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Bosnia and Herzegovina – Understanding Reform

About

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at www.balkan-observatory.net, the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.

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This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.

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BOSNIA AND HERZEGOVINA – Understanding Reform

Introduction

Bosnia- Herzegovina's (BiH) recent economic environment and development priorities have been primarily determined by the requirements of post- war reconstruction, following an end of a three and a half year war in 1995. Reforms towards creation of free- market economy were identified as medium- term priority, once the basic infrastructure and institutional prerequisites for the normalization of economic activity were in place. Besides war- related, large- scale physical and institutional destruction against which transition process was launched, its unique character was determined by the fact that it took place within the framework of building BiH as an independent and highly decentralized political entity. With a minimum of state- level economic prerogatives, transition reforms in post-Dayton BiH were pursued with variable speed and in certain respects modified contents by its two entities i.e. the Federation of BiH and Republika Srpska, which has had important repercussions on the overall profile, sequencing, success and shortcomings of the process. Another important difference compared to the transition experience elsewhere is the decisive role played by the external actors in the economic management of the country by way of setting up economic policy and reform agendas (the High Representative is effectively the supreme authority), and providing financial and expert support for its implementation. The international community has taken over the policy processes in many key reform areas: from fiscal and monetary to the regulation of telecommunications and reforms of judiciary, rendering local leadership rather a subordinate role. This gives a qualitatively different meaning to the crucial issues of political consensus over the reforms and hence ownership of reforms, which, as the transition experience of other countries suggests, is key to the sustainability of reforms and their impact on economic performance. While local consensus on reform issues was often achieved by resorting to aid conditionality, it is the obstacles in the process of implementation that testified to the lack of genuine local commitment, thus affecting profoundly the dynamics and the outcome of the reform processes. Another important difference relevant for understanding BiH's transition experience is an exceptionally high level of international assistance. While facilitating and sustaining reform processes, it has resulted in an aid dependent pattern of development reflected in a fact that eight years after the end of the conflict international community still remains the main service provider in key governance areas. This is an important fact that has to be taken into account in the course of analysis of the experience of transition in BiH and a telling indicator of its outcome in terms of developing a functioning market economy in the specific environment of BiH.. And last among the specific features of BiH's transition context is a short, 2-year political cycle characteristic of most of the period since the end of the war in 1995. The delays in constituting governments at various levels and a lack of constructive political dialogue among the parties represented in the government has also had a strong impact on the final shape of reform measures and dynamics of their implementation by rekindling instability and uncertainty. The other aggravating factor was the succession of coalition governments with weak executive power.

Macroeconomic stability has been the cornerstone of the economic programme pursued as part of a broader reconstruction effort in BiH supported by the international community. In contrast to many transition countries that similarly aimed at macroeconomic stability as an early key objective of transition, BiH has had a relatively coherent stabilization programme the implementation of which was facilitated by substantial international financial and technical assistance. The key element was the consistent and strict implementation of the currency board regime coupled with the public finance reform and the reform of the financial system. The currency board regime, which was initially envisaged to last until 2003, was extended due to ongoing political risks. Because of strong international presence in BiH some of the reforms were pursued more vigorously e.g. financial liberalization and others e.g. labour market reforms initiated at an earlier stage compared to experience of most other countries. Political obstructions to the implementation of the reforms have made the problem of sequencing and reform inter-locking even more pronounced, which in turn diminished some of their positive effects. The "second generation" reforms were stepped up towards the end of 2002 while some of the "first generation" reforms, notably privatization, were still far from being completed. At this stage reforms had to be carried forward in a somewhat different economic environment. Economic recovery spurred by international assistance was clearly running out of steam and the level of international assistance had fallen sharply. At the end of 2003 the BiH government adopted Development Strategy as part of the poverty reduction strategy exercise, which was the first document involving broad consultations among local stakeholders over the country's economic priorities. The international assistance conditionality moved more firmly towards European Union accession agenda whereby the implementation of a number of reforms was made a condition for BiH signing Stabilization and Association Agreement. International community signaled with greater determination its intention to scale down its involvement and transfer responsibility onto local authorities. All this presents a new challenge in managing transition in BiH since local political environment remains one of the main constraints to the implementation of remaining complex reform agenda.

This paper starts with a brief overview of the initial conditions and the framework within which the reforms in BiH were initiated. It then highlights some of the key elements of BiH's new administrative set up of crucial relevance for the analysis of reform experience, pointing to the specific role assigned to the international actors under the terms of the Dayton Peace Agreement. The third part examines the contents and problems of implementation of some of the key sectoral reforms focusing on the institutional constraints. Problems, obstacles and failures of the reform process in the selected areas are then taken up and analysed in the fourth part. In part five the current status of reforms in summarized. Part six concludes by looking into the state of BiH's economy in a comparative perspective within the region of South East Europe and identifies some of the major areas affecting its progress towards self- sustained growth.

1 Initial conditions and beginning of reforms in Bosnia and Herzegovina

BiH's transition started in conditions of large- scale physical destruction, massive population displacement and dissolution of the system of governance established while BiH was one of the republics of SFR Yugoslavia. Although difficult to determine with any precision, direct economic losses of the 1992-1995 war, not including lost output, were estimated at $60-$80bn. Pre- war economy collapsed; at the beginning of 1996, BiH's GDP stood at some 20% of its 1991 level, amounting to $500 in per capita terms[1]. The decline in industrial output to 5% of its pre- war level and the rate of unemployment estimated at 70-80% with most job losses in industry indicated not only the extent of war destruction but also the scale of deindustrialization that the country had undergone and was unlikely to reverse to any significant degree. Worst still was the impact on agriculture, which virtually ceased. With an average salary of DEM90, and paid irregularly, most people survived on humanitarian aid. Large scale internal and external migration, accounting for over a half of the pre- war population, against the change in the country's economic structure, contributed further to previously already serious problems of labour market rigidity. All this would prove an enormous challenge to efforts aimed at reviving economy while maintaining macroeconomic stability and pursuing economic reforms. Facilitating factor at the initial stage was that rampant inflation of early 1990s was brought under control in larger part of the country. Stabilization programme in the parts of BiH with Bosniac and Croat majority, involving introduction of a new currency and use of Croatian kuna, respectively, and sanctions on Republika Srpska by the Federal Republic of Yugoslavia contributed to the improvement in fiscal discipline towards the end of the war.[2] However, the governments in both entities ran large arrears in payments towards pensions, army and other budget beneficiaries as well as to the public in respect of frozen foreign currency savings, which combined with large external debt meant that the overall public debt was very high. Foreign debt stood at $3.5bn at the end of 1995, most of which was owed to London and Paris Club of creditors and was unserviced during war years. Furthermore, BiH was not a member of the World Bank and the IMF. Estimates of exports in 1995 ranged between $295m and $90m, the latter figure being probably more realistic. Against the country's reduced production capacity, and consequently large imports the trade deficit was likely to have been substantial.

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[1] Source: IMF, unless indicated otherwise.

[2] Inflation continued to be higher in Republika Srpska than in the Federation for much of the post- war period; the rates only started to converge in 2000-02.

The institutional heritage of post- war BiH was not conducive to the development of market economy and democracy. Administrative control over economy increased during the war, strengthening the concept of state enterpreneurship based on totalitarianism of state property in companies and banks. It became the very source of bureaucratic management over the economy, politicization and socialization of economic relations, political and bureaucratic redistribution between economy and state and within economy, coupled with an inefficient use of resources, lack of incentives for the expansion of economic partnership, etc. Free enterpreneurship had no access to resources, thus undermining the efficiency with which resources were used. In actual fact resources were captured by national bureaucracies, group-property interests and inertia of the socialist system, and largely isolated from the impact of market forces. Accordingly, institutions that support development of free economic initiative were seriously underdeveloped and public trust in state institutions was lacking. Another important effect of war was political and economic fragmentation of the country, and the establishment of the three more or less self- sufficient economic and political entities and an absence of the institutional framework for macroeconomic management of the country.

Initial steps towards market reform of the system based on self-management including a self-managed type of social property were made in BiH in the pre-war period. Between 1989-1991 the government of the SFR Yugoslavia introduced an entrepreneurial concept of business management in the economy and started privatization. The reform processes in BiH were stopped soon after the first multi-party elections in the republics of former SFRY, dissolution of the country and the outbreak of war. During the war reforms were not only halted but also partly reversed. This experience was another factor adding to the complexity of the environment in which transition reforms were launched following the signing of the peace agreement and BiH's admission to the membership of the World Bank and the IMF in 1996.

2 Administrative structure of BiH and readiness to implement the reforms

The Dayton Peace Agreement defined a new state of BiH as a union of two entities: the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS). Definition of entities and distribution of territories in the ratio of approximately 51% to 49% are primarily based on ethnic principle. FBiH is constituted as a Bosniac-Croat entity while the RS is constituted as a Serb entity. This domination of ethnic principle in administrative and economic arrangements has created numerous problems, particularly regarding the possibility of conducting efficient foreign trade, fiscal and social policies, requiring at least some degree of state- level policy making.

The established structure of authority in BiH has enabled national elites strong influence in deciding whether to implement the reforms or to boycott them. Coordination between the entities, and in the Federation between the Bosniac-majority and the Croat-majority areas, regarding the adoption of strategic laws for implementation of reforms remained very poor for most of the 1996-2000. Adopting laws in the BiH Parliamentary Assembly was an extremely difficult process, marred by obstructions and frequent rejections of laws. This behaviour was particularly evident in the first three post-war years (1996-1998) during which institutional structure of BiH failed to provide a minimal framework of legislative, executive and judicial authority required for the introduction and implementation of reforms.

To counteract obstructions to the implementation of peace agreement including economic reforms the powers of the High Representative were gradually extended. While initially the High Representative acted primarily as an intermediary between the entity authorities, facilitating consensus on key decisions and laws necessary for the implementation of reforms, since 1998 his authority has extended allowing him to impose legislation, if necessary. This was deemed necessary because, despite formal agreement among the local parties that there was no alternative to the development of modern market institutions protecting property rights, executing contractual obligations, and accepting business risks, morals and disciplines, obstructions of processes aimed in this direction remained strong.

Given the fact that, in economic sense, during 1995-1998 BiH was practically a virtual creation, the necessary laws aimed at creating the conditions for economic integration of BiH were either directly imposed by the High Representative or the state parliament adopted them under concerted pressure of the High Representative. Although under the Dayton Agreement the BiH state is given the responsibility over monetary, customs and foreign trade policy, the first state level laws providing a legal basis in this area were adopted only in 1998.[3] The application and harmonization of the laws at the entity level proceeded slowly as local parties tried to reject or delay moves towards strengthening integrative elements contained in the state- level legislation. For example, the BiH Law on Foreign Direct Investment was adopted in mid-1998, but the entities codified and adjusted their corresponding laws only three or four years later: FBiH in mid-2001 and the RS in 2002.

