

## *Chapter 9*

# **Challenges and Expectations for Reform Activities in BiH: The Perspective of Republika Srpska**

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Beginning a process of economic revival and modernization that would foster viable, efficient, stable, and socially just economic growth are only a few of the priorities for the reform path of BiH. Creating new employment opportunities, better and more effective distribution of social benefits and creation of just business environment should be the epilogue of all these reform processes. If the path taken by Republika Srpska, FBiH, and BiH is to be successful, it is necessary to continue activities that would improve the rule of law, combat corruption, and enhance the efficiency of public institutions through what has been stated as an unequivocal determination by all actors.

The reform path of BiH is formally defined by the Reform Agenda (RA), which should be realized by 2018 and which includes a wide set of medium-term priorities that serve as the basis for setting very concrete objectives and development guidelines. The Agenda, which has been agreed on with international financial institutions and the European Union, represents the starting point for talks about individual programs of financial and technical assistance, and that by itself proves its relevance. The RA and the Program of Economic Reforms of Republika Srpska for the period 2017–19 are also the framework for the writing of this chapter.

The chapter consists of an introduction, three separate but closely connected parts, and a conclusion. The first part provides a short description of Republika Srpska, one of the two entities of Bosnia and Herzegovina, and provides a list of its advantages for potential investors and also provides an answer to a question: Why invest in Republika Srpska? The second part provides a detailed description of the macroeconomic situation in Republika Srpska and in Bosnia and Herzegovina as a whole, taking into account global developments and regional tendencies, whereas the third and key part refers to ongoing reforms and their expected results.

## Republika Srpska, an Entity Within BiH

Republika Srpska, one of two entities within BiH, due to its geo-strategic position in the heart of South East Europe and on the very border with the European Union, is an ideal place for investment. Geographically and traffic wise, RS has a peculiar position and relevance being intersected by vital communications connecting the Balkans, Europe, and Asia.

The city of Banja Luka, as the biggest business and administrative center of RS, is connected to the most important transport passageway in the region, Paneuropean Corridor X, and with the International Airport Banja Luka, which at the moment performs both passenger and cargo traffic, should become one of the most important pillars of the development of Republika Srpska. Banja Luka has been recognized as a regional center and declared a reformer in the improvement of the business environment in South-East Europe by the World Bank Doing Business Report from 2011.

Inhabitants of Republika Srpska are traditional and very proud. Daily life is deeply rooted in a rich tradition, cultural heritage, and the abundant natural resources in RS. Republika Srpska has abundant natural resources and an ideal combination of the moderate continental, mountain, and mediterranean climate. Natural wealth gives Republika Srpska a conspicuous advantage in food processing and wood industries. Due to hydro power and coal reserves, RS is among the most significant producers and exporters of the electricity. Natural goods also provide the grounds for tourism development. Jahorina, an Olympic Mountain from the 1984 Sarajevo Olympics, is the jewel among them, where lately we saw increases in health tourism (spa tourism and dental services) due to a qualified medical staff. Nevertheless, the largest exporters in Republika Srpska come from the metal industry, primarily due to a competitive labor cost, good geographic position, low transportation costs and significant raw material resources.

The RS population is 1.3 million, but its market openness and free trade agreements (FTAs) enable the businesses in Republika Srpska to access a market of close to 600 million people.

On the one hand, as the result of signing the Stabilization and Association Agreement, Republika Srpska can export all goods that meet EU quality standards to the European Union. On the other hand, the countries of the region have improved their economic and trade exchange by signing

the CEFTA Agreement at the end of 2006 (entered into force on May 1, 2007), which gave access to a market of 30 million people. Due to some other agreements signed, Republika Srpska has access to an even larger market, and that makes it very attractive for foreign investors.

Tax free trade and an encouraging tax policy provide for lower costs for business activities and starting a new business in RS. The tax policy in Republika Srpska is one of the most encouraging in the region, and there is an intention to improve it even further. As a matter of fact, the new Law on Corporate Income Tax, the income from dividend and profit share are exempt from income tax payment and this mere fact makes RS even more attractive for investments. The value added tax (VAT) is 17 percent, which makes it one of the lowest in Europe (it is lower only in Luxembourg). The profit tax of 10 percent is the lowest in Europe.

