

NO TIME TO LOSE



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We Need to Find the Money NOW

There are some things in life we can't avoid. No one can run a government on credit forever.

But unfortunate as it may be, the time is coming when the governments in Bosnia and Herzegovina must confront the critical imbalance between revenue intake and outgoing expenditures.

The way things currently stand, Bosnia and Herzegovina is going to face ever expanding budgetary deficits in the next several years, which will, if left unaddressed, make it impossible to pay salaries, provide services and ultimately meet the requirements of a Stability and Association Pact with the EU.

This is not something that can be swept under the carpet for a later date. It is something that must be dealt with now.

As the Macroeconomic Survey in this quarter's Newsletter makes clear, BiH's cash-flow problem arises from the combination of a sprawling, multi-tiered governing structure that sucks up public money, and an inefficient and inequitable tax system.

The good news is that in the last few weeks the BiH authorities have taken steps to revolutionise tax collection, by enacting the legislation that will provide this country with a modern, efficient, single and fair fiscal system. This, together with the merger of the customs services, will begin to staunch the loss of hundreds of millions of KM in public revenue – an annual loss to the people of BiH that has been allowed to continue for much too long. (It will also send a very positive message to investors, that BiH is a place that is worth investing in, and that in turn will help create desperately needed jobs.)

But even with more efficient revenue collection, there is still too much government bureaucracy in BiH for the citizens of this country to pay for. So choices are going to have to be made and made soon. Steps must be taken to decrease the cost of government, while ensuring that institutions necessary for EU accession are put in place. Every accession country has had to create new agencies and institutions in order to meet the requirements of EU membership. BiH can do this only if it eliminates unnecessary layers of government while improving the effectiveness of government at each level.

As part of its European-integration effort the BiH Government is endeavouring – again in the words of the Macroeconomic Survey – “to reinstate services (veterinary inspections are one example) that have been conspicuously and dangerously absent since the early 1990s and which, in any case, have to be maintained at a higher standard than applied before the war if BiH is to meet EU accession requirements.”

This is not just a matter of joining Europe. It's a matter of giving citizens better services; it's a matter of making BiH a more prosperous and a more secure country in which to live.

This effort will cost money. But if this country is to succeed in joining the European Union, it has no choice but to find the money and find it now.

There is a growing consensus behind the present drive to make BiH compatible with Europe and give the people of this country the kind of public services people elsewhere on the continent take for granted.

It can be done. But it can only be done if in 2005 BiH's politicians focus on how to pay for it. If they don't, soon, very soon, maybe even this time next year, the budget deficits will increase to a level that will make these requirements and the country's dream of membership in the EU impossible.

Ambassador Donald S. Hays
Principal Deputy High Representative



The Right Kind of Government

Charles de Gaulle once famously asked – ‘How can you govern a country which has 246 varieties of cheese?’

Present day BiH hasn't got that many cheeses but it does have almost as many different fees and taxes, as well as an astonishing profusion of ministries.

In recent months, significant progress has been made in rationalising the tax system – the Indirect Taxation Authority is at the forefront of this – and there has also been progress in cutting back on administrative overkill – the Bulldozer Process has led the way in eliminating pointless bureaucracy. With regard to excessive government, the simple answer would appear to be to start cutting departments and personnel. But of course, nothing is that simple. The fact is that in some respects, BiH needs more rather than less government. The current average capacity of BiH State-level government is just over 50 per cent of the minimum requirement. This has to be fixed. Until it is fixed, citizens will not receive the services they are entitled to expect, and BiH will not have instituted a government system that meets minimum European standards.

What BiH needs is more of the *right kind* of government: it needs adequate and operational State institutions if it is to make any progress towards EU accession and towards membership of other international bodies, such as the World Trade Organisation and NATO's Partnership for Peace. These organisations require certain institutional criteria. They do not require the establishment of particular ministries and agencies for arbitrary reasons but because the existence of such institutions – Defence, Interior, and Justice Ministries, for example – are accepted prerequisites of modern democracies. These ministries deliver benefits to citizens. This is a crucial point, because the object of building

the capacity of the BiH Government is not to meet criteria laid down by international organisations but to improve the lives of the people of BiH.

At present, the capacity of the BiH Government to deal with the different accession needs and – even more important – with the needs of this country's citizens is weak.

At the core of this weakness is inadequate funding. There are two reasons for this – a sprawling, multi-tiered governing structure (with the shortcomings of which every citizen is painfully familiar) that sucks up public money, and, an inefficient tax system (which has allowed a proliferation of fees and taxes in the way that France has a proliferation of cheeses).

The fiscal system is being reformed – and elsewhere in this Newsletter the elimination of double taxation and the rationalisation of customs and excise and indirect tax are discussed. Developments in this field in the last three months represent a huge step forward in consolidating the Single Economic Space in BiH, encouraging investment and, in the long term, setting the stage for the creation of more jobs.

This corresponds to the generally accepted academic view that the introduction of Value Added Tax can have a “revolutionary” impact on transition economies. As Robin Burgess and Nicholas Stern argue in an article entitled *Taxation and Development*¹, VAT has consistently been found to deliver benefits ‘in terms of coverage, revenue and simplicity relative to the existing system’².

The introduction of VAT will help to reduce the grey economy and provide a level playing field for all businesses. The implications for BiH cannot be overstated – a more efficient system of indirect taxation and a rational VAT regime should produce a more predictable revenue stream for State institutions.

