

POLICY BRIEF

**TRADE POLICY AND COMPETITIVENESS
OF BOSNIA AND HERZEGOVINA**

Brief Summary

Between 1998 and 2008, Bosnia and Herzegovina (BiH) reduced trade and current account deficit from 71% to 38% of GDP, and from 30% to 15% of GDP, respectively, while the GDP rose by 270%. The real per capita GDP growth in 2000-2007 ranked BiH in the group of 25 fastest growing economies in the world. Despite relatively favorable results in 2000-2007, in the last three years BiH has been lagging behind most transition countries. Two reasons are of particular importance: 1) a significantly lower rate of growth of private external debt in BiH compared with majority of the fastest growing countries in transition and worldwide; 2) decline in BH competitiveness caused by institutional weaknesses, complicated administrative structures, the non-enforcement of the necessary reforms and falling investment. Transfer of global economic crisis from Western European market has only reinforced the existing problems: according to the latest Global Competitiveness Report BiH is ranked 109th out of 133, and 116th out of 183 economies in Doing Business 2010 Report.

This Policy Brief critically assesses some of the key failures of trade and fiscal policy of BiH. One of the main problems in improving competitiveness are the misconceived trade and foreign direct investment policies. To improve the competitiveness of BiH, the law on foreign direct investment and the provisions of the law on corporate income tax in both entities should urgently be changed in order to stimulate foreign direct investors. Unlike the current law on foreign direct investment, the new law should make clear differentiation between foreign direct investors who increase export potential and foreign direct investors who are oriented to the domestic market. The new law on foreign direct investments should free from taxes those investors who achieve significant net exports. In addition, emergency measures to improve business environment should cut the time firm managers loose on tax payments, simplify the procedures for starting new business from 12 to 6, and certification of institutions for quality control of imports.

Context and importance of the problem

Since the end of the war (1992-1995) in Bosnia and Herzegovina (BiH) up until the end of the third quartal of 2009, there has been a series of reforms which enabled a relatively fast economic growth, development of institutional structure among two entities of BiH (Federation of BiH – FBiH and Republic Srpska – RS) as well as the gradual integration of this country to the SEE region. Thanks to the adoption of the Quick Start Package (1997), five extremely important laws for economic reintegration of BiH took place, namely: The Law on Foreign Trade Policy, The Law on Unifrom Basis for Customs Policy, The Law on Customs Tariffs, The Law on Foreign Direct Investments, and The Law on Central Bank of Bosnia and Herzegovina.

In the period of 1998-2004, BiH was the thirteenth fastest growing economy in the world, and in the period of 2000-2007 average growth rates positioned BiH on 23rd place in the world.¹ However, in the period of 2004-2007, the average growth rates of BiH were below the average growth rates of 20 out of 29 countries in transition. After the adoption of the Law on Foreign Trade Policy (1998) in the period of December 2000-October 2003, BiH concluded nine bilateral free trade agreements with all the countries of South-eastern Europe, including Turkey. These agreements implied cutting down the customs barriers on export from BiH on most of the goods, while customs on import in BiH were gradually cut down in the period of three to four years. Bilateral agreements on free trade were replaced by the CEFTA agreement, signed by the South-eastern Europe countries in December 2006. BiH signed SAA with EU in June 2008, taking over the obligation of cutting down the customs on import of the most of the goods from EU.

In the period 2000-2008 total merchandise trade volume increased from 4.52 billion EUR to 11.86 billion EUR (by 162.3%), while trade deficit increased from 2.21 billion EUR to 4.82 billion EUR (by 118%). Over the last eight years GDP of BiH has increased from 4.9 billion to 12.6 billion EUR (157%). Merchandise trade of BiH expressed in percents of GDP has increased from 92.1% to 93.4%, while trade deficit has been decreased from 45% to 38.1%. Current account deficit was decreased from 26.5% of GDP in 2000 to 10.2% of GDP in 2007. However in 2008 current account deficit increased to 15.2% of GDP largely due to increase in trade deficit by 720 million EUR.²

