Foreign Investors Council
Improving the Business Environment in BiH

FOREIGN INVESTORS COUNCIL

WHITE PAPER 2007

Priority Solutions for Obstacles to Investment and Growth in Bosnia and Herzegovina

April 2007
Sarajevo and Banja Luka

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Foreword

The Foreign Investors Council (FIC) was registered as a state-level private business association in December 2006. It joined FICs that already existed in all of the other transition economies of Southeast Europe – Croatia, Serbia, Macedonia, Montenegro, Albania, Romania, Bulgaria, and Moldova. The FICs of this network are associated with the ministerial-level *Investment Compact for Southeast Europe*, an initiative of the Vienna-based Stability Pact for Southeast Europe and the Organization for Economic Cooperation and Development in Paris. All of these institutions collaborate to promote investment in the SEE region. The FICs, as a group, are the strongest private sector voice in the region for collectively advocating reform of the business environment.

The FIC now has approximately 25 member companies and is growing rapidly. While its principal members are foreign-owned companies in BiH, associate membership is open to any locally-owned company with an active interest in improving the investment environment. The purpose of the FIC is regularly and strongly to communicate the interests and views of these companies, foreign and domestic, to BiH officials.

The *2007 White Paper* is the first publication of the FIC. Its purpose is to provide BiH authorities with a prioritized agenda for reforms to address key obstacles to investment that can be accomplished over the coming twelve months. At the end of that period – i.e., in March of 2008 – we will evaluate progress on this agenda, and issue our second annual White Paper.

The FIC would like to thank USAID for its technical assistance in preparation of this document.

We welcome comments from all quarters, invite participation and membership, and look forward to productive collaboration over the coming year for reform and for the growth of investment, business, and jobs in BiH.

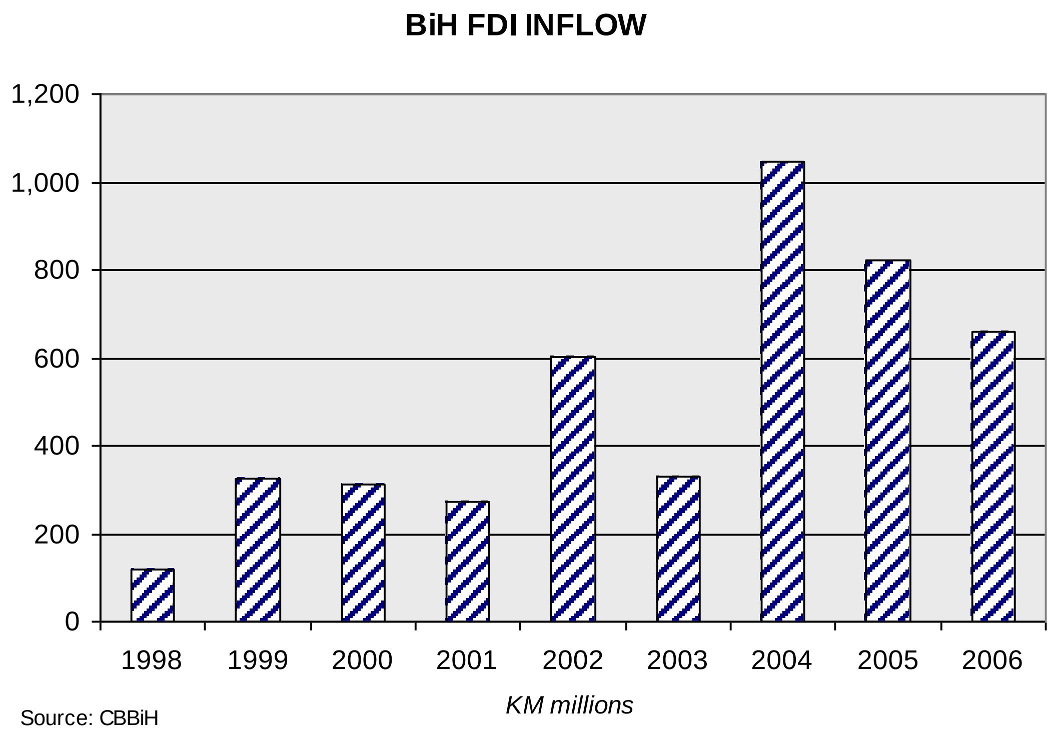
Mark Davidson
Board President

Nermin Zukić
Executive Director

Foreign Investors Council

1. EXECUTIVE SUMMARY

Foreign investment in BiH is on a growing trend, as seen in the chart below. However, the trend is uneven, and the decline in FDI over past two years is of concern. Furthermore, on a per capita basis, foreign investment is still well below that of the more rapidly growing economies of the region. We believe that BiH can attract far more investment, foreign and domestic, than it is now doing. Given the strong correlation between investment and the growth of jobs and incomes, BiH policymakers should be doing all they can to make the country an attractive place to do business.



