

**BOSNIA'S PRECARIOUS ECONOMY:
STILL NOT OPEN FOR BUSINESS**

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Table of Contents

| | |
|--|-----------|
| EXECUTIVE SUMMARY AND RECOMMENDATIONS | ii |
| I. BOSNIA'S POLITICAL ECONOMY TODAY | 1 |
| A. UNBALANCED INTERNATIONAL PRIORITIES | 3 |
| B. ECONOMIC INDICATORS | 4 |
| C. SOCIAL INSECURITY | 6 |
| D. POLITICAL WILL | 7 |
| II. BARRIERS TO INVESTMENT | 8 |
| A. THE REGISTRATION NIGHTMARE | 10 |
| B. KAFKAESQUE CONTROLS | 10 |
| C. TAXING TAXES | 11 |
| D. LEAKY BORDERS | 13 |
| E. INSUFFICIENT PRIVATISATION | 13 |
| F. QUESTIONABLE BANKS..... | 13 |
| G. PARTIAL JUSTICE..... | 13 |
| H. INADEQUATE LEGISLATION | 15 |
| I. OBSCURE OWNERSHIP AND COLLATERAL DAMAGE | 15 |
| J. BANKRUPT LAW | 15 |
| K. FOREIGN INVESTMENT LAWLESSNESS..... | 16 |
| L. A DIALOGUE OF THE DEAF | 16 |
| M. THE RESPONSIBILITY OF THE INTERNATIONAL COMMUNITY | 16 |
| III. THE EMBARRASMENTS OF PRIVATISATION | 18 |
| A. WHAT WENT WRONG? | 18 |
| B. THE ROLE OF THE INTERNATIONAL COMMUNITY | 20 |
| C. FOREIGN NON-PARTICIPATION IN PRIVATISATION | 21 |
| D. ANTI-PRIVATISATION IN RS | 22 |
| E. FURTHER PROBLEMS WITH PRIVATISATION | 23 |
| F. THE ETHNO-POLITICS OF PRIVATISATION..... | 24 |
| 1. Aluminium Mostar..... | 25 |
| 2. Eronet..... | 26 |
| IV. REAL IMPROVEMENTS IN THE FINANCIAL SECTOR | 27 |
| A. THE ANAEMIC RS BANKING SECTOR..... | 28 |
| B. THE IRRESISTIBLE RISE OF ZEPTER KOMERC BANKA | 30 |
| C. LESSONS LEARNED IN THE FEDERATION | 31 |
| D. FIGHTING BANK FRAUD | 31 |
| E. WHAT REMAINS TO BE DONE..... | 33 |
| V. CUSTOMS EVASION | 35 |

| | | |
|-----------------------|---|-----------|
| A. | CORRUPTIBLE POLITICIANS AND OTHER WEAKNESSES | 36 |
| B. | CAN THINGS BE FIXED? | 38 |
| VI. | UNREFORMED TAXES..... | 38 |
| A. | TAX COLLECTION AND COMPLIANCE MONITORING | 39 |
| B. | ENFORCEMENT AND CORRUPTION | 40 |
| C. | THE FIGHT AGAINST TAX AND CUSTOMS EVASION | 41 |
| VII. | CONCLUSION..... | 43 |
| A. | REFORMS OF THE POLITICAL ECONOMY | 44 |
| B. | LIFTING BARRIERS TO INVEST | 44 |
| C. | LEGISLATION FOR BUSINESS..... | 45 |
| D. | JUDICIAL REFORM..... | 45 |
| E. | TAX REFORM..... | 45 |
| F. | CUSTOMS AND TAX ADMINISTRATION REFORM | 45 |
| G. | ENHANCED REVENUE COLLECTION AND LAW ENFORCEMENT | 46 |
| H. | PRIVATISATION MEASURES | 46 |
| I. | BANKING REFORM | 47 |
| APPENDICES | | |
| A. | TAXES IN BOSNIA..... | 48 |
| B. | TAX ADMINISTRATION AND FINANCIAL POLICE | 50 |
| C. | ABBREVIATIONS | 51 |
| D. | ABOUT THE INTERNATIONAL CRISIS GROUP | 52 |
| E. | ICG REPORTS AND BRIEFING PAPERS | 53 |
| F. | ICG BOARD MEMBERS | 57 |

BOSNIA'S PRECARIOUS ECONOMY : STILL NOT OPEN FOR BUSINESS

EXECUTIVE SUMMARY

Bosnia's economic reality is still bleak. After more than five years and five billion dollars of Dayton implementation, the country seems only at the beginning of an economic transition that should have begun in 1996.

Since Dayton, many impressive gains have been registered. These include a stable currency and functioning central bank; abolition of socialist-era payments' bureaus and notable improvements in the banking sector; rudimentary labour reforms and preliminary steps towards pension reform; as well as anti-fraud measures aimed at demolishing illegal parallel structures in the Bosniak-Croat Federation. Yet however necessary or desirable these achievements have been, they have not moved Bosnia significantly closer to sustainable economic growth or created an environment attractive to more than a handful of foreign investors. Most importantly, the international community has taken insufficient action to cut the Gordian knot that binds Bosnia's politicians to its state-owned firms and allows them to benefit from the funds and jobs they generate. This is seen most clearly in the failure of the international community's efforts to ensure the rapid and effective privatisation of the commanding heights of the Bosnian economy and the creation of a single economic space.

The spurt of growth that came with post-war reconstruction is now faltering. The numbers of people unemployed and/or living in poverty are rising. Tax and customs evasion remains rife, undermining the power and legitimacy of governments whose coffers are often empty and need regular replenishment by donors. The debt

caused by budget deficits is mortgaging Bosnia's future. Smugglers and traffickers in goods and people easily and regularly violate Bosnia's still-porous borders. The black economy remains predominant in Republika Srpska (RS), and is relatively widespread in the Federation as well. The privatisation of strategic enterprises – which should be a major engine of growth – has yet to take place. Increasing numbers of young and educated Bosnians are queuing in front of Western consulates seeking a way to a better future outside the country. Those already living abroad show no sign of returning. Three hundred and forty strikes in 2000, numerous demonstrations over the late or non-payment of pensions, and frequent roadblocks set up by dissatisfied workers testify to a deep economic crisis and simmering social unrest.

The engagement of the international community has been unbalanced in one major respect. Rather than attempting to carry out the numerous microeconomic reforms needed to make Bosnia attractive to investors, the international community has focused most of its economic reform effort on strengthening the several Bosnian governments' abilities to collect and control revenues. Although necessary as a means of creating functional governing structures and reducing corruption, these efforts have not affected the underlying causes of a significant portion of the corruption and tax evasion: the existence of unreasonable and irrational tax codes and business regulations that force much economic activity underground. Various organisations, including the World Bank, USAID, and the Office of the High Representative (OHR), have carried out studies describing the

problems in detail; and all their studies agree on what must be done. Yet until autumn 2000, their recommendations were either swept under the carpet or given only rhetorical endorsement.

Meanwhile, the low credibility of Bosnia's political establishment is further undermined by each new corruption scandal. The myopic pursuit of personal enrichment by many members of Bosnia's ruling national elites has helped scare away foreign investors. Sadly, Bosnia is still heavily reliant on donor aid and foreigners' spending for significant portions of its economic activity. The past unwillingness of many Bosnian politicians to enact meaningful reforms, particularly in Republika Srpska and in the Croat majority areas of the Federation, argues for more aggressive and specifically targeted action by the international community.

As political and financial attention turns increasingly to Bosnia's neighbours to the south and east, both Bosnians and the international organisations working with them must focus urgently on weaning the economy off dependence on foreign aid. This will require a series of thoroughgoing economic reforms. Bosnia's leaders and their foreign helpmates still face an enormous challenge: to create an economically viable, self-sustainable and governable country with a true common market, functioning institutions, effective and affordable administrations, and a modern, comprehensive economic and legal framework underpinned by the rule of law. Without these things, the business environment will remain unattractive to foreign and domestic investors alike, and Bosnia's European future will remain in jeopardy.

If Bosnia is to capitalise on the promise held out by peace – as well as on such institutional reforms as have taken place thus far – there must now be wide-ranging microeconomic reforms. These will also demand the active engagement of the international community.

GENERAL RECOMMENDATIONS

[Section VII contains detailed proposals for carrying out each of these general recommendations.]

1. The international community should continue to press for the rationalisation of Bosnian government structures and, in particular, for the merger of entity-based agencies dealing with banking, customs and railways, making them responsible to the state-level Council of Ministers.
2. The entity governments need urgently to remove bureaucratic barriers to business by enhancing the legal environment and simplifying or doing away with numerous controls, inspections and registration requirements.
3. International agencies should work with the entities to reform their tax systems by reducing the number and rates of taxes, broadening the tax base, and improving revenue collection through the introduction of Value Added Tax (VAT).
4. The entities should reform their judicial systems to assure expeditious, effective and disinterested legal processes in the commercial sphere.
5. OHR should devote as much attention to combating fraud in the RS as it does in the Federation.
6. International agencies and the entity governments should accelerate the privatisation process, particularly of large and strategic enterprises.

Sarajevo/Brussels, 7 August 2001

BOSNIA'S PRECARIOUS ECONOMY : STILL NOT OPEN FOR BUSINESS

I. BOSNIA'S POLITICAL ECONOMY TODAY

Bosnia is burdened by an oversized administration attempting to collect high and numerous taxes; by bureaucratic barriers to setting up and doing business that are exacerbated by multiple levels of government;¹ by unclear ownership laws which a sluggish judicial system can do little to rectify; and by a widespread perception abroad that the country is still seething with violence and hatred. Nevertheless, some notable reforms have taken place, especially in the financial sector. Several foreign banks, including the Austrian Raiffeisen Bank and Volksbank and the Turkish Ziraat Bank, have set up shop. Foreign investors such as Coca-Cola, Heidelberg Cement, Mercator, and the Kuwait Investment Agency have made long-term investments despite the difficulties. However, if Bosnia is to avoid having merely token investments and become a viable market and state attractive to both foreign and domestic investors, its various governments and governors must step up the pace and extend the scope of reform.

The current economic situation is dire. Following the war, Bosnia experienced a surge of

reconstruction and development financed by abundant foreign aid. Once the flow of aid began to slacken, however, it became apparent that Bosnia had few viable companies that could continue to grow in a no-aid or low-aid environment. Given the dismal levels of foreign and domestic private investment – and the fact that, thus far, large-scale privatisation has yet to take place – it is hard to see from where any sustainable growth is to come.

Bosnia is still dependent on donor support. The two entities' revenue shortfall totalled some KM 800 million in 2000,² all of which had to be covered by multilateral and bilateral donors.³ Republika Srpska's shortfall amounted to 73 per cent of revenues expected, while that of the Federation was significantly lower, at 31.5 per cent, but still serious. The RS would have collapsed by now had it not been saved by international community funds. Donor dependency means that Bosnia's foreign debt continues to accumulate, not only constraining the present functions of government, but also putting a brake on Bosnia's recovery and future. Huge deficits are both indefensible and unnecessary, given that the expenditure of public monies to date has been accompanied by siphoning off funds to political parties and potentates, embezzlement, abuse, fraud, and incompetence. Recent findings by the entities' audit institutions confirmed the

¹ Any would-be foreign investor in Sarajevo, for example, would have to deal with five separate levels of government in order to obtain the requisite licences to set up a company: state, entity, canton, city, and municipality. Even if matters proceeded smoothly at all five levels, the multiplication of effort would still be wasteful and require several months. In the age of the Internet, when it is possible to register a company on-line without ever visiting an office, the procedures required in Bosnia put the country at a serious disadvantage. ICG interview with a foreign investor in Sarajevo, 23 May 2001.

² KM = *Konvertibilna Marka* (Convertible Marks), the common Bosnian unit of currency, equal in value to the German Mark (DM). In late July 2001, the rate of exchange was KM 2.22 to the U.S. dollar, thus making the deficit \$360.36 million.

