

WHY WILL NO ONE INVEST IN BOSNIA AND HERZEGOVINA?

**An Overview of Impediments to Investment and Self Sustaining
Economic Growth in the Post Dayton Era**

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EXECUTIVE SUMMARY

The donor countries hoped the governments of Bosnia and Herzegovina would use the promised \$ 5.1 Billion post-war reconstruction aid to undertake the structural changes necessary to transition from communism to capitalism. As donor-aid diminished, private investment would replace it, stimulated by structural reforms. Unfortunately, this has not been the case. Indeed, interviews with Bosnian and foreign businessmen show a common reluctance to invest in BiH.

The current economic and political structures in all three ethnic sections of BiH maintain the failed communist-era policies that contributed to former Yugoslavia's economic downturn and eventual break-up. These policies discourage business activity and investment. The continued existence and implementation of these failed economic policies and structures means that donor aid, no matter how wisely targeted or spent, will prove ineffective in creating long-term, sustainable economic development.

To date, the experiences of foreign investors in BiH have not been very positive. In most instances they engage in marketing goods produced outside BiH. Those engaged in manufacturing have largely failed. Some have closed and left. Interviews with businessmen in BiH revealed significant concern over the banking system, payments bureaux, delays with privatisation, high tax rates, communist-era business regulations, non-functioning judiciary, excessive official corruption, and porous borders.

Yet the key to Bosnia and Herzegovina's viability under the Dayton Peace Accords is economic growth. Refugees will return to their pre-war homes only if they have reasonable opportunities to earn a living. Government will function only if a stable tax base exists. A stable tax base will exist only if businesses thrive and prosper. And businesses will thrive and prosper only if the government creates stimulatory economic policies and regulations. In the end, the long-term success of the Dayton Peace Accords depends on Bosnia and Herzegovina's ability to develop a self-sustaining economy, which creates jobs, keeps inflation in check, and provides fertile ground for investment.

In order to set Bosnia's economy on a sound footing a series of structural and other reforms are needed:

- dismantle immediately all payment bureaux;
- improve the legal environment for business:
- rationalise tax policies;
- rationalise business regulations;
- create a viable commercial banking system;
- implement the Law on Tariffs of Feb. 11, 1998;
- remove customs authority from the entities and place it at the national level;
- remove barriers to inter-entity trade;
- privatise without further delay.

Sarajevo, 21 April 1999



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I. INTRODUCTION

"We say to everyone in Bosnia and Herzegovina: yours is now one of the most assisted countries in the world. International assistance is at its height. It will inevitably begin to reduce in the near future. Bosnia and Herzegovina must use the time that remains to prepare for life without total reliance on foreign aid, and to face up to the challenge of transforming the economy to generate jobs and a better standard of living. This...requires a greater degree of commitment and co-operation and a more responsible attitude from the authorities of BiH"

(Declaration of the Peace Implementation Council, Madrid, 16 December 1998)

The massive (\$ 5.1 Billion) internationally funded post-war reconstruction of Bosnia and Herzegovina was not intended to be eternal. The donor countries hoped that the four-year period of donor aid would be used to undertake the structural changes necessary to transition from communism to capitalism, while creating the basis for a viable, self-sustaining economy. The combination of structural change and NATO-backed political and military stability would develop an attractive business climate, as private sector investment (foreign and domestic) gradually replaced aid.

Unfortunately, this has not happened. Over the past two years private sector investment in BiH has totaled approximately \$ 160 million, a figure equal to 4.7% of total donor aid. Of this, \$ 129 million (80%) comes from foreign investors,¹ though many of these are in fact Bosnians using off-shore companies and funds. Today, total private sector investment in BiH is so low as to be insignificant. Indeed, interviews with Bosnian and foreign businessmen uncovered a common reluctance to invest in BiH.

Yet the key to Bosnia and Herzegovina's viability under the Dayton Peace Accords is economic growth. Refugees will return to their pre-war homes only if they have reasonable opportunities to earn a living. Government can function only if a stable tax base exists. A stable tax base will exist only if businesses thrive and prosper. And businesses will thrive and prosper only if the government creates stimulatory economic policies and regulations. In the end, the long-term success of the Dayton Peace Accords depends on Bosnia and Herzegovina's ability to develop a self-

¹ World Bank figures obtained from the Sarajevo office.

sustaining economy, which creates jobs, keeps inflation in check, and provides fertile ground for investment.

Since the economy is dependent on aid, what would happen if the aid stopped? Has BiH developed the self-sustaining economic and legal structures necessary to support a self-sufficient economy and polity?

The current economic and political structures in all three ethnic sections of BiH maintain the failed communist-era policies that contributed to former Yugoslavia's economic downturn in the late 1980s, as well as the eventual break-up. These policies discourage business activity and investment. The continued existence and implementation of these failed economic policies and structures means that donor aid, no matter how wisely targeted or spent, will prove ineffective in creating long-term, sustainable economic development.

Yet, in spite of the current dependent state of the BiH economy, the country needs far less donor aid than is often thought. In fact, if managed properly, BiH should eventually be able to achieve self-sustaining economic growth. In order to create this growth in BiH, the governments need to change rapidly their failed economic policies and structures. If they do so, BiH will become economically and politically viable, while developing all the necessary prerequisites for sustainable long-term growth. The potential for taking effective action may be seen in one of the few positive economic achievements in the post-war era: the creation of the Central Bank of Bosnia and Herzegovina (CBBH). The CBBH, with World Bank and IMF guidance, has created a new currency (Konvertabilna marka) backed by a currency board. It has successfully controlled inflation, and has created a macro-economic financial environment with many of the pre-conditions necessary for long-term investment in BiH.

This report examines the BiH economy, and attempts to answer the question: "Why does no-one invest in Bosnia and Herzegovina?" It concentrates on specific difficulties from the point of view of the entrepreneur, as emerged in interviews with over 50 private businessmen, both foreign and Bosnian, who were asked to identify barriers that discourage business activity and private investment. From these interviews it is possible to identify measures which, in the view of the private sector, would encourage business activity. Accordingly, this report (i) looks at the investment record to date, and (ii) suggests ways to improve it.