¹ Burgess, R & Stern, N.; ‘Taxation and Development’, *Journal of Economic Literature*, (June 1993)

² *Ibid.* p. 812

While the rationalisation of the fiscal system will certainly help to pay for a more effective State-level government, this is not going to be enough. Cutting down on superfluous sub-State government ministries and staff can release funds for essential services. The practice until now has been to reduce the scope of sub-State-level government activities as State-level services are expanded. However, experience shows that the process is not revenue-neutral. For one thing, establishing new ministries and agencies involves a significant one-off investment in start-up costs. Staff reductions in sub-State institutions likewise involve one-off expenses such as redundancy payments. And, as the State Government endeavours to reinstate services (veterinary inspections are one example) that have been conspicuously and dangerously absent since the early 1990s and which, in any case, have to be maintained at a higher standard than applied before the war in order to meet EU accession requirements, this effort is accompanied by unavoidable and new capital outlays.

The plain fact is that EU accession requires effective public institutions, and European



Figure 1³ integration is an excellent incentive for promoting their establishment. It's logical, but it isn't easy. The ten countries that joined the EU in 2004 are all much richer than BiH and they did not have to contend with the enormously complicated bureaucratic system currently operated by BiH. Yet they had to marshal all their reserves of

³ Figure 1: 'Westward, look, the land is bright', *The Economist*, (24th Oct 2002);

political and administrative acumen and devote the bulk of their energy and revenue to the sustained effort that went into adopting and assimilating the *acquis communitaire*. And none of them had to conduct a state-building exercise alongside this process.



Figure 2⁴

This makes it all the more important to stress that cutting and pruning the BiH bureaucratic apparatus is not about reducing services. The opposite is true. A simpler government structure can make it possible to improve services, by ensuring that money is spent on the services themselves rather than on pointless intermediate layers of bureaucracy. Simple structures also militate against corruption – the fewer forms that have to be filled in and accompanied by a cash payment, and the fewer official stamps that have to be secured, then the fewer opportunities there are for underpaid and unprincipled petty officials to skim a percentage from the general public.

So, simplicity is in everyone's interest.

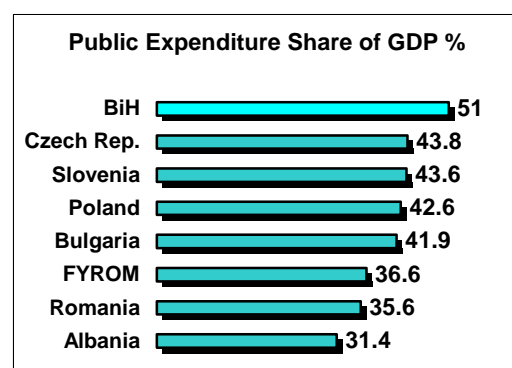


Figure 3

⁴ Figure 2: 'Why Slovenia is not the Balkans', *The Economist*, (20th Nov 2003)

The restructuring of government functions and the rationalisation of expenditure do not represent a bleak and irredeemably painful proposition. Far from it, the reforms that BiH must institute in order to gain a modern, efficient and cost-effective government structure will have direct benefits for civil servants. A recent study conducted by the research arm of McKinsey & Co, the international management consultants (McKinsey Global Institute), notes that: 'productivity lies at the heart of government performance. ... Improving productivity can certainly come from reducing inputs, but it can also come from increasing the quality and quantity of the output.'⁵

It's not simply a matter of fewer bureaucrats; it's a matter of giving bureaucrats the tools they need to do their indispensable work.

Since in BiH, the state commands such a large share of the economy, even comparatively modest improvements in the productivity of government departments can unlock large savings. As the McKinsey authors noted, public sector organisations around the world – schools, public-welfare agencies, health care systems... have improved their performance by five to 30 percent ... Often they have chosen among three classic management tools to raise productivity: organisational redesign, strategic procurement, and operational redesign.⁶

The advent of the "e-government initiatives" was also singled out as a good way of saving money. Thus, it took 21 forms and three weeks to get an export license in Singapore that can now be processed in 15 seconds via an online application. Similar examples could be found all over the world where a restructuring of back-office processes often realised cost savings to the tune of 30 to 40 percent.

Reorganising the government of BiH has to be viewed in this light. If we are talking about reducing bureaucracy from 21 forms to 15

seconds we are talking about something every citizen in this country would readily support. There are political and constitutional issues to be addressed, but these should not obscure the practical interests of people who stand in queues.

Similarly, many governments around the world have undertaken shifts away from the gigantic public monopolies and end-to-end ownership. The public sector role is increasingly seen as being more focused on system design rather than end delivery. Thus, whereas governments continue to finance and specify the costs and quality of services, these may be delivered by others – private companies, for example – in a competitive and cost-efficient paradigm of public-private partnership.

This may be the way forward for BiH, where the preponderant political option continues to favour decentralised government. By introducing public-private partnerships, effective services can be secured by concentrating policy design at the State level and delegating end delivery to executive agencies and contractors. These bodies usually have a more manageable structure and a more delivery-conscious ethos and can be more easily held accountable for their actions.

The arithmetic facing the BiH authorities is unambiguous. Unless the government structure is rationalised and public revenue is significantly increased, there will not be enough money to run the most important ministries and agencies. This may happen as early as 2006. Thus, the issue of projected revenue shortfalls, likely to occur in the period of intensive pre-accession activity, ought to be at the top of the governments' policy agenda in the course of 2005.

REGIONAL DEVELOPMENT

Northwest

The final version of the Regional Strategy Paper for the Northwest Economic Region was presented by the Northwest Regional

⁵Dohrmann, Thomas & Mendonca, Lenny; 'Boosting Government Productivity', *The McKinsey Quarterly*, No.4 (2004)

⁶Ibid.