Source: CBBiH

Comparative FDI Inflow		
Country	**2002 – 2005** *€ millions*	**Per capita** *€*
Romania	13538	604
Bulgaria	7347	896
Croatia	5300	1128
Serbia	3681	368
Bosnia and Herzegovina	**1349**	**397**
Albania	787	238
Montenegro	533	761
Moldova	514	114
Macedonia	373	187

Source: OECD

The major themes of this first FIC *White Paper* are (1) market integration and (2) "doing business" reform. Market integration, applying to the cross-entity internal BiH market, the Southeast Europe regional market, and the connection of BiH to the EU and global markets, is critical for the businesses of BiH to be able to grow and therefore attract investors. Doing business reform, which really means removing the many obstacles to rapid growth in that exist in BiH business regulations, is essential if BiH is to become a real magnet for investment.

The focus of this first *White Paper* is on key areas for reform, rather than on detailed individual fixes to law and regulation. We want to prioritize reform themes, in order to put forth an agenda for government action that can actually be put in place over the coming year. Therefore, while there could easily be many more individual recommendations for improvement, our approach is carefully to limit our list to actions that are:

- **Substantive** – likely to have a strong impact across a wide front, and
- **Achievable** – realistically able to be accomplished by March 31, 2008.

Our list is short in order that it may be achieved. If these recommended actions are in fact carried out over the course of the next year, the economic prospects and investment attractiveness of Bosnia & Herzegovina will be enormously improved compared to where we stand today. BiH will be recognized as a "leading reformer" of the doing business environment, which will translate into many millions in new investments, tens of thousands of new jobs, marked increases in household incomes, and strong growth in the tax revenues to fund the substantial expansion of government services that the country needs.

In most cases, these actions must be undertaken by all three principal governments of Bosnia and Herzegovina – BiH, FBiH, and RS – and some of them also require reforms by cantonal and municipal authorities. In a number of cases they require that authorities collaborate in order to harmonize policy and further market integration.

The following table summarizes the major inhibitors of investment in BiH, and broadly how we recommend they be addressed.

Major Inhibitors of Investment in BiH		
Issue	**Impact on Investment**	**How to Address**
1. Overlapping, non-standardized policies and procedures for obtaining permissions required for doing business	• Uncertainty as to time and expense for permissions • Investment goes to more "business friendly" countries whenever there is a choice	• Create a central commercial registry • Publish clear, standardized "road maps" for all business permissions procedures
2. Taxes are un-harmonized, excessive	• Increased cost, reduced return • Excessive cost of creating jobs • Limited growth because of double taxation when operating nationwide	• Eliminate double taxation in entity law • Harmonize entity tax regulations • Reduce payroll taxes
3. Construction permissions and procedures are	• Extreme uncertainty in forecasting project duration	• Adopt pro-construction policy • Clarify zoning, streamline

Major Inhibitors of Investment in BiH		
Issue	**Impact on Investment**	**How to Address**
burdensome	• Excessive construction project cost, unpredictable return	permitting procedures
4. Limited access to business finance, lack of money and capital markets	• Narrow options in obtaining routine business finance for operations – limits growth prospects and projected ROI • Small financial market size reduces loan, insurance, and investment product variety; raises cost	• Unify financial markets regulation in BiH • Initiate program to fully integrate regional financial markets
5. Readily accessible market is small – internal market segmented, border obstacles to regional trade, trade barriers	• Investment in alternative SEE locations with larger internal markets and from which BiH could still be sold is safer, more attractive • Many medium-sized firms can't expand	• Eliminate all obstacles to trade within BiH (between the entities) • Prioritize and promote an SEE common market • Eliminate all tariffs and non-tariff barriers on imports of BiH producers' inputs

We now proceed in the sections that follow to provide background and greater definition as to our recommendations.

2. OBSTACLES TO INVESTMENT IN BIH

The FIC has organized what it sees as the priority obstacles to investment in BiH in five categories:

1. Permits and Procedures
2. Taxes
3. Construction
4. Business Finance
5. Trade Policy and Market Size

These are covered in the following sections. Each section provides (i) a table summarizing strengths, weaknesses, and governance authorities in the area, (ii) a narrative overview of the key problems and priorities, and (iii) a presentation of major recommendations for reform that are feasible within the next year.