II. BOSNIA AND HERZEGOVINA'S ECONOMIC POTENTIAL

"Sustainable economic growth is essential to political stability."²

In spite of massive wartime destruction and the displacement of over 2 million people, Bosnia and Herzegovina need not be an economic write-off. Several factors argue that, given the proper economic policies, the BiH economy could provide an atmosphere suitable to investment and growth, which over time could become self-sustaining. As an indication of the potential, areas of interest for Bosnia's long term growth include:

A. The People

Bosnia's greatest economic potential lies in its people. The typical Bosnian will work his entire life, and end up with a 30 m² apartment, an 85 DM per month pension that is always four to five months in arrears, and little else. Some foreign observers, seeing this, as well as watching Bosnians at work, come to the conclusion that Bosnians lack ambition and motivation. Yet that very same Bosnian, when working in Western Europe or the U.S., will rapidly adapt, and within a very short period of time achieve a far greater level of material comfort and wealth than he or she ever could in BiH. Bosnian emigrants are consistently successful, through hard work and innovation. This suggests that Bosnian workers are good material. So what prevents them from achieving their potential at home? The obvious answer is: bad laws and restrictive business regulations. If the BiH governments were to implement stimulatory economic policies to unleash this untapped human potential, the people of BiH could become its greatest resource.

B. Hydroelectric Energy

Bosnia has one of the highest hydroelectric generating potentials in Europe. Its mountainous terrain and ample rainfall, of more than 1,100 mm annually,³ combine to create numerous potential sites for hydroelectric dams. Even in 1991 this was relatively untapped, at roughly only 28% of potential.⁴ The construction of new hydroelectric generating facilities could provide BiH with a significant source of foreign currency earnings, and enable it to cover a substantial portion of its trade imbalance and national debt. Such investment depends either on yet more aid, or on the pursuit by government of policies that will attract private capital.

C. Forestry and Furniture

One of the few industries to survive the war relatively intact is the forestry and furniture-manufacturing sector. BiH had more forested area than any other republic in former Yugoslavia,⁵ and by the late 1980s production of lumber and furniture approached that of Croatia and Slovenia in terms of total output.⁶ During the war, companies such as Sipad and Krivaja continued manufacturing and exporting. Today, the more than 75 lumber mills throughout the country combine with Bosnia's hard wood forests, to present numerous opportunities for investment and growth.

² Annex to the Madrid Declaration, Peace Implementation Council, 16 December 1998, section IV.4.

³ Bertic, Ivan, *Geografski Atlas Jugoslavije*, SNL, Zagreb; 1988, p.79.

⁴ Privredna Komora BiH, *Ekonomska karta BiH*, p.12. *Workshop on Reconstruction, Reform, and Economic Management in Bosnia and Herzegovina: Review of the Economic and Social Situation in Bosnia and Herzegovina*, p.24.

⁵ Bertic, Ivan, *Geografski Atlas Jugoslavije*, SNL, Zagreb; 1988, p.80.

⁶ *Ibid*, p.111.

Today, BiH firms continue to export furniture throughout the world. Unfortunately, many of these firms are state-owned and uncompetitive. If adequately husbanded, the country's forests and furniture industry present a tremendous asset for future growth.

D. Mineral Extraction and Processing

Bosnia abounds with mineral resources. These include iron ore, coal, bauxite, mercury, asbestos, salt, and manganese.⁷ Many foreign investors are interested in not only mineral extraction but also in processing. If the governments revise their disastrous policies regarding foreign investment in mineral resource extraction, which prevent foreign partners from taking majority positions in this sector, then BiH can expect significant investment and growth in this sector.

E. Food Processing

In spite of Bosnia's mountainous terrain, there are substantial investment and growth opportunities in the food processing industry, particularly in the country's northern Posavina region. Although the agricultural potential of this region is not as high as that of Vojvodina or Slavonia,⁸ it still holds significant potential to support a small regional food processing industry. This may be seen in the post-war activities of such firms as Vegafruit in Gracanica and Frigos in Celic. Given the proper mix of stimulatory economic regulations and export orientation, this sector could exhibit continued growth, as well as assist the country in import substitution.

F. Animal Husbandry and Meat Processing

BiH has a considerable potential for animal husbandry and meat processing. By the mid 1980s BiH produced approximately 138,000 tons of meat per year.⁹ Although the war destroyed much of this sector, the basic infrastructure and knowledge still exist. Given the relatively high (by European standards) levels of meat consumption in the Balkans and eastern Europe, this should be an ideal sector for future investment and growth.

G. Hospitality and Tourism

This is not a sector which is likely to grow quickly as long as the Balkan region as a whole remains politically volatile, as the frustrations of the Dalmatian tourist industry have shown. Still, the longer term offers opportunities for development. BiH hosted the 1984 Winter Olympic Games and has ski-tourist infrastructure, some of which has survived the war but needs upgrading to attract affluent tourists. Also eco-tourism could be developed, given Bosnia's natural beauty and many relatively unspoiled areas.

⁷ Privredna Komora BiH, *Workshop on Reconstruction, Reform, and Economic Management in Bosnia and Herzegovina: Review of the Economic and Social Situation in Bosnia and Herzegovina*, pp.23-24. *Ekonomska karta*, p.8.

⁸ Bertic, p.104-105.

⁹ Ibid. p.104.

III. THE IMPACT OF DONOR AID ON THE BiH ECONOMY

"The flow of donor assistance – unprecedented in its scope and scale – has reached its height, and will soon inevitably start to diminish. BiH and its leaders must make the most of what remains of this window of opportunity, and strive for a BiH that is ready for life with a reduced level of foreign aid."¹⁰

Under the Priority Reconstruction and Recovery Program (PRP), the international community was to spend approximately \$ 5.1 billion on reconstruction aid for Bosnia and Herzegovina over a four-year period beginning in 1996. By the end of 1998, donor nations had committed approximately \$ 4 billion, of which roughly \$ 2.7 billion has been spent. At the fourth and final donors' conference (scheduled for May but likely to be delayed), the donors are to approve the final tranche of approximately \$ 1 billion.¹¹

A. Industrial Investment: Only 2% Of Total PRP Expenditures

In spite of spectacular official growth rates, which average 39% per annum since 1995,¹² the actual economic picture is grim: these impressive growth rates required investment equivalent to 40% of GDP, almost all of which came from donor countries.¹³ Indeed, today's BiH economy is based almost entirely on artificial, donor-related economic stimuli, which will soon disappear. During the period from 1996 to the end of 1998, donor spending on infrastructure reconstruction projects created most of Bosnia and Herzegovina's growth. This growth occurred in the construction sector: actual investment in the manufacturing sector was minimal, totaling only 2.3% of total PRP expenditures.¹⁴

B. Sarajevo: 60 million DM per Month on Living Expenses Alone?

Nowhere is the impact of donor aid more clear than in Sarajevo, which plays host to approximately 15,000 foreign civilians.¹⁵ They are employed by non-governmental aid organizations (NGOs), foreign embassies, international organizations (UN, UNHCR, European Commission, OSCE, OHR, World Bank, IMF, etc.), de-mining companies, NATO-funded service companies, and western sub-contractors working on donor-funded projects. This number does not include military personnel under SFOR. As a conservative estimate, each foreigner spends on average 1,000 DM per month on rent, 1,000 DM on living expenses, employs one Bosnian worker at an average salary of 1,000 DM per month, and spends an additional 1,000 DM per month on office rent and associated overheads. This amounts to a minimum monthly expenditure of 60 million DM in a city with approximately 400,000 residents, or 150 DM per month per Sarajevo resident. With an average net monthly wage in the Federation of 354 DM,¹⁶ foreign spending per Sarajevo resident equals approximately 42% of the average monthly salary. These figures do not reflect expenditures on

¹⁰ Annex to the Madrid Declaration, Peace Implementation Council, 16 December 1998, section IV.1.