As for the engagement of labor, investors can count on full support of the RS Employment Institute, which can recruit qualified and experienced workers within a short period of time. It is important to mention that the ratio between the quality of the labor and the average salary is very good. The average net salary in Republika Srpska is 420 euro, and the cumulative contributions rate is 33 percent, with the intention to decrease it even more. The Personal Income Tax is also the lowest in Europe and amounts 10 percent, while the nontaxable income is 100 euros.

Additionally, electricity prices are the lowest in the region, there is a low cost for all communal services, and good prices for the rent or purchase of business premises. Moreover, business registration takes approximately three days to complete. Keeping all this in mind, it becomes clear that RS has excellent preconditions for doing business.

Finally, foreign and domestic investors in Republika Srpska are subject to the same regulations. In other words, any investor can own a real property in Republika Srpska, open an account in any commercial bank, employ foreigners, and transfer their profit abroad. One additional benefit for foreign investors is that foreign capital invested through equipment is exempt from import customs and customs fees.

In order to create an encouraging business environment, the RS government and local governments make a continuous efforts to eliminate bureaucratic red tape. At the same time, all relevant RS institutions and representative offices abroad are available to foreign investors.

## Macroeconomic Framework in BiH and in Republika Srpska

To understand the macroeconomic situation in BiH and in Republika Srpska, we must also look at global trends. This chapter offers the main characteristics of the global economy and the EU economy.

According to the latest IMF Report,<sup>1</sup> the World Economic Outlook (WEO), which analyzes global economy developments, the global growth projection for 2016 is 3.1 percent, and 3.4 percent for 2017. The projections for the second half of 2016 and 2017 were revised to reflect weakened growth prospects for the developed economies after the referendum in the U.K.,<sup>2</sup> and a weaker than expected growth in the US. Consequently, modest growth in developed economies has been projected to stand at 1.6 percent in 2016 and 1.8 percent in 2017. As for the Eurozone, a growth of 1.7 percent in 2016 and 1.5 percent in 2017 has been forecast as the result of low oil prices and economic incentives offered by the European

**Table 1. Real GDP Growth (IMF projections)**

	2014	2015	2016	2017
Real GDP Growth, %				
World	3.4	3.2	3.1	3.4
Developed economies	1.9	2.1	1.6	1.8
USA	2.4	2.6	1.6	2.2
Euro Zone	1.1	2.0	1.7	1.5
Developing countries	4.6	4.0	4.2	4.6
European Union	1.6	2.3	1.9	1.7
European developing countries	2.8	3.6	3.3	3.1
BiH	1.1	3.2	3.0	3.2
World trade growth (goods and services), %	3.8	2.6	2.3	3.8
Oil prices growth, in US dollars, annual change, %	-7.5	-47.2	-15.4	17.9
Consumer prices				
Developed countries	1.4	0.3	0.8	1.7
Developing countries	4.7	4.7	4.5	4.4
BiH	-0.9	-1.0	-0.7	0.5

Source: IMF, World Economic Outlook, Update October 2016.

<sup>1</sup> October 2016.

<sup>2</sup> Even though the market reaction to Brexit was encouraging, the final effect is still unclear due to the uncertain fate of institutional and trade arrangements between the U.K and the EU.

Investment Bank. The projection for European developing countries is 3.3 percent growth in 2016 and 3.1 percent in 2017, whereas the projected rate of real GDP growth for BiH in the 2016–2019 period is 3 percent, 3.2 percent, 3.7 percent and 3.9 percent, respectively.

Foreign direct investment (FDI) inflow recorded a significant recovery in 2015. Worldwide, there was a 38 percent rise of FDI, the biggest since the global economic and financial crisis. It is expected that FDI would drop between 10–15 percent in 2016 as the result of the global economy's vulnerability, weak demand, low export of goods in certain countries, tax evasion, and the fall of profits for multinational companies. Nevertheless, in the medium term it is expected that FDI in 2017 and 2018 would rise as the result of global economic growth.