³ ICG interview with high ranking international official, 3 July 2001.

ubiquity of irresponsible public expenditure.⁴ The frivolous and non-transparent spending of public money is, alas, relatively easy in Bosnia, as neither entity has an adequate public procurement law.⁵

Bosnia's administrative order is also slow and cumbersome, and as such represents one of the greatest barriers to creating and sustaining a business-friendly environment. An intending foreign investor faces multiple levels of government with which he must negotiate and from which he must seek permission to set up a business. And no amount of reform or elaboration of technical assistance programs will remedy what is fundamentally wrong with Bosnia's current governmental structure – its bloated size and formidable fragmentation.⁶

Governance is currently shared among thirteen political units possessing constitutional and legislative authority: the state, the two entities (Republika Srpska and the Federation of Bosnia and Herzegovina), and the ten cantons into which the Federation is further divided.⁷ This means there are five levels of government – state, entity, canton, city and municipality. Each of the thirteen political units has between six and twelve ministries, effectively amounting to at least 181 ministers for 3.7 million people.⁸ If this ratio were applied to Germany, that country would have 4,240 ministers. As long as Bosnia continues to be so fragmented and over-governed, no reforms

designed merely to strengthen existing structures can do more than make marginal improvements, for they will fail to address the fundamental problem.

The relative strength of the different levels of government is best depicted in the size of their budgets. The state budget in 2000 totalled approximately KM 281 million, of which KM 83 million was used to pay for Bosnia's state-level institutions such as the six ministries (Foreign Affairs, European Integration, Foreign Trade and Economic Relations, Treasury, Civil Works and Communications, Human Rights and Refugees) and the State Border Service, while KM 198 million went on servicing the foreign debt.⁹ The sources of state income were as follows: the Federation contributed 35 per cent and the RS 18 per cent; administrative fees provided 33 per cent; while 13 per cent was covered by foreign aid. This meant that only 33 per cent of the state budget was raised from a predictable and controllable source, that is, from administrative fees.

In comparison, in 2000 the Federation budget was KM 954 million and the RS budget totalled KM 678 million, excluding foreign grants and credits.¹⁰ On the other hand, Sarajevo Canton alone had a budget of KM 386.42 million, or more than one-third of that of the Federation.¹¹ As is obvious, the cantons and entities are much stronger financially and, hence, politically than is the state. Given that both the Federation and RS budgets suffer haemorrhages of between KM 300 and 500 million per annum due to tax and customs evasion,¹² their contributions to the state's revenues cannot be taken for granted. This undermines the state's ability to initiate and implement programs. If, as

⁴'OHR and OSCE assess necessary reforms for entity budgets', OSCE press release, 3 July 2001; 'Konacni izvestaj do kraja jula - intervju: Bosko Ceko, glavni revizor RS' and 'Proslogodisnja poreska evazija iznosi 500 miliona – intervju Milica Bisic, Savetnica Predsednika Vlade RS za ekonomska pitanja', *Reporter*, 27 June 2001; 'Jasno je da su Zivalj, Sabeta, i Djurdjevic ucestvovali u teskom kriminalu!', *Slobodna Bosna*, 31 May 2001; 'Bicakcic pred sudom', *BH Dani*, 16 March 2001.

⁵ ICG interview with a former OHR official, 12 July 2001.

⁶ See Chapter 7, 'Bosnia and Herzegovina', in *After Milosevic: A Practical Agenda for Lasting Balkans Peace*, ICG Balkans Report No. 108, 2 April 2001, p. 154.

⁷ In fact, there is a fourteenth and unique unit – Brcko District. Brcko is currently governed by an OHR-appointed international supervisor.

⁸ The figure of 181 ministers results from the facts (1) that each of the six state-level ministries has three ministers (one from each of the 'constituent nations'), (2) that there are two ministers (one Bosniak and one Croat) for every Federation ministry, and (3) that two mixed cantons in the Federation replicate this latter practice.

⁹ During 2000, Bosnia repaid KM 75,816,978 in World Bank credits, KM 53,929,313 in IMF credits, KM 31,263,708 to the Paris Club, and KM 36,690,001 in other liabilities. 'Early Warning System in Bosnia and Herzegovina', *UNDP Quarterly Report*, October-December 2000.

¹⁰ Odluka o izmjenama i dopunama budzeta Federacije Bosne i Hercegovine za 2000. godinu, *Sluzbene novine Federacije BiH*, broj 32/2000; Rebalans budzeta Republike Srpske, document provided to ICG, 26 June 2001.

¹¹ Izmjene i dopune budzeta Kantona Sarajevo za 2000. godinu, *Sluzbene novine Kantona Sarajevo*, broj 2/2000.

¹² 'Proslogodisnja poreska evazija iznosi 500 miliona – intervju Milica Bisic, Savetnica Predsednika Vlade RS za ekonomska pitanja', *Reporter*, 27 June 2001.

the international community hopes, the state-level Council of Ministers is to strengthen existing state institutions and to establish new ones, it must also have the capacity to raise an independent and continuous flow of revenue. Otherwise, Bosnia's government apparatus will continue to expand while becoming ever more dysfunctional and ineffective.

In any case, Bosnia's governments must change their spending priorities and reallocate scarce resources if they are to create a business-friendly environment. For example, the entities' largest item of expenditure is on their respective armies. In the Federation alone, KM 305.45 million was spent officially on defence in 2000, although various undeclared sources of income probably increased significantly overall expenditure by the two components on their armies.¹³ If Bosnia's governments are serious about economic reforms, they must cut such unproductive expenditure. This would free significant sums for meeting public sector needs, such as paying regular salaries to law enforcement agencies, teachers, and doctors, and supporting capital investment in such areas as Bosnia's woeful transport infrastructure, so helping to remedy the isolation that makes the country unattractive to both foreign and domestic investors.¹⁴

¹³ 'Vojska u Orasju dobijala 20 tona vina sedmicno', *Dnevni avaz*, 4 May 2001.

¹⁴ Recently renewed efforts to connect Bosnia to the region and the rest of Europe and, in particular, to revive its railway and road infrastructure have been driven politically and financially by the international community. The Japanese government financed a master plan for Bosnia's transport infrastructure, and the European Investment Bank provided a KM 80 million credit to modernise the railways. Unfortunately, Bosnia has three over-bureaucratised railway administrations that - unless modernised and consolidated according to EU standards - will serve only to keep Bosnia isolated. 'Zajednicka strategija Zeljeznica BiH u naredne tri godine', *Dnevni avaz*, 6 May 2001; 'Japanci trasiraju obnovu BiH zeljeznice', *Dnevni avaz*, 5 May 2001; 'Za BiH zeljeznicu 80 miliona maraka', *Dnevni avaz*, 25 April 2001; 'Hvatanje voza za Evropu', *Dnevni avaz*, 8 April 2001.

A. UNBALANCED INTERNATIONAL PRIORITIES

The international community's economic reform efforts have until recently focused primarily on institution building and, in particular, on strengthening the capacity of the state to collect revenues.. This is necessary, but a strong state does not in and of itself generate economic growth. In its efforts to enhance government revenue collection, the international community has paid too little attention to the arguably even more important question of creating a viable business and investment climate.

In focusing on reforms that target the state apparatus, the international community has paid inadequate attention to the fact that this apparatus neither generates growth nor stimulates business and investments - the very things necessary to create a functioning economy able to support both the country's population and the reformed administration it must have for entry into European structures. Only several months ago, the High Representative, working with the World Bank and IMF, took decisive steps to improve the economic framework by imposing a package of economic laws. These aimed to strengthen the financial sector (abolition of the payments' bureaus), to instil financial discipline by disallowing budget arrears (pension reform), and to initiate the reduction of taxes (wage and service taxes).¹⁵ However, these measures have not yet included elements sufficient to create an investor-friendly business environment.

Tax and customs evasion dominates Bosnia and the international community's reform agenda. Widespread evasion is the main cause of the entities' budget deficits. These result, in turn, in poor performance by government bodies and, in particular, in their failure to fulfil their most rudimentary obligations to citizens. Such huge

¹⁵ On 12 November 2000, the High Representative imposed a set of laws forbidding the entities from paying pensions from their budget receipts. For example, 50 per cent of pension payments had come previously from the RS budget. Instead, the governments are now meant to pay out only as much as they collect through employee contributions and, at the same time, to cut arrears. As a result, pension payments, although smaller, are now more regular. ICG interview with high-ranking OHR official, 3 July 2001.

revenue losses to the illegal economy seriously impede the governments' ability to function effectively. Moreover, the illegal economy creates an uneven playing field for those businesses that seek to operate legally. Either they are seriously disadvantaged in comparison to those that evade taxes and customs duties and may go to the wall, or they are compelled eventually to join the grey and black economies to survive. Rampant tax and customs evasion mocks the rule of law, as smugglers and tax evaders not only go unpunished, but prosper, thereby contributing to a downward spiral of impunity for law-breakers, impoverishment of governments and those dependent on them, and criminalisation of ever-larger portions of society.

Despite the international community's efforts to build and strengthen the institutions that collect revenue, customs fraud and excise evasion regularly cost both entities at least 30 per cent of their budgeted income. Recent estimates of revenue losses from tax and customs evasion in the RS run to some KM 500 million per annum, a figure nearly equivalent to that entity's annual budget.¹⁶ In 2000, the Federation was estimated to have lost KM 200 million in excise taxes alone.¹⁷ Goods smuggled into Bosnia are sold openly at sites such as the notorious Arizona Market north-west of Tuzla, causing monthly revenue losses on sales taxes alone of approximately KM 3 million to the Federation and KM 2.5 million to the RS.¹⁸ According to conservative estimates by the European Union's Customs and Fiscal Assistance Office to Bosnia and Herzegovina (CAFAO), the revenue lost to tax fraud amounts to at least KM 1 million per day. Yet despite its own huge revenue losses due to the smuggling of high tariff goods, the Federation is still better off than Republika Srpska. The latter manages to collect only one-third as much as the Federation. During 2000, the Federation raised KM 665 million in customs and excise duties, whereas the RS collected just KM 254 million.¹⁹

This vicious circle of evasion, impunity and empty government coffers must be broken. For this to happen, Bosnia's governments will need to enact and apply real reforms: not only to enforce revenue collection, but also to provide incentives for businesses and citizens to act lawfully. The two must go together. Evasion of unreasonable imposts capriciously or ineffectively collected can easily seem justified to all and sundry. Reasonable duties, on the other hand, will be easier to justify and collect, will encourage legal business practices, and will ultimately produce more revenue. But until the circle is broken, Bosnia will offer only marginal investment opportunities at best – and represent a no-go area at worst. Bosnia, according to the World Bank, now leads only Albania in the league table of poverty in Central and South-Eastern Europe, but Albania is catching up fast.²⁰ A small market burdened with high costs, a congeries of would-be governments, an inadequate transport infrastructure, a reputation for ethnic hatred and violence, and a deepening culture of corruption and dependency does not also need to provide itself with administrative and fiscal disincentives to trade and investment.

B. ECONOMIC INDICATORS

The Bosnian economy has failed to meet either its citizens' or foreign helpmates' expectations. The projected growth of 9 per cent in 2000 turned out to be no more than 6 per cent.²¹ Unemployment rates remained very high in both entities²² and are set to rise further in 2001, as firms are privatised or liquidated. Although the number of persons employed increased by a minuscule 0.002 per cent

¹⁶ 'Utaja Poreza: Nabijanje rogova poreskom sistemu', *Nezavisne novine revija*, 27 April 2001. 'Proslogodisnja poreska evazija iznosi 500 miliona – intervju Milica Bisic, Savetnica Predsednika Vlade RS za ekonomska pitanja', *Reporter*, 27 June 2001.

¹⁷ Data obtained in ICG interview with CAFAO officials, 14 February 2001.