¹¹ World Bank.

¹² Ibid.

¹³ Ibid.

¹⁴ OHR Economic Newsletter, Vol.2., No 1., February, 1999.

¹⁵ No accurate figures exist on the number of foreigners in Sarajevo or BiH. This figure is based on estimates based on conversations with officials in World Bank and USAID. ICVA (International Council of Voluntary Associations) reports that as of March 1998 there were approximately 185 international non-governmental organizations, and 18 UN agencies, as well as an additional 18 international governmental organizations present in BiH. *The ICVA Directory*, March 1998, foreword.

¹⁶ OHR Economic Newsletter, Vol. 2., No. 2., March, 1999.

actual reconstruction programs or by SFOR, which would increase substantially the amount expended per Sarajevo resident.

C. GDP growth of –1%?

The impact of donor aid is echoed throughout the country in varying degrees. Without this massive donor aid, Bosnia and Herzegovina would have negative GDP growth, approximately –1% annually.¹⁷ Given the need to face a future without such massive aid, it would have been prudent for the governments of BiH to use the four-year period of massive aid flows to prepare their economies for free-market capitalism, for example by trying to attract domestic and foreign capital through stimulatory, liberal economic policies. However, the governments appear to have ignored the looming economic disaster, and have instead concentrated on resisting the international community's attempts to promote reform. The old communist era economic, political and social structures that contributed to the economic collapse and breakup of the former Yugoslavia still remain in place.

IV. FOREIGN INVESTMENT TO DATE

"Foreign capital, which is necessary for the economy to take off, will not come before a set of drastic reforms have been completed..."¹⁸

Although the war completely destroyed the BiH economy, it also brought a tremendous outpouring of world sympathy for the war's victims and for the plight of the Bosnian people. Since the signing of the Dayton Peace Accords, numerous foreign businessmen have visited BiH, seeking investment opportunities. They hoped to make money, certainly, but also to use market forces to assist BiH in the reconstruction process: they were looking for investment opportunities which would enable them to employ Bosnians. Some of these potential investors never returned. One foreign business consultant stated: "many of them had their pictures taken in front of ruined buildings, examined the local business regulatory environment, and said they would return in ten years to see if the situation had improved."

For some, undoubtedly, the political uncertainty surrounding Bosnia's future were a disincentive. Others were put off by security risks. Still, there remained plenty of serious potential investors including CitiBank, McDonalds, ABN AMRO, Pilkington, AES, Tebodin, Guardian, Coca-Cola, Volkswagen, DHL, Metal Glas, IMSA, Siemens, Ericsson, and Gluck, to name but a few. Some, such as McDonalds, are still trying to surmount the numerous bureaucratic hurdles and barriers necessary to open a business in BiH. For the tenacious few who have tried it, the experience has been enlightening, and often disillusioning. We will examine some of these.¹⁹

A. Aluveneto

One of the earliest and most prominent foreign investments in post-war BiH was Aluveneto, an Italian joint venture with a prominent state-owned construction

¹⁷ *Payments Bureaus in Bosnia and Herzegovina: Obstacles to Development and a Strategy for Orderly Transformation*, USAID, Sarajevo, 15 February, 1999, pp.56-58. This figure is based on the assumption that no donor aid is being spent.

¹⁸ Annex to the Madrid Declaration, Peace Implementation Council, 16 December 1998, section IV.3.

¹⁹ ICG is indebted to the Bosnian Association of Foreign Investors (BAFI) for much of the following information.

company. In early 1996 Aluveneto opened a factory for manufacturing aluminum door and window frames, and double-glazed windows. Well-capitalized, and equipped with the latest Italian aluminum processing equipment and a double glazing line, Aluveneto rapidly encountered difficulties with working capital, caused in part by problems collecting accounts receivable. The payment bureau system increased the quantities of working capital necessary for day to day operation, while also raising inventory costs. In addition, the Bosnian partner brought with it many of the inefficiencies inherent in the state-owned sector. The Italian partner became dissatisfied with the company's performance and lack of profitability. By late 1998 Aluveneto's workers' salaries were nine months in arrears, and the firm filed for bankruptcy.

B. AES Cargo

This American-owned transport and freight-forwarding firm, which caters primarily to U.S. diplomatic needs and SFOR, opened in BiH in 1996. Their customer base is comprised almost entirely of foreign customers with diplomatic or extraterritorial status, such as SFOR, OSCE, embassies, etc. Without these foreign customers AES would not be in BiH. For all intents and purposes, given the duty free status of most of their customers, AES is operating outside the BiH economy.

C. Gluck Norm

In late 1996 Germany's largest manufacturer of PVC door and window frames, CVA, opened a factory in Tesanj, through its Austrian subsidiary, Gluck. The new company, Gluck Norm, formed in partnership with a state-owned firm, sent its Bosnian employees to Austria for training, and then imported new equipment for manufacturing and assembling the PVC frames. In 1997 the director of the state-owned company attempted to extort money from the parent company and illegally increase his shareholding in the firm. When Gluck refused, he locked them out of the factory, and began creating problems using the local tax and financial inspectors. Attempts to carry out normal business activities through the Payment Bureau (ZPP) proved frustrating, time consuming, and expensive. Illegal activities and corruption in the ZPP hampered efforts to collect accounts receivable. Normal legal channels proved useless. After investing several million DM in the business, CVA shut down Gluck Norm in 1998.

