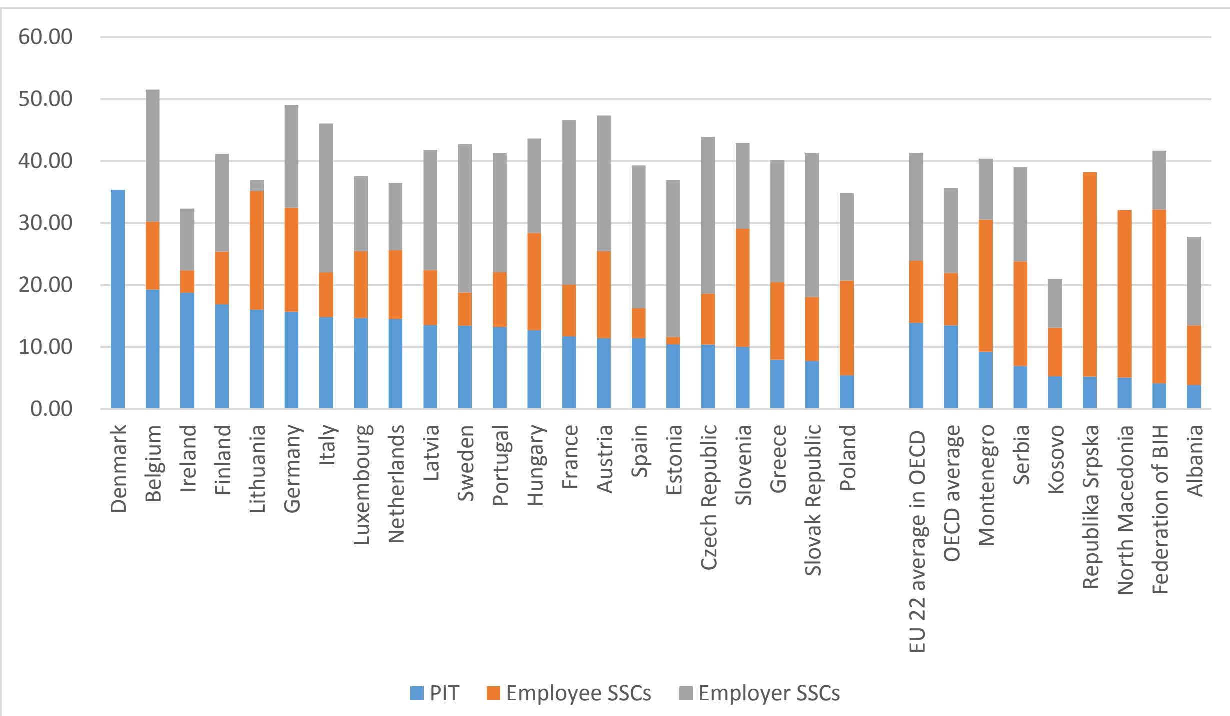
Figure 6 - Tax wedge across the wage distribution in Serbia, 2020



Source: Authors' calculations.

In most countries, SSCs represent a larger portion of the non-wage labour costs than does personal income tax. In Figure 6, the only exceptions are Denmark and Ireland. However, nowhere is this feature more pronounced than in the Western Balkans.

Figure 7 - Tax wedge components as a percentage of labour costs, single workers without dependents, on the average wage