¹⁸ *Ibid.*

¹⁹ *Ibid.*

²⁰ Sead Luckin, 'Mi, pa Albanija', *Oslobodjenje*, 12 June 2001. Moldova, however, appears not to have been included in the reckoning.

²¹ Although the official figure for 2000 was not available at the time of writing, alternative sources (including the World Bank, IMF and OHR) indicate that a realistic figure would be between 4.5 and 6 per cent. ICG interviews with World Bank, IMF and OHR officials, March and July 2001.

²² In the Federation, the average number of registered unemployed during 2000 was 265,542. In the RS the figure was 154,236. This represents a slight increase on 1999, when the Federation recorded 261,793, and the RS 147,662 unemployed. ICG was unable to obtain figures for the rates of unemployment due to the unavailability of official data on the size of the working population.

in the Federation and by 0.11 per cent in the RS during the final quarter of 2000, the irregular, late and often symbolic payments of wages to notional employees of effectively bankrupt state-owned enterprises makes the concept of 'employment' highly problematic.²³

Bosnia has now embarked with World Bank support on enacting modern labour laws that conform to the standards of the International Labour Organisation and redress the balance of power between employers and employees. However, these laws still present problems. They place too much of the burden of providing compensation for jobs lost during the war on the shoulders of former employers, thus providing an incentive for them to erect administrative barriers to the exercise of this right. They also discourage refugee return and mobility of labour and make it hard to assess the true value of companies slated for privatisation because of the uncertainty surrounding their liabilities to former staff and obligations to current employees.²⁴

However desirable the new labour legislation may be, its usefulness will not be obvious until a market economy exists and private businesses are the norm. Currently, it is the government apparatus that dominates the labour market, as it is government itself and the enterprises it owns which provide most employment. The public sector, in fact, still accounts for between 51 and 56 per cent of GDP. This puts Bosnia in the same league as rich countries like Sweden (55 percent),

Denmark (52 per cent) and Germany (50 per cent) that can afford to lavish benefits upon their citizens. By comparison, in the Czech Republic and Hungary, the public sector consumes just 25 per cent and 20 per cent, respectively, of GDP.²⁵

Trade, not production, is the main economic activity in Bosnia. Although the index of industrial production increased in 2000 (by 8.8 per cent in the Federation and 5.6 per cent in the RS), trade still dominates the economy. Bosnia's trade deficit is estimated to be 64 per cent of GDP. In the Federation in 2000, the trade deficit was KM 3.4 billion; in the RS it was KM 900 million.²⁶ This represented an overall decrease of 6 per cent from 1999. The improvement was due largely to increased exports of raw timber and semi-finished wood products, that is, goods with little or no added value.²⁷ As official statistics are sometimes either unreliable or simply unavailable and incomplete, they require corroboration and comparison with alternative sources. According to one of Bosnia's international economic mentors, imports increased by a whopping 60 per cent last year. This rise was the result of purchases of consumer goods, not of capital goods. On the other hand, Bosnia has been failing to take advantage of enhanced opportunities to export domestic products. The country recently signed a free trade agreement with Croatia that exempts its products from import duties until January 2004; and at the end of last year it won tariff breaks on exports to EU countries. Yet in order to benefit from the latter, Bosnia is required to establish an Institute for Standardisation that will ensure its products conform to EU norms. The High Representative imposed a law to this effect in November 2000.²⁸ Unfortunately, the Institute

²³ Employment figures are deceptive. For example, Bosnia has 90 factories producing shoes, textiles and leather goods that supposedly employ 42,000 workers. Yet 30,000 of these 'workers' do no work as the factories operate either at minimum capacity or not at all. Nor are their minimal basic wages paid regularly. 'Osamsto skupova gladnih', *BH Dani*, 23 February 2001.

²⁴ FIAS argues that Bosnia still lacks a modern and comprehensive legal system for regulating domestic labour issues. The current legislation provides adequate coverage of the basic employment issues of concern to foreign investors – particularly of the right to hire and fire. But other issues remain unresolved, such as non-competitive wages with high employer contributions, government's monopoly over employment bureaus, and the ill-defined powers of labour inspectors. These are disincentives of lesser or greater significance to private sector and foreign investors. Foreign Investment Advisory Service (FIAS), 'Bosnia and Herzegovina: Commercial Legal Framework and Administrative Barriers to Investment', March 2001.

²⁵ Figures on the public sector share of GDP in 1999 or 2000 are those of the Economist Intelligence Unit, taken from the website of *The Economist* (www.economist.com/countries). See also the German government website (www.statistik-bund.de).

²⁶ OHR Economic Newsletter, April 2001.

²⁷ Aluminium represents one of Bosnia's few 'added value' exports. 'Early Warning System in Bosnia and Herzegovina', *UNDP Quarterly Report*, October-December 2000.

²⁸ The High Representative imposed the Law on Standardisation on 12 November 2000, one of 23 decisions on urgent reforms he imposed in November and December 2000.

exists only on paper, as the RS government has so far failed to commit funds to make it operational.²⁹

Despite the several negative indicators reflecting the parlous state of the official Bosnian economy, there is clear evidence of vigorous economic activity outside the legal system. As noted above, commercial beehives such as Arizona market generate wealth but impoverish the state by depriving it of customs and tax revenues.³⁰ Meanwhile, the ever more widespread trafficking in contraband goods and people makes criminals out of ever larger numbers of Bosnians. If companies and entrepreneurs operating outside the law are to be brought back into the fold – and if conditions of stability, predictability and security for investments are to prevail – then business people must be offered incentives. These will need to be both conducive to growth and demonstrate tangibly the advantages of operating within the law.

C. SOCIAL INSECURITY

Most Bosnians are getting poorer, particularly in Republika Srpska. The average monthly wage in the Federation amounted to KM 437 in 2000. But the basket of typical consumables needed to keep a family of four cost KM 441. The shortfall was more striking in the RS, where the average monthly wage was KM 299, but the basket of essential items cost KM 399. In fact, the picture is even bleaker than these averages indicate, given that 46 per cent of the Federation's population and 75 per cent of those in the RS cannot afford this

notional basket of goods and foodstuffs.³¹ The retail price index rose by 1.2 per cent in the Federation in 2000, but by 13.6 per cent in the RS. Between January 2000 and January 2001, the rate of inflation was 4.3 per cent in the Federation and 12.2 per cent in the RS.

Rising prices and unemployment – and falling government revenues – affect pensioners disproportionately. Recent reform of the pension systems in both entities, initiated by the World Bank, IMF and OHR, has led to more regular payment of smaller monthly pensions, as well as to greater budget discipline by governments.³² The 281,000 pensioners in the Federation now receive a minimum monthly payment of KM 117, which although lower than the previous average payout of KM 171, represents a real annual increase since pensioners are in fact now paid almost every month. Pension reform has been a notable achievement, both in itself and as a means of cutting budget arrears, even though it does no more than keep pensioners at an existential minimum. The key to making adequate social security provision, not only for pensioners, but also for other groups such as war veterans, invalids and displaced persons, is legal economic growth, for the income of pension and health funds is dependent upon and directly proportional to employees' contributions to these funds.

As the privatisation and/or liquidation of companies and banks approaches, the risk of social unrest increases. Some 800 strikes have been recorded in Bosnia since 1997, 340 in 2000 alone. Strikers invariably raised the same issues: their late and inadequate wages and lack of confidence in the ability of newly installed management teams to

²⁹ ICG Interview with a high ranking foreign official, 3 July 2001.

³⁰ Arizona market was recognised as a problem as early as 1998, but it took over two years for the international community and the local government to take action and regulate the market. In October 2000, OHR, SFOR, OSCE and the UN Mission to Bosnia (UNMIBH) declared their intention to clamp down on the sale of smuggled goods and on tax evasion, prostitution and human trafficking. Initial efforts to regulate the market, including the registration of traders, resulted in significant increases in revenue collection. 'International Community to clean up trade at the Arizona market, Brcko', Joint OHR, SFOR, OSCE, and UNMIBH press release, 26 October 2000; 'Poreski prihodi – pet puta veci: Uvodjenje reda na trznici Arizona', *Oslobodjenje*, 24 December 2000.

³¹ 'Early Warning System in Bosnia and Herzegovina', *UNDP Quarterly Report*, October-December 2000.

³² Decision amending the Federation Law on Pension and Disability Insurance, providing for financial feasibility and independence, 12 November 2000; Decision imposing the Federation Law on Pension and Disability Insurance Organisation, providing a framework for the merger of the Sarajevo and Mostar pension funds, 12 November 2001; Decision annulling the Amendments on the RS Law on Pension and Disability Insurance from October 2000, 12 November 2001; Decision amending the RS Law on Pension and Disability Insurance, providing for financial feasibility and independence, 12 November 2001. For details see the OHR website: www.ohr.int.

secure their firms' future operations.³³ Polling evidence suggests that 52 per cent of people in the Federation and 45 per cent in the RS are ready to protest or take industrial action over pay.³⁴ At its current lethargic pace, however, privatisation will take considerable time to impact positively on employment. In fact, it is more than likely that unemployment will continue to grow as enterprises are taken into state ownership in preparation for their privatisation or re-privatisation, as has happened of late in the mining industry.

D. POLITICAL WILL

Governments demonstrate political will when they actually do what they have resolved to do. Bosnia's previous governments, dominated by the mono-ethnic parties which had fought the war and forged interlocking directorates to control their constituents' political and economic lives, paid lip service to economic reform but declined to undertake anything that would diminish their power. The Alliance for Change coalition governments, installed at state and Federation levels after the November 2000 elections and led by the moderate Bosniak Party for Bosnia (SZBiH) and the multiethnic Social Democratic Party (SDP), have already demonstrated that they are in earnest when it comes to economic reform. Laws previously imposed by the High Representative have been belatedly shepherded through the state and Federation parliaments. The Alliance's most notable action, however, has been to meet the challenge mounted by the Croat Democratic Union (HDZ) when it proclaimed 'Croat self-rule' on 3 March 2001, aiming to keep its hold on the state and public firms which had long served as its sources of patronage and cash.³⁵ The Federation government has likewise asserted its authority over revenue collection and its right to appoint the governing boards of public sector companies. It

has also adopted regulations reducing wage taxes, and has moved to cut public expenditure.³⁶

Republika Srpska's new government, led by an economist, Mladen Ivanic of the Progressive Democratic Party (PDP), was portrayed on its formation in December as a cabinet of experts. In fact, it is dominated by the Serb Democratic Party (SDS), which has been only rhetorically reconstructed since it was led by Radovan Karadzic between 1990 and 1996. In the first months after the current RS government took power, the SDS began putting its members in positions of power in key public companies and government agencies.³⁷ The party's interest in maintaining its control over such sources of wealth as the pauperised RS has to offer renders the chances of economic reform under its auspices virtually nil.

The Alliance for Change appears to possess the political will to reform Bosnia for the better; but in their respective bailiwicks the SDS and HDZ machines can be expected to continue to give primacy to policies of narrow self-interest. Thus far, despite its protestations to the contrary, the RS government has taken few, if any, positive steps in the economic sphere. Meanwhile, the recrudescence of chauvinist violence this spring will have deterred even the hardiest of would-be investors. Similarly in HDZ-controlled areas, the proclamation of 'Croat self-government', the extortion of 'contributions' from businesses to finance that 'self-government', and the riots organised in April 2001 to oppose the OHR's attempt to audit the books of the party's bank have already had a negative impact on the local economy.³⁸ For example, a potential foreign investor in the Mostar Tobacco Factory withdrew from negotiations, while the local owners of the Lijanovici meatpacking firm in Siroki Brijeg are

³³ Strikes have included those by teachers in the RS and miners in the Federation. 'Osamsto skupova gladnih', *BH Dani*, 23 February 2001.

³⁴ 'Early Warning System in Bosnia and Herzegovina', *UNDP Quarterly Report*, October-December 2000.