Over the last two years the most important export partners have been the EU countries (57.3%), Croatia (18.4%), Serbia (13.7%) and the rest of world (10.6%), while the most important countries origins of imported goods were EU countries (47.9%), Croatia (17.6%), Serbia (10.2%), Turkey (5.8%), China (4.3%) and the rest of world (10.2%).³ Over the last five years the average trade deficit with Croatia has been 623 million EUR, with Germany 484 million EUR and with Serbia 297 million EUR. In the same period

¹The author's calculations based on the World Bank: Data and Publications (<http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20535285~menuPK:1192694~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html>). See also: Čaušević, Fikret, *Economic Sovereignty and Global Capital Flows*, Icfai University Press, Hyderabad, 2008, pp. 176-184.

² Sources: The author's calculations based on data from Agency for Statistics of Bosnia and Herzegovina (www.bhas.org) and Central Bank of Bosnia and Herzegovina (www.cbbh.ba)

³ World Economic Forum, *The Global Enabling Trade Report 2009*, Geneva 2009, p. 128. (http://www.weforum.org/pdf/getr09_dev/GETR09_Fullreport.pdf - accessed on 8 November 2009)

trade deficit with Croatia increased from 524 million to 829 million EUR (by 58%), with Serbia from 256 million to 401 million EUR (by 57%) and with Germany from 426 million to 512 million EUR (by 20%). Merchandise export of BiH to Germany increased by 241%, to Serbia by 111% and to Croatia by 90% while merchandise import from Croatia has increased by 70%, from Germany by 74% and from Serbia by 82% from 2004 to 2008.⁴ In the first three quarters of 2009 trade deficit of BiH has been decreased by 1 billion EUR (28%). However, a driving force of that decrease in trade deficit has not been an expansion of export but an impact of current global economic crises that has had spill over effect on BiH.

Despite the above mentioned data that over the last eight years BiH has been able to decrease a current account and trade deficit to GDP ratio from 45% to 36% and from 26% to 15% respectively, in the latest the Global Competitiveness Report 2009-2010 (the GCR) BiH is ranked 109th out of 133 countries included in the report.⁵ The other countries of Southeastern Europe ranked as follows: Albania (96), Bulgaria (76), Croatia (71), the former Yugoslav Republic of Macedonia (84), Montenegro (62), Romania (64), and Serbia (93).⁶ The major differences in ranking between the countries of the region cannot be explained by any major difference in export capabilities between BiH and other countries of SEE. In 2004 and 2007 the ratio of external debt to export of goods and services was following: Albania (119%; 94%), BiH (173%; 117%), Bulgaria (124%; 166%), Croatia (161%; 181%), FYR Macedonia (98%; 70%), Romania (110%; 138%) and Serbia (254%; 222%).⁷ Bulgaria and Romania are the most obvious examples. In spite of the clear decline in export capacity (and competitiveness in the original meaning of the word), these two countries achieved a better ranking in the GCR than BiH, ranking above BiH for 33 and 45 places respectively.

Comparing the competitiveness rankings in the last GCR with the rankings of United Nations member states by the human development index (HDI) suggests an even greater paradox.⁸ In the GCR, Namibia was ranked 74, Sri Lanka 79, Gambia 81, Guinea 90, Kenya 98, and Nigeria 99. Consequently, these countries are more competitive than BiH. More competitive Namibia, 35 places ahead of BiH, has an average life expectancy of 51.6 years, compared to BiH's 74.5 years. Average life expectancy in Gambia, ranked 28 places ahead of BiH in the GCR, is 58.8 years. One finds even starker paradox, regarding the great competitiveness gap between these two countries found by the GCR, when one looks at the education index (one of the three sub indices used for calculating the HDI). Gambia's education index is 0.450, compared to 0.874 for BiH - approximately half.