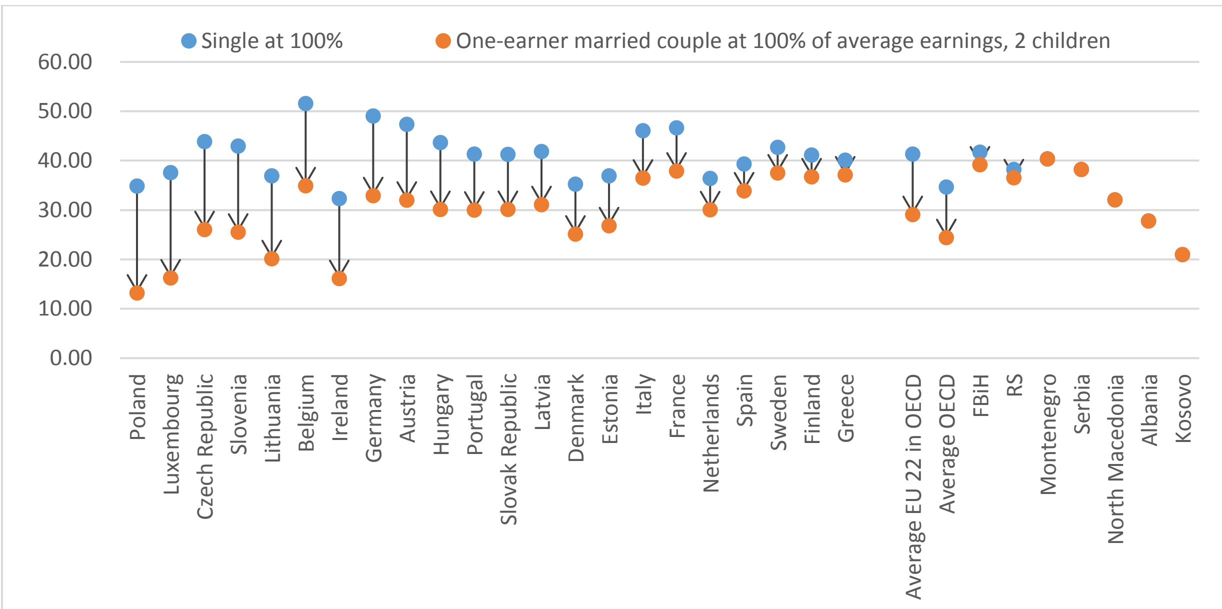


Source: Authors' calculations for Western Balkan countries; OECD for others.

Tax wedges for a one-earner couple with two children

The lack of tax-free family allowances (except for comparatively small amounts in Bosnia and Herzegovina) suggests that the effective tax burden per employee should be even higher from a comparative perspective than if only single workers without dependents are taken into account. Figure 7 supports this assumption by showing the difference between the tax wedge for a single worker earning 100% of the average wage and the tax wedge for the same worker with a non-employed spouse and two children. For the latter family, in terms of the tax wedge, Montenegro shifts its ranking from 13th place to the top of all countries in the graph; Serbia moves from 14th place to 2nd; and so on.

Figure 8 - Comparison of tax wedge for a single worker (100%) and one-earner couple with two children (100+0%)



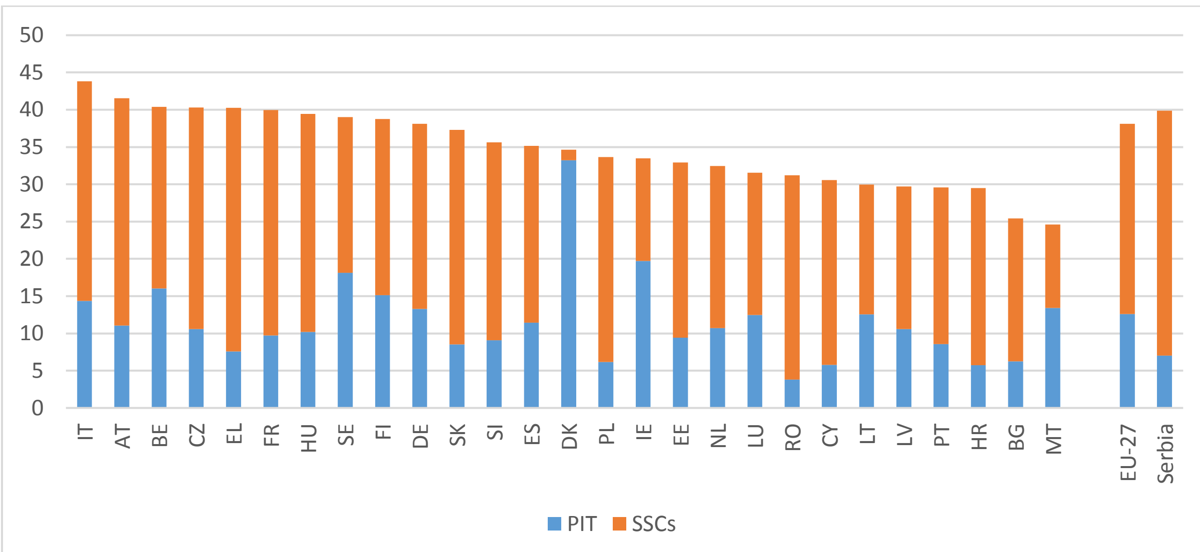
Source: Authors' calculations for Western Balkan countries; OECD for others.