³⁵ See ICG Balkans Report No. 106, *Turning Strife to Advantage: A Blueprint to Integrate the Croats in Bosnia and Herzegovina*, 20 March 2001.

³⁶ 'Kako je Vlada uštedjela 19 milion maraka', *Dnevni avaz*, 30 June 2001.

³⁷ 'Posljednji krug birokratskog maratona', *Reporter*, 1 May 2001.

³⁸ 'Privrednici ne zele finansirati paralelne institucije', *Dnevni avaz*, 17 March 2001; 'High Representative condemns terrorist act against the Ivankovic family', OHR Sarajevo Press Release, 10 April 2001; 'OHR expresses concern over campaign of intimidation against BiH Croats', OHR Sarajevo Press Release, 26 April 2001.

considering moving to the internationally supervised Brcko District.³⁹

Unfortunately, positive developments in one part of the country can have but limited impact if they are not extended to all of Bosnia and Herzegovina. On the other hand, negative developments in RS and 'Herceg-Bosna' – phoney privatisation, hollow reforms, rampant corruption and cronyism, smuggling of goods and people, gangsterism, ethnic violence – affect the whole country's image. If Bosnia is to escape the economic morass in which it finds itself, all its several governments must work towards the same goal. Until such time as the economy begins to generate jobs and hope, ever increasing numbers of young people will abandon their country in search of better opportunities abroad. And until Bosnia creates a stable and predictable economic climate where criminality and capricious administration are the exception rather than the rule, potential foreign investors will give it a very wide berth.

II. BARRIERS TO INVESTMENT

To attract investment, a country must appear to offer comparative advantages in one or more respects over its competitors. Bosnia cannot trade on Western guilt any longer. It needs to offer positive incentives to the investors who – in the absence of abundant domestic sources of capital or unique natural endowments – offer its only lifeline to sustainable growth. Unfortunately, Bosnia's image as an unstable and conflict-ridden land has recently been reinforced by outbreaks of violence in RS and 'Herceg-Bosna' which, according to Bozidar Matic, the outgoing chairman of the Council of Ministers, have already cost it dear in terms of investments lost.⁴⁰ A report last year by the Bosnian Academy of Sciences and Arts on the country's international economic competitiveness ranked it among those least appealing to foreign investors, alongside Russia and Ukraine in such categories as political interference, corruption, and the absence of the rule of law. The same report portrayed Bosnia as a backward country where inadequate managers run weak companies that are unable to adapt and apply new technologies, and where people live in potentially volatile insecurity, unable to rely on their government or judicial system to assert and protect their rights. In other words, the overall climate in Bosnia appears hostile to investment and business, whether foreign or domestic.⁴¹

In focusing most of its economic reform efforts on those factors that strengthen the state apparatus, the international community has done little to improve the workaday business environment or to remove

⁴⁰ See Vildana Selimbegovic and Senad Pecanin, 'Intervju Dana: Dr Bozidar Matic: Eto im Alijanse', *BH Dani*, 29 June 2001, pp. 8-11. According to Reuters as well, the disorders which accompanied the raids on Hercegovacka Banka in April 2001 and the failed attempts to lay foundation stones for the rebuilding of mosques in Trebinje and Banja Luka in May have 'damaged the economy, deterring potential investors and potential donors'. Reuters, 'Violence deterring foreign investment and donors', 4 June 2001.

⁴¹ In comparison to Russia and Ukraine, Bosnia has an additional disadvantage: it offers a very small market of just 3.7 million people, divided into two (or three) often hostile entities. Academy of Sciences and Arts of Bosnia and Herzegovina and Management and Information Technologies Centre, *Competitiveness Report: Bosnia and Herzegovina*, Sarajevo, 2000.

³⁹ "Lijanovici" bi u Brcko, Orucevic i Tomic ih zovu u Mostar', *Dnevni avaz*, 15 December 2000.

the barriers that impede both investment and legal business activities. Most businessmen operate in and are concerned with the microeconomy. This means their problems lie in obtaining licences and documents from numerous government agencies, dealing with the courts, importing goods and coping with customs officials, paying a variety of taxes and fees, finding reliable banking services, enduring various forms of inspection, and complying with numerous sets of regulations. The prospect of having to go through all this can deter a would-be investor at the very outset, while the experience of some of it can soon cause a putative investor to change his mind and withdraw. If, however, the investor perseveres in battling the bureaucracy, he must then struggle actually to sell his goods or services at margins high enough to leave him with a profit after paying all the taxes, fees and overheads that Bosnia also demands. It is the sum total of these experiences that creates a business environment and determines eventually whether a country wins or loses the race for investments.

ICG's interviews with Bosnian business people have indicated that the current environment is extremely forbidding, characterised as it is by a series of barriers created, perpetuated or permitted by government. The most obnoxious are burdensome registration procedures, high and numerous taxes, unfair competition from illegal operators, numerous capricious inspections, and an ineffectual judicial system.

Yet Bosnia does possess some competitive advantages, even if its governments and their foreign advisers have so far failed to mobilise or exploit them. The fact that at least a few large-scale foreign investors have seen potential in the banking, manufacturing and extractive sectors has been noted above. But no substantial rush to invest can be expected unless and until the barriers created, permitted or perpetuated by governments on several levels are dismantled.

As elsewhere in Eastern Europe, Bosnia's greatest asset is its human capital: a young, educated, underemployed populace with some entrepreneurial experience and spirit, widespread knowledge of foreign languages, and readiness to work for modest wages. Bosnians took home the largest number of medals among all competitors at the May 'Concours Lepine' (international inventors' fair) in Paris: eleven prizes for thirteen

inventions.⁴² Another recent international success was the prize for best screenplay won by the young director Danis Tanovic at this year's Cannes Film Festival. Yet it is symptomatic that his acclaimed 'Bosnian' film ('No Man's Land') could only be made with foreign capital and that Tanovic himself now lives and works in France. Current disincentives to business make it difficult for talented Bosnians to realise their potential at home.

Neither the international community nor Bosnia's several governments have until recently come up with a comprehensive development plan for the microeconomy. Much has been said -- and something done -- to root out corruption in government (see Sections V and VI below), but little vision and less detailed planning have animated state or entity governments. The result of indirection from above and stifling interference from below has been stagnation and drift. Instead of putting their ingenuity and ambition into building businesses which will innovate, grow and prosper in a predictable environment, business people have had to devote their energies to finding ways to circumvent a dysfunctional system in order to survive another day. It was not until March 2001 that an economic plan for Bosnia emerged from the state Council of Ministers. Entitled 'Entrepreneurial Society: A General Framework for an Economic Development Strategy for Bosnia and Herzegovina, 2000-2004', this 50-page document recognises the problems, identifies at least some of the solutions and emphasises the need to liberate and strengthen the private sector. But it represents only a start, after too many wasted years, and is far from being a plan fit for implementation.⁴³

⁴² 'Za 13 inovacija 11 medalja', *Oslobodjenje*, 9 May 2001.

⁴³ 'Poduzetnicko drustvo: globalni okvir ekonomske strategije razvoja Bosne i Hercegovine', 12 March 2001. In addition, in February 2001, the new RS government issued its own economic plan entitled 'Ekonomska politika u 2001. godini', which acknowledges current economic problems but lacks any comprehensive implementation strategy. ICG was not successful in obtaining a copy of the Federation government's economic plan, but the steps taken by the Federation government over the past six months speak for themselves.

Other recent studies either helped pave the way or have taken the discussion forward. Last year's *Competitiveness Report* by the Bosnian Academy and Management and Information Technologies Centre has been referred to above. A thoroughgoing study by FIAS (the Foreign

A. THE REGISTRATION NIGHTMARE

The problem of a lengthy and overly bureaucratic business registration process was recognised as early as 1996, and has been closely examined in several reports by the OHR, World Bank and ICG. The most comprehensive recent report is by FIAS (the Foreign Investment Advisory Service jointly sponsored by the World Bank and the International Finance Corporation). It details the legal and administrative barriers to investment and spells out the obstacles to registration. Fourteen visits to government agencies and ministries are required in both the Federation and RS. In the Federation, on average, 95 days are needed to register a company (with a maximum of 150), whereas in the RS the number of days required averages 70 (with a maximum of 90). In comparison with other countries in transition in Eastern Europe, Bosnia is by far the worst, followed by Poland (with an average 60 days needed for registration). In the best case, the Czech Republic, only two or three days are needed.⁴⁴

Many of the steps required make no logical sense and simply add yet another bureaucratic barrier and opportunity for corruption. Intending foreign investors are even required to seek permission from both the Ministries of Defence and Foreign Affairs. Often an official in one of the numerous agencies on whom an investor must wait will halt the paperwork, in the expectation that a bribe will be offered to shake it loose. Many investors succumb. Any bribe paid comes on top of a slew of mandated registration taxes and fees. Should subsequent amendments of the original registration document be required – including something as innocuous as a change of address – the entire registration process must be repeated. This rigmarole can discourage enterprises from expanding or changing the location of their operations.

Investment Advisory Service sponsored by the World Bank and the International Finance Corporation) entitled 'Bosnia and Herzegovina: Commercial Legal Framework and Administrative Barriers to Investment' was published in March 2001. Finally, a draft report from the Open Society Fund of Bosnia and Herzegovina ('Specijalna inicijativa - Politike medjunarodne podrške zemljama jugoistočne Evrope: lekcije [ne]naucene u BiH') was discussed at a conference in Sarajevo in June 2001 and will, presumably, soon appear in print.

⁴⁴ FIAS, 'Commercial Legal Framework and Administrative Barriers to Investment', March 2001.

Despite longstanding acknowledgement of the problem, few real improvements in the registration process have been made.⁴⁵ However, the new Federation government has at least set up a working party under a minister without portfolio to examine the streamlining of business registration procedures. What Bosnia needs is a centralised, 'one-stop shop' business registration system for the entire country. This is nowhere in sight.

B. KAFKAESQUE CONTROLS

Current business regulations are complex, cumbersome and intrusive, providing for the maximum of bureaucratic control and offering official inspectors of every ilk abundant opportunities for extorting bribes.⁴⁶ The typical business is visited by an endless parade of sanitary, market standards, environmental, municipal, customs and financial inspectors, some of whom are replicated at each level of government. Both the Federation and RS budgets rely to a considerable extent on fines from inspections as sources of revenue.⁴⁷ This puts added pressure on inspectors to find violations.

Many of these inspectors are vested with sweeping powers, including the right to shut down a company on the spot or to seize goods. When

⁴⁵ One change for the better is that companies no longer have to register in both entities. Banks were the first to benefit from the abolition of the double-registration requirement in late 2000. Now other firms have been freed of this obligation: by the Federation in June, and by the RS in July 2001. ICG interview with OHR Economic Department official, 24 July 2001.

⁴⁶ Several market inspectors, including a cantonal minister, have allegedly been involved in extorting money from businesses by suggesting they buy insurance policies if they wish to avoid fines. 'Istraga protiv bivseg ministra Durakovica i trzisnih inspektora', *Dnevni avaz*, 30 May 2001.