In Republika Srpska, according to the data of the RS Institute for Statistics, the real GDP growth rate in 2015 was 2.6 percent. After the floods in 2014, there was a fall in the second quarter and stagnation in the third quarter of the year, leading to larger growth in 2015. Besides, the GDP growth in 2015 was mostly due to an increase in private consumption.

As for other macroeconomic indicators described in more details further in the text, it is clear that developments with relation to previous years are mostly positive, a positive sign for reforms.

The average net salary in RS is relatively stable, and amounted to 831 BAM in 2015 (more than 420 euros), which is a nominal rise of 0.7 percent when compared to 2014, but in reality, it represents a 2.2 percent rise once deflation is taken into account. The average net salary in 2016 is expected to remain at approximately the same level.

The labor market is gradually recovering. This is supported by an unemployment rate of 25.2 percent in 2015, equaling a fall of 0.5 percent from the previous year. This trend continued in 2016 when the unemployment went down to 24.8 percent. Accordingly, the number of unemployed in 2015 (139,465 persons) shrank by 4.4 percent, whereas the figures for 2016 are even better (the number of the unemployed in September 2016, according to the official records is below 130,000). Positively, the number of employed is going up at the same time, and in September 2016 it totaled 257,001 persons, which is a 3.3 percent increase from the same period last year. By analyzing the statistical figures of the labor market, we see that the unemployment rate is falling, while the employment rate is rising.

The foreign trade exchange in 2015 was seven billion BAM, which shows a fall of 8.6 percent compared to the previous year. A larger fall of import (11.7 percent) in relation to exports (2.9 percent) resulted in a decrease in the trade deficit so that the export-import coverage was 5.4 percent higher than in 2014. In this notion, the data for the current year also demonstrates an improvement compared to the previous year. In concrete terms, trade in the period of January–September 2016 is characterized by a lowering of the trade deficit by 18.2 percent, as the result of increased exports (by 8.7 percent) and decreased imports (by 2.3 percent), whereas the export-import coverage is 65.5 percent. In terms of time, export-import coverage has improved year after year, which is viewed as a positive indicator. In the last 10 years, from 2006–2016, the export rate grew twice as much as the import rate (geometrical growth rate).

Speaking of macroeconomic assessments and projections for RS in the 2017–2019 period, a stable economic growth is expected at the rates of 3 percent, 3.2 percent, and 3.3 percent, respectively. This is mostly as the result of industrial production growth, expected rise of economic activities in the area (especially with the largest foreign trade partners) which can maintain a certain level of export demand, mild growth of domestic demand due to higher employment and the positive effects of investments. In the three-year period, it is expected that average consumer prices will rise by 0.1 percent in 2017, 1.1 percent in 2018, and 1.4 percent in 2019. It is also expected that average net salaries will record a mild growth: 843 BAM in 2017, 850 BAM in 2018, and 859 BAM in 2019. Unemployment rates are projected to drop to 24.4 percent, 24 percent, and 23.6 percent, respectively.

At the end of this part, it is important to look at indebtedness as a relevant factor of the overall economy. Even though at the moment the debt level is close to the limit of 60 percent of GDP,<sup>3</sup> the forecast projects that this limit will not be overstepped in the near future. According to the projections of the RS Ministry of Finance, which are included in the Program of Economic Reforms for the 2017–2019 period, all debt indicators show a declining trend. In 2017, the overall debt (i.e., public debt in relation to GDP) would be 59.5 percent. By 2018, it will be 58.8 percent and 44.8 percent, and in 2019, it will be 56.6 percent and 42.7 percent respectively.

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<sup>3</sup> One of the so-called Euro convergence criteria, defined in Maastricht in 1992, on the basis of which the readiness of the EU member state for the third phase of economic and monetary union is evaluated.