D. Pilkington

A prominent glass manufacturer, Pilkington, opened a distribution warehouse in Sarajevo in 1996, as part of the first phase of a planned expansion in the region. Pilkington moved out of its first warehouse site because of obstruction from the landlord (a prominent state-owned construction company), following the refusal of Pilkington to pay bribes to the director. Pilkington was forced to move from its second warehouse, after the landlord (another prominent state-run company) signed a lease for the warehouse space with another tenant, even though Pilkington had a valid contract and had paid the rent in advance. Attempts to collect accounts receivable met with limited success, due in large part to corruption in the ZPP. Legal recourse proved of no avail. Following numerous problems with financial, tax, communal, and other types of inspectors, all of whom attempted to extort bribes, as well as problems with contradictory tax laws, and retroactive taxes, Pilkington closed in the middle of 1998. The planned expansion to the second phase -- processing -- never occurred.

E. Volkswagen

Under extreme pressure from the German government to reopen its pre-war factory in the Sarajevo suburb of Vogosca, Volkswagen began negotiations with the BiH government in 1996. During the war the Vogosca plant was located on the front line. Its co-location with an ammunition factory caused it to be a frequent target for Bosniac artillery, while the adjacent ammunition storage bunkers were hit by NATO aircraft during the 1995 air strikes. What the war did not destroy, the Serb population carried with them when they vacated Vogosca in early 1996.

In spite of the seeming social importance and urgency of reopening production, the Bosnian partner, UNIS, engaged in delaying tactics, driving VW representatives from the bargaining table on numerous occasions, stating that they would not re-open the Vogosca facility. UNIS's director insisted that it remain a 51% majority shareholder, even though VW would contribute almost all of the operating capital and shoulder all start-up costs. Strong German government pressure on both the BiH government and VW led to an agreement in mid 1998, in which VW took a 58% shareholding, even though it financed all the start-up costs. Under this agreement, the VW subsidiary Skoda would manufacture the Felicia automobile from partially assembled kits. So too, the BiH government was forced to lower its tax rate for domestically produced automobiles, while at the same time agreeing to purchase only Skoda Felicia vehicles for its government fleets. Facing worldwide over-capacity of automobile production in the automotive industry, VW would not have re-opened the partially devastated plant without strong pressure from the German government.

Today, VW's Sarajevo operation faces enormous difficulties. It is able to sell only a small fraction of the Vogosca plant's capacity within BiH. Customs officials have been known to delay clearance of automotive parts. Due in part to difficulties with rail transportation, export sales have not begun. Today the Vogosca facility produces between five and ten vehicles per day, which it has difficulty selling on the local market. And given the large numbers of non-Skoda vehicles the BiH governments have purchased since the plant's opening, the BiH governments appear to have at least partially reneged on their agreements with VW to purchase only domestically manufactured vehicles for their vehicle fleets. Given that the Skoda plant has yet to make a profit, and given that the factory will continue to operate at a loss for the foreseeable future, one must ask how long VW will continue to tolerate the financial losses before economic considerations force the factory to close.

F. Coca-Cola

Another prominent pre-war investor, Coca-Cola Amatil, has also re-entered BiH. Like the VW factory in Vogosca, the Serb population plundered the Coca-Cola bottling plant in Rakovica when they departed in early 1996. The director of the state-owned (51%) pre-war company, in which Coca-Cola maintained minority ownership, refused to come to an arrangement which would allow Coca-Cola to take majority ownership in the company. Unwilling to operate under the old pre-war agreement, where it held a minority shareholding in its Sarajevo operation, Coca-Cola formed a new company, in which it was sole proprietor.

Following an initial phase of operations, in which Coca-Cola marketed products produced outside BiH, the company entered into an agreement with the Sarajevo Brewery and the European Bank for Reconstruction and Development (EBRD). Under this arrangement the Brewery acquired bottling and canning equipment to produce the full range of Coca-Cola beverages under license, using EBRD credit.

Although Coca-Cola is still interested in purchasing the old Coca-Cola plant under privatization, the state has placed an unrealistically high price on the company's remaining shares. Coca-Cola is faced with numerous difficulties, many caused by the porous borders. Coca-Cola in BiH is forced to compete with Coca-Cola products manufactured in Hungary and illegally imported to Republika Srpska via FRY. In addition, the paperwork and obstruction by various officials, particularly in the customs service, are a burden. Today Coca-Cola maintains a well-developed marketing and distribution network, but has yet to engage in production. If the situation warranted, Coca-Cola could shut its operation down with little loss of investment.

G. Prohigy

A prominent Slovenian attempt at a joint venture occurred in early 1998, with the state-owned company FAMOS in Hrasnica. The joint venture company, Prohigy, was formed by a Slovenian detergent manufacturer to package and market detergent imported from Slovenia. After investing significant sums of money in repairing the war-damaged facility next to the inter-entity boundary line in Hrasnica, which included re-paving the road out to the FAMOS compound, Prohigy opened in early 1998 to much fanfare, attended by the Slovenian Prime Minister and high ranking BiH government officials. Following the ceremony, the plant never began operation. In spite of the opening ceremony, the plant has yet to function.

H. Plena

A joint venture between one of Europe's largest cement manufacturers and the state-owned railway, Plena has set up a cement warehousing, packaging, and marketing operation. As of now, Plena engages primarily in marketing imported cement, and also repackages the cement for smaller purchasers. Plena's future plans include the possible buyout of the Kakanj and Lukavac cement manufacturing plants, when privatisation occurs. Yet these plans will likely be affected by a downturn in the construction sector, likely to result from the slowdown and eventual cessation of donor aid. So too, they may be affected by Hidrogradnja's claims to ownership of the Kakanj plant.

I. Meat Processing

A German meat processing company (which asked to remain anonymous) employed BiH refugees during the war. Impressed with their skills, work ethic, and stories of their experiences, the German firm decided to form a joint venture with its Bosnian employees in Bosnia. The Germans actually got so far as to register the company, import equipment, and send some of its management to BiH with the intention of opening a meat processing plant. After struggling with BiH regulatory barriers for three months, the Germans threw up their hands in frustration and left BiH.

Upon examining the record of foreigners who have chosen to invest in BiH, it becomes clear that most are involved in services or in the distribution of goods manufactured outside of BiH. Others live almost entirely off the international community. Those foreign investors who have attempted to engage in manufacturing activities have either failed or are failing. The experiences of foreign investors raise serious concerns about the BiH governments' economic regulations and laws. Foreign investors talk among themselves, and with other potential foreign investors visiting BiH. Due to the bad experiences to date, word has spread in the international business community that BiH is to be avoided at all costs.