⁴⁷ According to official data, the entities' expected yield from fines last year ranged from KM 4 to 6 million. The RS envisaged a take of KM 6 million, while the Federation counted on KM 4.66 million. Sarajevo Canton also expected KM 6 million. 'Rebalans budzeta Republike Srpske za 2000', undated document supplied to ICG by the RS authorities on 26 June 2001; 'Izmjene i dopune budzeta Federacije BiH za 2000', *Sluzbene novine*, No 16, 7 August 2000; 'Budzet Kantona Sarajevo za 2000', *Sluzbene novine Kantona Sarajevo*, No 2, 25 February 2000.

inspectors arrive, the party being inspected rarely knows what criteria the inspector will apply. The typical business is thus often vulnerable to the 'discovery' of fictitious violations of non-existent regulations. Even when inspectors play straight, the businessman often cannot possibly comply with myriad codes about which information is usually unavailable. This combination of power in the hands of the inspectors and ignorance on the part of the inspected is made to measure for extortion. Because no effective appeals machinery exists to resolve disputes between inspectors and businesses, the latter must either pay up or face being shut down on the spot.⁴⁸

The use of inspections by local politicians determined to punish the owners or managers of companies that support their opponents or criticise them too volubly is thought to be widespread. According to one estimate, approximately 35 per cent of management time is spent dealing with inspections. One company in Tuzla is reported to have endured the presence of financial inspectors on its premises for 140 days in a single year. Another, in Banja Luka, had three visits from the financial police in a year, each of which lasted twenty days.⁴⁹

Unscrupulous businessmen or political foes can take advantage of government's hunger for fees and fines, inspectors' turpitude and their own connections to punish their competitors or enemies by reporting alleged violations to the authorities. The resulting investigation and controls may shut down the affected firm for lengthy periods or otherwise damage its prospects.⁵⁰ In the case of the profitable Sarajevo brewery (Sarajevska Pivara), both the Union Pivovarna of Slovenia and the Pepsi-Cola Company were interested in investing, with Union considering an investment of approximately KM 16 million and Pepsi envisaging a franchising deal. The protracted negotiations came to a halt, however, after the Sarajevo cantonal police and tax inspectorate launched a criminal investigation in February 2001

into the brewery's finances. Although the brewery has been alleged to serve as a cash cow for the formerly ruling SDA – which might have been a legitimate reason for an inquiry – this investigation was, it seems, based on no more than an anonymous letter.⁵¹ Its effect was to frighten off the potential investors.⁵²

C. TAXING TAXES

Bosnia imposes too many taxes on a too small base. The tax regime is burdensome, opaque and retrogressive. In part, this is a legacy of the socialist era, when taxation served to keep a bloated administration, to pay for an expensive army, and to maintain artificially high rates of employment and benefits in the self-managed economy. Old habits die hard, and despite the new slogans hailing transparency and tax cuts, the authorities preserve hidden charges and administrative fees. For example, the entity governments recently imposed a fee (not a tax!) of two-tenths of one per cent on total turnover in order to finance tourist associations at the municipal, cantonal and entity levels. The 'fee' does not appear in the governments' budgets and is to be paid when enterprises submit their annual reports.⁵³ This emphasis on taxing business is, of course, another holdover from times past, and is rightly perceived by firms as discriminatory, counterproductive, and non-transparent – even if it plays well with the public.

Under pressure from the IMF and the World Bank, the entity governments have made some tax reductions and reforms. More importantly, they have accepted a degree of harmonisation in their tax laws. The new Federation tax law, introduced in April 2000,⁵⁴ shifted responsibility for the payment of the most lucrative turnover taxes (*porez na promet*) from the wholesale level to the

⁴⁸ See ICG Balkans Report No. 64, *Why will no one invest in Bosnia and Herzegovina?* 21 April 1999, for an extensive discussion of this problem.

⁴⁹ ICG interview with international financial adviser, 26 March 2001.

⁵⁰ Numerous interviews with businessmen from the Federation and RS conducted by ICG between February and July 2001.

⁵¹ "Parasistem i sistem para: Javna preduzeća na tajnom zadatku", *Dani*, 19 December 1999; 'Dvanaest posto preostalog drzavnog kapitala vrijedi vise nego sto su svojevremeno Pasovic i Selimovic platili za 88-postotno vlasnistvo!', *Slobodna Bosna*, 30 November 2000.

⁵² Copies of correspondence among the potential investors, Sarajevo brewery and the Sarajevo police provided to ICG.

⁵³ ICG interview with a senior official of an international financial institution, 9 March 2001.

⁵⁴ Law on the sales tax on the turnover of goods and services, *Sluzbeni list Federacije BiH*, No. 13/10.

point of final sale.⁵⁵ This change was welcome since it brought practice in the Federation into line with that in the RS and encouraged inter-entity trade.⁵⁶ Another change introduced by the April 2000 tax bill was to devolve the job of collecting – and the joy of spending – tax revenues to the municipalities. This means that the local authorities in populous areas with big retail sales should now be keener on efficiently collecting what is due to them. On the other hand, the low population municipalities of western Herzegovina (where many big Croat trading companies are based) are seeing their previously swollen tax revenues fall as a consequence of the shift from wholesale to retail collection. In the RS, meanwhile, the collection and distribution of taxes remain highly centralised. Each municipality is entitled to a percentage of the revenue collected by the RS tax authority on its territory, but several municipal officials claim that they do not even know how much the entity collects in their municipality.⁵⁷

These moves towards harmonising the basic thrust of the entities' tax systems and – at least in the Federation – making the distribution of receipts more equitable have been positive. But they do not alter the fact that Bosnia's entities continue to have distinct tax codes, rates and administrations. For example, tax inspectors from one entity have no authority in the other. They can merely request information. This means that a large and legal loophole still exists for tax evaders.⁵⁸ In this as in so many other spheres, a true common market remains to be created.

Taxes remain too numerous and too high. Although the service tax on hospitality has been abolished, the general service tax reduced from 12 to 10 per cent, and the turnover tax cut from 24 to 20 per cent, both the Federation and the RS have recently introduced – at the instance of the IMF – a 10 per cent levy on construction materials. These were previously exempt from tax.⁵⁹ Also, in May 2001, the Federation reduced the wage tax from 10 to 5 per cent, an example that may now be followed by the RS.⁶⁰ However, the basic turnover tax rate is still far too high. Slight reductions have been made in other taxes, but these adjustments have failed to address the core problem: too many separate taxes at too high rates are being paid by too few people – and disproportionately by business. (Tables setting out the various taxes and their rates in each entity can be found in Appendix 1.)

What Bosnia urgently requires is an integrated Value Added Tax (VAT) system which collects taxes at every point of sale, thereby assuring evenly distributed and continuous revenue collection, as is the EU standard. The plethora of petty, disguised and regressive taxes, and the army of bureaucrats required for collection, must go. The International Advisory Group on Taxation (IAGT) – which involves the OHR, USAID, the IMF, the World Bank, the U.S. Treasury, GTZ, and CAFAO – plans to introduce VAT to Bosnia by July 2003. Bosnia needs VAT sooner than that. The Federation has recently proclaimed its intention to adopt VAT by the end of this year. This, however, may prove an unrealistic target.⁶¹

⁵⁵ The Federation previously collected sales taxes on high tariff goods on the wholesale level, but other products were taxed on retail sale. ICG interview with CAFAO official, 24 July 2001.

⁵⁶ Under the previous system, goods sold wholesale in the RS to a customer from the Federation went untaxed because the RS did not tax wholesale transactions while the Federation did not tax retail sales. As a consequence, the Federation raised trade barriers against 'imports' from RS. On the other hand, goods from the Federation were uncompetitive on the RS market because they were taxed twice (at the wholesale level in the Federation and on retail sale in RS), thereby adding some 20 per cent to their cost in RS shops. This meant that Federation-bottled Coca-Cola could not compete with RS-bottled Pepsi or Coke imported from Hungary or Bulgaria.

⁵⁷ ICG interview with municipal officials, 8 June 2001.

⁵⁸ ICG interview with a prominent foreign businessman, 20 March 2001.

⁵⁹ Recent changes in the law on turnover taxes abolished tax exemption on many goods, including fuel, meat and building materials. 'Skuplje gorivo, meso, proizvodi za gradjevinarstvo, ugalj', *Dnevni avaz*, 2 June 2001. The amendments to the law are published in *Sluzbene novine Federacije BiH*, No 22, June 2001.

⁶⁰ The RS government is currently discussing a set of laws that will reduce several taxes, including wage taxes. 'Set zakona iz oblasti poreske politike', *Oslobodjenje*, 18 July 2001; and 'Porezi i doprinosi smanjuju se na 50 posto', *Dnevni avaz*, 18 July 2001.

⁶¹ 'Bunde nece pojeftiniti', *Oslobodjenje*, 5 July 2001.

D. LEAKY BORDERS

Illegal imports (i.e., smuggled goods) are perpetuating the informal economy and sustaining an uneven playing field for business. They are sold at lower prices on the market than are legal goods because smugglers pay no customs duties or taxes. As a result, the law-abiding business is either driven out of the market place or forced to join the black economy.⁶² Although the international community has made and continues to make strenuous efforts to establish a strong State Border Service,⁶³ its financing, manning and effective deployment depend principally on the entity governments. RS, in particular, remains resistant to the creation of state-level institutions that enhance state sovereignty, even when such institutions would yield tangible benefits for its honest businesses. The issue of customs evasion is discussed further in Section V.

E. INSUFFICIENT PRIVATISATION

The continuing absence of thoroughgoing privatisation of major state-owned firms remains a fundamental barrier to domestic and foreign investment. Bosnia's governments still own or control the country's most productive assets and resources. As long as this remains the case, significant private investment is excluded almost by definition. As pointed out in the extensive discussion of privatisation in Section III, Bosnia has been saddled with an inappropriate model ineffectually applied. The reform and revivification of the privatisation program is an urgent necessity.

⁶² Two businessmen interviewed by ICG – and who naturally wish to remain anonymous – either went bust or abandoned the import trades in which they were engaged because they could not compete with the low prices of illegally imported goods. Their companies dealt, respectively, in imported bulk sugar and cooking oil. Interviews of 2 July 2001.

⁶³ The World Bank has approved a trade and transport financial project that will allocate U.S.\$ 9 million to improve border crossings. ICG interview with a high-ranking official from an international financial institution, 9 March 2001.

F. QUESTIONABLE BANKS

A robust banking system is central to the creation of a healthy climate for business. As pointed out below in Section IV, notable successes have been recorded in reforming the banking sector in the Federation, but Republika Srpska lags far behind. Eleven of its eighteen banks are state-owned. Almost all are subject to pervasive political interference.⁶⁴ Most are thought to be illiquid. They are not an attractive proposition for foreign investors. Yet if state-owned and illiquid banks in both the RS and Federation do not find buyers by the recently extended deadline of 31 December 2001, they are slated for liquidation.⁶⁵ Some banks with healthy balance sheets are suspected of profiting from money laundering. This is a growth industry in Bosnia, but one which will have increasingly dire consequences for legitimate businesses as it further tarnishes the country's image, reinforces the nexus of crime and politics, and undermines the rule of law.⁶⁶

G. PARTIAL JUSTICE

Once on the ground, foreign investors risk falling foul of a judicial system which remains inconsistent and politicised. The UN Judicial System Assessment Programme (JSAP), OHR, ICG and others have carried out numerous studies of the judiciary in Bosnia and highlighted its failings.⁶⁷ As a result, important changes were

⁶⁴ The grand old man of Serbian politics, Nikola Pasic (1845-1926), once remarked that 'every politician worth his salt must have his own bank.' RS politicians continue to observe this maxim.

⁶⁵ 'Produzen rok za privatizaciju banaka do kraja godine', *Dnevni avaz*, 6 July 2001.

⁶⁶ Initial findings in the investigation of Hercegovacka Banka appear to confirm the existence of direct links between the bank, the HDZ establishment and criminal elements. For a full account of what went wrong (and right) with the April raids, see: R. Jeffrey Smith, 'Failed NATO Raid Humiliates the West: Bosnia's Fraying Peace: Gangs and Politicians Join Forces', *The International Herald Tribune*, 28 June 2001. See also ICG Balkans Report No 110, *No Early Exit: NATO's Continuing Challenge in Bosnia*, 22 May 2001.

⁶⁷ ICG's comprehensive review of the obstacles preventing the creation of an independent and efficient judiciary called two years ago for action to end the financial and political dependency of judges, for the provision of adequate resources, for the selection and

made in June 2000, when the law on judicial service amended the rules governing the appointment of judges and prosecutors and set higher salaries in both entities as a hedge against bribery and corruption. OHR has, in addition, lately set up an Independent Judicial Commission (IJC), an advisory body of foreign and domestic legal experts that will advise on and supervise the implementation of legal and judicial reforms.⁶⁸ While these measures may have marginally enhanced the independence of judges, the system is still susceptible to political or other influences, particularly in cases involving large sums of money, official abuse of power, individuals close to the national political establishments, and crimes with an ethnic or religious element.