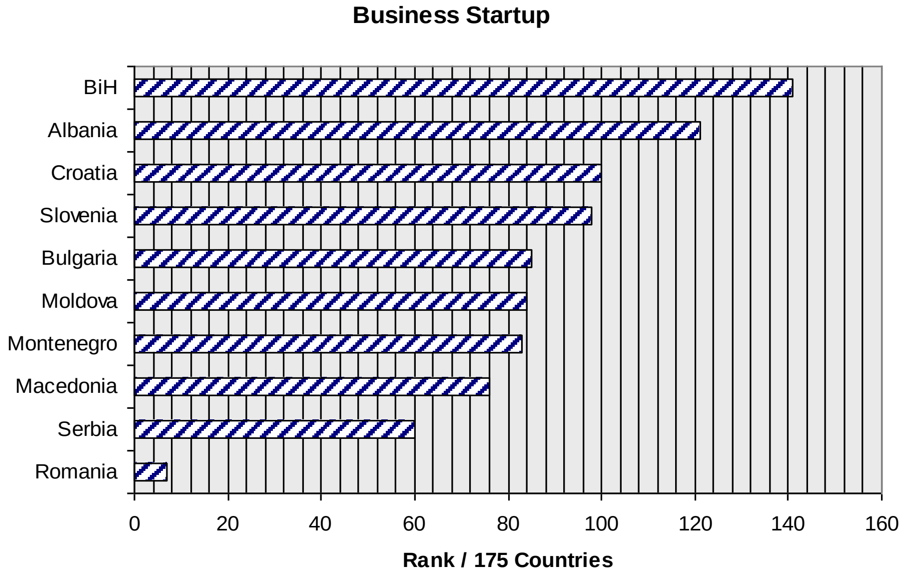
2.1 Permits and Procedures

Compared to all other obstacles to investment, the time, expense, red tape, and dealing with officials needed to start and conduct normal business in BiH is the greatest.

Table 1: **Permits & Procedures**

Strengths: • Relatively low fees in comparison to other countries • Core laws are straightforward **Key Governance Institutions:** • Ministry of Finance -Tax Administration (both entities) • Cantonal Courts (FBiH) and District Courts (RS) • Municipal Administrations • Ministry of Justice (both entities) • Ministry of Spatial Planning (both entities and cantonal ministries in FBiH) • Ministries supervising specific business activities • Inspectorates (both entities, all cantons, all municipalities)	**Main Weaknesses:** • Complexity of the governmental structure in BiH • Slow, inefficient, complicated procedures due to poorly-defined laws and duplicative, overlapping jurisdictions of various authorities • Lack of standardized, published procedural roadmaps and application forms • Duplicate documentary submission requirements, even within the same agency • Enforcement of extraneous matters: business start-up is used for enforcement of matters that are not business related (e.g. spatial planning, tax enforcement, etc). • Inadequate information management and communications technology; extremely underdeveloped e-government • Poor customer service attitudes by authorities' public-facing staff; lack of respect for customers' time and cost • Understaffing of public-facing permitting / registration / licensing authorities • Potential for unpredictable political interference with any larger project; need for proper political connections to get things done; absence of governmental / political cooperation needed for some larger projects.

Unfortunately for its workers and households, BiH has a well-deserved reputation as an extremely difficult place to do business. The following two charts, which report data from the World Bank's recently-released annual worldwide survey of business environments in 175 countries (World Bank 2007), tell a very sad story as far as investment in BiH is concerned.



As can be seen in these charts, BiH is by some distance the worst place Southeast Europe to start a business or register property, the two most fundamental indicators of the ease of doing business. BiH is not only bettered by Slovenia, Romania and Bulgaria, who are now part of the EU. Even such countries as Albania, Moldova, Macedonia, and Serbia, against which BiH would like to think it compares favorably, in fact are all easier places to do business than BiH. Ranked around 140, there are only 35 countries in the *world* that are harder places to start a business or register property than BiH. Unless you count Belarus, BiH is the **worst place in all of Europe** when it comes to the bureaucratic and legal hurdles entrepreneurs must overcome to start a business.

It is common to cite the multiple layers of government in BiH – State, entities, cantons, and municipalities – as the source of much of the problem, and there is truth in this. However, we do not think that such solutions as "getting rid of the cantons" in the Federation are the answer. The real issue is the failure of these multiple governmental levels clearly to define and allocate their proper roles and responsibilities in the "business of government", and to cooperate. One of the greatest problem areas in permits and procedures is the duplication of essentially the same authority over multiple governmental levels.

BiH governments fail fully to understand that there *is*, in fact, a "business of government". It is impossible to overstate how much investment, growth, employment, and income this has cost BiH. However, this is something that is within the power of BiH authorities, acting with commitment, to change quickly. The assessments, strategies, and plans have been done many times – they are ready and waiting to be acted upon.