Development Agency (ARDA) at the RDA meeting held in Sarajevo on 13 December 2004. The document contains a total of 148 projects scheduled to be realised within the next three years. For the first year, implementation of eight projects is planned.

On 23 November, ARDA signed a contract with the EC, securing €100,000 in co-financing (together with local founders).

Following plenary sessions of the BiH Bulldozer, the Northwest Bulldozer Committee scrutinized more than 40 reform recommendations, submitted mostly by members of the business community in the Northwest. As a result, eight initiatives, adopted by the BiH Bulldozer Committee, will be presented to the authorities.

Alpos, Prnjavor – an example of successful privatization

The Alpos pipe factory in Prnjavor is a recent example of successful privatization. The Alpos Group, from Sentjur in Slovenia, with annual production of 200,000 tonnes of pipes, is among the major pipe producers in central and southern Europe and among the top ten European producers of special pipes. In 2004 the company concluded the purchase of Fahop, in Aleksinac in Serbia and Montenegro, with the aim of raising the Group's total European production to 300,000 tonnes of pipes per annum.

The Alpos Group, which earned €87 million in 2004, will invest €5.3 million in Alpos, Prnjavor by March 2005. The production target for the plant is 30,000 tonnes of pipes. Most of the production of Alpos, Prnjavor will be sold in Germany, Austria, Poland, Russia, and Hungary.

According to the privatization contract signed in July 2004, the Alpos Group undertook to pay KM1.45 million for its stake in the company, to invest KM11.75 million within two years, and to employ an additional 30 workers within three years.

Mljekara AD Banja Luka – comeback

On 7 December 2004, the state-owned capital (65.75 percent) in Mljekara AD Banja Luka (Banja Luka Dairy) was sold to Subotica Dairy for KM 500,000. Two bids were submitted during the tender procedure, where the bid by Subotica Dairy was selected as the best, and the bid by Vindija Varazdin was rejected.

The British Investment fund Salaford, which owns Subotica Dairy, owns four formerly state-owned dairies in Serbia (Imlek – Belgrade, Impaz - Zajecar, Novi Sad Dairy, and Zemun Dairy). These facilities account for almost 70 percent of the dairy product market in S&M. According to the privatization contract, Subotica Dairy undertook to pay KM500,000, to invest a total of KM13.4 million within three years, and to continue employing all 166 workers. The new owners also reached agreement with the RS Government that the dairy's overall debts toward the RS Government, standing at KM1.8 million, would be converted into shares of Mljekara AD Banja Luka.

Aviation news from Banja Luka

The project to build a new Air Traffic Service (ATS) Building at Banja Luka International Airport, which started on 5 April 2004, was successfully completed on 31 December 2004. The new building has seven floors and 2,238.58 sq. m of useful space. Bearing in mind the fact that this building has enough useful space to accommodate the full Air Traffic Monitoring (ATM) System of BiH, the RS Civil Air Traffic Directorate - RSCAD (see <http://www.rscad.org>), as the institution responsible for Banja Luka Airport, is offering to host the ATM system of BiH. According to Dejan Todorovic, director general of RSCAD, the new building is one of the most modern in BiH and could present a strong basis for the development of the ATM system in this country.

Northeast

NERDA (Northeast Regional Development Agency) appointed its Director in October 2004, and in December signed a contract with the



European Commission under which seven projects were approved for funding. These cover a Business Support and Promotion Centre, Establishing a Centre for Promoting Entrepreneurship and Self-Employment Support Activities, a Feasibility Study for the Provision of Business Development Services to Small and Micro Business Owners in BiH, a Job Centre, a Programme on Broadening Business Perspectives among youth entrepreneurs, Boosting the Development of Tourism in Rural and Less Developed Regions of BiH, a Centre for Entrepreneurship, and the promotion of Innovation and Market Development for Posavina Region. In addition, partial funding was approved, under the Tuzla Cantonal Tourist Agency, for the Djevojacka Cave project in Kladanj. The Northeast region was granted around 30 percent of the total amount originally requested for funding projects submitted by the five regional development agencies.

At an event by OHR Tuzla organised on 7 December 2004, EU RED, NERDA and REZ presented a programme on local self governance and economic development in the context of European integration, to newly elected mayors beyond the Northeast Region.

In light of activities complementary to implementing the Banovici Municipality and Tuzla Canton Tourism Strategy, the authorities of Banovici Municipality (a mining town near Tuzla) announced in December that during 2005 they will rebuild the road leading to Zlaca Mountain Resort, one of the key tourist resources in the area. This is likely to have a significant and positive impact on efforts to develop the region's overall tourism potential.

It is expected that several European consortia will be involved in privatizing strategic companies in FBiH following the publication of the FBiH Privatization Agency's plan for 2005. Among the companies slated for privatisation under the plan is Krivaja Zavidovici, a wood processing and furniture company.

An organised system of forestry management in the Zenica-Doboj region has begun to take

shape with the signing of a contract between the Cantonal Ministry of Forestry and the Forest Management Agency. Legal preconditions have finally been met for establishing a single cantonal agency responsible for managing natural wood reserves, which until now have in practice been managed by the wood processing companies that in general opposed the idea of creating a single forest management body for the canton. The Forest Management Agency will not be able to function properly until the question of competencies is fully resolved. Creation of a single body may also bring improvements in the field of illegal and uncontrolled deforestation. BiH forests in general have been exposed to this type of abuse due to the lack of properly coordinated control of forests. Some wood processing companies still manage forests, and have not been successfully privatised due to unresolved forest management and other issues. These companies include Krivaja Zavidovici and Stupcanica Olovo, both of which are categorised as strategic companies.