**Table 2—Breakdown of macroeconomic indicators for 2012–15 period, assessment for 2016 and projections for 2017–19**

Description	2012	2013	2014	2015	2016	2017	2018	2019
GDP								
GDP nominal, in mil. BAM	8,585	8,761	8,847	9,153	9,501	9,890	10,325	10,790
No. of inhabitants – in millions	1.43	1.43	1.42	1.42	1.41	1.41	1.41	1.40
GDP per capita in BAM	6,006	6,146	6,225	6,465	6,725	7,015	7,340	7,686
% of GDP growth, nominal	-1.1%	2.1%	1.0%	3.5%	3.8%	4.1%	4.4%	4.5%
% of GDP growth, real	-1.1%	1.9%	0.2%	2.6%	2.9%	3.0%	3.2%	3.3%
Inflation measured by the consumer price index (CPI), average annual rate	2.1%	0.0%	-1.2%	-1.4%	-1.2%	0.1%	1.1%	1.4%
Real GDP growth	-1.1	1.9	0.2	2.6	2.9	3.0	3.2	3.3
Private consumption*	2.9	1.8	2.1	1.9	1.9	2.1	2.2	2.2
State consumption	2.6	0.8	2.0	-1.8	1.1	0.8	0.9	0.7
Gross investments in means of production	11.0	-5.0	5.4	-0.2	3.1	3.2	3.4	3.8
					(nominal growth rate %)			
Assumptions:								
Average net salary in BAM	818	808	825	831	836	843	850	859
Import of goods in mil. BAM	4,488	4,558	4,946	4,369	4,346	4,503	4,719	4,955
Import of goods, annual growth in %	-2.0%	1.6%	8.5%	-11.7%	-0.5%	3.6%	4.8%	5.0%
Export of goods in mil. BAM	2,375	2,604	2,692	2,614	2,792	2,956	3,169	3,404
Export of Goods, annual growth in %	-7.3%	9.7%	3.4%	-2.9%	6.8%	5.9%	7.2%	7.4%
Export-Import coverage %	52.9%	57.1%	54.4%	59.8%	64.2%	65.7%	67.2%	68.7%
Unemployment rate %	25.6%	27.0%	25.7%	25.2%	24.8%	24.4%	24.0%	23.6%

Source: Institute of Statistics of Republika Srpska (2012–2015), assessment (2016) and projection (2017–2019) of the Ministry of Finance of Republika Srpska.

## Directions of the Reforms in Republika Srpska in the Upcoming Period

The main program goal of RS institutions has always been a strong, democratic, and prosperous entity vested in all its competences verified by the Dayton Peace Accords, open to the world and capacitated with institutions that can respond to the needs of its citizens.

Based on a clear program goal, taking into consideration macroeconomic situation and trends, starting from the policies set by the Reform Agenda for the 2016–2018 period and corresponding Action Plan agreed with the European Union and international financial institutions, key reform areas for Republika Srpska are: public finance, primarily the reduction of the tax burden on labor, health care, business environment, an enhanced labor market through improved ties with education reforms, continuation of infrastructural projects especially in the areas of energy and communal infrastructure, sector development based on the reform of public enterprises, improvement of the agriculture and finance sectors.

Taking all these directions into account, the Program of Economic Reforms of Republika Srpska for the designated period includes the following guidelines:

- Public Finance Management;
- Energy, Transport, and Telecommunications Markets;
- Sector development;
- Business Environment and Shrinking of the Informal Economy;
- Research and Innovation;
- Foreign Trade and Facilitation of Investments;
- Education and Skills;
- Employment and Labor Market and;
- Social Inclusion, Reduction of Poverty, and Equal Opportunities.

The positive side of this new package of reforms (the Reform Agenda), is that activities are coordinated and carried out simultaneously at all levels of government, which is extremely important for a decentralized country such as BiH. This is also a confirmation that the decentralized structure of the country is no obstacle to reforms and development, if activities are coordinated. To date, reforms and similar measures have been implemented more or less separately without particular coordination between various



levels of governance, very often having different regulations in the two entities which, constitutionally, are the main bearers of development in BiH.

For example, Republika Srpska is in charge of the economy, agriculture, energy, infrastructure, ecology, health care and social protection, education, labor, employment and pension system, and local development, all areas that matter to the everyday life of its people.

The results achieved in Republika Srpska, the Federation of BiH, and at the level of BiH institutions are fairly promising and are indicative of a successful outcome. More precisely, all levels of government adopted their action plans for the implementation of the RA and ensured regular monitoring of its implementation in cooperation with the EU. The results are encouraging since all activities planned for 2015 and 2016 have either been fully implemented or are ongoing.<sup>4</sup> A similar situation is true in the FBiH and at the BiH level.