Monetary system represents another example of BiH's divided economic space in the first post-war years. BiH did not have a single currency until June 1998. Internal payment operations system was divided along ethnic lines into three separate systems. Fiscal policy was managed at the level of entities and at the cantonal and entity level in the FBiH. Budget of the BiH joint institutions did not even exist in 1996 and 1997. The first budget of the BiH joint institutions was adopted in 1998, reflecting the peculiarity of BiH's constitutional set up, namely that the state had no independent revenues other than the

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[3] Law on Customs Tariff of Bosnia and Herzegovina, Law on Foreign Trade Policy, Law on Direct Foreign Investment Policy in Bosnia and Herzegovina and the Law on Customs Policy of BiH were adopted in 1998. During the period from 1996 to the day of adoption, the laws at the state level did not exist.

fees. According to the Constitution the central state is funded from the transfers by the two entities. The most telling indicator of BiH's state lacking a minimum of competence in terms of economic management of the country was the fact that until 2000 BiH had no state border service.[4]

3 Contents of reforms and implementation procedure – programme, goals and instruments

3.1 Reconstruction and beginning of reforms

Rehabilitation and reconstruction projects in BiH, as a material precondition for the initiation of economic reforms, were implemented in 1996-2000. Priority reconstruction programme aimed primarily at rehabilitation of infrastructure and restoration of public services. By far the largest share was invested in the reconstruction of devastated or damaged housing units, electricity supply systems, transport and water infrastructure. In the public services sector, reconstruction projects were directed into reconstruction of health and educational facilities with the aim of restoring basic health services and initiating educational reform at all three levels (primary, secondary and university education). The main instruments for the realization of these projects were multilateral and bilateral donations.

Table 1

Sectoral distribution of reconstruction projects in Bosnia and Herzegovina, 1995 to 2000

	SECTORS	SECTORAL DISTRIBUTION OF RECONSTRUCTION PROJECTS
		in %
1	Housing construction	16,11
2	Power supply sector	12,99
3	Transport	11,18
4	Water supply system	7,81
5	Support to social security system	6,84
6	Education	4,32
7	Credit lines to the business sector	8,20
8	Agriculture	3,82
9	Construction of the state institutions	3,94
10	Servicing of f oreign debt	4,40
11	Other	20,38
	TOTAL	100,00

Source: International Management Group Databases, Summary Report: Donor Aid to BiH, u: Economic Task Force Secretariat, Vol. 3, Issue 5.

[4] The State Border Service was established only in 2000 by the decision of the High Representative.

Following BiH's admission into the World Bank and the International Monetary Fund membership, economic reforms were included as a compulsory element of the internationally assisted reconstruction programme. Unlike in other countries implementing reforms, the first step in BiH was to create legal and institutional base for the very process itself. This required an agreement with the entity authorities and the High Representative for BiH acting as an intermediary. The basic set of economic reforms included the following:

- fiscal reform;
- monetary reform;
- privatization;
- financial sector reform;
- trade liberalization, and
- labour market reform.

In its initial stage reforms concentrated on public finance, banking and privatization. The goal of the reforms was development of market economy based on private property and elimination of the state from the management of the economy. Social protection system and labour market reforms were placed within this context. Although the goals of these reforms did not differ from most other transition countries, in BiH the task was additionally complicated by the necessity to build the whole new institutional framework for macroeconomic management as envisaged by the Dayton peace agreement. This has had defining impact on the pace and success of economic reforms.

3.2 Contents of the sectoral reforms

3.2.1 Fiscal system reforms

Defining new fiscal structure was one of the immediate post- war priorities. Significantly larger competencies were assigned to the entities than to the state, and the structure of the fiscal system in BiH was defined accordingly. As mentioned previously, fiscal sovereignty rests with the entities[5], while the state has no revenue rising powers other than the fees and is financed by entity transfers.

The Constitution has defined as a minimum condition: (1) establishment of the BiH budget and (2) provision of its revenues to cover servicing of the external debt and financing of BiH joint institutions. The BiH Constitution provides a possibility for the entities to agree on how to regulate the fiscal system. The constitution has not defined a permanent basic fiscal model, i.e. division of fiscal sovereignty, neither has it postulated that the fiscal model must be modified. This makes it clear that the Constitutional solution was primarily based on

[5] The district of Brcko which is under the jurisdiction of the central state is also fiscally autonomous.

political principles, rather than economic. Given the political situation in BiH, the constitutional approach started from the assumption that the fiscal system which places fiscal sovereignty with the entities may contribute to the political stabilization and confidence building as an initial step in improving relations among BiH's three main ethnic groups.

The political structure of BiH is aimed at securing the interests of the constituent peoples, which is reflected in the principles underpinning the allocation of public revenues and expenditure. Apart from external debt servicing, which is the responsibility of the central state, all other public services are responsibility of the entities. The fact that the central state does not have its own independent revenue has come to be one of the major obstacles for its functioning as new state level institutions have been created in the course of the implementation of the peace agreement eg state border service and new ministries. Establishment of the Indirect Tax Administration in 2003 represented the first example of a substantial transfer of fiscal sovereignty from the entities to the State. It is a step towards the introduction of the state- level value added tax, which is planned in 2005. This example shows that a consensus on a rational organization of institutions is possible provided there is confidence in their professional and efficient conduct.

Administrative structure of the FBiH, which is composed of ten cantons, places most service delivery obligations on the cantons, without assigning them sufficient revenues. Canton are responsible for education, social welfare (except for the war invalids and families of killed soldiers), and cantonal administration. Cantons have an exclusive right to turnover tax on their respective territories. This source of fiscal revenues for most of the post-war period accounted for approximately 75% of the total revenues of cantonal budgets. In contrast, three main obligations related to the FBiH budget are payment of social benefits to the war invalids and families of killed soldiers, military expenditures and servicing of the external debt of BiH allocated to FBiH in accordance with the Law on External Debt of BiH. Federation main sources of revenues are customs, excise and taxes. Tax policy, which is conducted at the Federation level, has a major implication for the cantonal finance where payments arrears, especially in economically weaker cantons, are recurrent. Expenditure rules are imprecise and revenue allocation uneven. However the institutional set up provides no mechanisms and procedures to address these problems, which are a constant jeopardy to fiscal stability.

Structure of the RS fiscal system is much simpler and includes collection of all significant fiscal revenues at the entity level. Such a solution for the RS was a consequence of the administrative structure, i.e. non-existence of the cantons in this territory. The RS budget is responsible for all three levels of education, military expenditures, social welfare of war invalids and families of killed soldiers, entity administration and foreign debt allocated to the RS.

As noted before, political considerations were determining factor in shaping up the particular model of BiH's fiscal federalism. Its implementation has however revealed serious shortcomings and need for re- defining some of its key parameters, which requires local cal consensus. Some adjustments were made in the Federation in 1990-2000 to address the misalignment in fiscal responsibilities and revenue entitlements among the various levels of government, while the major attempt at a country- wide realignment was initiated in 2002 with the indirect tax reform. The result was that throughout the second half of the 1990s, weak economic performance and large needs for public spending, kept fiscal position in a precarious state and sustained only by substantial international budgetary support.

3.2.2 Reform of the monetary system and the system of internal payment operations

The Central Bank of Bosnia and Herzegovina (CBBiH) is the sole monetary authority in BiH. Specific nature of the political re-organization of BiH as a result of war is also reflected in the organization of the monetary system. The choice of a concept of limited monetary sovereignty of BiH was politically motivated, depriving its Central Bank of the right to choose the type of monetary policy in the first six years and of its function as a lender of last resort.

Limited monetary sovereignty of BiH is aimed at the elimination of political voluntarism in the monetary field, i.e. elimination of abuse of discretionary monetary policy. Such constraint was inevitable given the political make up of BiH as well as its sensitivity to the possibility of abuse of discretionary monetary policy. The decision to extend the same monetary regime for another six years as of August 2003 suggests that political risks still loom large over BiH capacity to takeover full monetary sovereignty.

The Central Bank (CBBiH) is often identified as one of the most successful institutions in post -war BiH. The CBBiH was established in August 1997, operating on the currency board principles. A single currency - Convertible Mark (KM), introduced in June 1998[6], became the only legal means of payments in both cash and non- cash transactions in September 1999. The direct impact of the reform was a high increase in money supply:

[6] KM was fixed to the German Mark until January 2002 and to the euro from then on.

Table 2

Money supply

millions of KM

	1998	1999	2000	2001	2002
Demand deposits in domestic currency	147.5	584.6	750.0	1,018.4	1,273.3
Currency in circulation	162.5	515.3	651.7	1,673.9	1,734.4
MONEY - M1	**310.0**	**1,099.9**	**1,401.7**	**2,692.3**	**3,007.6**
Time and savings deposits in domestic currency	8.0	22.4	77.9	140.9	272.2
Demand deposits in foreign currencies	762.0	465.5	559.5	928.5	817.1
Time and savings deposits in foreign currencies	467.0	577.3	428.2	907.7	974.4
QUASI-MONEY- QM	**1,237.0**	**1,065.1**	**1,065.6**	**1,977.0**	**2.063,7**
BROAD MONEY -M2	**1,547.0**	**2,165.0**	**2,467.3**	**4,669.3**	**5,071.3**

Source: Central Bank of BH, Bulletin No 2/ 2003

According to the principles of the currency board, the total amount of KM in circulation, increased for the deposits of the commercial banks with the CBBiH, must be covered by the foreign currency reserves in the amount exceeding 5% (after 2000 exceeding 10%) of the KM supply. This rule led to an increase in foreign currency reserves, which corresponded to the growth in primary money. Foreign currency continued to grow steadily, not least due to the substantial inflow of international assistance. By 2002-2003 gross foreign currency reserves on average amounted to around 4.5 worth of monthly imports.

Table 3

Foreign currency reserves

millions of KM

	1998	2000	2001	2002
Net foreign currency reserves	283.3	1,021.2	2,666.5	2,463.2
Monetary liabilities	253.9	973.2	2,591.6	2,345.2
Net free reserves	29.4	48.0	75.0	118.1

Source: Central Bank of BiH, monthly balances 12/1998 - 12/2002, www.cbbh.gov.ba

Introduction of a single currency in non- cash payment transactions has created necessary prerequisites for a more efficient control of payment operations. It has also resulted in gradual reduction in the role of cash in payment transactions, which in turn has facilitated gradual elimination of the possibility to use foreign exchange to finance illegal activities. Another positive result was improved efficiency in controlling public revenue collection.