Southeast

The last quarter of 2004 in the Herzegovina region was marked by a number of economic events and projects aimed at improving the overall economic landscape of the region.

The Herzegovina Regional Economic Development Strategy was officially launched on 13 December 2004 at a Conference in Sarajevo jointly organized by the five RDAs and EU RED. The Herzegovina Strategy lays down four strategic goals for the region (developed and sustainable economy; institution building for regional economic development and town planning; human resources and employment rate development; environmental protection). The strategy has so far yielded 196 project ideas, out of which a list of 57 regional priority projects has been drawn up.

The total amount of funds awarded to the Herzegovina region as a result of two Calls for Proposals on the EU RED Fund was approximately €346,000. The funds will be spent on five projects in total. Three projects embrace



the development of quality control systems and the introduction of international standards in the SME sector; the enterprise-industrial zone in Posusje; and preparation of a feasibility study exploring the possibility of establishing a Business Incubator in the Herzegovina region. Two other projects aim to support the enhancement of the tourism sector and the development of a system of marking tourist attractions in Herzegovina-Neretva Canton.

Looking into problems in the tourism sector and working out solutions for these problems were the main topics discussed at the first working meeting of the representatives of the Mostar tourist associations and agencies, which was held in December. The meeting was organized on the initiative of the Mostar Business Service Centre with the aim of initiating high-quality preparations for the next tourist season. Lack of accommodation capacity, absence of adequate tourist signs, shortage of parking places and inadequate urban sanitation were listed as the main problems in this sector, while the main objective set at the meeting was to increase tourist turnover by at least 50 percent in the next three years.

There have been other similar cases of tourism development. Three JICA (Japanese International Cooperation Agency) pilot projects in Blagaj, Podvelezje and Nevesinje, each worth around KM 400,000, are aimed at stimulating economic growth through the development of eco-tourism.

Following \$20 million worth of investment in modernizing equipment and technology, Aluminij Mostar put into operation a new facility for producing state-of-the-art aluminium blocks in October. The project was implemented in partnership with the US Company Wagtsaff. At the same time, Aluminij signed a new contract worth \$80 million with its Croatian partner, TLM Sibenik, which foresees delivery of 45,000 tons of special aluminum products this year. This represents an increase of 6,000 tons compared to 2004.

In spite of the rather slow pace of the privatization process in the region, there have been some examples of privatized companies. The privatization of strategic company Granit d.d from Jablanica was successfully completed in October, when the ownership structure was changed and a new Supervisory Board appointed. The company currently employs 428 people and earns more than 70 percent of its income from foreign sales. It is expected to invest 14 million KM and employ an additional 85 people in the next three years.

After the employees purchased, through the Banja Luka Stock Exchange, 30 percent of the state-owned capital, raising their total ownership share to 85 percent, the Factory of Forgings and Fixtures in Bileca recently re-started production thanks to contracts concluded with a Slovenian company and several companies from the RS and Serbia and Montenegro, with the combined value exceeding KM1 million. Although these contracts may not necessarily be very favourable for the Bileca company, they will enable the firm to meet its obligations toward its workers and the state and basically break-even. State-owned capital (30 percent) was also sold through the Banja Luka Stock Exchange in two other Bileca companies (Zitoprodukt and Zrak). These shares were sold for KM 30,042 and KM 181,024 respectively. Once the new owners have become legally registered and included in the management structures, it is expected that production will be restarted.

The pace of agricultural development continues to grow. With the support of UMCOR and USAID, the Agricultural cooperative Agropod in Stolac, whose main activities are growing and collecting wild-grown herbs and producing essential oils, is currently engaged in planting two hectares of medicinal herbs. In order to expand production and create new jobs, Agropod plans to put into operation a new tea-production line in the next couple of months. The production of seedlings of medicinal herbs and vegetables is expected soon.



Sarajevo

Sarajevo RDA launched its regional development strategy at the meeting of all five RDAs held in the Army Hall, Sarajevo, on 13 December 2004.

In the course of December 2004, the Agency signed several agreements, including:

a contract with UPI bank to handle the funding of a project supporting 150 family farms as well as other regional development projects supported by SERDA, a protocol with KJKP Sarajevogas and AD Sarajevogas East Sarajevo to develop a study on gas supply in the region partnership agreement with the Danish Council for Refugees, an MoU with REDRIN, a memorandum on mutual cooperation to support the "Trolley Bus Dobrinja" project, with East Sarajevo, Novi Grad Municipality, Gras Sarajevo, Gras East Sarajevo, Sarajevo Canton Ministry of Traffic and Communications, the Assembly of the City of East Sarajevo, Lukavica Municipality, and Kasindol Municipality

In the course of 2005, SERDA will continue with projects begun in 2004. These are:

- A business incubator project, a project on developing feasibility studies for industrial zones, and a regional infrastructure improvement programme comprising three projects:
 - Public lighting at the Krupac intersection
 - Lighting of the Kalovita Brda Tunnel, and
 - Public lighting at the Vrace intersection,

Projects to upgrade the regional waste-disposal system establish web portals for municipalities, introduce ISO 90001 standard in municipalities, and support 150 family farms.

In 2005, work on projects to launch business development centres and development studies programmes, not covered by SERDA's mid-term and short-term plans but which have been initiated at the prompting of the founders and adopted by the SERDA Assembly, will commence.