<u>Survey of Permits & Procedures Issues</u>

Analysis of the *business startup process* shows that permitting procedures are extremely complicated, even for simple businesses, because of the large number of overlapping regulations imposed by different government levels – State, entity, canton, and municipality. Often it is not clear to the business which authority is in charge of a particular permit. Conditions that have to be met for a particular permit differ from region to region, even within the same regulatory authority. Often it is unclear whether a particular permit is required prior to or after the registration of the business. Permissions are subject to varying and random personal interpretations by authorities. Many ordinary registration procedures must be conducted in a commercial court hearing. Even with a good lawyer it is impossible to know in advance exactly how many or which business permits will end up being required.

The regulatory environment is so inefficient that, as is well-known by those who deal with it on a daily basis, officials end up in practice opting out of enforcement at certain points, to keep the "system" (such as it is) from collapsing. Authorities cannot keep up with reasonable demand for services because of the complexity of the regulations they are required to enforce, understaffing, and inadequate information management technology. Regulatory revision and organizational management improvement to address these systemic stresses is not actively pursued by the authorities or by legislators.

In the post-registration stage, the biggest problem is compliance with "Minimum Technical Requirements" (MTRs). A recent RS reform allows the founder to simply to certify, by signature, that he or she is aware of the listed MTRs and has met them. This is followed after business start by ordinary regulatory inspection to verify compliance. In the FBiH, however, the old system of requiring advance verification of all MTRs prior to initiating business is still in effect, and there is no apparent effort underway to change this system.

The commercial legal structure in BiH consists of normal core laws and supplementing regulations which always apply. Their number is small and it is relatively easy to identify them. However, there are a very large number of other non-core laws and regulations applying to specific situations, that impose many more additional terms and conditions on a business to become fully operational. These are connected to the legal structure of the company, the specific business activity, the geographical region, the profession, etc.

In FBiH, the commercial law system is often referred to by practitioners in many of its respects as a "twilight zone", caused by an effective duality of legal regimes: a "new" regime has been adopted but is effectively not enforced, while the "old" regime was abolished, but still in use.

Key Recommended Actions Prior to 31-Mar-08

PERMITS & PROCEDURES

- Establish a **central commercial registry** and initiate the process of re-registering all businesses in this registry and thereafter removing business registration from the commercial courts. Or establish a parallel fast-track company registration procedure on entirely new principles, outside the courts.
- As a precursor to streamlining procedures, eliminating duplication, and implementing cross-agency access to information, cause all business authorities to **publish complete permissions roadmaps** for permitting procedures.

2.2 Taxes

The very high level of payroll taxes coupled with the fact that they are not capped, and the inconsistency and complexity in the corporate tax systems in BiH, are major obstacles to investment.

<table>
<tr><th colspan="2">Table 2: Taxes</th></tr>
<tr><td>Strengths:
New Corporate Income Tax Law in RS provides for low 10% rate, 100% first year deduction for machines and equipment, no thin capitalization rules, no withholding tax on dividends, 5-year rolling forward foreign tax credit
FBiH CIT law allows 5-year tax holiday for foreign companies, tax Incentives for newly-established local companies, re-investment relief of up to 100%
VAT introduced throughout the country on 1/1/06 at uniform 17% rate; VAT refund system fully introduced
Customs, excise, and VAT collected at State level</td><td rowspan="2">Main Weaknesses:
Lack of cross-governmental coordination within BiH on tax policy, resulting in:
– Different rates, incentives and rules in the two entities’ CIT legislations
– Inability to credit tax paid in FBiH or Brcko against RS tax
– Inability to credit tax paid in RS or Brcko against FBiH tax
– Inhibition of statewide business expansion
Many shortcomings in FBiH corporate income tax law, including:
– Withholding tax requirement on payments made to a non-resident, which means it applies to payments to RS and Brcko
– Overly complex reinvestment relief mechanism
Lack of clarity regarding Double Taxation Treaties, their validity and their practical application</td></tr>
<tr><td>Key Governance Institutions:
State Indirect Tax Authority
Entity Ministries of Economy and Tax Administrations
Cantonal Tax Administrations
Municipal tax authorities</td></tr>
</table>

The tax system of BiH has markedly improved over the past ten years, most recently with the introduction of nationwide largely EU-consistent VAT in 2006, and a new corporate income tax law adopted in the RS as of the 1 January of 2007. The fact that customs, excise and VAT are now all levied at the level of the State, and all under the administration of the Indirect Tax Authority, is a major step forward, both in terms of tax effectiveness and of realizing a vision of many foreign investors: to see BiH as a **single economic space**.

However, in general, rates remain excessive (especially payroll tax rates in both entities and corporate income tax rates in the FBiH), tax administration is uneven and discretionary, and the lack of harmonization between entity tax policies creates major obstacles for businesses that want to operate on a nationwide basis.