State control over domestic payment transactions was eliminated by the abolishment of entity payment bureaus, and transfer of payment operations to commercial banks. The payment bureaus had been retained from the command economy, allowing full control of payment transactions and providing channels for diverting public funds. Moreover, they were perceived as depriving the financial system of much-needed liquidity, hence harming the banking sector, which combined with their capability to create credit, could undermine the currency board. In early 2001 the payment bureaus were closed and replaced by a commercial-bank clearing system, while the Central Bank assumed responsibility for high-risk transactions. After some initial difficulties, the banks managed to provide an adequate payment-transactions clearing service but the transfer of some other responsibilities e.g. statistics has been less smooth. BiH has become the first country in transition to successfully implement the reform of the payment system. Since January 2001 BiH has in place one of the technologically most sophisticated systems of internal payment of any country in transition, accompanied in full by the upgrading of the payment operations abroad. The reform of the payment system was important for sustaining the currency board and was therefore completed in BiH at a relatively early stage of transition.

3.2.3 Privatization

3.2.3.1 Approach and implementation (problems of sequencing)

Privatization process in BiH started before the war under the SFRY Law on Socially Owned Capital. Although the law had many weaknesses, it is nevertheless worth pointing out that its primary goal was privatization as part of transition to a market economy. However, new authorities in BiH quickly decided to review and halt privatization. The main objections were not to do with the efficiency of privatization or its detrimental effect on business performance. It sounds somewhat paradoxical that the first democratically elected authorities resisted the sale of socially owned property on the account of an extremely low sales price, although it was unclear on what basis the authorities concluded that something was undervalued when the capital market in BiH did not exist during that period (1991/92).[7] Therefore, the new authorities applied the same value judgements on the capital as the previous ("undemocratic") authorities. The issue of merit for such a move notwithstanding, it created widespread public distrust in privatization. This distrust culminated when the authorities nationalized socially owned property, ignoring a number of rights, which were defined during the period when the Law on Socially Owned Capital was

[7] It was evidently aimed at realigning political and economic powers of the existing authorities. Only a few months after the privatization process had been stopped, the new authorities proposed that socially owned assets should be distributed to the citizens.

in force.[8] Against BiH's specific circumstances eg the war's human toll and large scale devastation, violation of many rights, all of which are, from an ethical perspective, clearly above the right to property, it is obvious that the property issue in BiH is not yet viewed primarily or sufficiently in economic terms. Consequently, privatization in BiH does not have the social and economic importance it is commonly assigned to in a transition context.

Privatization of the state-owned companies was set as one of the priority tasks in both BiH entities. Institutional framework for privatization was defined at the entity level. The state-level law, providing for the harmonization of entity laws, was passed in 1998. The approach, championed by the international community, was one in favour of fast privatization based on the assumption that enterprise restructuring would be easier once privatization is completed. The first drafts of entity privatization laws were prepared during 1996 and early 1997 but privatization did not start before 1999. Although with some entity variations, the basic model was mass privatization. The Government issued certificates in the Federation and vouchers in RS to citizens in compensation for war-related debts, such as unpaid wages, pensions and lost foreign currency savings. Furthermore, in the Federation all citizens over 18 years of age were entitled to a general certificate, valued at KM 1,900, augmented by an amount corresponding to the number of years in employment. Mass privatization was designed to remove rapidly state-owned enterprises from the public sector, while tender was to be the principal means of attracting strategic investors and fresh capital.

Quick privatization presupposed an accelerated procedure for the adoption of laws, the grasp of the letter and the spirit of the laws in a very short period of time, and their subsequent implementation. The rationale of accelerated privatization implied fast formal conversion of the certificates and vouchers into companies' shares and subsequent establishment of shareholders' assemblies, and new management in charge of creating of development and business policies of privatized companies. Establishment of financial market institutions went in parallel to the distribution of certificates and vouchers, and public shares offering.

Privatization involved a wide range of activities both in technical- organizational terms as well as in terms of the adoption of necessary legislation. By way of illustration the legislative process in the Federation will be analysed briefly. Preliminary drafts of the Law on Privatization of Enterprises and Banks and the Law on Privatization of Apartments were finalized in mid - 1996. It took over fifteen months for these laws to be adopted. Sequencing in the adoption of the laws and decrees regulating the privatization process

[8] In Republika Srpska, the Law on Transfer of Assets from Social to State Property was adopted, Official Gazette of the Republika Srpska, number 4/93. Bosnia and Herzegovina adopted the Law on Transformation of Social Property, Official Gazette of BiH, 33/94.

was to a certain extent illogical. The Law on property relations, which *inter alia*, defines the basic principles, subject and holders of rights and ownership, and the provisions of acquiring and cessation of ownership rights, was adopted more than three months after the adoption of the Law on Privatization of Enterprises, published in November 1997. The Ordinance on Review of the Previously Performed Ownership Transformation was also passed after the Law on Privatization of Enterprises (the 15th of January 1998), although the review of privatization in the pre-war period was a precondition for preparing the opening balance sheet of enterprises in preparation for privatization.[9]

There were similar shortcomings in the adoption of other relevant pieces of privatization legislation. The law on privatization of banks was adopted in 1998, four months after the law on enterprise privatization, despite a common view that the sequencing should be reverse. The Instructions on Procedure of Drafting Bank Opening Balance Sheet were published on the 11the of June 1998.

Since privatization in the FBiH was primarily based on mass distribution of the certificates to the citizens over eighteen, it was necessary to adopt the laws and decrees regulating the modalities, criteria, deadlines and techniques of issuing certificates. The Law on Determination and Realization of Citizens' Claims in the Privatization Process was published on the 28th of November 1997. Subsequently, the Instructions for Recording and Settlement of Citizens' Claims from Unique Citizens' Accounts were passed (15th of January 1998). Since some of the deadlines defined in the Instructions were too ambitious, due to numerous organizational and technical problems related to the realization of this task, the Instructions on Amendments to the Instructions for Recording and Settlement of Citizens' Claims from Unique Citizens' Accounts were passed on the 6th of July 1998. If one adds to this a series of other problems such as re-examination of distribution of funds registered at the military foreign currency books, outstanding debts in terms of unpaid pensions and, of course, the problem of determining the value of index point of the general certificates, one gets a better picture of the scope of legal standardization and harmonization required by the provisions of all relevant laws and decrees.

In the meantime, two sets of general elections took place- in 1996 and 1998, having an impact on the dynamics of implementation of privatization laws. In the FBiH parliament adopts all laws pertaining to privatization. Given the time required for the elections and constitution of the new Parliament, adoption of the laws necessary for the efficient implementation of privatization was slowed down. Additional problem was that any newly adopted law might imply adoption of decrees or even adoption of new law(s), in order to ensure that the whole process was legally regulated in an appropriate way. In this sense,

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9 Legal framework of privatization in both BiH entities recognised a continuity of the privatization process initiated in the pre-war period. In other words, the share capital which had been subscribed and effectively paid in accordance with so called Markovic's Law was recognised as incontestable private capital and it was not subject to privatization.

the Law on Securities, the Law on Securities Register, the Law on Securities Commission (published on the 15th of October 1998) and the Law on Fund Management Companies and Investment Funds (published on the 22nd of October 1998) serve as good examples. The Czech Republic experience may be used as a vivid example of negative consequences arising out of insufficient legal regulations of all important aspects of the privatization process. The Czech Republic adopted some of the important laws only at a later stage (e.g. Law on Securities Register), which resulted in major application problems *post festum.*

3.2.3.2 Basic models of enterprise privatization

All companies with state owned capital entered the privatization process having gone through appropriate preparatory procedure, which involved preparation of opening balance sheets. The balance sheets were cleared of all pre- war domestic and foreign debts. The state owned capital was a subject of privatization. Out of that amount, in RS 10% was allocated to the pension fund, 5% to the restitution fund, 55% for the distribution to the population in the form of vouchers and 30% was to be sold for cash and old foreign currency savings. In the Federation, the value of the index point of certificates was derived from the total value of the state capital, and certificates were distributed to all the citizens over eighteen in various amounts depending on the age, years of service, service in armed forces during the war, and outstanding claims on pre-war foreign currency savings. In RS, vouchers did not have a nominal value unlike in the Federation. All RS citizens, including children, were entitled to vouchers, although not everybody received the same number of vouchers. Citizens were free to choose companies in which to invest. They were also given a possibility to exchange their vouchers for the shares in investment funds.

Mass privatization was meant to be implemented in a relatively short period of time (up to 2 years). Some feared that such a process, including all state owned companies and banks and almost all citizens, could become chaotic. One of the fundamental problems stemmed from a formal freedom of choice given to the citizens in terms of deciding what to do with vouchers and certificates, given the low purchasing power of majority of the citizens, lack of information and inadequate knowledge of the process itself. Freedom of choice is basically a good approach and it represents a basis for establishment and further development of market economy. However, freedom of choice implies that vouchers and certificates on the privatization accounts of the citizens are at their unlimited disposal. Therefore, citizens have a choice to decide which company to invest in, but also whether to sell or give away their vouchers or certificates. Prices of vouchers and certificates are quickly formed at the market. However, it is likely that the prices will be lower than the assumed nominal value of vouchers and certificates. Of course, there is nothing wrong with vouchers and certificates transactions, provided that they are purely considered as market transactions. However, taking into account the fact that they had been created in order to allow the citizens to participate in the privatization, their purchase at low price may cause social and political problems. Given on one hand a large number of citizens in dire economic situation, and sudden availability of a large number of vouchers and certificates on the other, the price of these mass privatization instruments had dropped drastically. This opened way to speculations with certificates and vouchers, which began to be traded informally. Faced with all these problems both technical and more substantial related to the very method of mass privatization, the process was completed by 2001 in Republika Srpska and 2002 in the Federation- way beyond the initial schedule. Some 70% of small enterprises in the Federation and 47% in Republika Srpska were sold. The effect of mass privatization has been however negligible as far as providing economy with fresh funding, expertise, know how and markets.

