



## Role and position of micro-businesses in BiH in the light of COVID-19 pandemic, Executive Summary

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### Introduction

COVID-19 crisis has had a tremendous economic impact in Bosnia and Herzegovina (BH). It is estimated that the country will enter a recession of 5%, which implies a number of negative economic indicators – decrease in exports, rise of unemployment and possible rise of interest rates, budget instability and the like. Of particular concern is the rise of unemployment and decrease in BH diaspora support, which is very important for the BH economy. COVID-19 has mainly endangered the service sector, i.e. all businesses that depend on the so-called "moment of truth" – the direct contact with customers. There are many micro-enterprises and crafts operating within the service sector, while freelancers are mainly exposed to the crisis due to the decrease in global demand for their services (exports).

So far, the main support for the BH economy was coming from the BH entities in the form of the so-called "corona" laws. In the Federation of BiH (FBH), it was a comprehensive law, passed relatively late in May 2020, while in the Republika Srpska entity (RS) there were series of regulations that were dealing with individual problems caused by COVID-19. The greatest importance of these laws refers to the stabilization of the economy,

through financing of a certain amount of contributions on salaries and net salary (from the cantonal level in FBH) for business enterprises that were blocked or that experienced an exceptional decline in revenues.

In addition, special guarantee funds were established, which yet have to be utilized by the businesses. A special type of measures refer to the support of the financial sector, in the form of a moratorium on loans. The moratorium was not mandatory, but a great number of banking and microcredit services clients were given the opportunity to use it. This partially alleviated the liquidity problem, especially of micro-businesses (individuals were the dominant beneficiaries of these measures). Freelancers and other representatives of the informal economy have not been the subject of direct support from various levels of governments in BH. Although individuals engaged in self-employment and crafts are covered by the existing measures, freelancers and other representatives of the informal economy are not.

In underdeveloped "transition" economies such as the BH economy, which is characterized with an unfavorable business environment, inadequately defined legislative framework and modest business financing opportunities, micro-enterprises



face a number of specific obstacles, largely caused by poor economic policies that hinder their development since they overlook their optimal potential. As the external sources of funding are generally less available to micro-enterprises, their representatives generally have less access to policy makers and decision-makers, or have less public, social or political influence, which makes them even more vulnerable in times of economic crisis.

The dramatic general decline in economic activity around the world that marked the 2020 has been the main argument for this research with an aim to determine the importance of micro-enterprises and self-employed people for the BH economy and to assess their capacity to cope with short- and medium-term economic consequences of the COVID-19 pandemic. The decline in economic activity caused by the pandemic was most severely experienced by the companies in tourism and service sectors, where micro-enterprises and the self-employed are the dominant actors. Finally, having in mind the previously mentioned share of micro-enterprises in the total economic activity of a national economy, the loss of jobs and businesses in this sector will inevitably affect the wider socio-economic situation in BH.

In the light of the current challenges induced by the economic crisis caused by the COVID-19 pandemic, and in order to strengthen the long-term position and status of micro-enterprises and self-employed people in BH, this study examines several key aspects of problems faced by entrepreneurs and employees based on:

- assessment of their participation in the economy,
- estimation of the number of formally and informally employed people,
- analyzes of the legal status of formally operating entities, and
- circumstances that obstruct their development and discourage persons in the informal sector from initiating formal businesses.

### Economic Relevance of Micro-Businesses

**The micro-business sector provides formal and informal employment to more than 400,000 citizens of BH.** Almost two thirds of all active enterprises in BH are micro-enterprises employing between one

to nine workers, while more than half of active enterprises are micro-enterprises providing employment to between one and five employees. Although the share of micro-enterprises in the total employment is far less than their share in the total number of enterprises, analyzes implicated that this sector (micro-enterprises with one to nine employees) provides jobs and livelihoods for more than 65,000 workers who during 2019 generated personal income amounting to BAM 960 million. The direct contribution to budget revenues is significant as well - in 2019, micro-enterprises contributed with BAM 720 million in net profit tax.