⁴ The author's calculations based on the Central Bank of BiH data (www.cbbh.ba)

⁵ The World Economic Forum, *Global Competitiveness Report 2009-2010* (<http://www.weforum.org/documents/GCR09/index.html> - accessed on 7 November 2009)

⁶ The World Economic Forum, *Global Competitiveness Report 2009-2010* (<http://www.weforum.org/documents/GCR09/index.html> - accessed on 7 November 2009)

⁷ EBRD, *Transition Report 2008 – Growth in transition*, London, 2008, pp. 95, 99, 103, 107, 111, 115, 119, 123, 127, 131, 135, 139, 143, 147, 151, 155, 159, 163, 167, 171, 175, 179, 183, 187, 191, 195, 199, 203.

⁸ The data on human development indexes for the countries compared in the text are the United Nations Development Programme data: The United Nations Development Programme, *Human Development Report 2007/2008 – Fighting climate change: Human solidarity in a divided world*, New York, 2007, pp. 229-232.

The average human development index value for developing countries in the last HDR was 0.691, and BiH counts as a developed country, that is to say a country with an HDI 16.2% higher than the average for the developing countries. BiH's HDI is also 15% higher than the average for the middle income countries, and exactly on the same level of human development as the average for the Latin American countries. On the other hand, BiH is some 14% behind the average for the OECD countries, which is 0.916. BiH is just 0.6% lower than the average for the countries of Central and Eastern Europe, and ranks higher than Albania or the FYR Macedonia, when it comes to the countries of South-eastern Europe.

It was necessary to review the above data to arrive at a more objective understanding of the potential of economic growth and the actual economic results achieved by BiH in comparison to those countries. Presenting BiH as the most economically backward country in Southeastern Europe, as well as the least competitive economy, is simply not consistent with basic economic indicators. Moreover, given the scale of the losses the BiH economy suffered between 1992 and 1995, particularly with regard to human capital, but also in the form of physical capital (plant and infrastructure), on the one hand, and the actual rate of economic growth achieved with a below average level of foreign debt. Still, and in spite of these results, it must be admitted that the BiH economy has not made optimal use of the generous potentials for economic growth. The basic question is why has this happened and is it continuing to happen?

The answer to this question, again somewhat paradoxically, is to be found in the GCR and Doing Business 2010⁹ report of the World Bank. According to the GCR the main barriers to economic development and competitiveness in BiH are government instability, political instability, the inefficient government bureaucracy, the tax rates, and corruption. According to the Doing Business, the lowest rankings received by BiH related to: complicated procedures for starting a business, procedures for the issuing of operational licenses, inefficient registration of ownership, and procedures for paying taxes. Of these barriers to the development of business and the national economy, only the tax rates represent a classic economic problem or barrier deriving directly from the economic system. The other main barriers are of an institutional and political nature.

In comparison to the GCR in which BiH was ranked two places lower compared to the two previous ones (2007 and 2008), BiH was ranked three places higher in Doing Business 2010 than it was in 2009. The biggest progress BiH made was in Paying Taxes group of criteria in which it improved its ranking position for 27 places. During 2008 and at the beginning of 2009 in the FBiH as one of the two BiH entities, two new laws on direct taxation were prepared and adopted, namely the Law on Personal Income Tax and the Law on Corporate Income Tax. According to the Law on Corporate Income Tax in FBiH tax rate was lowered down from 30% to 10%, while a very complicated system of direct taxation on the level of cantons was finally eliminated by the adoption of the Law on Personal Income Tax. The application of these two laws in FBiH since the beginning

⁹ IBRD/The World Bank, *Doing Business 2010 – Comparing regulation in 183 economies*, (<http://doingbusiness.org/ExploreEconomies/?economyid=28> – accessed on 9 November 2009).

of 2009 has eliminated a big asymmetry which existed between the two entities. These laws balanced the tax rates in FBiH and RS (10% in both entities). This significantly enhanced tax harmonization in BiH. Also, social insurance contributions for health and unemployment were decreased, resulting in lowering down labor tax wedge.