Tender based privatization was another approach, which was only stepped up in late 2000[10]. According to entity laws regulating mass privatization, company buyers had no contractual obligations to take over specific responsibilities eg in terms of investment, number of employees and overall price. In contrast, tender based privatization sets a list of attractive companies, defines main criteria relating to investment, obligations to employees and cash payment. However, lack of agreement between foreign experts and organizations providing technical assistance with regard to the approach to the privatization process in BiH, coupled with a lack of knowledge of local actors were an important impediment to faster and more successful tender privatization. Equally important impediment were obstructions by the local authorities, reluctant to part control particularly over strategic enterprises, which provided an important source of funding for the political parties. The debate over an international loan to assist privatization went on for almost two years on the grounds that most of these funds would go to foreign experts, which might not necessarily work in the best interest of the country. By the end of 2002 only some 25% of the total of 1064 enterprises in the Federation, not including those declared as strategic, was fully privatized compared to 41% in RS. A total of some 40 strategic enterprises were sold by the end of 2002 and by 2003 the process was almost halted.

Inadequate powers, expertise and often insufficient engagement of privatization agencies have been identified as some of the main reasons for poor results of privatization. As stated before, political obstructions by the local parties were a major obstacle. In Republika Srpska the law was amended in 2003 stipulating that the government has to consult the parliament on the sales of strategic companies; the most vocal were the trade unions of the electricity company arguing in favour of keeping the state as majority shareholder. Various irregularities were identified in a number of privatization deals, thus further undermining the confidence of potential investors. In 2003, under the pressure from the international

[10] Tender sales were temporarily suspended in the Federation in early 2000, and resumed only after the changes demanded by the international community were implemented.

community, the entity governments pledged to revive privatization but no major breakthrough was underway in early 2004.

3.2.4 Financial sector reform

The BiH financial sector is predominantly based on commercial banking. The total assets of commercial banks in BiH in mid 2003 amounted to 6,8 billion KM, which represents 90,7% of the total assets of BiH financial sector. Apart from commercial banks, BiH financial sector includes 28 insurance companies and 44 micro-credit organizations. At the beginning of the reforms, commercial banking sector accounted for 96% of the total assets of BiH financial sector. The financial sector reform was mostly focused on the reform of commercial banks, given their predominant role in the financial system of BiH.

Commercial banking reform was primarily aimed at implementing financial liberalization measures. Financial liberalization involved: elimination of state in interest rate determination and the extension of credit, bank privatization, free entry of foreign banks and free international movement of capital. It also implied the adoption of Basle standards of managing assets and risks in commercial banking.

Financial liberalization was implemented at the entity level, and at a faster pace in FBiH than in RS. However, compared to other sectors, this set of reforms was the most dynamic one. In the FBiH the reforms commenced in 1997, and in RS in 1998. The first step involved establishment of banking agencies in both entities, which undertook the responsibility for issuing and revoking licenses to the banks, as well as for their supervision. Adoption of the Law on Privatization of Banks and the Law on Opening Balance Sheet of Companies and Banks (1997 and 1998) facilitated the beginning of the bank privatization process. Problems related to pre-war foreign currency savings and the pre-war foreign currency loans, that is - unrecoverable loans transferred from the pre-war period- were solved by either write-offs or transfer to the entity governments. Substantial part of the debt to Paris and London Club was also written off in 1997-1998.

Bank privatization in both entities was not so complicated and did not hinder development of this sector, unlike the privatization of companies. One of the most important reasons, apart from relatively painless solution to the problem of outstanding debt guaranteed for by BiH, was the fact that the Law on Foreign Investment from 1995 provided for the establishment of foreign banks in FBiH immediately after the war. Already in 1996-1997 in the Federation there were several foreign banks with 100% or majority ownership. The adoption of the BiH Law on Foreign Direct Investment (1998), the establishment of the CBBiH and introduction of a single currency in cash, and, in particular, non- cash transactions (1998/1999), stabilization of political and military situation (1999/2000), and the extension of the High Representative's authorities all contributed to strong interest by the foreign investors. At the end of 2002, market share of 10 major banks amounted to 61,6% of total assets of the banking sector, which increased from KM3,7bn to KM6,8bn between 1998 and mid- 2003.

Table 4

BiH Commercial banks consolidated balance sheet

in millions of KM

No.	Assets / Liabilities	Bosnia and Herzegovina					
		1998	**1999**	**2000**	**2001**	**2002**	**30/06/ 2003**
	A S S E T S						
1.	Reserves	208	275	287	872	595	537
2.	Foreign currency assets	605	848	961	1.364	1.469	1.568
3.	Receivables - Government	113	37	34	33	61	57
4.	Receivables - non-financial companies	2.547	2.467	2.584	2.602	2.715	2.809
5.	Receivables - households	260	277	399	704	1.506	1.828
	TOTAL ASSETS	**3.733**	**3.904**	**4.265**	**5.575**	**6.345**	**6.799**
	L I A B I L I T I E S						
6.	General Government deposits	222	170	143	278	390	376
7.	Sight deposits in domestic currency	148	585	750	1.016	1.270	1.413
8.	Sight deposits in foreign currency	638	466	555	929	817	772
9.	Time and savings deposits in domestic currency	8	22	78	141	273	326
10.	Time and savings deposits in foreign currency	467	577	428	908	974	1.037
11.	Bonds	1.606	1.519	1.577	1.526	1.794	1.963
12.	Capital accounts	1.311	1.257	1.096	1.118	1.214	1.227
13.	Other items (net)	- 667	- 692	- 362	- 341	- 387	- 315
	TOTAL LIABILITIES	**3.733**	**3.904**	**4.265**	**5.575**	**6.345**	**6.799**

Source: Central Bank BiH, Bulletin 2/2003, page 112.

Financial deregulation in interest rates is full. The CBBH, in conformity with the currency board principles, does not have any influence on the level of interest rates. Freedom of establishing banks, as an important element of financial liberalization, is granted to both residents and non-residents who meet the basic conditions in terms of minimum core capital requirement and technical and expert requirements set by banking agencies in both entities. The openness of the BiH banking sector is reflected in the that non- resident co-own over 75% of the bank capital stock in the country. Bank autonomy is legally guaranteed, with the exception of state owned banks whose share in the banking sector has been reduced significantly. Finally, liberalization of international capital flows is almost entirely implemented, except for investments in specific sectors such as military industry, lottery, media and public utilities.

Financial reforms in BiH are among the most advanced in South East Europe as the table on financial inter-mediation shows.

Table 5

Financial intermediation in SEE countries

in percentages

	Assets to GDP ratio	**Ratio of loans to companies and citizens to GDP**	**Loans to deposits ratio**
Albania			
1999	49.8	2.6	6.6
2001	50.7	2.9	7.1
Bosnia and Herzegovina			
1999	45.1	31.9	86.7
2001	51.4	29.8	71.8
Bulgaria			
1999	34.6	10.1	39.3
2001	41.3	14.0	43.4
Croatia			
1999	66.1	32.4	80.6
2001	91.1	39.5	61.5
Macedonia, FYR			
1999	53.6	11.0	76.6
2001	53.8	10.8	40.9
Romania			
1999	33.8	10.7	49.4
2001	31.2	10.5	50.3
Serbia and Montenegro			
2000	201.9	99.7	359.2
2001	41.8	16.6	122.8

Source: Web sites and annual reports of central banks of SEE countries; EBRD, Transition report 2002, London, October 2002, pages 113, 129, 133, 137, 149, 153, 189.

The BiH commercial banking sector is second to Croatia in terms of financial inter-mediation. Financial deepening in BiH was direct result of a rapid growth in the number and market share of foreign banks after 2000, which focused their credit activities on households, and much less on corporate sector. The household credit/deposit ratio amounted to 105% in 2002, suggesting negative savings rate.

Financial sector reform in BiH involved preparation of legal and institutional basis for the financial market, or more precisely, capital market. In FBiH, the package of laws on capital market was adopted in the last quarter of 1998, and in RS in 1999. Following the adoption of these laws, securities commissions and securities registers were established at the entity level (in FBiH and in RS). As with other laws, there is no unified regulatory institution in this domain at the state level. Therefore, from the very beginning of the reform financial markets are institutionally and legally divided on an entity basis. Establishment of the Securities Commission of FBiH, FBiH Securities Register, RS Securities Commission and RS Securities Register was the basis for the registration and sale of companies' shares in mass privatization. Their establishment preordained the establishment of the capital market on an entity basis. Capital market was institutionalized in RS with the establishment of Banja Luka Securities Exchange (BLSE) and Sarajevo Stock Exchange (SASE) at the end of 2001 and at the beginning of 2002, respectively.

3.2.5 Liberalization of the foreign trade regime

Liberalization of trade regime started in the Federation in early 1996, when quotas, taxes, tariffs and special licenses for exports were eliminated. Quantitative restrictions on imports other than licenses required for a limited number of goods were also eliminated. In RS quotas on exports and imports of certain products remained in place, and the tax of exports of certain raw materials was retained. In 1998 Foreign Trade Law at the country level was passed introducing a liberal trade regime. It guarantees free movement of exports and imports without quantitative restrictions. It stipulates non- discriminatory treatment of imports and gives it the same legal and tax treatment as to domestic goods. It allows the state temporary restrictions on imports, exports and transit of certain goods on health and safety grounds. The tariff structure was simplified and entities ordered to cancel preferential trade agreements with Croatia and FR Yugoslavia and to rescind additional entity taxes.

The state level law on foreign trade set up the conditions to start negotiations on bilateral free trade agreements with SEE countries as well as preparations for starting negotiations on the accession of BiH to the World Trade Organization.

Bilateral free trade agreements with the countries of former Yugoslavia were concluded first, followed by other countries in the region under the auspices of the Stability Pact for South East Europe trade liberalization initiative. The first free trade agreement was signed with Croatia, then with Slovenia, Serbia and Montenegro (former FR of Yugoslavia) and

Macedonia. The first three agreements were based on the principle of asymmetry, given the fact that BiH sustained the greatest degree of destruction after the dissolution of SFRY, and that it was excluded from the foreign trade exchange flows for the longest period of time (1992 - 1995). Asymmetry of these agreements is based on contractual provisions according to which goods and services produced in BiH were exempted from customs duties immediately in the first year upon conclusion of the agreement, while customs duties on goods and services of other countries of former SFRY are gradually reduced and are lifted in the fourth year after the signing of the agreement.

BiH has been granted preferential export regimes, on the basis of international system of preferences (GSP or GSTP). These arrangements provide for the export of all goods made in BiH to the countries of the European Union, if they meet technical and technological standards. This arrangement will be in effect until the end of 2005. Apart from the countries of the European Union, Bosnia and Herzegovina has been granted the preferential status by Switzerland, Norway, Japan, USA, Russia and Canada. Preferential arrangement between BiH and the EU countries may be annulled if BiH fails to respect the following conditions: EU rules on origin, refraining from introduction of new export levies and increase of the existing ones (customs and quantitative restrictions), involvement of BiH in the efficient crime prevention activities, readiness of BiH to commit to the economic reforms and regional co-operation in the process of accession and stabilization.[11] The effect of these arrangements aimed at redressing large trade imbalances, as will be shown later, has however been modest.