The inadequacies of both the judicial system and the legislative framework of company law continue to represent barriers to domestic and foreign investment.⁶⁹ Contracts are often violated and legal remedies are difficult to find. Changes of government or management are a particular hazard. One German company that had invested in Zenica incurred problems with its partner when the newly installed local government decided to

appointment of judges and prosecutors on a disinterested basis, and for steps to remove or retrain incompetent and inexperienced judges. ICG Balkans Report No 72, *Rule of Law: Obstacles to the Development of an Independent Judiciary in Bosnia and Herzegovina*, 5 July 1999.

⁶⁸ OHR Decision providing for an Independent Judicial Commission (IJC) with a comprehensive mandate, 14 March 2001 (www.ohr.int)

⁶⁹ The vast majority of today's laws derive from pre-war Yugoslav statutes. Much wartime legislation was hurriedly written and enacted to fill the legal void that followed independence, whereas post-war legislation has aimed to fulfil the demands of the Dayton Peace Accords and/or Bosnia's international guardians. In the rush to legislate, little care has been paid to harmonising new laws with old. As a result, many fields are unregulated, over-regulated or subject to mutually conflicting regulatory requirements. See ICG Balkans Report No. 84, *Rule of Law in Public Administration: Confusion and Discrimination in a Post-Communist Bureaucracy*, 15 December 1999. Moreover, Bosnian courts have often resorted to both discrimination and delay in judicial processes as a means of supporting the political agendas of the ruling parties. ICG demonstrated that time-wasting, dubious applications of the law, and blatantly discriminatory practices contribute greatly to the ad hoc nature of Bosnian justice in its examination of six individual cases of ethnic and political discrimination. See ICG Balkans Report No. 86, *Denied Justice: Individuals Lost in a Legal Maze*, 23 February 2000.

dispute the contract signed by its predecessor.⁷⁰ The court cases that result from breach of contract suits can take ages to resolve. For example, the suit launched by Hrvatske Telekomunikacije (Croatian Telecommunications) against Eronet required two years before an unsatisfactory settlement was reached (see Section III below). But even after lengthy court proceedings and favourable rulings, redress for breaches of contract can remain elusive in the absence of effective enforcement mechanisms.⁷¹ Unfortunately, the weakness of the judiciary will become increasingly obvious as more complex and up-to-date laws are enacted. An incompetent system will be unable to cope; the courts will become clogged; and the pace of economic reform will slacken.

Besides its tendency to be dilatory, partisan and ineffective, the judicial system is also subject to abuse by those seeking either a payoff from investors in Bosnian firms or protection from the competition such investors might offer. Favourite tactics are to lodge a frivolous lawsuit against an investor or to make anonymous allegations of wrongdoing in a company marked to receive a substantial investment.⁷² Such abuse of the judicial system may scare away foreign investors by calling into question their equality before the law, by threatening them with protracted legal battles, or by exposing their would-be partner to numerous inspections and lengthy investigations.

UNITIC, a joint venture between UNIS, one of the largest and most successful of Bosnia's pre-war enterprises, and the Kuwait Investment Agency, has thus far spent approximately KM 28 million (of an expected KM 40 million) in renovating the two most prestigious, glass-clad office towers in Sarajevo. The reconstruction of these and other war-damaged buildings naturally involves lucrative contracts and significant commissions for those

⁷⁰ ICG interview with a German economic adviser, 5 April 2001.

⁷¹ The part played by the judiciary in impeding investment is discussed in ICG Balkans Report No. 64, *Why Will No-one Invest in Bosnia and Herzegovina*, 21 April 1999.

⁷² ICG interviewed numerous businesspeople in both the Federation and the RS who had suffered legal harassment because they had refused to embrace a politically favoured business partner or because someone wanted to discredit and/or eliminate them from a particular market. All these interlocutors wish to remain anonymous for fear of further reprisals.

who facilitate them. Glass is an especially costly component.⁷³ When UNITIC started reconstruction of the twin towers, it sought to restore their previous appearance: both by using glass as similar in colour as possible and by employing the original architect, Ivan Straus. Straus, however, was not satisfied with the hue of the glass and was dismissed. He then sued UNITIC, claiming that his 'authorship rights' were being violated. As the buildings' architect, he asserted that it remained his unique prerogative to choose the colour of the glass cladding. He now wanted to use greyish glass which was different both from the original (and now unavailable) blue and from the bluish glass selected by UNITIC. It was also much more expensive, so inviting suspicion that Straus's interest was as much financial as authorial. The resulting case approached absurdity when an expert analysis demonstrated in court that the shades of the two rival makes of glass were not in fact distinguishable by the human eye. Straus nonetheless proceeded with his demand that the court should order a halt on all reconstruction work until a final ruling was made. Had the court agreed, UNITIC stood to lose KM 12 million.⁷⁴ This case has now been dragging on for over a year and has cost the investor both KM 40,000 and bad publicity. Expeditious and decisive settlement of this and similar cases would not only save time and money that could be put to better use, but also deter abuse of the judicial system to extort fees or favours from investors.

H. INADEQUATE LEGISLATION

Much of Bosnia's commercial law is either inadequate or outdated. At present there are approximately 11,000 regulations with which businesses in Bosnia must comply.⁷⁵ Although the sheer number is daunting, legislation covering such key areas as property ownership and the real estate

trade – essential to a market economy and commercial business – remains largely absent. Some crucial new laws governing commercial affairs have been drafted but not yet enacted due to political obstruction. Other laws that have been promulgated according to drafts produced by international legal experts already require substantial revision since their authors were unfamiliar with Bosnian legal traditions and peculiarities. Cases in point are the laws on privatisation and foreign investment considered below.

I. OBSCURE OWNERSHIP AND COLLATERAL DAMAGE

Bosnia's complicated and obsolescent system of land registry poses a problem for anyone buying properties or seeking to register changes of ownership. The land books that register ownership titles (*grunt*) are closely connected to cadastral books (*katastar*) that contain maps and descriptions of land, but say nothing about its ownership. The two are very much dependent on one another, while at the same time distinguishing between possession and ownership. The inadequate land and cadastral book system – combined with the lack of regulations on mortgages and the real estate trade - obfuscate a fundamental tool in a market economy: clear ownership. As will be discussed below (Sections III and IV), this is also of crucial importance to successful privatisation. As matters stand, it is possible fraudulently to sell a flat or other piece of real estate several times without being found out since registering changes in land title books is both slow and imprecise. On the other hand, securing a loan to buy a property is rendered difficult by the inadequate regulations governing collateral. Current laws make it hard if not impossible to seize assets offered as collateral in the event of default. The natural result is that lending is restricted.

J. BANKRUPT LAW

The law on bankruptcy is similarly inadequate. It gives the courts too much power in deciding on the disposition of assets. Moreover, the present approach to bankruptcy in Bosnia tends to destroy a company, in contrast to the common Western practice that attempts either to resurrect it or to save such parts as are salvageable. There are at

⁷³ ICG interview with a foreign businessman involved in the glass business, 2 July 2001.

⁷⁴ Based on ICG interviews with UNITIC, members of the judiciary, and the article 'Blue ili green, pitanje je sad', *BH Dani*, 22 December 2000.

⁷⁵ This figure is a 'guesstimate'. Nevertheless, the need to comply with thousands of arbitrary, overlapping and often contradicting regulations is a great diversion of a company's time and resources. ICG interview with an international financial institution, 26 March 2001.

present over 2,000 companies for sale in Bosnia, both public and private. Only some will find buyers. Others will have to be liquidated in part or in whole. The law needs to address this reality. If a company files for bankruptcy – which has not yet happened in Bosnia – it faces a lengthy court procedure, conducted by a panel of three judges, and governed by very strict rules denying the court the flexibility required for a speedy process that could save healthy parts of the firm and recover assets for creditors.⁷⁶ This means that potentially attractive assets will be squandered rather than sold.

K. FOREIGN INVESTMENT LAWLESSNESS

The current law on foreign investment – imposed by High Representative Carlos Westendorp in 1997 – is badly written and deficient. It fails to define a foreign investor with any rigour and is composed mainly of platitudes stating what an ideal foreign investment climate might look like in a perfect world. The poor definition of a foreign investor can be seen from the fact that, should such an investor take up even temporary legal residence in Bosnia, he or she ceases to be a foreign investor. Long on rhetoric and short on substance, it is – from a legal viewpoint – a document that needs immediate and substantive revamping. In 1998 the short-lived Bosnian Association of Foreign Investors (BAFI) requested OHR to amend the law, but was ignored.⁷⁷ In any case, this state-level law has not been implemented by the entities. In consequence, there are numerous crosscutting or confusing regulations governing foreign investment on the entity level. As has typically been the case, the international community has ignored the needs of legitimate private sector business in favour of pursuing its overarching

strategy of attempting to strengthen government's ability to collect revenues.

L. A DIALOGUE OF THE DEAF

The private sector in Bosnia has no formal channel, interest group or lobby through which it can articulate its needs and views to government ministers and legislators. In this country the governments still assume primacy in the dialogue between the business community and the state. Chambers of commerce -- government agencies set up to promote the interests of a given republic's public enterprises and party-managers during communist times and funded from republican budgets and taxes on businesses -- remain fundamentally unchanged. They have no authority to propose or press for reforms. Nor do they represent the private sector, but rather the interests of the state and its habitual urge to control the economy.

Modern chambers of commerce in market economies are self-sustaining voluntary associations, and are financially independent of the state. Bosnia needs such bodies. If the current chambers of commerce can be transformed to voice the interests of private business, then they can and will survive. Otherwise, they should be allowed to die a natural death.

M. THE RESPONSIBILITY OF THE INTERNATIONAL COMMUNITY

The international community has sought since the outset of its engagement in Bosnia to assist the country's governments to become less reliant on foreign aid by creating self-financing governmental structures. The lead international organisations in these efforts to enhance revenue collection have been CAFAO, the U.S. Treasury, OHR, the World Bank, IMF, and USAID. Initially they directed their attention towards regulatory and legal reform.

It soon became obvious that such efforts were insufficient, and that diversion of revenues was a mainstay not only of criminals, but also of ruling political parties and politicians.⁷⁸ Subsequent

⁷⁶The RS bankruptcy legislation for companies is still the old Yugoslav law. Although the Federation law dates from 1997, it is no more adequate. A good analysis of the shortcomings of the bankruptcy laws can be found in the FIAS study, 'Commercial Legal Framework and Administrative Barriers to Investment', p 29.

⁷⁷ ICG interviews with members of BAFI conducted in 1999. Having learned from that experience, a new Foreign Investment Promotion Agency (FIPA) was established in July 1999 as a government agency within the Council of Ministers. The agency is intended to promote foreign investment and to facilitate services for that purpose. See: www.fipa.gov.ba.

⁷⁸ 'Bicakcic pred sudom', *BH Dani*, 16 March 2001.

policies thus focused on building or strengthening the capacity of government institutions in both entities to collect and control revenues. In fighting corruption international agencies have acted to reduce the ability of politicians to manipulate the system for personal or party gain. However, the international community has largely confined its anti-corruption campaign to the Federation, letting Republika Srpska off the hook

According to one major foreign investor in Bosnia who prefers to remain unnamed, 'Those who have the power to change things must be held responsible for not changing them.' The international community has made great strides over the past six years in securing the peace, rebuilding Bosnia's infrastructure and trying, against the grain of Dayton, to build a functioning state. Bridges, roads, airports and dwellings have been repaired or built anew with foreign aid. More recently, belated attempts to revamp Bosnia's under-utilised railway network and reintegrate it into the European system have been driven politically and financially by the international community. Numerous laws establishing important institutions (State Border Service, Treasury, Central Bank) and strengthening the rule of law itself (Law on the Federation Prosecutor and Federation Law on Witness Identity Protection) have been imposed or impelled by the international community.