According to data from Doing Business 2010 fiscal burden on labor costs in BiH is 27.6% lower compared to the average for OECD countries and 23.5% lower compared to the average of the countries of Eastern Europe and Central Asia (EECA). Also, the tax burden of corporate income tax in BiH is 69.6% lower compared to OECD countries and 54.6% lower compared to EECA. Total tax burden of entrepreneurs in BiH expressed as a percentage of the realized profit is 39.1% lower than in the OECD countries and 37.6% lower compared to EECA. On the other hand problems related to the tax system in BiH are related to the number of payments that the average entrepreneur has to make during the year in BiH, which are 3 times higher (by 200%) compared to OECD countries (51 times compared to 12.8 times per year). In accordance with the previous problem average entrepreneur in BiH must annually spend 117% more working hours for tax payments in relation to the OECD average (422 hours in BiH and 194 hours in the OECD).

In the area of registration of ownership, BiH also made an improvement in this year's ranking of Doing Business for 10 places. As a basis for comparison of the openness of BiH foreign trade Doing Business in 2010 as the previous two (Doing Business 2009 and Doing Business 2008) show that BiH in the group of criteria called Trading Across Borders ranked in the first third of all countries included in this report. Namely, BiH in Trading Across Borders takes 63rd place, while Albania, Serbia, Turkey, Croatia and Bulgaria are ranked lower than BiH. In the group of indicators by which runs the country's ranking in the Trading Across Borders import cost (per container) in BiH is 4.9% lower than the OECD average and 38.5% compared to EECA countries. The costs of exports (per container) in BiH are by 3.2% higher compared to the OECD and in relation to EECA 28.9% lower. The time required for the export and import in BiH is 52.4% longer compared to the OECD.

The relatively high ranking of BiH in Doing Business 2010 in the area of Trading Across Borders is confirmed in the Global Enabling Trade Report 2009.¹⁰ In this report, the group of data called Efficiency of import-export procedures of the seven listed criteria five were classified into competitive advantage (time for import, documents for import, the import cost, time for export, and documents for export). On the other hand, BiH is ranked lowest in the group of criteria relating to institutional arrangement and administrative procedures in this report. In the eight pillar - Regulatory environment rankings of BiH are the lowest (property rights, ethics and corruption, undue influence, government inefficiency, business impact of rules on FDI). Efficiency of customs administration is also ranked very low. In Doing Business 2010 the lowest ranking of BiH is in the group of criteria dealing with Starting a business. In this group of criteria BiH is ranked 160th out of 183 countries included in the report.

¹⁰ World Economic Forum, *The Global Enabling Trade Report 2009*, Geneva 2009, p. 128 130. (http://www.weforum.org/pdf/getr09_dev/GETR09_Fullreport.pdf - accessed on 8 November 2009)

Critique of current policy approach

Foreign trade in BiH led during the last ten years was formally based on the application of the Law on Foreign Trade adopted in 1998, the provisions of bilateral free trade agreements in the SEE between 2000-2006, then the provisions of the CEFTA agreement from the beginning of 2007 and the rules resulting from signing the SAA with the EU (June 2008). Until the signing of the SAA, BiH has had MFN status in trade with EU countries. After signing the SAA, BiH has abolished customs duty on import of over 1100 industrial products from the EU.

One of the biggest weaknesses and contradictions of BiH's trade policy was contained in the Law on Uniform Bases of Custom Policy and the Law on Customs Tariffs, especially after signing the bilateral free trade agreements. Most of the inputs produced by the BH enterprises (especially the largest exporters) are imported either from EU or some other countries - ie, not from the countries of SEE. In accordance with the Law on Uniform Bases of Customs Policy and the Law on Custom Tariffs, until signing the SAA agreement BH companies were required to pay high tariffs on imports of equipment and materials which could not be produced in the domestic market and which is largely dependent on increased productivity and competitiveness of BiH exporters.

On the other hand, the abolition of duty on final products produced in the SEE region under free trade agreements effective tariff protection for over half of imports of goods turned in a negative effective tariff protection that has led most of the domestic producers in a subordinate position. This problem of customs policy was partially eliminated by signing the SAA. However, illogical application of Article 162 of the Law on Custom Policy under which producers are obliged to pay duty on import of equipment and materials from non-EU remains one of the measures of trade policies that discourage BiH companies to increase competitiveness on the basis of imports of goods.