By introducing amendments to the regulations in the field of customs tariffs and unified customs policy, average level of duty rates in BiH after 2000 was reduced significantly compared to other SEE countries. Table 6 shows the World Bank data on protective tariffs in SEE countries.

Given that throughout 1998/1999 enforcement of customs regulation was poor due to the lack of state control over the borders it can be argued that the BiH market, as far as the effective protective tariffs are concerned, was the most liberal in the region. This is supported by the World Bank data according to which no product in BiH has a duty above 15%. At the same time, the share of products with duties exceeding 15% among SEE countries is the following: Albania 38.3%, Bulgaria 30%, Croatia 30.8%, Macedonia 47.4%, Romania 45.9% and Slovenia 23.1%.

[11] See: BiH Council of Ministers - Ministry of Foreign Trade and Economic Relations, Second proposal of BiH Development Strategy - PRSP - 2003-2007, May 2003.

Table 6

Tariff barriers in SEE countries (all products) - 2001

	Simple mean Tariff (%)	Weighted mean Tariff (%)	Standard deviation of tariff rates (%)
Albania	11.8	11.8	6.9
Bosnia and Herzegovina	7.6	6.6	4.4
Bulgaria	13.8	10.9	11.3
Croatia	12.0	9.8	7.4
Macedonia FYR	15.9	13.8	11.6
Romania	18.1	13.7	15.9
Serbia and Montenegro	n.a.	n.a.	n.a.
Slovenia	11.4	9.9	7.0

Source: The World Bank, World Development Indicators 2003, Washington, 2003, Chapter 6, pp. 326-328; data for Serbia and Montenegro are not available.

3.2.6 Labour market reforms

Although labour market reforms were included in the initial list, during the first three post-war years they remained rather limited and burdened by the legacy of war. Working age men were the most affected category during the war in a sense that many took an active part in military. Following the signing of the Dayton Peace Agreement, a large number of men who were able to work were demobilized in 1996. The companies in which they worked before the war or during the war were legally obliged to keep them. Given that majority of companies was not operational or worked at a fraction of capacity, the return of demobilized soldiers implied significant increase in labour costs. Due to specific status of a large number of workers on pay roll in both entities, the category of "wait-listed workers", taken over from the pre-war legislation, became one of the biggest barriers to the reforms of labour legislation.

The status of "wait-listed workers" means that a worker for whom a company cannot provide a job is neither fired nor referred to the labour market, but remains on the company pay roll. These persons are considered as employed, and the companies take over a part of obligations toward them, such as health and pension insurance and in some cases pay a fraction of a salary. This category was created in a socio-political climate which may be described as a conflict of, on one hand self-management inertia still prevalent in state owned companies, and on the other, of objective market requirements necessitating the establishment of labour market. Therefore, it reflects a compromise between essentially guaranteed employment in state owned companies, as a self- management legacy, and an increasingly strong pressure to privatize state owned companies and make them competitive, including recruitment based on competitive footing.

The largest number of "wait-listed workers " in the post-war BiH consisted of persons who returned to their pre-war companies following the end of the war. Possibilities for their employment depended directly on the opportunities for resumption of production . And these were limited given that the availability of credit to mainly state- owned companies was much more restricted than to private ones. Therefore, "wait-listed workers" were de facto unemployed, but they were entitled to social protection and a minimum salary. For this reason the official employment and unemployment statistics in the entire post-war period were very unreliable, and could not serve as a basis for an objective evaluation of the extent of the problem of BiH labour market.

Table 7

BiH: Estimated Unemployment Rate, 1998

	FEDERATION OF BOSNIA-HERZEGOVINA	REPUBLIC SRPSKA	BOSNIA AND HERZEGOVINA
Number of inhabitants - 1998 estimation	2.250.000	1.392.000	3.642.000
Number of working age inhabitants, from 15 to 64 - estimation	1.500.500	907.200	2.407.700
Available manpower in total	872.000	528.000	1.400.000
Official employment in BiH	407.000	202.000	609.000
Registered unemployment	249.000	143.000	392.000
Number of wait-listed workers	70.000	45.000	115.000
Registered and unregistered unemployment	465.000	326.000	791.000
Narrow unemployment rate	28,6 %	27,1 %	25,2 %
Unemployment rate, including the wait-listed workers	36,6 %	35,6 %	36,2 %

Source: Authors' estimate based on the data published by the Federal Statistical Office, Statistical Office of RS, and Statistical Agency of BH

Labour market reforms started at the entity level without adoption of the state level law. The main incentive was to solve the problem of wait-listed workers, and subsequently to resolve the issues of minimum salaries, right to compensation based on employment, and other rights stemming from employment, by concluding collective agreements and branch agreements between trade unions and employers. The Labour Law, which was adopted in 2000, gave the companies two possibilities to resolve the wait- list status of their workers: to give them full time work or to make them redundant and provide severance payment. As the specified severance payment to dismissed workers was too high for majority of companies, the implementation of this law was postponed until mid 2001, when the amendments to the law were adopted. The main purpose of the amendments was to reduce the scope of obligations of companies in terms of providing payments to the wait-listed workers.

The rights of workers in BiH were institutionally regulated by a number of laws. Besides, labour costs, i.e. gross salaries were determined by previously adopted Law on Income Tax (1996,1997, 1998), Amendments to the Law on Income Tax (2000) and the Law on Contributions (1998, 2000). A major source of problems related to institutional regulation of the workers' rights is linked to signing of collective agreements, provisions of which are binding only for the companies with majority state ownership. Unequal application of institutional provisions referring to workers' rights protection has been conducive to formation of two parallel markets: official labour market, where the costs of labour are burdened with compulsory taxes and contributions, and informal labour market, the share of which amounts to almost 80%.

4 Problems, obstacles and outcome of the reforms

4.1 Institutional problems and obstacles

During 1995-2000 institutional obstacles were a major barrier to the creation of a legal framework necessary for the implementation of reforms. Complicated procedure of harmonization and adoption of laws, which would serve the interests of all citizens, and delays in the adoption of the key laws, prevented BiH from becoming an economic community and from developing as a single economic space. This is best illustrated by the fact that The High Representative decreed the establishment of some of the key state institutions. In 2000 only, some 27 decisions were taken, including on basic laws such as state border service, on standardization, on travel documents, on meteorology and on BiH customs policy.

The imposed laws are applied on a temporary basis until adopted by the BiH Parliament. It took 6 to 10 months for the BiH Parliamentary Assembly to adopt even these laws, which represent the basic minimum for the functioning of any state. Establishment of the BiH Institute for Standards and Metrology may serve as an example of the lack of interest in establishing BiH state institutions. BiH obtained a special preferential treatment for exports to the EU without restrictions, provided that the goods and services meet the standards. The fact that there was no a state-level institution in charge of quality certification meant that companies could not make use of this preferential arrangement. Although there was an alleged interest by both entities, the BiH Institute for Standards and Metrology was eventually established only after the High Representative imposed the state level law.

Another example of institutional weaknesses being exploited by the national elites in the post-war period was "privatization" of the state border. The Dayton Peace Agreement allowed entity authorities to control the state border crossings, which enabled networks of criminal groups involved in smuggling and other forms of illegal trade to operate almost unchecked, thus depriving the budgets of millions of KM. Given the extent of grey and black markets of goods, labour and services it is estimated that BiH lost approximately one and a half of its GDP in 1995-2000 or some $6 bn. Finally, the Law on State Border Service was adopted by the BiH Parliamentary Assembly following the decision by the High Representative.

4.2 Problems of the fiscal system

The concept and structure of fiscal federalism in BiH has showed serious shortcomings regarding the provision of public services. In a relatively small space (BiH market), entrepreneurs are faced with a non-uniform fiscal regulations. Of course, tax competition is not necessarily bad in a developed market ambience. However, against the level of development of fiscal decentralization in BiH it would result in entities alternating losses and gains, which has a negative impact on the long-term business development. Thus, in this model harmonization rather than tax competition, which could lead to "tax war", is a more rational solution.

The existing model of fiscal decentralization is mainly intended to resolve potential political conflicts at the level of peoples and entities. This is important by way of creating initial conditions for political stability. However, fiscal division between entities and the state, or the Federation and cantons, does not mean that the problem of fiscal decentralization is fully or adequately solved. What it can quite well do is to reduce or change the level of centralization, while tax payers at the local level still might not see the link between the taxes they pay and the quality of public services at the local level. Therefore, greater concern for economic principles is of critical importance in further reforms of the fiscal system, a concern that was only marginally addressed in the course of initial reforms.

Fundamental weakness of BiH fiscal system in 1996-2000 was the possibility of tax competition between the entities stemming out of differences in tax rates (turnover tax and excise duty) and uneven application of the Unified Customs Policy in BiH. Fiscal system has been one of the main obstacles to business development:

- The fiscal system is complicated, it includes unforeseeable retroactive tax obligations and is characterized by insufficient harmonization of fiscal laws between the entities, which discourages inter-entity trade, and encourages uncontrolled import.
- Legal system is slow, inefficient and discouraging for development of business operations, while administrative procedures are lengthy and complicated.[12]

[12] The World Bank, Bosnia and Herzegovina-1996-1998 Lessons and Accomplishments - Review of the Priority Reconstruction Program and Looking Ahead Towards Sustainable Economic Development, May 1999, Annex 11, page 3.

The reforms to address some of these problems were stepped up in 1999- 2000. The outcome was a significant narrowing down of the gap in tax rates, and the reduction of the number of taxes applied until mid 2000. The reduction in the number of taxes from 4 to 2 (2000), followed by a reduction in the tax rates in the FBiH (2001), significantly reduced the space for tax competition at inter-entity level. However, one of the fundamental problems of the tax system in both entities, i.e. its complexity arising from the approach that the turnover tax is collected at the final stage of consumption, remained one of the main barriers to development of efficient and harmonized tax system.