<u>Survey of Taxation Issues</u>

Payroll taxes – taxes that the employer is obligated to pay for each employee to the social insurance funds – average about 70% of an employee’s net pay in BiH. This is a large addition to the cost of creating a new job. It reduces any labor cost advantage BiH might have compared to other transition economies, and therefore eliminates one factor for investment attractiveness. It also encourages the under-reporting of wages and discourages smaller businesses from formally registering. While clearly the social insurance funds that depend on these taxes are under-funded, it is quite possible that lower rates would actually increase their overall revenues, by making the costs of compliance reasonable.

Double Taxation in BiH

A FBiH company with activities and a branch in RS paid corporate income tax there for its activities in that entity. It was not able to receive a credit for this tax when it submitted its annual FBiH CIT return, because only taxes from "another country" are deductible in double-taxation law.

There are a number of issues in the area of *corporate taxation*. Among the most frustrating areas to foreign investors, who seek rapid business growth for returns on their investments and therefore want to operate on a State-wide if not region-wide basis, are those that arise from the failure of officials in the two entities to appreciate the importance of harmonizing their tax policies and practices. There are significant differences in tax rates, tax incentives, tax concepts, and actual rules on calculating the tax base, greatly complicating tax compliance for statewide businesses. In several areas the rules are so unclear as to cross-entity tax treatment that companies simply do not know what to do.

- *Inter-entity double taxation*: Double taxation treaties (DTTs) are typically agreed between nations, but because of the unique characteristics of BiH, one is needed between the entities. Currently, taxes paid by a company in one entity cannot be credited against taxes owed in the other, so any company that tries to operate nationwide faces double taxation on the same revenues. This is an absurd situation – it means that it is easier and cheaper from the corporate tax perspective of both the RS and FBiH to do business with any other country in the world than it is to do business with the other entity of the home country. If companies do want to do business nationwide, they must artificially fragment themselves in order to avoid double taxation, greatly compounding the costs of doing normal business.

  This situation preserves BiH's status as two side-by-side economies, each of which is too small to accommodate the expansion of the medium-sized companies so important to job creation. Obviously, this is a major discouragement both to foreign and domestic investment. But it can be easily addressed by very simple changes to existing tax law.[1]

- *Federation CIT weaknesses*: The FBiH Corporate Income Tax law is badly in need of a re-write. There are many areas of ambiguity. The current law does not recognize the concept of the "permanent establishment", and therefore does not conform to other European CIT legislation. There was a new draft CIT law put together in 2006, but this never made it through Parliament, and now after a period of post-election inactivity, we view it as a priority to pass a new CIT law.

- *International double taxation treaties*: There is uncertainty concerning the validity of DTTs concluded between the former Yugoslavia and other

[1] In the FBiH Corporate Income Tax Return, amend the wording of 27 (e): instead of referring to corporate tax paid "in another country", it should state "outside of FBiH". In the RS CIT, Article 26(1) should be amended to replace "foreign state" with "foreign state or entity / district outside of RS".

countries. BiH has concluded new treaties with a number of countries, and the BiH Ministry of Foreign Affairs confirmed that old Yugoslav treaties with a number of other countries remain valid. A common criticism, however, is that the mechanisms to apply the provisions of these DTTs do not exist. The FIC would be happy to participate in a working group to develop clear, transparent methods of applying these treaties, if the Ministry for Foreign Affairs would set one up.

Key Recommended Actions Prior to 31-Mar-08

TAXES

- Eliminate double taxation and withholding taxes **between RS and FBiH**
- Adopt as policy the **harmonization of corporate tax legislation** of RS and FBiH and initiate this process, at least with formal agreed strategy and establishment of working groups.

2.3 Construction

The severe obstacles that investors face in permitting for land use and building robs BiH of one of its strongest potential contributors to rapid employment and income growth.

Table 3: **Construction**	
Strengths: • Land and real estate prices still attractive relative to other transition economies of East and Southeast Europe	**Main Weaknesses:** • Extremely complex and duplicative procedures for zoning, building, inspection, and use permitting • Judicial role in construction permitting • Understaffing of consumer- and business-facing municipality building offices • Risk in real estate transfer and mortgaging due to incomplete cadastral and ownership registration, incomplete land privatization, and unresolved restitutions
Key Governance Institutions: • State- and Entity-level economic policymakers – executive and legislative • Cantonal ministries • Local municipalities	

Particularly for a transition / emerging economy like BiH, the construction sector is one of the most important drivers of growth. Transition economies typically have housing stocks badly in need of upgrading, office facilities that are inefficient and inadequate to modern business needs, and a complete lack of shopping centers and large retail facilities. As BiH emerges and its businesses transition to global commercial and consumer practices, it needs massive construction of homes, offices, and retail buildings, as well as utilities and transport infrastructures. It is typical to see the skylines of the major cities of emerging economies studded with construction cranes, work hard and fast. When one looks out over Sarajevo at this writing, one sees only three.