Studies to be undertaken will cover issues such as tackling illegal waste disposal, optimizing the use of natural water springs in the region, analyzing programmes and funds for the development of rural areas in the region, analysing funds, activities and programmes for the utilization of medical herbs growing wild in the region; and analyzing the steps that need to be taken to upgrade the trolley-bus network and the gas distribution system in parts of the region. Work on setting up SERDA's business incubator is expected to start in mid-February.

Central

A representative of REZ, the RDA for the Central Region, together with representatives from the four other RDAs, participated in a study trip to Shannon Region in Ireland, organised by the EU RED project. The visit took place from 6-13 November.

Participants learned about the structure, organisation and aspects of RDAs in Ireland and the operation of the country's subregional network. Briefings covered regional profile, projects, programmes and related development issues.

At a Regional Investment Forum on Ecology and Water, held on 18 November, the RDA presented a project on the Integral System of Waste Management in the Central Region.

Implementation of this project will facilitate:

- Waste recycling and reutilisation of raw material (paper, plastic, glass, metals) and optimal use of energy (in cement, cellulose industry etc.)
- Introduction of ecologically acceptable waste management techniques for materials that cannot be recycled
- Reduction of waste and the number of illegal depots
- Easier access to containers and other rubbish collection implements
- More efficient public rubbish-collection services



REZ, in order to implement the Regional Economic Development Initiative, funded by Sida through CHF International, published a tender on 7 September 2004 for an Entrepreneurship Support Development programme.

The objective of this programme is to promote economic development and entrepreneurship at the local and regional levels. Funds that will be allocated under the project amount to €100,000. Nine proposals were received by REZ and the Project Selection Commission approved all nine, with allocations totalling €94,360,67. These projects, which will all be implemented in the Central region, are related to agriculture development (raspberry production, milk purchase network, nursery production), strengthening entrepreneurship among young people and women, market access, and IT training for entrepreneurs.

On 23 November REZ, together with the Dutch Embassy, Dutch SFOR CIMIC and the Association of Businesspeople of Travnik Municipality, organised the Second Trade Fair and Business Forum bringing together businesspeople from the Netherlands and BiH. The objective of the fair was to improve cooperation between BiH and Dutch companies, stimulate the entry of BiH companies to the Dutch market and strengthen local and regional economic development.

At the fair 25 BiH companies exhibited their products, from the textile, wood processing and metal sectors. They were joined by 12 Dutch entrepreneurs and company directors. In addition to the main forum there was a workshop and a presentation on investment possibilities in the Central region and in BiH as a whole. This was followed by a tour of BiH companies.

As a direct result of this event, four contracts have been signed, and four more are expected to be signed in the near future. One Dutch company, during this period, finalised the process of registering in the Central BiH region, a direct result of the first Trade Mission held last year in Bugojno.

REZ Director Amela Malicbegovic presented the methodology used in BiH's successful Bulldozer Process, at a conference on Eradicating Poverty through Profit, organized by the World Resources Institute in San Francisco from 12 to 14 December. This international conference focused on private sector approaches to development – how business can "do good and do well". The conference was attended by 800 representatives from different economic development projects from around the world.



The conference concluded, among other things, that the most effective way to help the private sector contribute the sustainable economic growth is by helping it prosper in new markets – specifically markets that meet the needs of the poor and markets that deliver goods and services that generate social and environmental benefits.

FINANCE & FISCAL SECTOR

All Indirect Taxation Laws at the State Level

Late in December, the BiH Parliament adopted the State level Law on Sales Tax and Law on Excise Tax. The adoption of these two laws abolished sixteen Entity and District level Laws or Decrees on Indirect Taxation.

For the first time, the same indirect tax rates, rules, enforcement regulations and payment system operate across the whole of BiH. This

marks a major step forward in improving the country's business environment.

A range of double taxation issues (some of which were addressed in the Bulldozer Process) arising from the previous situation, in which separate sales tax regimes operated in the Federation, the RS and Brcko, have now been resolved. The problem of double taxation – a major disincentive to investment and job creation in BiH – has been eliminated, since there is now one State level Law on Sales Tax.

Abolition of Excise Allocation Mechanism

Another major step forward has been the abolition of the excise allocation mechanism, whereby inter-Entity trade in excisable goods (tobacco, alcohol, coffee, petroleum products) required that excise tax had to be paid in the Entity of production or import and again if the goods were sold into the other Entity. Due to the State level Excise Tax Law and the commencement of the operation of the single account (see below), this system is no longer required.

The real benefits of this are immediately visible. The excise mechanism destroyed a vast amount of inter-Entity trading. Petroleum sellers in the Federation have already announced that they will now buy from the refinery in Bosanski Brod in the RS as the barriers to business have been removed.

Also, these measures mean that within the next few months, single State level Excise Tax and Control stamps will be issued by the Indirect Tax Administration (ITA). These will replace separate control stamps of the Federation, RS and Brcko District.

Single Account Comes into Operation

The BiH Parliament also adopted the Single Account Law in December and this came into operation on 1 January 2005. The single account is working! All customs tariffs, all excise tax and all sales tax on excisable goods now go into the single account.

With effect from the introduction of VAT (currently on schedule for 1 January 2006), all indirect taxes (customs, excises and VAT) will be paid into the single account.

Revenues from the single account are firstly used to finance the State based on its adopted Budget. The balance remaining is now allocated directly to the Federation, the RS and Brcko in accordance with the agreed revenue allocation formula.

Formerly the State was financed through transfers from the Entities and a negotiated payment from Brcko.

Debate Over Taxing Tobacco

There has been considerable debate in the media about the increase in the excise tax on tobacco products. The rate of excise tax on tobacco products was increased based upon unanimous agreement by the ITA Governing Board and following the law's enactment in the State Parliament.