The absence of family allowances and many deductions partly explains why the Western Balkan countries are able to collect a similar share of GDP in revenue from labour taxes as more developed European countries that have much higher employment rates. In the Western Balkans, the high tax wedge observed in Montenegro, Serbia, and Bosnia and Herzegovina applies to all workers in almost the same percentage, regardless of their income or family situation. In most other countries, tax wedges are in practice lower for lower-income workers or those with dependents.

A similar conclusion can be drawn from the other indicator of the tax burden on labour income - the implicit tax rate on labour. It is operationally defined as the ratio of the sum of total labour-related taxes and contributions and total labour costs for all employees in the economy. The implicit tax rate is actually a summary macroeconomic indicator collected from the balance sheet items of national accounts. In this regard, while the tax wedge is a measure of the tax burden at different points in the wage distribution for a hypothetical worker, the implicit tax rate on labour is an aggregate measure of the actual average tax burden for all declared work in the economy.

Data on the implicit tax rate on labour are available from Eurostat, but only for the EU Member States. As detailed macroeconomic data that would allow the calculation of a precise implicit tax rate on labour for the Western Balkan countries are not available, it is possible to make an approximation based on the Labour Cost Survey. The Labour Cost Survey contains, among other things, the sum of net salaries, gross salaries and labour costs of employers. Using the Labour Cost Survey data, we calculated the implicit tax rate on labour for Serbia and decomposed it into taxes and contributions. Decomposition of the implicit tax rate on labour for Serbia and EU countries is presented in Figure 8.

Figure 9 - Decomposition of the implicit tax rate on labour



Source: Labour Cost Survey for Serbia, Eurostat for others.

The decomposition of the implicit tax rate on labour provides a similar picture as the decomposition of the tax wedge. While personal income tax makes up about a third of the collected income from labour taxation in the EU countries, the corresponding share in Serbia is only 18%. In addition to the disproportion between the tax revenues and revenues from contributions, the implicit tax rate points to another important feature of labour taxation in Serbia. An almost uniform rule is that the average tax burden for a representative worker (tax wedge for a single worker earning exactly the average wage) is greater than the effective average tax burden (that is, the implicit tax rate on labour per worker). This relationship between the two indicators is conditioned by the existence of various personal and family allowances and tax deductions that reduce the actual tax burden. However, unlike in any EU country, in Serbia the implicit tax rate on labour is higher than the tax wedge for the average wage. Not only, but based on the tax wedge for the average wage, the tax burden in Serbia is somewhat lower than in the EU, while the implicit tax rate on labour is significantly higher than the EU average. Although we use Serbia as an example, this pattern is characteristic for most of the Western Balkan countries.

The question that arises is how is it possible that significantly lower employment rates in the Western Balkan countries generate similar revenues (in relative terms) from taxes and contributions as the EU countries that record significantly higher employment rates? The answer lies in the labour taxation system that is designed to maximize revenues by burdening the densest part of the wage distribution with above-average tax rates. The lack of personal and family allowances contributes to the fact that the largest number of workers, those with below-average wages, pays taxes and contributions that are much higher than those paid by their counterparts in EU countries. In this way, the high effective tax burden in the Western Balkans applied to a narrow base (due to a relatively low employment rate) generates a similar relative level of revenues as the on average lower effective tax burden in the EU applied to a much broader base (due to a relatively high employment rate). In other words, despite the relatively low employment rates, relatively high informal employment and the prevalence of envelope wages, the Western Balkan countries collect similar revenues (in relative terms) from taxes and contributions as the EU countries.