Parallel to the reforms aimed at streamlining the tax system and improving revenue collection, reforms at the reduction and restructuring of public expenditures were also put in place focusing on cuts in military spending, overhaul of the disability and war veteran benefits and pension system. Public spending was reduced from 64.5% GDP in 1998 to 56.2% in 2002- still in excess of BiH's fiscal capacity. As a result, fiscal performance improved and consolidated budget deficit fell from around 5.1% of GDP in 1998 to 4.3% in 2002. However, efforts at fiscal consolidation were accompanied by an increase in public sector arrears, which were arrested in 2002. Escrow accounts, including privatization proceeds and assets allocated to BiH as part of SRF Yugoslavia succession process, were set up to deal with domestic debt settlement. Oversized public sector remains a major source of fiscal pressures and will require significant downsizing. Rationalization and restructuring of public spending would also have to address the balance between the capital and current expenditures, since for most of the post- war period majority of capital spending was met by external funding.

4.3 Problems, obstacles and failures in enterprise privatization

Privatization process in BiH in the post-Dayton period was complicated by the fact that it was implemented separately in two entities. Non-existence of unified legislation was the first important contradiction of one of the main requirements of regulated market economy - to have a clear and comprehensive legal system. Privatization was politically motivated and was not a part of a coherent reform programme. Another fundamental problem was to do with the predominant privatization model. Majority of state capital in both entities was privatized through public offering of shares, i.e. by exchange of certificates and vouchers for companies' shares (some 85% of the privatized assets excluding utilities). The basic weakness of mass privatization is that it does not solve any of the issues of crucial importance for the enterprise performance. It brings no profit either to the state or companies and therefore no possibility of creating funds to finance company restructuring or to resolve social issues.

The second problem arising from mass privatization is a very low concentration of necessary knowledge about market and market institutions, and in particular about different options of restructuring and market re-positioning of companies. In majority of cases, shareholders in companies are persons who do not have the relevant knowledge, and managers of privatized companies lack skills and knowledge of local, regional and global markets. Apart from a lack of knowledge on the part of shareholders and managers, the problem of privatized companies is further complicated by the fact that new owners do not have a contractual obligation to invest and restructure their companies. The third aggravating factor is surplus of workers. Solution to this problem is neglected within the privatization process, without developing adequate social programmes and financial sources to fund them. In BiH many smaller companies were acquired by management, employees and private investment funds, which provided no investment or know how.

Formal corporatization of companies in both entities was conducted after the mass privatization. Selection of models and implementation of corporatization in RS companies were subject to political interests in order to preserve the influence of the authorities on the companies as long as possible. The chosen model was particularly confusing to strategic investors, who were offered up to 30% of the state capital value, while they did not know about the number of shares they would get, total issue of shares, or dispersion of the remaining 70% of the shares. This was the main reason for moderately low interest of strategic investors in privatization in RS, especially foreign investors. Thus, privatization in RS turned into "hunting grounds" for different speculators who invested in other people's vouchers, acquired them on someone else’s behalf with 70% discount of the average nominal value, or invested other people's coupons for pre-war foreign currency savings, also bought with a high discount rate. On the other hand, the state retained an important role in managing the unsold state capital and the shares of investment funds. Although one of the privatization objectives was to attract foreign investments, this did not materialize to any significant extent. In the privatization process, foreign investors were discriminated against: they could not use any of the preferential schemes. Therefore, privatization in RS became a privilege of domestic speculators and the state.

Mass privatization in the FBiH was implemented in 2001/2002. Privatization funds also participated in the mass privatization, enabling linking up physical and legal persons on the basis of their mutual interest or on the basis of ethnic affiliation. As in RS, corporatization of companies in the territory of FBiH did not result in creating conditions conducive to efficient and fast restructuring. The idea to bridge the huge gap in the know-how on privatization and corporate governance with participation of privatization investment funds and fund management companies has so far proved not particularly successful.

Overall the results of privatization have been very modest. The share of private sector in GDP is estimated at around 40-45%. Five years since the start of privatization many large enterprises have failed to restructure and privatize, while large number of privatized ones suffer from poor corporate governance. The participation of strategic investors on which the main economic impact of privatization hinged has been disappointing, Privatization in the way and at the pace at which it has progressed in BiH has failed to have a major impact on the development of market economy.

4.4 Problems of financial sector reforms

Two main problems of BiH's financial sector reforms are disproportionate focus on commercial banking reforms at the expense of institutions for financing restructuring and development of companies, and insufficient development of BiH financial market. Commercial banks reform in BiH has been one of the most successful among transition countries. However, strengthening control and supervision of banking operations, through the adoption of the Basle Standards, resulted in the restructuring of commercial banks assets. They shifted the focus of their operations away from the corporate sector towards households and maintained liquidity by keeping deposits abroad. This is important from the point of inter-linkage among various reforms in the process of transition. Because the banks continued to perceive lending to largely unrestructured corporate sector as higher risk option, they favoured households in their lending portfolio. Given the currency board arrangement, strong credit growth as a reflection of financial deepening produced by the reform became a threat to macroeconomic stability in 2002, by its upward pressure on the current account deficit. A set of monetary reforms was initiated to slow down the credit growth and further bank regulatory reforms enacted aimed at removing remaining deviations from international standards.

Beginning of financial liberalization in BiH resulted in an enormous increase in market interest rates. Gradually, as a result of new entry of foreign banks and an increase in the minimum capital requirement ratio, interest rates declined. However, one of the consequences of banks directing their activity to less risky portfolios led to the export of capital. As the reserves of the commercial banks with CBBiH are included in the CBBiH liabilities and have to be covered by foreign assets, the total amount of exported capital, intended as insurance of commercial banks against risk, amounted to KM2bn KM at the end of 2002. This amount is higher than the amount of loans that BiH received in the post-war period. These data clearly demonstrate that BiH economy will not be able to achieve significant growth rates without a strong support from development and export-import banks. Reliance on foreign direct investments, as the most important factor of balancing trade deficit and accumulation of foreign currency reserves, has so far proved not an effective strategy. Out of USS 848 million of total foreign investment in BiH (1994-2002), relatively small share were greenfield direct investment.

As suggested above, financial deregulation in an environment lacking institutions for crisis management and development incentives, resulted in the banks shifting their lending portfolio away from the corporate sector into less risky sources of revenue. This leads to a paradoxical conclusion of BiH becoming an exporter of capital. The commercial banks, which dominate the banking sector structure their portfolios in compliance with the rules based on the existing international standards. In this environment, more than two fifths of assets of commercial banks have practically no impact on the development of BiH economy. Therefore, a radical shift toward establishment and/or attracting financial institutions for funding development projects, along with well-defined export-orientated strategy, are crucial for economic revival of BiH.

4.5 Problems of reforms of foreign trade relations

The logic behind BiH's free trade agreements with countries in the region was based on the assumption that removing customs barriers on products and services from BiH would result in substantial export expansion, accompanied by a reduction or at least a slow down in the growth of imports. Data on BiH trade with Croatia, Slovenia, and Serbia and Montenegro suggest this has not happened. The key issue is that improvement in BiH trade performance is limited by its narrow export capacity as medium and large companies in the processing industry sector, the main potential exporters, were until recently state owned or are still undergoing privatization. In majority of these companies restructuring has not been completed, while in some of them it has not even started. Funds in support of continuous expansion of export activities either do not exist in BiH or they are available at interest rates twice as high as those in the neighbouring countries, which discourages potential exporters.

Table 8

BiH Trade deficits with main trade partners

in millions of KM

	Trade deficit		
	2000	**2001**	**2002**
TRADE DEFICIT IN TOTAL	**- 5,346**	**- 6,215**	**- 6,879**
OF WHICH WITH:			
Croatia	- 779	- 857	- 1.017
Slovenia	- 848	- 770	- 732
Germany	- 543	- 444	- 736
Italy	- 189	- 544	- 541
Hungary	- 300	- 402	- 478
Austria	- 294	- 333	- 380
Serbia and Montenegro	+ 26	- 57	- 277

Source: Federation Statistical Office, Statistical data on economic and other trends, 2/2002, pp. 44-45; Central bank BiH, Bulletin 2/2003

Much attention in analysing export performance in transition countries has focused on progress in trade liberalization. In BiH, the problem has not been in markets being closed; on the contrary, the World Bank data on tariff protection of domestic production indicate that BiH producers are the least protected in the entire SEE region. The weighted average tariff protection rate in Slovenia and Croatia is by 33% higher than in BiH. Similarly, weighted average tariff protection rates of Romania and Macedonia are twice as high. BiH has the largest trade deficit in the region; it stood at 31.4% of GDP in 2002.

Table 9

BiH: Balance of payments, 1998 to 2002

in millions of KM

	1998	1999	2000	2001	2002
I CURRENT ACCOUNT	**- 2,043**	**- 2,678**	**- 2,531**	**- 3,403**	**- 4,398**
1. Goods	- 5,482	- 6,052	- 5,567	- 6,456	- 7,023
2. Services	257	192	221	241	144
3. Income	751	715	669	697	533
4. Current transfers	2,431	2,468	2,145	2,116	1,947
II CAPITAL AND FINANCIAL ACCOUNT	**2,076**	**2,656**	**2,519**	**2,926**	**4,210**
1. Capital account	766	946	862	803	711
2. Financial account	1,310	1,710	1,657	2,122	3,499
- Direct investments	117	325	310	274	604
- Other investments	1,341	1,973	1,512	3,513	2,649
- Reserve assets	- 148	- 588	- 165	- 1,665	245
III NET ERRORS AND OMMISSIONS	**- 33**	**22**	**12**	**477**	**188**

Source: Central bank BiH, Bulletin 2/2003, page 139.

The main impediment to BiH benefiting from the opportunities created by the opening of the EU and neighbouring countries' markets and indeed to the development in general has been the lack of unified economic space. The lack of institutions supporting functional integration based on technological and resource compatibility and joint entry into foreign markets, along with the problems of financing, are some of the key obstacles for improvement in BiH's external position through the reduction in trade deficit. Although exports have grown steadily since 1996, they have been surpassed by strong growth in imports- a trend which was somewhat attenuated in 2000-2001 due to slow down in reconstruction- related activity as the main source of import demand. However, imports grew strongly again in 2002 propelled by the credit boom, driving the trade deficit up. Large trade deficit has been the main cause of current account deficit, which stood at some 22% of GDP in 2002.

4.6 Problems of labour market reforms

BiH labour market does not exist in the true sense of this word. Terms “employed” and “unemployed” represent formal categories rather than the actual supply and demand for work. This "formality" of labour market is a consequence of the still prevalent socialist-type legislation in this field, but also of the inertia evident in state owned companies and institutions. The main problems in the labour market are the following:

– lack of competition for every vacant job and between the employed and the unemployed;
– lack of sectoral and regional mobility of workforce;
– wage determination which does not reflect the true costs of labour, but depends more on the position of a company or institution and the line of business, rather than on efficiency and situation at the labour market.