Even though the reforms represent a comprehensive set of measures, we have identified several additional key areas in need of reform. Aside from the private sector, large enterprises owned by RS are also important employers and significant contributors to economic development. Unfortunately, those enterprises stick to their outdated business habits and have not developed as much as expected, thus it is fitting that an important part of the measures target those enterprises (belonging to the sectors of forestry, energy, railway traffic, road infrastructure, postal traffic, and others). Some of the reforms in this area are implemented along with international financial organizations, for example the World Bank, which is involved in the reorganization of the RS Railways. Other public enterprises have been classified as viable and non-viable, the possibilities for their restructuring or privatization have been identified and activities on the revival or sale of some others have started.

The process of privatization has advanced more in Republika Srpska compared to the Federation of BiH. The privatization process was designed within the framework of the reforms initiated by and implemented in cooperation with the international community, demonstrating weakness across Europe, including the countries of Central and Eastern Europe.

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<sup>4</sup> In the RS, 51.4 percent of activities have been finalized and 47.3 percent are ongoing, while only 1.4 percent are not realized. The implementation of certain measures foreseen for 2017–2018 have already begun, demonstrating a serious approach of the government to the reform process.

It is also important to mention that Republika Srpska founded the Investment-Development Bank by the collected funds gathered through the sale of RS Telecom and the oil industry. As a matter of fact, 49 percent of the funds collected in this way have been used for important infrastructure projects and other projects in RS municipalities, while 51 percent of the capital remained permanently in the ownership of Republika Srpska.

Health care is one of the areas included in the Reform Agenda. In Republika Srpska, health care falls under the entity's administration, while in the Federation of BiH it belongs to the cantons. With the World Bank, efforts are underway to identify debts in this area and introduce greater discipline and recovery measures. One of the measures is the introduction of a treasury system in hospitals and health centers, a project which is implemented in cooperation with USAID.

Many reforms in the financial sector are currently underway. A set of new laws related to the banking sector are being defined in cooperation with the IMF in order to strengthen the position of banks, their oversight, and supervision of their work. The intention is to have a harmonized banking regulation in both entities. Improving data exchange between tax administration authorities within BiH is also under way, and Republika Srpska passed a set of laws targeting the gray economy.

An important focus of the reforms pertains to the rationalization of public administration, or the public sector. A moratorium on salary increment and admission of new workers has been imposed in order to prevent the uncontrolled growth of the administration. Work on preparation of the Public Finance Management Strategy of Republika Srpska for the 2016-2020 period is completed, and the modernization of tax laws is pending.

One of measures implemented to unburden the economy was the creation of a Register of Parafiscal Charges. In cooperation with the IMF Mission, many activities related to reduction of the tax burden on labor have been launched, while at the same time finding real and stable sources of financing that would compensate for the lower influx of tax revenue.

Within the Reform Agenda, concrete steps are taken to improve the business climate and to increase competitiveness. Prior to the Reform Package, the RS government implemented certain projects relevant to the improvement of the business environment. Several years ago, the government carried out the business registration reform and applied the One-Stop-Shop model, which enormously reduced the costs and time needed for registration of private sector entities. This reform is now being carried

out in the Federation of BiH. Within the Reform Agenda, a second phase of the Project would be to implement online business registration. The procedures for obtaining construction permits have been accelerated, and some other reforms in this area are planned.

With regard to labor market reform, a new Law on Labor was passed a year ago, which provides solutions that offer higher flexibility of work conditions and differentiated salaries based on skills, qualifications, professional experience, and performance.

An important reform was carried out in RS by passing a new Law on Bankruptcy. The Federation of BiH is currently working on an identical law that would contribute to increased efficiency of the whole process and harmonization of regulations in both entities.

Both entities have yet to face serious reforms in the sectors of secondary and higher education, with the final aim to foster better connectivity between the education system and the needs of the labor market. Education falls under the competence of the RS entity, but in the FBiH it is the responsibility of the cantons.