However, a multiplicity of international agencies with overlapping mandates creates confusion by giving Bosnia's governments sometimes-conflicting advice and then abjuring responsibility for the consequences. The rapid turnover of international consultants and the lack of transparency and accountability damage the quality and continuity of reform.⁷⁹ Moreover, the international community's approach to economic reform has been mostly reactive, seeking quick fixes that too often later prove to be inadequate or even counterproductive.

The privatisation law is a glaring example. If economic reforms are to be beneficial and durable, international functionaries must take Bosnia's post-Yugoslav and post-war circumstances into

account. Otherwise, even the best international advisers and officials will be unable to make good use of their influence, let alone of their temporary powers to proclaim laws, reform institutions, summon financial aid, and facilitate Bosnia's transformation into a viable and self-sustainable state. If this influence and these powers are not used wisely, the international community in Bosnia becomes another part of the problem and not a key element in its solution.

'Jasno je da su Zivalj, Sabeta i Djurdjevic ucestvovali u teskom kriminalu', *Slobodna Bosna*, 31 May 2001.

⁷⁹ This assessment emerged from numerous ICG interviews with both business people and international officials.

III. THE EMBARRASMENTS OF PRIVATISATION

Privatisation is a necessary if not sufficient precondition for economic growth in Bosnia. It is also the fundamental prerequisite to cutting the Gordian knot that binds the political and economic elites and underpins so much of Bosnia's corruption. Unfortunately, privatisation has gone horribly wrong. The process that began in 1997 has thus far cost the international community more than U.S.\$ 40 million,⁸⁰ has suffered major and highly embarrassing setbacks, and has been completed only in part, primarily among small and medium-sized firms (SMEs). When the privatisation of large or 'strategic' enterprises begins in earnest, the process may last far longer than the international community suspects.⁸¹

While privatisation drags on, politicians continue to abuse their stewardship over state and publicly owned assets for corrupt purposes, and potential investors – whether foreign or domestic – move to greener pastures.⁸² Local politicians continue to use state-owned assets as if they were their own property or as sources of cash and patronage for their parties. If the international community wishes to help Bosnia out of its economic crisis and to achieve sustainable growth, it must also help cut the link between political parties and the economy. This can only be achieved by rapid and disinterested privatisation within a transparent regulatory environment.

Until such time as each ethnic party's *nomenklatura* is compelled to divest its control

⁸⁰ Final Report of the Privatisation Monitoring Commission, May 2000.

⁸¹ ICG Balkans Report No. 64, *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*, 21 April 1999, urged that the privatisation process should be completed as quickly as possible.

⁸² There are numerous examples of investors losing interest in local companies, including Fabrika Duhana Mostar, Natron Maglaj, Holiday Inn Sarajevo, etc. Strategic commercial partners are moving on as well. The German Chamber of Commerce opened an office in Bosnia soon after the war, but in early 2001 its regional director transferred to Zagreb. ICG interview with an international privatisation adviser, March 2001.

over the state-owned economy, these elites will continue to use their power to:

- Divert revenues from state-owned companies into personal and party coffers;
- Degrade the profitability of state-owned enterprises;
 - Reduce the working capital available to state-owned firms; and
- Employ state-owned assets to cement ethnic cleansing.

A. WHAT WENT WRONG?

The privatisation program imposed on Bosnia by the international community was misconceived from the start. Based on an already discredited model used in Russia and the Czech Republic, USAID hired the accountants and consultants PricewaterhouseCoopers to create a voucher-based scheme that would enable the state not only to liquidate its assets, but also to pay its debts to its citizens. The voucher model is flawed because it does not attract fresh capital. It merely changes ownership on paper. As a consequence, it does not bring the technology and know-how transfers necessary to boost both the production and productivity of worn out or war-torn plant. Moreover, the short-termism inherent to the voucher system provides incumbent management opportunities to accumulate shares in their firms, often marginalising shareholders who acquired stakes during the pre-war bout of privatisation under Yugoslav Premier Ante Markovic.⁸³

The system also required an intricate implementation infrastructure that war-torn Bosnia still lacks to this day. When USAID and the World Bank began constructing the system in 1997, more than half of all Bosnians were still refugees or displaced persons. The constitutional structure ordained by Dayton had already proved

⁸³ The so-called Markovic privatisation of 1990 permitted employees to buy shares in their enterprises. This capital transformation was real, but in most cases it was neither completed nor properly recorded by the courts or in cadastral books, so making it easy for wartime or post-war management to manipulate representations of their firms. The most notable example is Agrokomerc, the giant food products and processing conglomerate from Velika Kladusa whose pre-war crash symbolised the bankruptcy of the Yugoslav economy and whose ownership is still being disputed in the Bosnian courts.

dysfunctional, having created two entities which were – and remain – locked in mutual enmity, dead set against coordinated action for the common good, and led by politicians interested mainly in consolidating their wartime gains by retaining control over economic prizes. Furthermore, the prevalence of the fuzzy concept of ‘social ownership’ (dating back to the era of Tito, Kardelj and self-management) and the absence of clearly recorded land titles (dating back even further) made it extremely hard to establish ownership. This, in turn, permitted arbitrary interpretations of who ‘owned’ any given property, a circumstance which local politicians have flagrantly abused.

Rather than implement privatisation on the state level – which would have been the logical choice given the small scale of the Bosnian economy – the privatisation legislation, written and sponsored by USAID in 1998, created an entity-based scheme involving twelve privatisation agencies: one for the RS, one for the Federation as a whole, and one for each of its ten cantons. From the very start this institutional and regulatory framework had enormous potential for corruption. It offered politicians the chance to confirm the effects of ethnic cleansing by means of ethnically exclusive privatisations. It also afforded them a large measure of control over most aspects of the process. One clear conflict of interest was that the legislation permitted the managers of each state company to create the privatisation program for their own firm.⁸⁴ Moreover, the legislation provided numerous opportunities for local authorities to strip the assets of state-owned enterprises, thus leaving less of value to be privatised.⁸⁵

Privatisation has also stimulated ethnic politics, since entity governments were allowed to distribute disproportionate numbers of vouchers to

‘their’ war veterans, which discriminated against citizens who had fled or been forcibly removed from their homes during the war. In both entities almost half the vouchers (by value) issued thus far have gone to war veterans. In the Federation, vouchers were vastly overvalued and could be sold by their recipients for just 3-5 per cent of their face value. This allowed subsequent buyers to acquire vouchers very cheaply and to use them to buy an entire company for peanuts. It also favoured domestic over foreign investors, as demonstrated in the case of the ultimately quashed privatisation of the Sarajevo Holiday Inn.

In Republika Srpska, this problem was avoided by linking the worth of vouchers to the value of the enterprise being privatised and to the number of would-be investors. But this system, too, was easy to abuse, making sure that any shares acquired by ethnic minorities would always comprise less than 50 per cent of a firm’s capital. Until recently the RS system, unlike that in the Federation, did not permit voucher-holders to use them to purchase socially owned apartments. This made sure that minority returnees could not acquire property in the privatisation process, while providing discounts to war veterans and Serbs who moved into the RS during and after the war. However, on 17 July 2001 the High Representative issued a decision allowing for a 75 per cent discount to refugees and displaced persons returning to RS when purchasing their socially owned apartments.⁸⁶

Another flaw built into the system is the ill-defined and vague regulation providing for the proceeds from the sale of enterprises to revert to the government unit doing the selling – whether the municipality, canton, or entity – but with inadequate requirements for that unit to account for its use of the funds realised.⁸⁷ Having recognised this problem, and aiming to put the expected windfalls from privatisation to good use, the IMF

⁸⁴ Final Report of the Privatisation Monitoring Commission, May 2000.

⁸⁵ In May 2000, the High Representative dismissed the then director of the Federation Privatisation Agency, Stijepo Andric, for obstructing reforms that would have increased transparency in privatisation by tender. The obstructions, had they gone unchecked, would have meant privatisation of large enterprises without adequate preparation and under the existing flawed regulations. ‘Decision removing Mr. Stiepo Andrijic from his position of President of the Management Board of the Federation Privatisation Agency’, OHR Sarajevo, 22 May 2000.

⁸⁶ ‘High Representative amends entity laws on privatisation of socially owned apartments’, OHR press release, 17 July 2001.

⁸⁷ As of 17 April 2000, approximately KM 150 million had been realised from auctions and tenders in the Federation but only KM 55 million was in cash. The remainder came in the form of vouchers. In the RS, proceeds have been even more meagre, amounting to KM 2.9 million, less than KM 400,000 of which was in cash. Final Report of the Privatisation Monitoring Commission, May 2000.

recently proposed that the proceeds should pay for the privatisation process, boost the entities' pension funds, and contribute to the costs of property restitution.⁸⁸

On top of the problems inherent in the privatisation model and legislation sponsored by the international community, the machinery necessary to carry it out required substantial time to establish. Foreign agencies left this task to Bosnia's politicians. Largely unsupervised, they set up systems and procedures virtually guaranteed to admit no transparency. The result is a complicated system administered by the entity and cantonal privatisation agencies. These are under-funded, subject to political meddling, and dominated by the old socialist mentality. There are eleven privatisation agencies in the Federation, each empowered to privatise firms according to their location, size and value. However, the agencies' powers often overlap or collide, providing ample scope for intervention from above and beyond. For example, a large enterprise with operations in more than one canton or possessing strategic significance can fall within the purview of several cantonal agencies, as well as of the Federation agency.⁸⁹ This clash of competencies means that the fate of individual firms must often be negotiated on a case by case basis, and may need to be referred to the Federation government (in a process that can pit mutually exclusive political and economic interests against one another) or to the High Representative.⁹⁰ This situation stems from the fact that the Federation agency has no

authority over the cantonal agencies and cannot serve as a second instance body providing procedural recourse. Ad hoc settlement of difficult and politically salient cases delays and discredits privatisation.

Although the RS privatisation agency is a centralised body, it is no less coveted by political players with opposing interests. The government recently sacked the head of the privatisation agency for allegedly slowing down the privatisation process, although he had been in the job for only a few months.⁹¹ His dilatory approach reputedly allowed the SDS to keep its hands in the tills of the public companies that generate the largest cash flows. Whatever the merits of this particular dismissal, rapid turnover at the top of the agency facilitates both inefficiency and political control.

Financial dependence on government, overlapping powers among a congeries of agencies, high staff turnover caused by political bickering over who will control the resources, and remnants of the socialist preference for public over private enterprise are all obstacles to speedy and effective privatisation that must be removed.

B. THE ROLE OF THE INTERNATIONAL COMMUNITY

Large-scale privatisation in the Federation has yet to get off the ground. Following a series of high profile scandals, such as the annulled Holiday Inn privatisation,⁹² USAID suspended its assistance

⁸⁸ Restitution for property nationalised in Bosnia after the Second World War will not involve its return to the original owners or their descendants, but rather financial compensation for the loss. ICG interview with a high ranking foreign official, 3 July 2001.

⁸⁹ One such large company, with interests spread across the country, is Sipad, a forest products enterprise with activities ranging from cutting timber to making furniture. This sort of company can be regarded either as a single entity or as a conglomerate comprised of several divisions which should be separately privatised.

⁹⁰ Two cases in point are Aluminium Mostar and Eronet, both of which are deemed by the Federation government to possess strategic importance and, therefore, to fall within the ambit of its privatisation agency. In both cases, however, the local, HDZ-controlled cantonal authorities dispute the Federation's claim to primacy. Ivica Milivoncic, 'Federalni udar na ekonomsku snagu hrvatskog naroda u BiH', *Slobodna Dalmacija*, 13 June 2001. These cases are discussed below.