One issue which was not emphasised in the media coverage – an issue that will have to be clearly explained and repeated endlessly in the run-up to the introduction of VAT – is that tax is only one component of the final retail price, which is set not by the tax rate but by the market.

This debate though has served as a further indication of BiH's increasing normalisation. Demands by the tobacco lobby for changes in excise taxation may or may not have merit. However, the significance of what has happened cannot be overstated. Now, only one State-level law has to be changed and not several laws at the Entity level. The volume of debate surrounding the issue reflects the success of this reform. Had the tax rate change not been implemented properly, no one would have noticed.



Value Added Tax (VAT)

The final stage of Indirect Tax reform will take place when VAT is introduced, still on target for 1 January 2006.

On 12 January, the BiH House of Representatives adopted the harmonised version of the VAT Law, stipulating a single-rate VAT of 17 percent, with a zero percent rate on exports.

This was a bold step by the BiH Parliament, but a necessary one for BiH. The successful introduction of VAT, together with the other achievements made to date, will generate significantly greater investor confidence in the BiH business environment.

Budget

Timely and Responsible

Despite the fact that both Entities had to rebalance their 2004 budgets, the final quarter of 2004 witnessed a remarkable success in the fiscal policy area, perhaps the greatest achievement in this field since the war.

Firstly, the Single Account Law rationalized the fundamental mechanism for financing the State. In previous years a huge portion of revenue for State institutions consisted of transfers from the Entities. Since 1 Jan 2005 funding for the State has been based on direct allocations from the Single Account. Under this system a portion of indirect tax revenue (customs, excises and sales tax on excisable goods) collected by the Indirect Taxation Administration will automatically be allocated to State institutions, in proportion to the adopted budget

Secondly, the State and Entity finance ministers signed an agreement with the IMF in early December 2004 pledging to adopt the State budget in the amount of KM336.7 million, respecting the 45.6 million KM of consolidated deficit limit (including the Entities' extra-budgetary funds) as proposed by the IMF.

As a consequence, the parliaments of both Entities adopted the budget before the end of 2004, and the State Parliamentary Assembly adopted the 2005 State budget at a House of Representatives' session on 12 January 2005 – the earliest this has ever been done.

In a nutshell, timely and responsible fiscal policy at the BiH State Government level marked the final quarter of 2004.

Institutional changes in tax assignment, however, increased uncertainty at the lower tiers of government, particularly in the Federation.

Although the sales tax on excisable goods was assigned to the Federation, sales-tax revenues were received by cantons in accordance with the Law on Revenue Allocation of 1996. With the commencement of the Single Account functioning, and also with required increased State financing, the cantons were uncertain of the amount of sales tax on exciseables they might expect to receive in 2005. For this reason mainly, only five cantons adopted their budgets before the end of 2004.

AGRICULTURE

Growing Awareness

The remarkable initial estimates of agricultural income after the accession of new member states to the EU indicates that the impact of accession on the agricultural sector is likely to be overwhelmingly positive, principally as a result of access to the Single Market and implementation of the Common Agricultural Policy. Initial estimates of agricultural income for 2004 show a year-on-year increase of 3.3 percent in the European Union as a whole – and an average of 53.8 percent for new member states¹.

¹ Accession boosts farm income in new Member States by more than 50%, says Eurostat
<<http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/1509&format=HTML&aged=0&language=EN&guiLanguage=en>>

This stunning growth has not been achieved overnight. It is the product of years of agricultural reforms in the run-up to accession, combined with the optimal use of EU structural funds in the same period.

If we compare BiH's agricultural foreign trade deficit with the balanced agricultural trade achieved by some other countries it is easy to conclude that these countries are focusing more effectively than BiH on agricultural policymaking. This has to change – BiH can't secure EU structural funds for agriculture until it has implemented the reforms laid out in the EC's Feasibility Study, including establishing veterinary certification procedures, a phytosanitary agency, and a food safety agency, and implementing other structural reforms in the agriculture sector.

In 2004 BiH made substantial progress in the veterinary sector, but in the areas of plant health protection and food safety there is still too little forward movement – and this will certainly have a negative impact on securing EU assistance.

In the course of 2004 the issue of land management was addressed by several international organisations. Problems identified were: an inconsistent legal framework, sub-optimal public land management, inadequate access to land, and small plot size.

In the last quarter of 2004, at an Agriculture Conference organised by the BiH Council of Ministers, the European Commission and the OHR, the results of the EU's Functional Review of the BiH Agriculture Sector (a project undertaken within the broader review of Public Administration) were presented. One of the main conclusions of the Conference was that BiH urgently needs to set in place more efficient administration of its agriculture sector. If this is not done, EU funds will not be forthcoming, and further integration in European structures will be blocked.

The Conference concluded that one of the principal means through which agricultural administration can be improved is through the

establishment of a BiH Ministry for Agriculture and Rural Development.

The problem of sub-optimal land management was addressed at a conference organised at the end of 2004 in Sarajevo by the United Nations Food and Agriculture Organisation (UN FAO) as part of a project designed to produce an inventory of postwar BiH land resources.

Despite the fact that the nature of this and other problems is generally well understood there remains a debilitating absence of political focus on these issues. Agriculture is an influential sector of the BiH economy (roughly two thirds of the population live in the countryside or depend on the farming and food-producing sector and agriculture accounts for about 12 percent of GNP) yet it is not a policymaking priority at any level of government.