According to the official statistics, gross value added in construction was approximately KM 550 million in 2005 (latest year for which statistics are available). Looking at the sector's gross revenues – some KM 2 billion – gives an impression of how large an impact it can have through the value chain. However, the construction sector actually grew more slowly (5.8%) than nominal GDP growth (7.4%) in 2005, so it *fell* in relation to GDP, to about a 4.5% share. Employment in construction was about 36,000 people, some 5.5% of the labor force. [2]

Obviously, for a transition economy, the construction sector should be *adding* to the GDP growth rate, not reducing it. As detailed at length by a thorough assessment by USAID released last year,[3] construction in BiH is weighed down by complex and repetitive bureaucratic and judicial procedures, as well as by "business of

Real Estate Development Delays

One major foreign real estate investor is still waiting for necessary commercial building approvals in a prominent urban location for which the investor three years ago deposited several million KM with the cantonal privatization agency. The project, once started, with produce over KM 20 million in local procurements and create 100 onsite jobs.

[2] Source: EPPU (2006 2)

[3] USAID SPIRA (2006)

government" problems including lack of computerization of registries and GIS data, and inadequate staffing of business- and consumer-serving municipality construction offices.

BiH authorities must properly recognize the importance and potential of construction as a driver of growth, and act forcefully to make it a priority for reform of the doing business environment. We estimate roughly that if this was accomplished in 2007, the growth rate of construction could quadruple, to 20% per year or higher, and the share of construction could rise to 8-10% of GDP. By the end of next year we could see at least 20,000 new jobs in the construction trades, reducing the BiH unemployment rate by itself by over two percentage points.

Key Recommended Actions Prior to 31-Mar-08

CONSTRUCTION

- Develop and publish clear **zoning protocols and regulations** for land use determination, to speed the process and reduce uncertainty and official caprice in land use approval.
- Streamline the **construction permitting system** by eliminating of the Urban Permit ("ubanistički saglasnost") for new construction as a precursor to the Building Permit.
- Adopt **published, standardized building codes** modeled on EU regulations, implemented by well-trained inspection officials.
- Launch well-publicized, time-dimensioned program for comprehensive **real estate ownership registration**.

2.4 Business Finance

Even though bank credit to businesses is growing rapidly, the narrow range of financial instruments available for accessing business finance is a key inhibitor of investment in BiH.

Table 4: **Business Finance**	
Strengths: • Stable currency • Competitive interest rates • Capable, professional bank supervision • High growth rate of business credit • Established pledge registry • Functioning private credit information bureaus	**Main Weaknesses:** • Inadequate range of bank credit instruments • No bond or money markets • No public equity finance • Small financial market size **Key Governance Institutions:** • Central Bank of BiH • Entity Ministries of Finance • Entity Banking Agencies • Entity Securities Commissions

A recent survey of the BiH financial sector presented options for accessing local business finance.[4] Important conclusions relevant to BiH investment attractiveness are:

- Aside from owner- and "friends and relatives" finance, BiH enterprises must turn mainly to banks and leasing companies for credit. There is no money / commercial paper market and no bond market.
- Bank finance for business is restricted principally to simple term loans and overdraft facilities. Many of the flexible and efficient bank loan products common in developed financial markets do not exist. Collateralization of fluctuating receivables and inventory is rare; dependence on real estate for collateral (including principal residences of owners and guarantors) is excessive.
- BiH public stock markets are very small, fragmented between Sarajevo and Banja Luka, and serve basically as institutions for takeovers (as in the banking sector) and for speculative trading in the shares of privatization funds and companies still not fully privatized, but expected to be. They are useless as channels for raising new money – there has never been an initial public offering on either market, nor an public issue of new stock by a company already listed.
- No BiH company is in a position to issue bonds or shares on international capital markets.

A recent IFC-SEED survey of Bosnian businesses found that "shortage of favorable finance" was the third most frequently-cited obstacle to better business performance.[5]

[4] USAID CCA (2006), *BiH Financial Handbook*

[5] SEED (2006), *Business Barometer*

Business Finance Products in BiH

The following are the principal types of business loans offered in BiH:

- *Term loans:* Three- to five-year commercial loans for equipment purchase are common. Real estate development loans, secured by property and buildings, can be obtained for longer periods.
- *Overdraft facilities:* The most common product for working capital, sometimes called a "revolving" loan, but actually it is not. A capped amount, generally for 12 months. Interest often must be paid on the unused amount, and a 1-2% origination fee must be paid prior to disbursement. Unsecured, limited in size. Inappropriate in design for regular use as working capital.
- *Short-term loan facilities:* Three- to twelve-month general or earmarked credit. These carry high interest rates and origination fees. If exceeding only KM 30,000, they require full-scale real estate mortgages or fixed assets security. Circulating assets like inventory or receivables are not used as collateral for these loans.
- *Factoring* and other facilities for selling financial claims apply to receivables. They can relieve working capital pressures to some extent, but factoring is generally more expensive than bank finance.
- *Leasing* is a rapidly-growing business for equipment and vehicle finance. The major leasing companies are owned by the key foreign banks.