Weaknesses of the two mentioned laws could have been at least partially reduced by a well thought out strategies and policies to attract FDI based on appropriate legislation. Law on Foreign Direct Investment in BiH was adopted in 1998 and at that time it was a good basis to start attracting FDI. Unfortunately, this law was not enhanced further on and especially not in the segment relating to the Law on Corporate Income Tax (with regards of tax exemptions). According to this law, foreign direct investors were freed from paying tax on profits for a period of five years in the percentage equivalent to their share in the ownership of BH companies but in all sectors and industries alike. In other words, according to the laws on corporate income taxes in both entities a distinction between foreign direct investors net exporters and foreign direct investors primarily oriented to domestic market has not been made. In that sense, all foreign direct investors have been freed of paying corporate income tax regardless whether or not they were net importers or net exporters.

A next systemic weakness has been related to the excise policy in BiH. After signing bilateral free trade agreements and then the CEFTA agreement the most important regional trade partners have compensated the lost fiscal revenues coming from customs by a new system of higher excises. As an illustration of such a policy Drina cigarettes status in neighboring Croatia can be used. Sarajevo Tobacco Factory's product Drina cigarettes has been classified in the highest quality group of cigarettes in Croatia. The reason was simple – the highest quality products are taxed by highest rate of excises. One of the most important obstacles in carrying out trade policy on the state level in BiH is a lack of key institutions responsible for quality control of imported goods, certification of exporting products, and for simplifying export procedures. This obstacle is a direct product of current institutional structure of BiH in which the entities are trying to dominate even in the areas of economic policy in which they have no responsibilities.

Policy recommendations

In the next ten months, that is until the general elections that will take place in BiH in October 2010, the politicians in current political structure in BiH (on the state level and on the entity level) should undertake following measures in order to increase competitiveness of BiH:

- The most important step forward for improvement competitiveness and decrease of trade and current account deficits is an initiative for changing the Law on Foreign Direct Investment and changing the laws in fiscal and trade policy related to the implementation of the Law on Foreign Direct Investments.
- A new version of the Law on Foreign Direct Investment should be based on a clear definition and distinction of tax exemptions for paying corporate income taxes for manufacturing companies that have at least 20 percent higher export than import. BH companies net exporters should be free of paying corporate income taxes in the period of five to seven years. Attracting foreign direct investors in BiH also assumes an immediate decrease of extremely high costs of construction permits that are in BiH ten times higher than in the OECD countries. An immediate target should be lowering down these costs to the level of 10 percent below average of EECA.
- Since the proposed tax exemptions for foreign direct investors could cause a decrease in fiscal revenues the proposed measure should be followed by a proposal for introduction of two tax rates of VAT – a low VAT rate of 5% for basic goods and services, and a high VAT rate of 20% for the all other goods and services.
- The Law on Custom Policy should be changed in the paragraphs related to the imposing custom tariffs on imported equipment and machinery, and raw materials that are not produced in BiH. Customs tariffs on import of equipment and machinery produced in non-EU or non-SEE countries should be abolished.
- There is an urgent need of imposing measures of quality control on all imported goods. Due to a lack of certified domestic institutions responsible for quality control it is possible to import goods of very low quality in BiH. So introduction

of quality controls assumes speeding up the procedures for giving licences to domestic institutions responsible for quality control.

- It is necessary to improve customs procedures for export oriented companies especially for the largest exporters. There is already an ongoing process and project of improving customs procedures financed by the EU. Licences for certified exporters should be given to at least 100 exporters in the next five months.
- Simultaneously with the above mentioned measure it is necessary to shorten the time that entrepreneurs in BiH spend on paying taxes from 422 hours to 336 hours per year which is an average time for paying taxes in EECA countries.
- Cutting down the number of procedures for starting a new business from 12 to 6 procedures. Over the last two years some municipalities in RS have already succeeded to shorten the time necessary for starting new businesses. Good examples from RS should be followed in other municipalities in BiH.