V. BOSNIA-HERZEGOVINA'S ECONOMY: A BUSINESS PERSPECTIVE

"BiH's economy remains crippled by a bureaucratic mind-set and a statist system."²⁰

Interviews with over fifty private businessmen in Bosnia and Herzegovina brought to light numerous areas of concern in the economy. During the course of these interviews several things became clear. The primary desire of all Bosnians is to have a good job, earn a good living, and provide for their families in a decent, normal manner. The economic potential of Bosnians is being held back by restrictive legislation – the society does not lack entrepreneurs, but the system stifles them. If the Bosnian businessman is allowed sufficient freedom, he will create job growth and increased economic activity through his own initiative. The following were areas of concern for Businessmen in BiH.

A. The Market

When viewed as a potential market by domestic and foreign investors, Bosnia-Herzegovina exhibits several discouraging characteristics. Bosnia's population is relatively small, with approximately 3.6 million people²¹. The population is aging, and the youngest and brightest are emigrating. This relatively small BiH market is divided among three mutually uncooperative ethnic groups and two political entities (Federation 2.4 million and Republika Srpska 1.2 million). Purchasing power is low: average monthly salaries in the Federation and Republika Srpska are respectively 354 DM and 236 DM.²²

Interviews with Bosnian businessmen indicated that, in spite of the international community's best efforts, both RS and Federation have erected numerous regulatory barriers, which effectively discourage inter-entity trade. These include illegal taxes, as well as bureaucratic hurdles. As a result of these barriers, almost all inter-entity trade occurs illegally. The barriers force an investor to open up a company in each entity, if he wishes to do business in the entire country. As a result, many businessmen question whether the return on investment is sufficient to warrant investing in BiH. As long as barriers to inter-entity trade remain, it will be difficult to revive the BiH economy.

B. Infrastructure

Although wartime damage to the transportation infrastructure has been largely repaired, rail transport is problematic, as the different ethnic groups often obstruct passage of trains. In addition power, telephone and water services, while adequate in the larger towns, remain sporadic in some areas of the country and non-existent in remoter parts. Telephone communications between the two entities are possible but remain thin, because of the small number of telephone lines. One foreign telecommunications specialist working in BiH (who wishes to remain anonymous) states that only 8 telephone lines connect Sarajevo with Banja Luka. Poor communications between the two entities hinder the development of trade. And government revenues are currently inadequate to maintain even the existing infrastructure. This makes it even harder to modernize using domestic resources. In the worst case, the BiH infrastructure will slowly collapse after the donor aid era.

²⁰ Annex to the Madrid Declaration, Peace Implementation Council, 16 December 1998, section IV.3.

²¹ OHR estimates.

²² *OHR Economic Newsletter*, Vol. 2., No. 2., March, 1999.

C. Currencies

Four currencies are in circulation in Bosnia and Herzegovina, though two – the German Mark (DM) and the Bosnian Convertible Mark (KM) - are freely interchangeable at par rate. Thanks to the strength of the KM, it is used throughout the country. But the Croatian Kuna (KN) remains the currency of preference in areas under Croat control, and the Yugoslav Dinar remains in wide – though dwindling – circulation in Republika Srpska. Neither of these foreign currencies is acceptable in other parts of Bosnia and Herzegovina. This confusing financial environment is being surely but slowly improved by the success and strength of the KM.

D. Commercial Banking System and Payments Bureaux

All public and private financial activity, including payment transactions, savings, tax collection, tax distribution, treasury functions, and private and public expenditures are controlled through a monopoly institution, subject to exclusive party control, known as a Payments Bureau (PB). Each ethnic group maintains its own separate payments bureau (ZPP – Bosnia, ZAP – Herceg-Bosna, SPP – RS). These organizations are inefficient, charge high fees, engage in corrupt practices, lack transparency, and increase dramatically the costs of doing business. They promote “the fundamental subversion of private property rights.”²³ They hold huge money surpluses which can and have been diverted to the use of political parties (who are better organised than government to take advantage of them). They drive much of the economy underground and drain working capital from business and the commercial banking sector. They dramatically increase the amount of working capital a firm needs to carry out normal business activities. In essence, the Payments Bureaux act as a brake on the BiH economy.

Under the current system, banks are not allowed to conduct payment transactions. Neither are they able to mediate consumer cash deposits. Only the Payments Bureaux may do this. At the end of each day, all businesses and banks are required to deposit their day's receipts at the PBs. This robs banks of their primary source of cash deposits, reducing the amount of working capital available to the economy. It also dramatically lowers banking income, causing many banks to hover on the brink of insolvency.²⁴

Of the more than 60 banks currently operating in BiH, no more than five are financially sound. The high degree of insolvency stems in large part from the Payments Bureaux' monopoly control over all capital in BiH. As long as they exist, Bosnia will never develop a healthy commercial banking sector.²⁵

Banks must take over the role of payment transfers from the PBs. Unfortunately, the past history of banks in BiH and throughout the former Yugoslavia suggests that governments used banks to plunder the hard currency savings of private depositors. In addition, many banks in BiH are technically insolvent, while many are technically unable to handle payment transactions. As a result, depositors are sceptical of most

²³ *Payments Bureaus in Bosnia and Herzegovina: Obstacles to Development and a Strategy for Orderly Transformation.*, USAID, Sarajevo, 15 February, 1999, p.49.

²⁴ For an in-depth examination of the inter-relationship between Banks and Payments Bureaus, see the USAID report cited above, pp.56-58.

²⁵ For a description of the operation of the Payments Bureaux in Brcko, see the ICG report *Brcko, a Comprehensive Solution*, 8 February, 1999. For a detailed discussion of the Payments Bureaux and their negative effect on the BiH economy, see the ground-breaking USAID report cited above, pp.46-58.

financial institutions. Until this situation is reversed, Bosnia's financial sector will remain unable to support business growth and development.

E. Privatisation

Three years after the signing of the Dayton Peace Accords, privatization in BiH has not yet begun. The ruling political parties deliberately and consistently find bureaucratic reasons for delaying the start of privatization, so as to retain their hold over the economy and polity, as well as to profit from the financial gain accruing from state-owned assets. As happened before privatisation in other formerly communist countries, the directors of state-run firms attempt to reduce the book value of their firms, hoping that they can take control when privatization occurs. This means a dramatic downturn in productive activity and profitability in the state sector. Although this behaviour is both expected and unwelcome, given the experiences in other formerly communist eastern European countries, the slow start to privatization is drawing out the length of time over which many potentially profitable state-owned firms are forced to operate at a loss. As a result, the Bosnian economy is witnessing the destruction of capital, as directors of state-run firms deliberately slow or cease productive activity, hoping to drive down the book value of their companies. This means that the country's best industrial sites, real estate, and resources sit idle or under-utilized.