Despite the fact that comprehensive statistics on crafts in BH are lacking, the available data shows that in 2019 there were more than 73,000 active crafts in BH with more than 100,000 employees. Although the number of active freelancers is growing every year, BH has utilized only a small portion of the freelancing sector potential, which means that there is great potential for development. A conservative estimate is that around 8,000 freelancers are active in BH, contributing to the BH economy with BAM 91 million of net personal income and BAM 11 million of income for the state through the payment of income taxes and health insurance contributions. With a consumption multiplier of 5, their indirect contribution to aggregate consumption is estimated at BAM 453 million, and their contribution to collected VAT at BAM 66 million.

**The share of the informal sector in BH remains very high.** Estimates show that the number of undeclared workers ranged from 239,112 in 2014 to 250,266 in 2018, or ranging from 29.45% to 30.45% of the total employment, which is almost identical to the International Labor Organization (ILO) estimate..

### Financial Status of Micro-Businesses

**Micro-enterprises are burdened with large credit indebtedness and with obligations to suppliers. They mainly borrow from banks, while artisans, freelancers and representatives of the informal**

### **economy are mainly dependent on microfinance.**

Leasing and factoring companies are significantly underdeveloped compared to the rest of the financial sector. Micro enterprises sporadically use leasing services, mainly for the purchase of transport means. Financial operations of micro-enterprises are underdeveloped and influenced by the existing market opportunities, as well as by the enterprise life-cycle phase. In particular, micro-enterprises with up to five employees are burdened with both short-term and long-term loans, as well as with obligations to suppliers. It is estimated that this segment of micro-enterprises will be most exposed to the negative consequences of the COVID-19 crisis, especially taking into account the fact that many micro-enterprises operate in the areas of catering, tourism and other services that depend on physical contact between service providers and consumers.

**An unfavorable debt-to-equity ratio is likely to force a significant portion of micro-enterprises to borrow even more or lay off part of the workforce, and in the worst case, suspend operations.** As for artisans and representatives of the informal economy, they will rely on negotiations with micro-credit organizations, with the aim of maintaining their businesses..

### **Legal Framework and Obstacles for Micro-Business Development**

Legal framework analysis focuses on all three available ways of formal provision of services in BH - LLC (Limited Liability Company), Crafts (Independent Entrepreneur) and Freelancing (Individual) - with consideration of the advantages and disadvantages arising from the existing legislation for each form of the business.

**LLCs are facing a great number of administrative obstacles and procedures in starting, running and closing a business.** The process of registering a LLC in the FBH is too long, can take up to 60 days, and includes 16 procedures. In the RS, this process is much shorter, up to 20 days, but the number of administrative procedures is still high - a total of 11 procedures. Examples from many countries confirm that the process in both BH entities can

be significantly improved, especially with the help of e-government.

**The key problems of crafts sector are related to their financial and tax burden.** The process of registration and closure of crafts is not complicated throughout the country, but their tax base for contributions (as liabilities that take the relatively largest share of micro-business revenues) is significantly higher than LLCs, which to a great degree increases the expenditure on contributions. A noticeable number of artisans in both BH entities pay contributions that are calculated based on the average salary at entity level.

**Freelancers experience no safety in terms of regular business, while their legal status is unregulated in BH.** Although freelancers contribute to the country's economic growth in many ways, they are not entitled to be supported in the event of no revenue generation – no support if unemployed, not entitled to a pension, don't have the right to paid holidays or vacations, health care, and other rights that regular employees enjoy. The economic consequences of the COVID-19 pandemic further highlighted all the risks that freelancers face as well as the vulnerability of their economic position. So far they have not been recognized in support programs for businesses in both BH entities.