It is clear that BiH needs an efficient veterinary system, a single legal framework and appropriate institutions for plant health protection and food safety, as well as a comprehensive reform agenda for the agriculture sector as a whole. Issues such as certification, and administrative institution building, small plot size, incentives to switch to marketable and profitable production, scientific research services, animal health services, adequate inspection, land management and availability, farm training and the provision of expert assistance all have to be addressed.

There is now an awareness among politicians that the failure until now to address these issues in a disciplined and determined way has had a direct and negative impact on the economy – but this awareness is growing painfully slowly.

It is equally clear that the EU will provide assistance to support reforms – but only when current initiatives in the agricultural sector have been followed through to a conclusion that indicates the authorities are serious about improving the administration and operating climate of BiH agriculture.

This is not an issue of academic interest. Currently, the value of BiH food imports is sixteen times higher than the value of food exports, and rural unemployment is needlessly high. This can



and must be fixed without further delay, and the conferences held and policies agreed in the course of 2004 point the way to how this can be done.



STATISTICS

Statistically Better than Before

After protracted delays arising from primarily political considerations, a Director and two Deputy Directors were appointed by the BiH Council of Ministers to the BiH Statistics Agency on 16 September 2004. Before these appointments could be made, the BiH Law on Statistics had to be amended in order to provide for the Deputy Director positions.

Soon after these management appointments, the Agency began the process of setting up a BiH Statistics Council. This was established in November 2004. The Statistics Council is an expert advisory body to the Council of Ministers, which will assist in the development of statistics policy and a viable statistics service.

Development of a medium-term official statistics programme for 2005-2008 is stipulated by the BiH Law on Statistics, and was prepared by the Statistics Agency and adopted by the Statistics Council in the first half of January 2005. The Statistics Programme defines the objectives and activities that are needed for implementing statistics strategy/policy, combining local and international priorities and existing capacities and possibilities.

The next steps in establishing a reliable BiH statistics system will involve defining the relationship, cooperation, organization and responsibility of the Agency and the Entity statistics institutes. In this regard the State Agency and the Entity institutes must, under the BiH Law on Statistics, draft annual working plans and internal rulebooks covering their organization.



UTILITIES SECTOR

Transport

Moving in the Right Direction

The transport sector witnessed some progress in the final quarter of 2004, though much more could have been achieved with greater political support.

The BiH Law on Railways was scheduled to be discussed by the Council of Ministers in December. This law is crucial for BiH's economic development because it will provide a basis for the restructuring of this sector along standards set by the EU. This will not only mean greater efficiency within the sector but also greater transport opportunities for domestic heavy industries whose own growth will be limited by the possible transport bottlenecks in BiH. Unfortunately, because of intervention from the Government of FBiH, the law was withdrawn from the CoM agenda and has not yet been discussed by the CoM. It is imperative that the law is adopted by the CoM by the end of the first quarter of this year at the very latest because BiH would not be able to enjoy the benefits of loans and international financial assistance if the current impasse were to continue.

On 6 December OHR, along with other international organizations and in conjunction with BH Steel, organized a Conference on Infrastructure in Zenica. Presentations were made by OHR, EBRD, JICA, and the EC as well as by BiH Transport Minister Branko Dokic.

The overwhelming conclusion of this conference was that in the context of BiH's further development, transport will make the key difference in the next few years.

The Zenica conference followed an earlier seminar organized by the EBRD in Sarajevo, which looked at transport issues in a regional context.

Privatization

Legal and Administrative Environment Still Less than Satisfactory

The Turkish private company Kastamonu Entegre has emerged as the preferred investor in Natron, Maglaj. The terms of the joint-venture agreement are currently being finalized between representatives of the current owner, the Government of Zenica-Doboj Canton, and the prospective investor. USAID and OHR have played a role in facilitating Natron's revival.

On 1 December 2004 the RS Government appointed Vladimir Mackic, a former executive with the Banja Luka Clinical Centre, as the new Director of the RS Directorate for Privatization. The Privatization Directorate has already prepared its annual plan and despite recent political turbulence in the RS, the pace of privatization in the RS is likely to pick up.

Federation Privatisation Agency Director Resad Zutic will retire at the end of his term in the early spring of 2005. His Deputy's term also expires around the same time. The Federation Government has not yet begun the procedure to select and appoint successors.

The Federation Government has adopted or is in the process of adopting several controversial amendments and new laws in the area of privatization. The most harmful amendments raise the possibility that already privatized companies or companies that have been earmarked for sale could be audited at any time, thereby creating enormous legal uncertainty. Another problematic set of amendments would ban foreign majority state-owned companies from participating in privatizations in BiH. If fully adopted and applied consistently, these measures could reduce public and foreign investor confidence in FBH institutions, undermine the judicial system, and strain already

limited resources in courts and privatization agencies.

Institutions in both Entities have largely been unable to use bankruptcy proceedings as a way of restructuring state-owned enterprises, particularly those with potentially sustainable business and product lines. Bankruptcy proceedings allow companies to reorganize and to reduce the number of employees and accumulated debt. Reasons for delays in instituting bankruptcy proceedings include lack of political will, lack of mechanisms to identify and bring in suitable investors, and inadequate management capacity to prepare business plans that meet international standards.

Business Environment

Entity Laws on Accounting and Auditing

With a view to establishing mandatory accounting and auditing standards and introducing a professional code of ethics for the whole of BiH, the Parliamentary Assembly adopted the BiH Law on Accounting and Auditing on 29 June 2004. The Law was gazetted on 10 September 2004.