At the beginning of transition, deteriorating situation in the state sector, implementation of economic reforms and development of private sector necessitated changes in the approach to labour market regulation inherited from socialist times. Establishment of labour market has evolved through the conflict of socialist and market principles of the utilization of labour as a factor of production. The phenomenon of so called "wait- list" workers discussed earlier was the side effects of the confrontation of these two concepts, and an indication of resistance of socialist principles. At the same time informalization of labour as an anarchic approach to establishing free market came to be one of the main characteristics of BiH labour market. The confluence of a range of factors i.e. heritage of pre- war legislation, aggravated by the specific problems related to war and post- war situation, restricted access to finance for the state owned enterprises and slow privatization opened the way for the creation of two labour markets in BiH. The formal one regulated by entity laws and collective agreements and an informal one, which offered opportunities for temporary and occasional work, as a source of income. By its nature, informal labour market was not regulated by the law. Contractual provisions and rules of collective agreements were not applied at this market either. Dual nature of labour market resulted in an enormous increase of obligations related to unpaid salaries to registered workers in the state or majority state owned companies that were subject to privatization. Direct consequence of this problem was reduction of the value of the state capital due to accumulated losses arising out of costs growing faster than revenues.

Table 10

BiH: Employment and Unemployment, December 2001

	Bosnia and Herzegovina	**Federation of Bosnia and Herzegovina**	**Republic of Srpska**
- In thousands			
Working age population (15-64)	2,390.6	1,475.1	915.4
I Employment			
1. Total	999.5	551.3	448.2
2. Formal	627.0	407.0	220.0
- primary sectors*	21.0	11.0	10.0
- secondary sectors*	247.0	156.0	92.0
- tertiary sectors*	359.0	241.0	118.0
3. Informal	361.5	175.8	185.7
II Unemployment	190.7	111.0	79.7
III Activity rates (in %)			
1.Rate of employment	40.1	36.7	45.5
2.Rate of unemployment	16.4	16.9	15.8
3. Labour force participation	48.0	44.2	54.0

Note (*) - the number of persons employed in formal sector listed under "agriculture" covers agriculture, forestry and fishing industry; the manufacturing sector covers mining industry, processing industries, production and distribution of electrical power, gas supply, water supply and civil engineering; the service sector covers trade, catering, transport and telecommunications, financial services, business services, education, health, public administration and other services.

Source: Survey of living standard in BiH households, 2001, FBiH Statistical Yearbook, 2001, BiH Statistical Agency, Federation Statistical Office, RS Statistics Institute;

The emergence of the informal market was partly related to the high fiscal burden on labour. Aggregate rate of taxes and contributions on net salaries until August 2000 amounted to 81% (average rate for both entities), and was subsequently reduced twice to 68% (income tax rate has been reduced from 15% to only 5%). Compared with other countries, the total tax burden on net salaries does not exceed international average. However, the existence of dual ownership and uneven application of tax and labour legislation created a possibility for the development of a large informal market. Tax evasion and non-payment of social insurance contributions, as well as non-registration of workers, are particularly evident in the small enterprise sector. Since these companies account for the biggest share of the total of registered companies (over 75%), financial inspections are not in a position to control it adequately.

5 Current status of reforms

Since mid 2002 the office of the High Representative, in co-operation with local authorities and international experts, has stepped up efforts to deepen the reforms focusing on fiscal system, business environment and judicial reform. Reform of the tax system focuses on the elimination of tax competition between the entities, introduction of value added tax and the establishment of a Unified Customs Administration for BiH. In mid 2003, a draft Law on Indirect Taxation was proposed, aimed at changing the fiscal structure, i.e. to grant considerably larger competencies to the state level authorities in collection and transfer of customs duties and value added tax. Given the fact that introduction of value added tax is foreseen for the beginning of 2005, as an interim measure for addressing the weaknesses related to tax collection, the Law on Turnover Tax on Goods and Services was amended, thus enabling collection of turnover tax at the stage of import, or production, instead of collection at the stage of final consumption.

As far as the BiH fiscal system is concerned, preparations for the Law on Income Tax, which has not been applied during the entire post-war period, are also underway. Adoption of this Law is foreseen for the beginning of 2004, and its application will introduce progressive taxation in accordance with the levels of generated income. Parallel to the preparation of this Law, Amendments to the Law on Corporate Tax are being prepared. They are aimed at reducing the existing 30% rate in FBiH to the RS level of profit tax rate of 10%. However, the announced amendments to this Law imply that tax exemptions will be far less frequent in comparison with the regulations that have been applied over the past 8 years.

A particular effort has been put towards reforms aimed at removing administrative barriers to business. A commission was established at the end of November 2002 charged with proposing measures, which would improve business environment such as the removal of unnecessary legal provisions that imply lengthy and complicated procedures delaying the registration of business. In the period between November 2002 and the end of February 2003, Parliaments of both entities received 50 requests for amendments to the laws that, according to the opinion of employers, represented a barrier to business development. These amendments were mainly adopted under the fast track procedure, and their result was a partial acceleration of the company registration process. Another important peace of legislation the Law on Bankruptcy finally came into force in the Federation in 2003, following strong resistance by the local parties including the trade unions. The Trade unions demanded that privatization be reviewed in order to cushion the expected impact of the bankruptcy law.

As far as the financial sector is concerned, amendments to the Law on Banks made in both entities in 2003 reinforced financial supervision, i.e. introduced stricter procedures of classification of commercial banks' assets with the aim of improving risk management. The proposal by the CBBiH to place the entity banking agencies under the auspices of CBBiH, and to make them more resilient to fend off potential pressures by entity authorities, was not accepted. The proposal of CBBiH governor to have CBBiH as an issuer of certificates on deposit was not accepted either. This proposal was a logical step toward expanded role of this institution and a contribution to initial development of money market in BiH. Interest of commercial banks in investment in foreign securities, aimed at protection against risk, would be at least partly compensated by introduction of first-class domestic securities. This proposal remains as an option and, most probably, will soon be again put on the agenda.

Privatization of strategic enterprises is the most important issue in the area of privatization. International experts in co-operation with local experts employed in the entity privatization agencies have drawn a list of strategic enterprises awaiting privatization. During September and October 2003, tenders were opened for several enterprises from this list. Another burning issue is that of the reform of corporate management in public enterprises, primarily in energy sector and telecommunications. There are three enterprises in each of these two sectors. As BiH is one of the rare countries in SEE region that has a positive energy balance, it makes investments in energy production and distribution sector more attractive, and, likewise, increases the interest of foreign investors. The situation is similar in the field of telecom-operators, which have significantly upgraded their technology in the last 8 years, primarily by re-investing the profit they have gained via the expansion in capacity.

6 Current situation and prospects of BiH economy

By the end of 2002, BiH economy reached 51,2% of its 1991 GDP, or 59,5% in per capita terms. In order to understand the effects of the reforms and complexity of transition in BiH, it is necessary to bare in mind that in 1991, the direct or indirect share of military industry amounted to approximately 20% of GDP. If we exclude military industry, and look at the civilian sector only, then the GDP in 2002 would amount to 62,5% of the 1991 level.

At the beginning of 2003, the World Bank published, for the first time, the data on GNP (Gross National Product) for BiH expressed in USD, based on purchasing power parity (USD PPP).[13] In the country ranking produced by the World Bank, BiH ranks 92 out of the total of 208 countries. Our analysis of BiH position in the context of SEE region (including Slovenia), which was based on the World Bank data and statistical addendum to the study made by Angus Maddison, indicates that BiH made a progress in SEE region, in particular during 1998-2001. This analysis was derived using wealth coefficient, defined as the ratio between participation of a country in the global GDP, and its participation in the world's population. According to the wealth coefficient BiH, ranks third, after Slovenia and Croatia.

[13] The World Bank, World Development Indicators 2003, Washington, April 2003, p. 14.

Table 11

BiH: Gross domestic product - total and per capita

	GDP (millions of USD)	GDP/PC (USD)
1991	9.725	2.210
1995	2.029	615
1996	2.778	830
1997	3.773	1.075
1998	4.245	1.180
1999	4.548	1.246
2000	4.370	1.164
2001	4.750	1.265
2002	5.025	1.315

Source: BiH Agency for Statistics, Statistical Bulletin 4/2001; Central Bank BH, Bulletin 2/2003.

Table 12

Wealth coefficients of SEE countries in 2001

calculated on the basis of GNP in USD PPP 2001

COUNTRIES	G N P		POPULATION		WEALTH COEFFICIENTS
	Billions of USD PPP 2001	Share in the world in %	Millions	Share in the world in %	
Albania	12	0,027	3,2	0,052	**0,519**
Bosnia and Herzegovina	25	0,055	3,7	0,060	**0,917**
Bulgaria	54	0,120	8,0	0,131	**0,916**
Croatia	39	0,086	4,5	0,073	**1,178**
Macedonia FYR	12	0,027	2,0	0,033	**0,818**
Romania	130	0,288	22,4	0,365	**0,789**
Slovenia	34	0,075	2,0	0,033	**2,273**
Serbia and Montenegro	56	0,123	10,2	0,167	**0,737**
TOTAL SEE COUNTRIES	362	0,801	56,0	0,914	**0,876**
WORLD	**45.183**	**100,00**	**6.130,1**	**100,00**	**1,000**

Source: The World Bank, World Development Indicators 2003, IBRD/WB, Washington, 2003, pp.38-40; 190-192; calculation of participation and wealth coefficients are made by Dr F. Caušević.

For the purpose of comparing the position of BiH economy in the previous years, we have also calculated wealth coefficients for 1990 and 1998 (see tables in the annex). Assessment of the position of BiH in these two years was based on GDP expressed in 1990 international dollars (Geary-Khamis). Comparison of wealth coefficients indicates a continuous relative progress of BiH economy, that is progress as compared to the developments in other countries of SEE region (including Slovenia).