5. Conclusions

Our analysis in the preceding sections leads to the following conclusions. First, the overall level of labour taxes is too high in three out of six Western Balkan economies - Serbia, Montenegro, and Bosnia and Herzegovina – and also to some degree in a fourth economy - North Macedonia. Second, the structure of labour taxes, namely the relative shares of personal income tax and social security contributions in total labour taxes, is tilted heavily toward contributions in almost all countries. Third, the progressivity of personal income tax, already limited by the small weight of personal income tax in total non-wage labour costs, is non-existent or very modest in all countries except Albania. All these features taken together have a negative effect on the relative position of low-wage workers and low-wage industries, especially in high-wedge countries.

In the high tax-wedge countries of the Western Balkans, the low-wage, high-tax trap translates into less incentives to work for low-skill workers (at least in the formal sector), and, on the side of employers, into less incentives to hire low-wage workers and to invest in labour-intensive low-wage sectors. And this, in turn, leads to lower employment and activity rates, higher informality and higher income inequality.

The current structure of labour taxes has its roots both in the socialist past of the region's countries and in the historical context in which post-socialist reforms took place. In former socialist Yugoslavia, pre-tax income inequality was relatively low, and progressive taxes were not perceived to be required to redistribute income (as in market economies). Social contributions were relied upon to finance a series of social benefits, such as pensions, health, unemployment, and housing. In Albania, wage control was more direct, and again there was little ideological justification for progressive taxation. In addition, the post-socialist reforms of labour taxation in the Western Balkans coincided with, and represented an integral part of, the "flat tax revolution" that swept Central and Eastern Europe in the 1990s and 2000s, and that has slowly started to retreat only in the course of this decade. On a less ideological note, as less-appealing latecomers to transition and as riskier investment destinations, countries of the Western Balkans attempted to attract foreign capital by offering very low (at times single-digit) headline profit and personal income tax rates.

On the other hand, fiscal concerns and the need to finance pensions amid shrinking retiree–employee ratios have required high social security contribution rates. In effect, as has been shown, low personal income tax rates, coupled with high SSC rates and other specific rules (such as minimum mandatory social security contributions), have created high tax wedges that (a) are incapable of incentivizing investment, especially in low-wage sectors and firms, and (b) do not encourage formalization of informal employees and businesses. The interplay between the rising number of pensioners and the mostly stagnant employment has led to further pressure to increase pension contribution rates and/or to reform pension systems in order to enhance sustainability.

In effect, the Western Balkan countries have in recent years (and with the partial exception of Albania and North Macedonia) largely ignored the high level and unbalanced structure of non-wage labour costs, or have opted for fine-tuning measures that have only scratched the surface of the problem. Serbia, for example, has further painted itself into a corner by increasing the combined pension contribution rate from 22% to 24% and then to 26% in two revenue-neutral moves, first by reducing the personal income tax rate by 2 percentage points, and then by reducing the health insurance rate by 2 percentage points. In the past two years it has started the reverse process, by cutting the rate back by 0.5 points.

In order to improve their – at best – sluggish labour markets, the countries have instead opted for various other policy interventions. In an effort to improve the demand side of the labour market, Serbia (in 2014) and Bosnia and Herzegovina (in 2015) reformed their labour legislation to enhance flexibility. Montenegro is presently preparing a similar reform. On the other hand, Albania has chosen a different direction, amending the Labour Law in 2017 to widen workers' rights and to accommodate the requirements of European integration in the area of social policy and employment.

More recently, with certain improvements in quantitative labour market indicators, and with a generally more favourable macroeconomic situation, regional policymakers have started to pay attention to supply-side problems of stagnant wages, a shrinking working-age population (except in Kosovo and Albania), and increased emigration rates. A common impulse has been to increase the minimum wage, sometimes after several years of nominal stagnation and real decline. Trade unions favour a policy of increasing the minimum wage, but this cannot occur unless approved by the government. Unsurprisingly, finance ministries often look favourably on trade union initiatives because they see an increase in the minimum wage as a way of boosting labour tax revenues and reducing envelope wages.