### **Organizing and Capacities of Associations**

**Existing associations relevant to micro-businesses are characterized by insufficient capacities for effective advocacy and by the weak ability to achieve larger membership.** In Employers' Associations, there is a great heterogeneity of members' interests and a dominant role of large companies in setting the advocacy agenda. While the relatively new "Association of BH Freelancers" who is still building its membership base, is active in advocacy initiatives, it is difficult to predict the next steps of the informal "Voice of Small Business" network established at the beginning of the COVID-19 Pandemic. Regarding the effects of the COVID-19 Pandemic, the two Entity Employers' Associations, the Chamber of Trades and Crafts, the BH Freelancers' Association and the Voice of Small Businesses have formulated specific proposals to the executive authorities, but without having a significant impact on the measures undertaken.

## Impact of Pandemic and Mitigating Measures

**The COVID-19 pandemic had an exceptional economic impact in BH, with the most severely affected activities involving a large number of micro-enterprises and crafts.** It is estimated that the country will enter a recession with a 5% drop in GDP in 2020. Of particular concern is rising of unemployment and relatively modest support from the BH diaspora. The mostly endangered sector by the COVID-19 crisis is the service sector.

**The largest support for the economy came from the entity level, although this support was largely overdue and related to a relatively small number of business activities.** In the FBH, a comprehensive so-called "corona" law was adopted, while in RS a number of regulations was passed that referred to individual problems and business activities. The most important measures include financing of a certain amount of contributions and minimum wages, and the creation of entity guarantee funds. The financial sector provided support to both the economy and citizens through a moratorium on loans, which partially alleviated the liquidity problem of micro-enterprises and crafts. Freelancers and other representatives of the informal economy have not been the subject of direct support from various levels of government in BH.

## Good Practices from Other Countries

**Implementation of innovative financial support instruments designed for small businesses and start-ups that are developed in other neighboring and European countries can significantly improve the financial environment for micro-business in BH.** Described supporting instruments include private guarantee funds, support program for digital transformation of micro and small enterprises, associations of "business angels", credit unions, cooperation of state capital with commercial banks and private capital, loan audit office, loan ombudsperson, digital platforms with comprehensive information on available financial instruments for micro and small enterprises.

## Recommendations

### Recommendations in the Sphere of Tax Policies

**The high share of undeclared workers and the presence of the grey economy in companies coming from the real sector are a consequence of the**

**high tax burden on labor.** In order to facilitate the operations of companies, especially those coming from the micro sector, it is necessary to stimulate the reduction of contribution rates and increase the non-taxable portion of income.

Reforms of the tax system in the FBH, that are aimed at increasing the taxable part of the base, while reducing the cumulative contribution rate, will lead to a tax relief on higher, but also the tax burden on lower wages. Given that above-average salaries are predominantly being paid in the public sector, this will lead to the release of budget funds, which should be directed to additional tax relief for the real sector. The moment for the adoption of the proposed legal solutions is not favorable, since it comes at a time of economic crisis caused by the COVID-19 pandemic, which has largely caused damage to micro-enterprises, but also led to a drop in budget revenues. The additional tax burden on micro-enterprises would lead to unemployment increase and to the closure of a significant number of companies.

Equalization of contracts for works and contracts for temporary services through cumulative contribution rates will be detrimental to persons carrying out activities as freelancers. Instead of reducing the tax burden, in this way the tax burden will rise to 32.5%, which will have a very disincentive effect on this sector, the sector that demonstrates great potential. Our recommendation is to introduce a lump sum payment of contributions instead of a percentage calculation of earned income.

The basis for calculation of the contribution of artisans should be changed. The current solution is to link the tax base for the growth of the average salary in FBH, which means that this base grows even in conditions when the business of an entrepreneur is declining or stagnant. Our recommendation is that the basis for calculation of contributions should be the minimum wage, or to prescribe a fixed lump sum for health care and define a lower limit for the payment of pension contributions.