Rule of law, good governance and increased security are constant challenges for all governments. Republika Srpska is developing capacities for the fight against terrorism and adopted the Action Plan for the fight against terrorism for the 2016–2020 period. One of the priorities is fighting cyber-crime, where excellent cooperation with services from the US has been established. The new Law on Combating Corruption, Organized Crime and Severe Economic Crime has also been passed in Republika Srpska. Furthermore, an Operational Agreement with EUROPOL has been concluded which facilitates efficient data exchange.

In the first part of this chapter we referred to the business environment and investment opportunities in Republika Srpska, but we also have to mention certain facts which are important for domestic as well as for foreign investors:

- Encouraging tax policy—among the most encouraging in the region and in Europe;
- Quality labor and;
- Low electricity prices.

Besides, the rights of local and foreign investors are equal and guaranteed by the Constitution, including certain benefits such as exemption

from customs payment for the import of equipment as an equity share of the foreign entity, free transfer of profit, etc.

All of the facts referred above have been recognized as an investment potential, and have been supported by recent investments. One of those is large British-Chinese investment of over 550 million euro, and refers to construction of a thermal power plant. Another is an Italian investment of over 40 million euro for the construction of a silicon metal factory, as well as major infrastructure projects such as the construction of highways with the assistance of the European Investment Bank (EIB) and European Bank for Reconstruction and Development (EBRD). In addition, talks with Chinese companies on some major infrastructure and energy projects have started.

All the above stated is indicative that the most comprehensive and the furthest reform process in BiH and Republika Srpska are taking place, and that their final goal is to create a stable and modern economy following the example of advanced economies of EU members states. Support from international partners such as the European Union, IMF and the World Bank in a financial and technical sense is enormously important so that the demanding reforms could successfully be implemented. Therefore, one of key requirements before domestic and international partners, which has not been the case with some earlier initiatives, was a complete exclusion of the reform processes from the political sphere and placing the focus on joint coordinated actions that would lead to economic development and a better standard of living for citizens of Republika Srpska and the Federation of BiH.

## **Conclusion**

Reform activities in BiH (on the state-level, and on the entity level in the FBiH and RS), are based on a joint synergy of local institutional factors and international partners—including the European Union, the International Monetary Fund and the World Bank Group—and are proceeding in accordance to the anticipated dynamics. Taking into consideration the impetus, the depth, nature, and medium-term timeline of the reform processes, real effects are yet to be seen, even though the European Commission and international financial institutions reported positive results in 2016. The continuation of structural reforms in BiH and Republika Srpska are a guarantee for the facilitation of economic stability and are a precondition for strenghtening competitiveness of the local economy in

a European and regional framework, including an even greater influx of foreign investment in various sectors. At the same time, the successful continuation of reforms would enable Republika Sprska and the Federation of BiH to respond to European and global macroeconomic developments.

An important aspect to consider when analyzing the anticipated results of the Reform Agenda is the very moment of its implementation, i.e., the fact that the most comprehensive economic reforms (the Reform Agenda and the Program of Economic Reforms) come twenty years after the end of the armed conflict in BiH. This does not mean that the country has not been the subject of reform initiatives in the past, it means that previous measures were wrongly designed. Unlike the existing reform platform, which has been the result of a negotiating process between local actors and international partners, previous reform initiatives were often imposed by the international community, neglecting or underestimating the relevance and the role of domestic stakeholders in the process. Moreover, the majority of the reform proposals targeted the re-composition of the internal constitutional structure of BiH, without a consensus among key domestic political factors. While it comes as no surprise that previous reform attempts harvested dissapointing results, the existing platform of reforms is more promising, with a focus on the economy rather than on political and constitutional matters, and based on a general consensus of all relevant domestic actors.

The Reform Agenda recognizes the necessity to move away from BiH's label as a playground for various unsuccessful political initiatives and where all economic development has been completely neglected. In other words, instead of imposing big issue reforms which lack consensus of all key actors in BiH and consequently lead to dissapointing results, the international community should demonstrate their good intentions and partnership with BiH through their support of the implementation of economic reforms within the existing legal framework of BiH. Regardless of its complex internal structure, BiH can accomplish succesful reforms through coordinated activities and a harmonization of its valid laws and practices, and certainly not through the re-composition and unconstitutional centralization of powers at the level of BiH institutions.