Table 13

Rankings of the countries in transition according to the achieved level of the wealth coefficient, 1990 to 2001

	2001	1998	1990
Slovenia	1	1	1
Croatia	2	2	2
Bosnia and Herzegovina	3	6	5
Bulgaria	4	3	3
Macedonia FYR	5	5	6
Romania	6	4	7
Serbia and Montenegro	7	7	4
Albania	8	8	8

Source: F. Causevic's calculations based on: The World Bank, World Development Indicators 2003, Washington, 2003; and Maddison, Angus, The World Economy: A Millennial Perspective, OECD, 2001

However, the high-ranking position of BiH in 2001 was calculated based on GDP expressed in USD in PPP. The World Bank assessed that GDP expressed in terms of PPP was 5,2 times higher than the GDP expressed in absolute dollars. However, BiH wealth coefficient calculated in absolute dollars GDP places BiH on the next-to-the-last position in the same year:

Table 14

Wealth coefficients in SEE countries in 2001

COUNTRY	GDP		POPULATION		WEALTH COEFFICIENTS (share in GDP / share in number of population)
	Billions of USD	Share in the world in %	Millions	Share in the world in %	
Albania	4,1	0,013	3,2	0,052	**0,250**
Bosnia and Herzegovina	4,8	0,015	3,7	0,060	**0,250**
Bulgaria	13,6	0,044	8,0	0,131	**0,336**
Croatia	20,3	0,065	4,5	0,073	**0,890**
Macedonia	3,4	0,011	2,0	0,033	**0,333**
Romania	38,7	0,124	22,4	0,365	**0,340**
Slovenia	18,8	0,060	2,0	0,033	**1,818**
Serbia and Montenegro	10,9	0,035	9,5	0,155	**0,226**
WORLD	**31.121,4**	**100,00**	**6.130,1**	**100,00**	**1,000**

Source: The World Bank, World Development Indicators 2003, IBRD/WB, Washington, 2003, pp.38-40; 190-192; calculation of participation and wealth coefficients of economies are made by Dr F.Caušević

In deciding on the coefficient of 5,2 for calculating GDP in PPP the World Bank assumed large share of informal labour market (approximately 40%). However, in order to assess the sustainability of macroeconomic trends and competitiveness of BiH business sector, it is important to emphasize an extremely negative influence of the informal economy on sustaining the competitiveness of the formal sector, as well as of the system of social protection.

Research on BiH competitiveness[14] indicates following positive sides of BiH economy: moderately low tax rates, macroeconomic stability achieved primarily in the monetary system, openness, commercial banking sector reform, and increasing quality of services in fixed and mobile telephone networks.

CHARACTERISTICS OF COUNTRY AND GOVERNMENT
1. Growth of GDP per capita in USD PPP
2. Tax rate on total income of citizens
3. Corporate tax rate
4. Average turnover tax rate
5. Pension indicator - average pension in relation to GDP/pc
I N F R A S T R U C T U R E
6. Density of telephone lines - fixed telephone network
7. Density of telephone lines - mobile telephone network

Source: Competitiveness Report Bosnia and Herzegovina 2002, Faculty of Economics-MIT Centre and Academy of Sciences and Arts of BH, Sarajevo, October 2003

However, the negative elements undermining competitiveness of BiH economy are far more prevalent. Despite the fact that the tax rates in BiH are relatively low, the tax system is inefficient and opened for misuse. The tax system in force in 1995- 2002 directly contributed to tax evasion and the creation of large grey market.

[14] Competitiveness Report Bosnia and Herzegovina 2002, Faculty of Economics-MIT Centre and Academy of Sciences and Arts of BH, Sarajevo, October 2003.

CHARACTERISTICS OF GOVERNMENT AND COUNTRY
1. Administrative regulations in the country
2. Structure of public consumption
3. Independence of civil servants
4. Tax system in the country
5. Tax evasion
6. Illegal additional payments / bribe
7. GDP per capita in USD (absolute value of USD)
8. Total public expenditures - in % of GDP
I N S T I T U T I O N S
9. Institutional stability
10. Illegal additional payments
11. Independence of judiciary
12. Costs of bringing legal action
13. Reliable legal framework
14. Business sector can rely on efficient police protection
15. Problem of organized crime
16. Confidence of the public in independence of politicians
17. Grey economy - evasion of fiscal obligations
COMPANY OPERATIONS AND STRATEGIES
18. Competitive advantages of domestic enterprises at international market
19. Development level of exporting enterprises
20. Export orientated enterprises that develop their own brands
21. Procurement of new technologies
22. Product designing
23. Production processes in the country
24. Marketing development level
25. Orientation toward customers
26. International distribution and marketing
27. Export to neighbouring countries
28. Export enterprises export to all international markets
29. Approach to human resources
30. Competence of main managerial structures

Source: Competitiveness Report Bosnia and Herzegovina 2002, Faculty of Economics-MIT Centre and Academy of Sciences and Arts of BiH, Sarajevo, October 2003

Prospects of BiH achieving sustainable growth depend critically on the success of re-integrating its economy. This presupposes economic co-operation of BiH enterprises, which has according to the Competitiveness report been poor so far. The approach to reforms between 1995-2000, and partly in the last two years, was grounded in the belief that the formally applied principles of free market economy and entrepreneurship would be sufficient to engender integration of administratively divided country. The consequence of this approach was that the administrative system of BiH was repeatedly misused at the local level, contributing to the creation of parallel systems and widespread influence of informal economy, and to a large extent criminal economy.

BiH represents a complex mixture of building simultaneously constitutional structure and political institutions as defined by the terms of the Dayton peace agreement along with efforts to transform its economy. This has created many contradictions, for which solutions have been difficult to come about. For example, strengthening central state institutions requires additional funding but at the same time the public sector reforms require reduction in public spending. The constitutional set up dividing BiH into highly autonomous regions has been a constraint to policy making and international community has been instrumental in maintaining the reform momentum. It has dominated the policy process across a wide range of areas. However, while it has been able to set the agenda and influence to some extent the dynamics of the legislative process underpinning the reforms it has had much less leverage on their actual implementation. Genuine consensus among the local political elites on the shape and the pace of reforms is lacking as it requires political compromise, which even at this stage is often only possible thanks to international mediation and sometimes outright coercion. The public perceives the government as corrupt and incapable, and given economic hardship of the post- war economy there, is a strong opposition to the reforms among some sections of the population, e.g. workers in manufacturing, pensioners and war veterans. BiH lacks mechanisms to ensure that the legislation on various aspects of reforms is implemented consistently through the state. It also lacks human potential and necessary expertise as well as financial means to carry out reforms in a comprehensive manner. The confluence of these factors has caused the reform process to progress in a sporadic fashion and overall very slowly. Economic performance has suffered as a result; price stability being the main achievement aside, there remain serious imbalances on the foreign account and in public finance, large unemployment and slow recovery of production capacity. A major challenge regarding the implementation of remaining structural reforms is ahead in a situation when growth sustenance is still dependent on international assistance and BiH's ability to raise commercial funding limited.

A N N E X

Table 1

Wealth coefficients of SEE countries, 1990

(on the basis of GDP international dollars (Geary-Khamis dollars))

COUNTRIES	GDP Billions of internat. dollars 1990	GDP Share in the world in %	POPULATION Millions	POPULATION Share in the world in %	WEALTH COEFFICIENTS
Albania	8,1	0,030	3,3	0,063	**0,476**
Bosnia and Herzegovina	16,5	0,061	4,4	0,084	**0,726**
Bulgaria	49,8	0,184	9,0	0,171	**1,076**
Croatia	33,1	0,122	4,8	0,091	**1,341**
Macedonia, FYR	7,4	0,027	2,0	0,038	**0,711**
Romania	80,3	0,297	22,8	0,434	**0,684**
Slovenia	21,6	0,080	2,0	0,038	**2,105**
Serbia and Montenegro	51,3	0,189	9,7	0,185	**1,022**
TOTAL SEE COUNTRIES	268,1	0,990	58,0	1,104	**0,897**
WORLD	**27.076,0**	**100,00**	**5.253,3**	**100,00**	**1,000**

Source: F.Causevic's calculations based on: Maddison, Angus, The World Economy: A Millennial Perspective, OECD, 2001

Table 2

Wealth coefficients of SEE countries, 1998

(on the basis of GDP international dollars 1990 (Geary-Khamis dollars))

COUNTRIES	GDP: Billions of internat. Dollars 1990	GDP: Share in the world in %	POPULATION: Millions	POPULATION: Share in the world in %	WEALTH COEFFICIENTS
Albania	8,0	0,024	3,3	0,056	**0,429**
Bosnia and Herzegovina	9,3	0,028	3,4	0,058	**0,483**
Bulgaria	38,7	0,115	8,2	0,139	**0,827**
Croatia	27,9	0,083	4,7	0,080	**1,038**
Macedonia, FYR	5,9	0,017	2,0	0,034	**0,500**
Romania	64,7	0,192	22,4	0,379	**0,507**
Slovenia	23,6	0,070	2,0	0,034	**2,059**
Serbia and Montenegro	28,7	0,085	10,5	0,178	**0,478**
TOTAL SEE COUNTRIES	206,8	0,613	56,5	0,956	**0,641**
WORLD	**33.725,6**	**100,00**	**5.907,7**	**100,00**	**1,000**

Source: F. Causevic's calculations based on: Maddison, Angus, The World Economy: A Millennial Perspective, OECD, 2001

Table 3

Rankings of the countries in transition according to the wealth coefficient, 1990-2001

	2001	1998	1990
Slovenia	1	1	1
Czech Republic	2	3	4
Hungary	3	6	12
Slovakia	4	4	7
Poland	5	5	18
Estonia	6	2	2
Croatia	7	8	11
Lithuania	8	9	5
Belarus	9	10	10
Latvia	10	7	3
Russian Federation	11	13	6
Bosnia and Herzegovina	12	19	21
Bulgaria	13	12	16
Kazakhstan	14	11	9
Macedonia FYR	15	17	22
Romania	16	16	25
Serbia and Montenegro	17	20	17
Ukraine	18	22	15
Turkmenistan	19	26	23
Albania	20	23	27
Azerbaijan	21	24	19
Georgia	22	18	8
Armenia	23	14	13
Kyrgyz Republic	24	25	24
Uzbekistan	25	15	20
Moldova	26	21	14
Tajikistan	27	27	26

Source: F. Causevic's calculations based on: The World Bank, World Development Indicators 2003, Washington, 2003; and Maddison, Angus, The World Economy: A Millennial Perspective, OECD, 2001

Table 4

Transition indicators for selected SEE countries

	BiH	Albania	FYR Macedonia	Serbia and Montenegro
Price liberalization	3	3	3	3
Trade and foreign exchange	3	4+	4	3+
Competition policy	1	2-	2	1
Large scale privatization	2+	2+	3	2
Small scale privatization	3	4	4	3
Governance & en. restructuring	2-	2	2+	2
Banking reform	2+	2+	3	2+
Nob- bank financial institutions	2-	2-	2-	2-

1 indicates little or no progress in reforms; 4+ standards of functioning market economy

Source: EBRD Transition Report 2002

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