Still, the strategy of minimum-wage increases has its natural limits. After a certain threshold (all other things being equal), any further increase in the minimum wage inevitably crowds out low-wage employment and low-wage industries. A recent empirical study (Petreski et al., 2019) found that the 2017 minimum-wage increase had positive, significant effects on wages in North Macedonia without negatively affecting employment (partly thanks to temporary government subsidies to low-wage industries that were to facilitate the transition to uniform national minimum wage that replaced sectorally differentiated minimum wages in 2017) and that its main beneficiaries were low-wage workers. However, based on scenario analysis, the authors warn that any further arbitrary increase in the minimum wage level above productivity growth (or GDP growth) may have a harmful effect on employment.

A comparison of the two main reform directions applied in recent years in the Western Balkans (and intended to improve the labour market situation) along with the hypothetical reform of labour taxation systems shows that the latter has some clear advantages. Both the “flexibility-enhancing” and the “minimum wage-increasing” reforms are, in principle, one-sided, zero-sum game reforms, and can bring benefits only if they help to restore a healthy balance in the labour market. However, for some time both the employment legislation index and the Kaitz index[11] throughout the region have been well within standard international values, indicating no major institutional disruption. Especially in labour legislation reforms, monetary gains for employers almost always imply monetary (and non-monetary) losses for employees. In the long run, such a reform may turn into a *negative*-sum game if it results in fewer employer–employee matches due to the withdrawal of members of the labour force from the formal labour market or to their emigration.

On the other hand, this analysis confirms long-standing findings that the labour taxation system in the region – and especially among the high-wedge countries – is far from optimal. Nevertheless, the reform of labour taxation has intrinsic win-win (positive-sum game) properties for both employers and employees. This is not just the case with revenue-negative reforms. It is well established that, under not so restrictive conditions, this should also be true for revenue-neutral tax reforms. In Pissarides’ (1998) theoretical elaboration, changes in the structure of taxation that are revenue-neutral can often have a larger impact on employment than a general tax cut that substantially reduces overall tax revenues. In bargaining and search models – which appear to be a good proxy for the regional labour markets – a more progressive labour tax shifts the wage-setting (labour supply) function to the right, with a large and positive impact on employment.

However, given the dominance of intrinsically proportional SSCs in the current structure of labour tax revenues in the Western Balkans, to sufficiently increase progressivity to produce the desired effect on the employment and/or wages of low-wage workers would require readjusting the shares of personal income tax and SSC in total labour tax revenues - by increasing headline personal income tax rates and reducing SSC rates - and at the same time introducing explicit progressivity of personal income tax. Naturally, this may generate widespread concern, in the first place among current and future pensioners, and may hamper the political viability of labour taxation reform.

Undertaking simultaneously a major reform of the entire system of labour taxation and social insurance is clearly a difficult and risky endeavour. Still, it is the most promising avenue for the revitalization of regional labour markets. The most important next step for policymakers and stakeholders is an informed and honest debate about the key features of social protection and, more specifically, pension systems.

Paradoxically governments, now faced with demographic decline, emigration and increasing labour shortages, are gradually changing their attitude and are becoming more labour-friendly. Still, in most Western Balkan economies it is the Covid-19 crisis upheaval rather than labour market institutions and policies that have created the breathing space for the governments to prepare a more thorough reform to make work pay, increase the labour share, and warm up the labour force to stay in the region instead of moving abroad. Among these pro-labour reforms, the most radical is certainly the one in Montenegro,

[11] Kaitz index is defined as the ratio of the minimum wage to the mean or median wage.

which should include, if it becomes effective in 2022, near-doubling of the minimum wage and a radical reduction in labour taxes, especially for the low-wage workers. Only time will tell whether such a huge leap was the right reform strategy.

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