Another barrier presented by the delay of privatisation is investment uncertainty. Businessmen will not invest in a property or a business whose owner is in doubt. All businessmen interviewed stated that the delay in privatising the state-owned sector was dragging down the entire economy and preventing them from investing. In essence, the state-owned sector was likened to a "dog in the manager", which sits on the best assets, preventing others from making good use of them, while itself unable to exploit them effectively.

No-one pretends that privatisation in Bosnia and Herzegovina will be easy, or free from scandal. Experiences elsewhere in eastern Europe indicate that the process is likely to concentrate wealth in the hands of people with political influence and former directors of state owned firms. Yet these same experiences also suggest that new owners who are incompetent or incapable of managing the newly privatised companies quickly sell them on to more capable owners. In any event, it is important that state-owned assets be transferred to the private sector, which can utilise them in a far more productive manner than the state. Over time these assets will end up in the hands of those most capable of maximizing their economic potential. In any event, all businessmen interviewed stated that the delay in privatisation affects their activities, both directly and indirectly.

F. Business Regulations

The regulations governing business activities are extremely intrusive and time consuming. They are based on the old communist philosophy that capitalism is bad and that the state ultimately retains ownership over all means of production. As such, the business regulations and laws are inherently biased against private business. One businessman stated that his company's accountant spends an entire day every two weeks, simply filling out the forms necessary to meet payroll for a staff of eight employees.²⁶ The paperwork tax officials require of businesses requires a small company to fill out numerous forms when changing prices, and when buying and

²⁶ USAID, p.97.

selling goods or services. Unable to come to grips with capitalism, government officials continue to control the state economy as under communism.

Current business regulations are cumbersome and designed to provide maximum bureaucratic control over business. The typical business is visited by an endless parade of various inspectors, including:

- Sanitation;
- Market;
- Municipal;
- Environmental;
- Customs;
- Financial.

Many of these inspectors are vested with sweeping powers, including the right to shut down a company on the spot or seize goods. The inspectors use these powers to extort bribes. Because due process of law and an effective appeals system do not exist, businesses are left with no effective legal recourse.

Municipalities often abuse signage regulations. Several companies reported being driven out of business because of their signs. Many of the other regulations are confusing, contradictory, and open to interpretation by inspectors.

Often the state expects private companies to solve social problems, such as unemployment, or financial problems, such as the low level of revenue collection, which the government is incompetent to handle. An example of this is the misguided and destructive Federation law on employment of April 1998, which attempted to simultaneously solve unemployment and revenue problems. This law requires all general contractors to maintain a full-time staff of at least 15 employees.²⁷ Businessmen interviewed state that this requires a monthly expenditure of approximately DM 10,000, simply to meet payroll and the necessary payroll taxes. This law fails to take into account the seasonality in the construction industry, particularly the months from November through March, when most construction firms are idle and lay off their workers. The law also requires firms in other sectors to have two full-time employees, whether the firm is active or not. Such employment laws discriminate against small firms and favour large, inefficient state-owned enterprises. They also discourage work-place efficiency.

Similar bizarre laws governing signs, bomb shelters for paint factories, and hot meals for employees remain on the books throughout BiH. One businessman commented that the regulations governing business activity are inconsistent and contradictory. He stated "you can't obey the laws, even if you want to, because they contradict one another." This creates a system that encourages illegal economic activity. Indeed, in the course of its business interviews ICG did not find one single business that obeyed all the laws. When all businessmen operate illegally, government authorities have tremendous influence over the economy: they are able to selectively enforce regulations, punishing those who will not pay bribes, while ignoring the activities of those who do. This maze of conflicting regulations creates favouritism and encourages official corruption. For businesses, these regulations create unforeseen costs and bureaucratic obstacles, which can appear from nowhere to shut down a company. They present a serious obstacle to all forms of investment in BiH.

²⁷ Sluzbene Novine Federacije BiH, Broj. 15, p.366, 28 April 1998.

G. Taxes

For a country undergoing a period of post-war reconstruction, Bosnia has excessively high taxes. In the Federation for example these include:

- 10% tax on services;
- 10% tax on turnover;
- 5% tax on cash deposits (all retail sales);
- payroll tax of 87% tax on employees' salaries;
- tax to support the chamber of economy;
- 36% tax on profits;
- Annual business registration taxes;
- Miscellaneous municipal taxes and levies, often retroactive.

The typical Bosnian business has a mark-up (margin) between wholesale and retail of 25% to 30%, as compared to typical western margin of 75% to 110%. This leaves Bosnian businessmen with too-thin operating margins and cash flows. A company operating within the law and declaring all of its income will typically have a 1% to 3% year end profit margin in a good year. The Sarajevo giant Energoinvest had a net profit of 70,000 DEM in 1998 on revenues of over 100 million DEM.²⁸ This represents a profit of less than 1% of total revenues. Given such low potential earnings, it is smarter to deposit one's funds in a foreign bank and get a higher annual return without risk. As a result of high taxes, most businessmen are forced to conduct substantial amounts of their business activities in the "black" economy. Businessmen were unanimous in stating that the high tax levels were destroying their businesses and forcing them to work illegally. In addition, many businessmen complained that taxes were occasionally instituted retroactively, which made it impossible to plan normal business activities or cash flows.

One businessman reported being called into a tax court after refusing to bribe tax inspectors. The court fined him on the basis of a law which, according to officially published government documents and statements, was legally not in force. The court placed a lien on the company's ZPP account until the allegedly unpaid taxes and fines were collected. There was no possibility of appeal.

H. Judiciary

The BiH legal system remains relatively unchanged since communist times. This means it is not independent of the ruling political party, and will often render judgements based on instructions by party officials.²⁹ The most glaring example of this was the 1998 court case of *Intrade vs. Energoinvest*, in which party intervention first overturned and then delayed a ruling by the BiH Supreme Court. Small claims courts are nonexistent, and the typical civil suit to collect unpaid accounts receivable takes approximately 14 to 18 months to go to trial. In addition, the exorbitant up-front taxes on civil suits act as a deterrent to legal action. Businessmen claimed that upon a case reaching court, the opposing party often bribes the judge.

²⁸ "Izvoz dobiva podrsku," *Oslobodjenje*, 10 March 1999.

²⁹ See the OHR Anti-Corruption Task Force document "A Comprehensive Anti-Corruption Strategy For Bosnia and Herzegovina," Sarajevo, 1999; pp.22-27.

Most businessmen interviewed stated that in the case of business disputes, the court system proved completely non-functional. Contract law is unenforceable. Many also complained of extensive corruption in the judicial system. The nonfunctional judicial system has led to a business environment where cheating and fraud appear to be the rule, rather than the exception, as reflected in the all too common greeting "pazi da te neko ne prevari" (be careful that no one cheats you).