This piece of legislation represents a major step forward, as it not only foresees a uniform approach to accounting and auditing, but also addresses severe criticisms of accounting and auditing practices in BiH. To give effect to its provisions and to ensure uniform application of its principles throughout the country, the Entities and the Brcko District now need to adopt corresponding laws fully harmonized with the State Law and with each other.

The Entity Laws on Accounting and Auditing were adopted by the respective Governments in December 2004 and are awaiting parliamentary consideration. If enacted without delay and in a form that does not contradict the aims of the accounting and auditing sector reform, they will contribute to creating a system based on four main principles: (1) *independence and integrity of the accounting and auditing profession*; (2) *self-regulation, according to internationally accepted*

and enforced standards; (3) protection of the public; and (4) continuous improvement of standards.

By introducing these principles, the new legislation will bring BiH into line with internationally recognized practice, thus also contributing to the country's attempts to align itself to the *acquis communautaire*. It is therefore crucially important that this legislation is not subject to unnecessary delay or ill-considered amendments. The four principles must be maintained and the opportunity that this legislation presents for the revitalization and regeneration of the accounting and auditing profession in BiH must not be lost.

Entity Laws on Business Registration

The State Framework Law on Business Registration was adopted by the BiH Parliamentary Assembly on 29 July 2004 and gazetted on 10 September 2004. Its main purpose is to define the manner of business registration in the Entities and Brcko District, as well as to achieve harmonization of State, Entity and Brcko District legislation with EU regulations. It provides for a fast and uniform business registration procedure throughout BiH and is applicable to all businesses established in BiH by domestic or foreign legal and physical persons.

To give effect to the provisions of the State Law and to ensure uniform application of its principles throughout the country, the Entities and the Brcko District must adopt corresponding laws, fully consistent with the State Law and with each other, and harmonize any regulations that may be consistent with the State Law.

The legislative procedure at the Entity level is, however, still at a preliminary phase. The RS Government adopted the RS Draft Business Registration Law only on 30 December 2004, while the Federation Draft Law has yet to be presented to the Government. This slow progress in taking forward the reform (implemented with the assistance of the UK Department for International Development), may send negative signals to international and domestic investors.

An additional concern is the possibility that the World Bank's Business Environment Adjustment Credit, which is conditional on, among other things, the implementation of this reform, could be jeopardised.

The path forward is clear. The steps that are needed in order to provide BiH with a more efficient business environment, which will encourage investment and facilitate the creation of new companies and new jobs, are already laid out. It is now up to the politicians to take these steps. The sooner they do this the sooner citizens can begin to experience the ensuing benefits.

Bulldozer

A New Era



OHR's direct involvement in the Bulldozer process officially ended at the close of 2004. Coordination of the process is now in the hands of the Association of Employers of BiH following a handover that took place over several months.

The systematic increase in the role of BiH players, as the International Community has withdrawn to the sidelines, has continued with Phase Three. In Phase I, OHR was responsible for the coordination of the entire process, from collecting the initial suggestions from entrepreneurs all the way up to the verification of the implementation of the reforms. In Phase II, six Regional Bulldozer Committees and one national Bulldozer Committee on Agriculture were established. These committees took on the responsibility of collecting information from entrepreneurs on what it is that makes doing business in BiH difficult. With that information, they formulated the reform proposals that were ultimately presented to the government. Also in Phase II, the prime ministers established the Emergency Reform Units. These units, consisting of young and professional civil servants from some of the most relevant ministries, were tasked with coordinating the adoption and



implementation of the reforms. The OHR's role was to help in the capacity building of the new structures, and to provide overall coordination of activities.

The Regional Bulldozer Committees and the Emergency Reform Units have thus continued to improve their work as representatives of the private and public sector. The overall coordination, which in Phase II was still the responsibility of the OHR Bulldozer Unit, has been gradually transferred to the newly established Association of Employers of BiH.

The 50 reform proposals selected and formulated under Phase III were formally presented to the governments on 10 January 2005 at a ceremony in the Holiday Inn in Sarajevo. The Association of Employers of BiH will now generate publicity for these reforms in order to maximize lobbying effectiveness. The Emergency Reform Units, assisted by the Bulldozer Committees, will explain the reforms to government officials and parliamentarians in an effort to speed up the adoption process. Finally, the implementation of the reforms will have to be verified and an assessment of the results will have to be made.

With the end of Phase III, a total of 150 reforms will have been proposed to the government. Most of these reforms are likely to produce significant improvements in the BiH business environment. This in itself will be a considerable achievement. However, at least as important as these individual reforms is the establishment of a dialogue between the public sector and the private sector. A conventional forum for this kind of dialogue is a social and economic council, of the type that is now common in many modern economies around the world. These councils already exist in the FBiH and the RS, but not yet at the BiH level. The logical successor of the Bulldozer Initiative, after Phase III, would therefore be a Social and Economic Council at the State level. Discussions with BiH and international stakeholders to this effect are now underway.



BiH Economic Data January – October 2004

Source: FBiH and RS Statistical Offices, Central Bank of BiH, Economic Department, OHR

Indicator	BIH
GDP nominal 2000 (Million KM)	10,050
GDP nominal 2003 (Million KM)	12,170
Nominal increase 2000-2003	+ 21%
Composite Index of Industrial Production in BiH January – November 2004 / January – November 2003	111.56
Consumer Price Index	0.6% (year end 2003)
Average Net Monthly Salary (in KM)	499.13
Number of Registered Unemployed	451.294
Number of Pensioners	464,180
Average Pension (in KM)	197
Imports 01/04 - 11/04 (Million KM)	9,534,413
Exports 01/04 - 11/04 (Million KM)	2,829,702
Balance	(- 6,704,711)