Freelancers are discriminated against by the existing legal solutions. They are obliged to pay a health contribution on the amount of payments made, which they cannot use. Similar to the artisans, we propose the introduction of a fixed lump

sum for health care, defining a lower limit for the payment of pension contributions, recognition of the non-taxable part of income, recognition of years of service and health insurance.

Para-fiscal benefits burden micro-enterprises and crafts more than other enterprises, so we believe that micro-enterprises and crafts should be exempt from these benefits in the initial period of operation.

### Recommendations in the Sphere of Financial Support

The analysis of the micro-businesses characteristics demonstrated their low financial strength and vulnerability in the event of economic crises. One of the strongest consequences of the COVID-19 crisis is the global decline in economic activity, which has hit small countries harder, and within these countries, the most disadvantaged social strata and economic sectors. Due to these facts, it is necessary to provide urgent support to micro-businesses in BH in order to ensure their survival, preserve jobs and the existence of a large number of families. Not less significant effect of this support would be a positive impact on the budgets of lower levels, municipalities and cantons, since a noticeable part of their revenues are coming from income taxes and revenue taxes from businesses and residents.

Urgent short-term measures of financial support to micro-businesses should include:

- Special financial grants for micro-enterprises, especially those with up to five employees, crafts and freelancers. These measures can be adopted most efficiently at the local and cantonal level, and their distribution to users can be most effectively achieved at these levels of government. Local and cantonal governments should involve international and bilateral donors in funding these grants.
- Extension of the moratorium on loan repayment for micro-companies, crafts, freelancers and other individuals until the end of 2020. Entity governments should require the banking agencies to make appropriate decisions and persuade financial institutions to provide this type of support to micro-businesses.
- Establishment of a grant programs for micro-enterprises at the local and higher levels of

government. The program should provide grants in the minimum amount of BAM 500 for: (1) industrial protection, i.e. reduction of health risks within the working environment and increase of readiness for the “second wave” of COVID-19; (2) developing of new business models based on digitalization, establishment of online stores, better distribution and providing new services.

- Inclusion of microcredit organizations into the newly formed Guarantee Fund at the FBH Development Bank, in terms of portfolio guarantees of the FBH Government in favor of these organizations. This was done in the RS entity as a part of the program for economic recovery from the effects of COVID-19. In this way, the micro-economy would be supported, as well as the marginalized groups that have been hardest hit by this crisis.

Bearing in mind that COVID-19 totally changes the economic paradigm (Economist, 2020) and that the establishment of hitherto known economic structures neither globally nor in our country can be expected, in addition to these urgent short-term measures, it is necessary to improve the financial environment for micro-businesses with set of instruments and changes in adequate institutional and legal solutions. We shall briefly explain the recommendations that would lead to a significant improvement in the business conditions of the micro-sector.

**Establish Freelancer Support Funds at various levels of governments.** These funds should provide small grants in order to co-finance the purchase of equipment or formalize the business of freelancers like with crafts and micro-enterprises. Ideally, these funds should be established at the level of cities/municipalities, possibly cantons in the FBH or with the existing development funds in the RS entity. According to the results of our research, it is clear that freelancers in BH do not have the support of either the financial system or the state, and these funds would provide them with a minimal form of support.

**Establishment of a Fund for the Development of Micro-Enterprises and Crafts within the Entity Development Banks.** This fund should support micro-enterprises and artisans based on non-repayable



grants, credit guarantees and soft loans. The independent operation of this fund, minimal political interference, and good management of equity should enable the expansion of services and provide significant assistance to the development of micro-enterprises and crafts.