This represents a restrictive range of financing options. It is unsuited to needs in the working capital area, and is quite limited in long-term financing choices.

Financial Sector Development and Investment Attractiveness

Greater investment is attracted to countries with well-developed financial sectors, because they provide the wide range of financing options that businesses need for growth and change. Underdeveloped financial markets mean investors must come up with more equity finance for normal growth, or adapt their borrowing to loan structures that are not suitable for their needs and may actually increase business risk.

Why is the BiH financial sector underdeveloped? We believe that the main reason is the relatively small size of the BiH financial market(s), which restricts competition and product innovation in finance. Like the market for real goods and services in Southeast Europe, the market for finance is also highly fragmented. As a result, no single national (or, in our case, subnational) financial market offers a wide enough range of borrowers for banks and financial investors (such as insurance companies

Working Capital Finance in BiH

In BiH the "working capital revolver", the most common instrument for working capital finance in developed financial markets, does not exist. This product, which provides a credit line tied to inventory and receivables, protects the bank and provides a form of "self-discipline" to the borrower. Credit fluctuates, increasing as inventory and receivables rise, but being repaid as inventory is sold and receivables collected, when cash comes in to the borrower. If, instead, working capital is financed by 12-month term loans, as is common in BiH, a growing business – one whose inventory and receivables are trending higher – would find it very hard to repay such a loan. A rollover or refinancing would be necessary, but this requires more procedure and delay and could put the company in default. In sum, a poor loan structure, for a viable business, could end up forcing the company into bankruptcy and causing the bank to write off the loan and pension funds) to obtain a well-diversified portfolio. Consequently, the investment and loan products they offer are mostly one-dimensional and expensive.

Key Recommended Actions Prior to 31-Mar-08

BUSINESS FINANCE

- Finalize legal and regulatory requirements for expansion of **leasing, insurance, pensions, and corporate bond markets** in BiH, and establish a effective supervisors for these nonbank sectors.
- Eliminate **judicial hearings** for the pledging of real estate as collateral for mortgage loans – make this a matter of private contract and administrative registration.
- **Unite banking supervision** under the CBBiH, as is consistent with Basle II principles and as has been recommended by the IMF and the BiH Presidency, to increase integration and growth of the financial sector.
- Move aggressively to collaborate with other SEE countries to begin the extensive legal and regulatory work needed for **unification of the region's financial sectors**.

2.5 Trade Policy & Market Size

The small size of the domestic market, and the persistence of obstacles to regional trade and to imports of supplies by BiH manufacturing businesses, is a critical inhibitor of investment and growth in BiH.

Table 5: **Trade Policy & Market Size**	
Strengths: • Bilateral FTAs with all the countries of Southeast Europe, and Turkey • Preferential trade relationships with EU, U.S., and other countries	**Main Weaknesses:** • Obstacles to inter-entity trade • Non-tariff barriers to intra-regional and international trade • Labor immobility • Financial sector fragmentation • Lack of unrestricted common market with neighboring countries
Key Governance Institutions: • MOFTER • Entity Ministries of Economy • Certification Agencies	

With a population of approximately 4 million and some 1.5 million households, Bosnia & Herzegovina is far to small a market to support in itself the business of many mid-sized companies. As a result, the BiH economy is made up of a small number of large companies, and a large number of small companies, that primarily serve this domestic market. Most medium-sized companies that engage in intermediate processing activities require an accessible market of 20 million or more to be viable. In larger economies, such as the U.S. or Germany, or smaller countries that have unobstructed access to wider economies, such as Slovenia or Luxembourg, these mid-sized companies attract the majority of investment and are the main drivers of economic growth, exports, and jobs.

BiH is now party to bilateral free trade agreements (FTAs) with all the countries of Southeast Europe, and preferential trade treatment with the EU. Nevertheless, and even though the unwieldy network of FTAs is being replaced by a single, multilateral regional trade agreement for Southeast Europe, such arrangements leave in place many obstacles to trade. Trucks must still clear customs when moving among the countries in the region, and this significantly raises transactions and logistics costs for regional business even if there is no tariff to pay. Meanwhile, numerous non-tariff barriers (NTBs) still inhibit intra-regional trade. A recent BiH government report on the country's regional FTAs found that the impact on the economy "has not been particularly strong" and noted the "very narrow BiH production and export base", and the "numerous non-tariff barriers hampering trade", including BiH's own "unilateral introduction of protective measures" on some products.[6] Even within BiH, there are artificial obstacles to trade between the two entities. The poor transport infrastructure, especially railroads and roads, additionally inhibits the free flow of goods within the region.