I. Corruption

Along with the payment bureaux, corruption is the most common complaint heard from businessmen. The most common form of corruption revolves around the various inspectors and minor government officials. Corruption is caused by a variety of factors. Because of low wages, government officials attempt to augment their official salaries by any means available. Bosnia's often-contradictory, overly burdensome, and very vague laws and regulations create a situation where everybody is a potential lawbreaker, no matter how well intentioned. In essence, BiH laws and regulations maintain systemic structures that criminalise what in the west would be considered normal and legal business activities. In this atmosphere, the various government officials are able to charge fees to look the other way at structurally-created illegal business activities. Businesses interviewed claimed that every inspector they dealt with (customs, market, sanitary, communal, etc.) augmented his income by accepting bribes.

At a higher level of society, corruption in BiH involves high ranking government and party officials. BiH businessmen stated that the various ruling political parties act as an organized family, with everyone getting a piece of the economic pie. Those in power use their influence to award lucrative contracts to cronies and family members. They avoid the payment of customs and taxes, they launder money, gain access to prime commercial and real estate sites, and block business activities of those who are not part of the "family," or are unwilling to bribe the appropriate officials.

Responsible authorities in Bosnia and Herzegovina are prepared to acknowledge the existence of this problem. Even so, few cases ever come to trial, though Bosnian media reports have accused by name some of the highest-ranking party and government officials of all three ethnic groups. Meanwhile the widespread official corruption raises the hidden costs of doing business so much that investors are unable accurately to forecast start-up costs and cash flows. This leads to a situation where business is no longer justifiable, as the return on investment is no longer profitable.

J. Customs

Bosnia and Herzegovina may be the only country in the world with two separate customs agencies. Even though the Dayton Peace Accords specifically provide the legal framework for the centralization of customs authority,³⁰ this has not occurred. In BiH each entity has its own customs administration, which acts independently of the central government. Although the entities are supposed to follow customs policy set by the central government, this has yet to happen. Up until now, the governments in Republika Srpska and the Croat-controlled regions of BiH have not yet implemented the Tariff Law of February 11, 1998, which created standardized tariffs for the entire country. Croat and Serbian non-compliance with this law creates a country with three

³⁰ "The following matters are the responsibilities of the institutions of Bosnia and Herzegovina: Customs policy," Dayton Peace Accords, Annex 4, Article III, 1.c.

separate tariff regimes: Republika Srpska allows the duty-free import of goods from FRY, while the Croat-controlled portions of the Federation allow the duty-free import of goods from Croatia. The Bosniac-controlled areas follow the customs tariffs set in the Law on Tariffs of February 11, 1998.³¹ Because of the differences in customs tariffs, the two entities have created illegal taxes on inter-entity trade, in an attempt to balance out the financial benefits that accrue to a business when importing through the entity with the lower customs tariff. This system of dual customs administrations discourages legal inter-entity trade, and creates a disadvantage for businesses attempting to operate legally.

Despite the best efforts of the Customs And Fiscal Assistance Office (CAFAO), funded by the European Commission, the BiH customs services still suffer from corruption. Quite often the illegal import of goods takes place with the connivance of highly placed government officials. Not only does smuggling harm the governments' budgets; it also harms legitimate business activities. The continuous flow of illegal duty-free goods into the country forces legitimate businessmen to compete against the lower-priced, smuggled goods. Businessmen stated that this uneven competition had forced some of them out of business, and in other instances, prevented them from carrying out planned expansion and new investment. Other businessmen stated that they were forced to operate in the "black" economy in order to remain competitive.

K. Business Registration

The current business registration process can take from six to twelve months, depending on the level of corruption and obstruction in the system. In the Federation, for example, registration requires approval from:

- Cantonal Court;
- Ministry of Defense (for foreign investors only);
- Ministry of Foreign Trade;
- Ministry of Finance;
- Statistical Association;
- Payments Bureau;
- Municipal government.

A similar but slightly less complicated process is in place in RS.³² These procedures are expensive, time-consuming, and intimidating even to a local resident who is a member of the majority ethnic group. For minorities, who may face prejudice in addition to bureaucracy, officials can make the process even longer and harder. For potential returnees outside of Bosnia, the expense of repeatedly traveling to Bosnia over a period of several months simply to register a business can be overwhelming. For foreign investors, the procedure is unfathomable and fraught with pitfalls and delays.

Registering a business also requires a detailed description of code numbers for the various business activities. It is common for a typical business to attach eight or nine pages of detailed business activities to its registration document. This requires the

³¹ *Sluzbeni Glasnik BiH*, February 11, 1998.

³² An in depth study of requirements for registering a business in the Federation may be found in Phare report "*Preliminary Survey of the Entrepreneurial Environment in the Federation of Bosnia and Herzegovina*," Appendix A.

added cost of engaging lawyers. In addition, there are no standardised forms or guidelines available to assist a potential businessman in registering his company. Businessmen stated that a procedure as simple as changing the address of a business requires completely reregistering the company.

Following the registration procedure, current laws require each business to maintain detailed documentation -- as part of its registration documentation -- regarding company administration, etc. This required paperwork strangles small companies and gives them the extra expense of hiring lawyers. As they stand today, the current business registration procedures discourage foreign investment, new business formation and even the return of refugees.

VI. RECOMMENDATIONS

"The Council expects the Entities to carry out a rapid transition to a free-market economy..."³³

The biggest brake on the BiH economy is a bureaucratic apparatus that is out of control. The biggest danger to the economic development in BiH has not in general been renewed war.³⁴ Rather, it has been a predatory bureaucracy that does not care for the needs of its ordinary citizens, or for the future growth of the country. Every businessman interviewed stated that he wanted someone to protect him from the bureaucracy. This report concludes with a list of the reforms most needed if the private sector is to flourish.

A. Dismantle the Payments Bureaux

Rapidly dismantle all three PBs! Any and all subsequent reforms depend on their elimination. The USAID programme should be encouraged and supported by the International Community and the BiH governments. The Entity governments should acknowledge that they have an interest in this process, which is distinct from that of the political parties, if Bosnia and Herzegovina is ever to enjoy transparent and good governance. The transfer of PB activities to commercial banks will both invigorate the banking sector and encourage other economic activity to move gradually from the black market into the legal economy, strengthening the government's tax base. And a major disincentive to foreign investment will disappear.