**Adoption of the Law on Credit Unions.** In order to improve the financing of representatives of the informal economy, artisans and micro-enterprises, and following the experience of neighboring Croatia, it is necessary to enact a Law on Credit Unions at the entity level. In this way, it would be possible to form new financial institutions, primarily by individuals who can deposit funds in the credit union and raise loans. Within this Law, it would be necessary to define that a credit union can be established by a minimum of 30 individuals, on the criteria of employment, or occupation, profession, but also a specific segment of the economy. The minimum founding capital of the Union can be BAM 100,000. The Credit Union operates on the principle of solidarity of the members and good capital management. Credit Union can be used by freelancers, farmers/agriculturists, representatives of service activities, but also by all others whose business carries an element of cyclical, i.e. depends on seasonal or other influences. Credit Unions would provide financial support to one segment of the economy that is now in financial uncertainty and lacks adequate funding instruments and institutions.

**Creation of a Credit Fund with the private sector.** In line with the examples of certain EU countries, such as Denmark, Credit Funds can be established in both BH entities based on private capital deposits in addition to the initial state one. In this way, companies would be able to invest the surplus capital in the Fund that will finance small companies, especially micro and start-up companies. Decisions on the granting of loans within the Fund should be made by the representatives of private capital. In this way, political influence would be minimized, while on the other hand the Fund would operate in the manner similar to the “business angels” concept, which is explained in more details in our paper. In order to establish a public-private fund, it is necessary to make certain changes to the laws related to investment funds, in terms of allowing different levels of government to enter into such arrangements.

**Establishment of a special Investment Funds for investing diaspora capital.** BH has a significant diaspora that has exceptional potential for financing the national economy. However, the diaspora is one of the informal sources of funding, which means that support comes down to helping relatives, friends (e.g. when starting and running a business). It is estimated that BH diaspora directly and indirectly transfers more than Euro 2.5 billion annually. In order to properly utilize the capital of the diaspora, it is necessary to formalize its role. This implies the establishment of special Investment or Venture Capital Funds by representatives of the diaspora, with the aim of supporting domestic business.

**Establishment of a single portal for tracking the funding information.** Micro-enterprises and artisans usually do not have a credible source of information on available sources of funding. Therefore, we recommend the establishment of entity or state internet portals that will unite all sources of funding in one place and update them regularly. This portal should specifically focus government funding, i.e. grants, guarantees and other support programs.

**Establishment of a Loan Ombudsman or Loan Audit Office.** It is necessary to establish the institution of a loan or banking ombudsman, or a credit audit office, whose goal will be to protect the rights and interests of loan users, whether individuals or companies. The Credit Audit Office proved to be very effective after the 2008/09 economic crisis in Ireland. Similarly, the potential of this institution can be used in the context of the current COVID-19 crisis, i.e. in the years following this crisis. The Credit Audit Office has the task to analyze the reported rejected loan applications and, based on the results of analysis, issues an opinion on the justification of the rejection. This opinion is not binding on the loan providers, but in cooperation with banking agencies and banking associations should have strong advisory power for the bank's activities. The goal is to preserve marginalized categories of the population and the economy, which often do not have access to bank loans even when they meet all the conditions for a loan. This measure implies new legal solutions.

**Revision of existing small business support programs.** There are a number of government small

business financing programs, but they are often ineffective and not adapted to new trends, crises and challenges. It is necessary to conduct continuous and independent assessments of the effects of such programs in order to timely detect those initiatives that do not give sufficient returns on invested public funds and to promptly redirect funds to the programs with the highest proven results. It is necessary to introduce a continuous process of program revision and mechanisms for rapid changes and adjustments to the needs of the economy and micro enterprises.

### Recommendations Related to the Legal Status of Micro-Businesses

#### **Micro-enterprises – LLC**

- Harmonization of the framework for registration of companies in FBH with regulations in RS together with introduction of a one-stop shop system and obtaining documents ex officio.
- Introduction of an online entrepreneurial service for registration of businesses and crafts in both BH entities.
- Introduction of an online system for submitting tax returns.

#### **Crafts**

- Introduction of a minimum base for the payment of contributions for artisans/ entrepreneurs in the amount of the minimum wage in both BH entities.
- Re-submission of the Draft Law on Crafts and Related Activities of FBiH to the parliamentary procedure.
- Solve the problem of licensing activities at the cantonal levels.