[6] BiH Economic Policy and Planning Unit (2006), *Regional Free Trade Agreements of Bosnia & Herzegovina: Analysis and Policy Recommendations*

Fragmented Business

To cite just one illustrative example, none of the overnight package delivery businesses that have been independently established in Serbia, Croatia, and BiH, even in cases where they are owned by a common investor, does cross-border deliveries. The most common means for an ordinary person to deliver a package quickly from Zagreb to Sarajevo is to go to the bus station, hand it to the bus driver, and have the recipient meet the bus on arrival and pay a small tip.

The countries of Southeast Europe, including BiH, behave as if they can depend on a "spoke-and-hub" relationship to the EU for their export expansion, ignoring the critical importance to any economy of the many opportunities to specialize and do business with customers within a radius of a few hundred kilometers. There are far too few regional businesses in the Western Balkans. .

Southeast Europe, or at least the Western Balkans, needs to re-integrate itself as a true **common market**. Creation of a common market in Southeast Europe requires mutual work across all of the participating countries in legal and regulatory harmonization in the areas of:

- Customs, trade, and transport
- Labor mobility
- Business regulation
- Financial markets integration, and
- Currency unification.

This work can take place under the auspices of the Southeast Europe Cooperation Process (SEECP), an established ministerial-level collaborative institution which is in the process of inheriting many of the functions of the Stability Pact for South Eastern Europe.

It is worth noting that the process of integration into EU for most of the countries of Southeast Europe would probably be accelerated by their intra-regional integration. The EU has called on regional countries to integrated economically. An IMF report noted that "greater regional integration could demonstrate that the Southeast Europe countries are capable of sustaining a closer political and economic relationship with the rest of Europe".[7]

We do not agree with the view that expansion of trade agreements with the EU should take priority over integrating the intra-regional market.[8] Both are important. Waiting for some indefinite period – up to ten years or more – for EU accession to deliver a common market in SEE "through the back door", rather than the countries of the region taking the initiative to produce it of their own volition, would sacrifice enormous potential wealth creation in the meantime for the businesses and citizens of the region.

The BiH FIC believes that the early establishment of a true common market for the region would enormously enhance intra-regional business prospects, dramatically elevate foreign investment, and quickly create tens of thousands of new jobs. The FIC calls on the governments of BiH, its entities, and the other countries of

[7] International Monetary Fund (2003), *Trade Liberalization Strategies: What Could South Eastern Europe Learn from CEFTA and BFTA?*, Working Paper

[8] Lamotte (2006)

Southeast Europe to commit themselves without delay to the goal of a common market.

Tariffs and Customs practices

As if the small size of the domestic market were not enough of a problem for BiH businesses and their investors, tariff policies and customs practices actually serve to limit market size further. Even when it finally reaches its full economic potential, as a small country BiH will of course never be able to satisfy all of its needs, nor should it. It is essential, therefore, that BiH be completely open to international trade. For all significant businesses here, it is and will always be most efficient to import some essential goods and services, even for major exporters. That is, the internal and export competitiveness of BiH businesses depends on their unfettered access to the most suitable inputs, whether from domestic or international markets. For a small open economy like BiH, there is virtually no trade restriction intended to protect domestic producers that does not at the same time have a negative effect on the competitiveness of other domestic producers.

Importing for Competitiveness

A good example is in the wood processing sector, certainly one of the most important for BiH economic growth. While the import of production machinery is free of customs duties, the import from the EU of many inputs essential to furniture production is not – such as hinges and handles, certain furniture parts, and even raw wood. Some of these inputs (such as hardware) are available locally in some form, but the "protection" of these producers actually removes competitive pressure on them to improve their products. The same could be said for most locally-produced doors and windows.

Furthermore, protection of suppliers by high tariffs on competitive goods imported from the EU actually allows them to continue to do business producing and inferior product, forcing inferiority in product quality on users of these inputs up the value chain that might be exporting, and therefore harming *their* competitiveness. *Competitiveness is created, in part, by competition.*

Key Recommended Actions Prior to 31-Mar-08

TRADE POLICY & MARKET SIZE

- Declare the creation of a **Southeast Europe common market** to be a foundation goal for economic growth, and convene a Ministerial-level regional conference to advance its establishment.
- Lower tariffs and non-tariff barriers generally, and **eliminate tariffs and non-tariff barriers on all inputs to production** of BiH businesses.

This concludes our survey of major issues for this first FIC *White Paper*. We know that there are many things we have not covered. We will give them attention in our work during the year ahead through our "Investment Issues Special Reports" series, and in our 2008 *White Paper*.

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