B. Make the Legal System Fairer to Firms

The question of Rule of Law in Bosnia and Herzegovina affects all aspects of society, and economic activity is no exception. In neither entity does the court system protect legitimate business interests, nor does it work in the interests of good business practice and common sense. The reform of the judicial system is a massive undertaking, but some reforms could be made quickly which would improve the climate for business. For example:

³³ Annex to the Madrid Declaration, Peace Implementation Council, 16 December 1998, section IV.10.

³⁴ The current situation regarding NATO bombing of FRY has altered perceptions of risk in the region. Any perception of security risk naturally makes the problems of attracting investment all the harder, but does not remove the need for the reforms here advocated.

- When inspectors seize goods or shut down firms without due process, institute a right of appeal, with a guarantee of a court hearing within two days;
- Create an effective and quick system of appealing court decisions;
- Create a network of economic courts to handle small claims quickly and with a minimum of procedure.

C. Reform Taxes

Because a wise tax policy is crucial to the economic growth of BiH, as well as vital to the revenues of the municipality, tax reform should be urgently considered. This is a particularly difficult decision for the entity governments, which already have a shortfall of income against expenditure, but taxes at the level now levied have a discouraging effect on business, and on the willingness of business to operate legally (and so pay taxes). A reduction in tax rates would in the short term decrease revenues, but the medium-term effect should be to increase revenues, as economic activity increases. The difficult interim period would need to be covered by loans from the International Financial Institutions. A sustainable tax regime might be:

- Abolish all current business taxes (except the year-end tax on profit);
- Replace business taxes with a VAT tax of 8% to 10%. As the economy strengthens this rate may be raised in ten years;
- Lower the level of payroll contributions from 87% to 35% of salaries;
- Lower the tax on profit from 36% to 20%.

D. Institute Government-Business Dialogue

A Council of private businessmen should be created in each entity, which would engage in permanent dialogue with government over economic policy. One of the Council's first tasks would be to recommend a more manageable regulatory regime.

E. Create a Viable Commercial Banking System

USAID has been assisting Bank Supervision Agencies (Agencija za Bankarstvo) of both entities, but their pace of work has been disappointingly slow. To promote confidence in the financial system, the agencies need to make rapid progress in shutting insolvent banks and consolidating the banking system of both entities.

F. Streamline Business Registration Procedures

Governments should reform business registration procedures, so that they are similar to those in Western countries. The new system should have the following characteristics:

- Quick (two days);
- Transparent;
- Inexpensive (less than 400 DM in administrative costs);
- Place the burden for refusing a license on the bureaucracy;
- Standardised paperwork (forms) to be filled in when applying for a business licence;

- Abolish the requirement to declare all areas of business activity to the smallest detail;
- Abolish the requirement for detailed company statutes.
- Automatic re-registration for all companies with valid registration documents in ethnically divided municipalities.

G. Reform the Customs System and Increase Control over the Borders

The two entity-level customs agencies should be merged into a single central government customs agency. Revenues from the customs tariffs should accrue to the central government, and not the entity governments. A portion of the revenues could be recycled back to entity governments in accordance with a formula to be agreed.

The three members of the BiH presidency agreed on April 20, 1999 to implement fully the Law on Tariffs of February 11, 1998. After such a long and typical delay it will be uncharacteristic if the law is indeed implemented. The High Representative may need to intervene to enforce revenue collection.

H. Remove Barriers to Inter-Entity Trade

There is no economic advantage to either entity in erecting barriers to trade within Bosnia and Herzegovina. Internal hidden taxes on inter-entity trade (*prelivmani*) should be abolished. As a result, inter-entity trade will increase, so raising revenues, and incentives to smuggle (which is not difficult across an unmarked and unmanned border) will be removed. Businesses attempting to operate legally (and pay taxes) will get welcome relief from illegal tax-free competition.

As a further measure to identify cross-entity barriers, with a view to their elimination, a cross-entity panel (comprised of private sector businessmen) should be set up to prepare a report on all barriers to inter-entity trade. Their report should be published, and entity governments should undertake to carry out its recommendations or publish reasons for refusing them.

I. Proceed with Privatisation

Privatisation should not be further delayed, despite the risk that some enterprises will fall into unscrupulous hands. Greater transparency in the ownership of enterprises will help to revitalise the economy and force business to work efficiently for profit rather than simply to keep going through inertia.

J. Create a Viable Tax Administration

One of the functions of the Payments Bureaux is the collection and distribution of all government revenues and expenditures through the PB account system. When the PBs close, government must find an alternate method to collect and distribute revenues. The entity tax administration now existing has grossly under-utilized manpower, as it relies heavily on the PBs to conduct much of its work. In the new system, tax collectors will have valuable work to do.

In addition, the tax administration should hire the former account controllers from the PBs to supervise tax collection. Each controller has an intimate knowledge of the companies in their portfolio, including cash flows, revenues, previous tax returns and

payments, etc. Hiring them to work in the tax administration will place their knowledge and experience at the disposal of the unified administration.

Because the present tax system relies on each enterprise calculating, reporting, and paying its own taxes through the PB, abolition of the PBs will create a gap only in regard to the deposit of revenues. Under a unified system, the BiH governments will keep their assets on deposit in commercial banks. Tax-payers will make their payments directly to the government agency or through a commercial bank. The government agency will hold its accounts at commercial banks, and not the PBs. Funds will then be distributed for government treasury purposes through normal banking channels, as in the west.

VII. CONCLUSION

"BiH must start to stand on its own feet."³⁵

As donor aid begins to shrink, and as donor energies and funds are drawn to other crisis areas, such as Kosovo, BiH must compete for private investment if it hopes to achieve self-sustaining economic growth. Although the BiH economy displays the potential to achieve a degree of self-sustaining economic growth, it remains handicapped by a statist, overly bureaucratic system, which robs the economy of its lifeblood and destroys incentives to invest in the country. Additional hurdles to investment include the lack of cooperation among the ruling ethnic elites in implementing laws, such as the uniform customs tariffs. This overly regulatory and bureaucratic system discourages legal business activities and new investment. The end result is that no one will invest in Bosnia and Herzegovina.

In order to make the difficult economic reforms necessary to create an environment hospitable to private investment and continued economic growth, BiH politicians must show the courage to cooperate with each other and the international community. If they carry out these reforms rapidly, the BiH economy will benefit through increased employment, investment, and economic growth. If these reforms do not occur, the BiH economy will slowly decay, as GDP growth begins to dip, and as Bosnians of all nationalities flee their birth place to find economic opportunities abroad.

³⁵ Annex to the Madrid Declaration, Peace Implementation Council, 16 December 1998, section IV.1.