#### **Freelancers**

- Providing grants for freelancers to cover losses resulting from the COVID-19 pandemic. The basis for this right can be taxes paid in 2019 compared to taxes paid in 2020.
- Active advocacy for more favorable treatment of freelancers/self-employed in the new Law on Contributions in FBH. Namely, the en-

visaged solutions according to which freelancers will pay full contribution rates for pension and health insurance can increase the social security of freelancers, but would put many of them in a situation where they cannot provide the net income necessary to cover existential needs.

- Active advocacy that the new FBH Law on Income Tax provide freelancers with the right to a personal tax deduction in the same amount as employees.
- Change in the procedures for payment of taxes and contributions on income from abroad, in terms of obligations to pay this tax two or four times a year, on income earned in the past 3 or 6 months, and not as is the case now immediately after earning income.
- Raising awareness of local communities about the economic importance and contributions of freelancers in order to provide business premises for "co-working space", or "business hubs" by local communities, which freelancers could use with minimal compensation as a place of work and possibly as the seat of their business or enterprise.
- Modification of labor and economic legal solutions at the entity level that would comprehensively define the position of the self-employed persons based on the solutions from some EU countries, and speed up the process of company registration, as well. Adoption of tax policies that will encourage the transition of freelancers and a large number of people from the informal sector to regulate their status, achieve some degree of social security and enter into formal business frameworks.

### Recommendations Related to Strengthening of Associations

Problems of the unfavorable legal, administrative and financial environment in which the micro-business sector operates have been present for many years. Within the economic crisis resulting from the COVID-19 pandemic, which to the greatest extent endangered the business operations of this particular sector, the necessity of improving their position became ever clearer. In these pro-

cesses, Associations have to contribute to the **formulation and advocacy for the adoption of the solutions that truly reflect the interests of micro-businesses and enable their survival** in the crisis that will last at least until the end of 2020.

Associations should play the key role in these processes of formulating and adopting adequate solutions. Employers' associations, both at the entity and cantonal levels, have the strongest advocacy position towards the legislative and executive authorities. **Increasing the influence of micro-enterprises within Employers' Associations** can be achieved through stronger engagement of their collective sectoral and territorial associations, in whose membership small and micro-enterprises predominate.

**Chambers of Crafts** in FBH do not have much advocacy power, but based on the relatively high number of members, they can certainly achieve more effective advocacy than that has been the case so far. The most important activity in the coming period in the FBH should be to demand changes in the Law on Crafts in order to reduce the basis for calculating contributions. This change would certainly result in the increase of the number of newly registered crafts, but would also make crafts an adequate legal solution for registering of a large number of freelancers as well as individuals who are currently operating outside the official business flows.

Almost all Associations have problems with increasing the membership and with collection of membership fees, which would enable the strengthening of their capacity to formulate and advocate the necessary legal and administrative changes in the status of their members. This problem would be significantly reduced **if Associations were more oriented towards providing or mediating in the provision of services aimed at improving the financial literacy** of their members. A large number of providers of these services would undoubtedly have an interest in entering into some kind of partnership with Associations while offering their services at reduced prices.

We strongly do believe that some international and bilateral organizations would have an interest in supporting such programs, especially for sectoral associations from the sectors that are more affected by the current crisis, as well as for associations from the sectors that have more potential for growth and development. Providing comprehensive and up-to-date information on available financial incentives as well as favorable credit programs would be of great benefit to the members of Associations.

Adoption of the **Law on Credit Unions** would open a new space in which Associations can have a sizeable advantage over the formation of new groups of citizens as the founders of these unions. The members of Associations already have a certain degree of mutual trust, while the administrative structure of Associations itself can provide effective support in gathering the mandatory number of founders, registration of the cooperative and its operational activities.

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