⁹¹ According to Rodoljub Djukanovic, he was dismissed as head of the RS Privatisation Agency because he was trying to implement the law in the face of opposition from vested interests. Some RS officials publicly denounced his dismissal, calling it unnecessary and rash. 'Ivanicevi ministri blokirali privatizaciju: Rodoljub Djukanovic, smijenjeni direktor Direkcije za privatizaciju RS', *Nezavisne novine*, 22 June 2001; 'Ne slazem se sa potezima Vlade RS: Damir Miljevic, savjetnik za privatizaciju premijera Mladena Ivanica', *Nezavisne novine*, 20 June 2001.

⁹² The Sarajevo Canton Court annulled the Holiday Inn privatisation in September 2000 in response to a complaint by the Federation Finance Police and in line with the Sarajevo Canton Prosecutor's recommendation. It cited violations of the procedures that allowed discounted vouchers to be used to pay for a part of the firm, as well as the failure of the cantonal privatisation agency to check on

program for privatisation in the Federation in April 2000. Once the reality of local political obstruction and corruption could no longer be ignored, several key international agencies formed an International Advisory Group on Privatisation (IAGP). These included the Deutsche Gesellschaft für Technische Zusammenarbeit (German Society for Technical Co-operation, GTZ), the World Bank, and OHR, acting under what would prove to be the somewhat loose coordination of USAID.

When USAID decided in April 2000 to withhold financial support for the privatisation process in the Federation (RS privatisation had not yet started at the time), GTZ proposed establishing tender commissions as a sounder way of taking matters forward. These commissions would require international experts to work closely with local officials to prepare and execute public tenders for strategic firms. The tender commissions – as currently constituted – are meant to be independent of the entity and cantonal privatisation agencies, and are tasked with overseeing all phases of privatisation, from the preparation of an enterprise, to conducting the tender process, opening the tenders, and carrying out negotiations with potential bidders. Yet the tender commissions can at any point in the process be overruled by the privatisation agencies within which they work. The latter can also reject the supposedly winning bid in a public tender. This means that the tender commissions cannot be fully effective until their powers are enhanced.

The tender commissions represent a compromise solution to the problems created by the ill-conceived, entity-based privatisation program. Although intended to introduce transparency and fairness to the bidding process, they have failed to address several issues, including the overlapping competencies of the cantonal and Federation agencies and their proclivities towards adversarial ethno-politics. As currently established, the tender commissions appear to be just another layer added to an already over-bureaucratised, conflict-ridden and inadequately resourced system. Simply adding the tender commissions to the mix has not and cannot improve matters greatly. Rather, the system must be streamlined and reformed if it is to be effective. In the first place, the cantonal

the reality of the cash committed to the deal. It seems this cash came from bank loans, and was not, therefore, a 'real' investment. *Dnevni avaz*, 15 September 2000.

privatisation agencies should be abolished and their functions merged into one central agency for the Federation. Otherwise, the tender commissions will not accelerate the privatisation process to any extent, nor will they prevent more fraud and abuse by local authorities.

USAID, GTZ and EU tender experts have been tasked with privatising 52 companies in Republika Srpska and 87 companies in the Federation. Although the timeline envisaged for privatising these 139 companies is two years,⁹³ it seems likely – given both past experience and the many obstacles that still exist – that the process will drag on for twice as long.

C. FOREIGN NON-PARTICIPATION IN PRIVATISATION

Foreign participants in the privatisation process in Bosnia have thus far been conspicuous by their absence. According to incomplete official data,⁹⁴ Bosnia received KM 581.3 million in foreign investment between 1994 and the end of 2000.⁹⁵ As with investment generally, this has been confined largely to the Federation. The most notable investors have been the Kuwait Investment Agency (KIA), Coca-Cola, Heidelberg Cement, and Raiffeisen and Volksbank. Since 1998, KIA has invested nearly KM 200 million, committing KM 120 million to BH Steel in Zenica, and participating in the UNITIC joint venture with UNIS to the tune of KM 40 million.⁹⁶ Since 1996, Coca-Cola has invested KM 55 million, including

⁹³ In interviews with ICG some international privatisation advisers expressed deep concern about the overly optimistic time frame, given the numerous obstacles.

⁹⁴ The data presented here are based on information provided by the Bosniak majority part of the Federation to the state Ministry of Foreign Trade and Economic Relations. How much has been invested to date in Republika Srpska and the Croat majority areas of the Federation remains a mystery. ICG interview with the Ministry of Foreign Trade and Economic Relations, Department for Foreign Investment, 5 July 2001.

⁹⁵ Such figures are incomplete and can vary significantly. According to the European Investment Bank (EIB), Bosnia received DM 940 million from 1994 through the end of 2000. 'Nesigurno za strane ulagace!', *Oslobodjenje*, 26 May 2001.

⁹⁶ 'Sto ce Kuvajcani donijeti Zenici', *Oslobodjenje*, 14 December 1998; Interview with UNITIC Deputy Director, 23 May 2001.

the rebuilding of the Hadzici bottling plant.⁹⁷ In July 2000, Germany's Heidelberg Cement invested KM 55 million in the Kakanj cement factory and has committed an additional KM 33.5 million to modernise its plant and equipment.⁹⁸ Austrian investors, the largest being the two banks, have so far invested KM 51 million. Slovene and Croatian investors have accounted for KM 36 million and KM 39 million in investments, respectively.⁹⁹

Other foreign investors have purchased majority shares in small textile companies, primarily in Sarajevo. Efforts to acquire 'strategic' enterprises have been both rarer and fraught with difficulties, usually owing to obstruction by local politicians such as in the failed French buyout of the Natron paper mill in Maglaj.¹⁰⁰ Political instability and violence appear also to have deterred potential foreign partners. The most recent examples are the Mostar Tobacco Factory and the Sarajka department store in Sarajevo, which had been in negotiations, respectively, with Japan Tobacco and Benneton.¹⁰¹ To date, the only instance of foreign participation in RS privatisation seems to be the acquisition of a 30 per cent stake in the Dubicanka textile company in Dubica by Intest Holdings of Italy for a price thought to be less than KM 200,000. Unfortunately, ICG has had to rely on circumstantial evidence, observation and interviews in order to conclude that foreign investment in the RS has been minuscule.

Compared to other ex-Yugoslav republics, foreign investment data for Bosnia are even more depressing. Since independence, Slovenia has attracted U.S.\$2.9 billion,¹⁰² while Croatia garnered U.S.\$4.68 billion in foreign investments

between 1993 and the end of 2000,¹⁰³ and has recently won another U.S.\$500 million through the sale of 16 per cent of its state telecoms firm to Deutsche Telekom.¹⁰⁴ Now Serbia is also in the race. Bosnia thus faces a daunting challenge. Not only must it overcome internal obstacles to foreign investment, but also compete with its larger or better-favoured neighbours.

D. ANTI-PRIVATISATION IN RS

The appallingly low level of foreign participation in RS privatisation is partly a direct result of the package of privatisation laws passed by the entity's Assembly. Although there are many other reasons why potential foreign investors might be loath to commit funds to the RS, the regulations enacted and operated thus far to cover the privatisation of small and medium-sized enterprises (SMEs) are an overwhelming deterrent. They favour domestic holders of vouchers over foreign owners of cash by permitting would-be buyers of state enterprises to acquire only 30 per cent of the shares with cash. Of the remainder, up to 55 per cent of shares can be purchased with vouchers, and up to 20 per cent with citizens' old hard currency savings; but 15 per cent of the share capital is reserved for the entity.¹⁰⁵ An additional disincentive is provided by the rule allowing voucher investors to appoint only two members to the board of directors, so permitting the entity (and its political elite) to retain effective control over the supposedly privatised company. What is more, the high ratio of vouchers to cash leaves most newly privatised companies without sufficient working capital to function, and places undue strain their cash flows. As a result, it is likely that many recently privatised SMEs in the RS have been condemned to unprofitability and insolvency, thereby rendering the process vain.

The problem of finding fresh capital infusions for newly privatised companies is thus particularly acute in the Serb entity. Yet the ownership

⁹⁷ ICG interview with Coca-Cola manager Mike Higgins, 25 March 2001.

⁹⁸ 'Heidelberger Zement vecinski vlasnik cementare Kakanj', *Oslobodjenje*, 21 July 2000.

⁹⁹ ICG interview with the Ministry of Foreign Trade and Economic Relations, Department for Foreign Investment, 5 July 2001. Slovene investors reportedly led all others in the first quarter of 2001, making Slovenia both Bosnia's largest foreign investor and trading partner during that period. ICG interview with Slovene diplomat, 4 June 2001.

¹⁰⁰ Final Report of the Privatisation Monitoring Commission, May 2000.

¹⁰¹ 'Violence deterring foreign investment and donors', Reuters, 4 June 2001.

¹⁰² ICG interview with the Slovene Ministry of Trade, Department for Foreign Relations, 5 July 2001.

¹⁰³ ICG interview with the Croatian Chamber of Commerce, 5 July 2001.

¹⁰⁴ 'Paket od 16 posto dionica prodan za 500 miliona eura', *Oslobodjenje*, 4 July 2001.

¹⁰⁵ RS privatisation laws can be accessed on www.rsprivatizacija.com, including the Law on Privatisation of State Capital in Enterprises (Zakon o privatizaciji drzavnog kapitala u preduzecima).

structure decreed by the law militates against investors who may have the cash by relegating them to perpetual minority status. Moreover, the 30 per cent limit also makes cash investors reluctant to throw in good money after bad in order to secure a company's working capital or to make improvements in its plant because, again, their increased investment will not be matched by a commensurate increase in ownership. All in all, the disincentives to investment in SMEs in the RS far outweigh the incentives.¹⁰⁶

The privatisation law adopted to govern the privatisation of the 52 strategic enterprises in the RS has been better conceived, but has yet to be tested. It provides for the cash sale of between 61 and 67 per cent of a company's shares, thus offering a greater incentive to investors.¹⁰⁷ But this more cash-friendly regime is not in itself enough to attract investors or to make up for the disaster of SME privatisation. To recoup what it has lost and to have any hope of successfully privatising its strategic firms, the RS authorities will also have to remove the legal obstacles barring investors from exercising control over newly privatised companies commensurate with their capital ownership.

The current RS legislation has worse to offer. It has created a significant legal loophole that permits either the entity government or management to strip a publicly owned company of its assets for up to a month and a half after privatisation has taken place. Once an investor has acquired a majority stake in a company, he has to wait for the government to confirm formally the change of ownership. This need not take place for 45 days, thereby leaving the business vulnerable during this legal vacuum.¹⁰⁸

The RS government recently issued an order regulating the ownership rights of the investment funds that have amassed and used citizens' vouchers in the privatisation process.¹⁰⁹ The

regulation forbids voucher-based investment funds from appointing members to the boards of newly privatised companies in proportion to their share of a firm's ownership. Even though the law permits a voucher investor to acquire as much as 55 per cent of a company, such a majority stakeholder is now allowed to name only two members to the governing board of the company.¹¹⁰ Since most companies have boards of eight to ten members, this leaves the majority owner with a minority voice in running the firm. Coming on top of the law limiting cash investors in SMEs to a 30 per cent share in a company's ownership, this latest ruling might as well have been crafted with the express purpose of sabotaging the privatisation of state-owned enterprises in the RS, and leaving them as playthings of the regime. It will certainly give pause to any domestic or foreign investor who has been brave (or foolhardy) enough to contemplate taking a fling on RS privatisation. Although the privatisation legislation was developed under the close supervision of USAID and other agencies, it remains impossible to explain how and why the High Representative should have permitted such counterproductive laws to stand.

E. FURTHER PROBLEMS WITH PRIVATISATION

The large number of privatisation agencies is a waste of scarce resources and a source of inefficiency and corruption. The agencies are supposed to provide financial and logistical support to international experts and tender commissions, but can hardly do so, given their anaemic budgets and susceptibility to political interference. The RS privatisation agency appears to be both sorely under-funded and to lack qualified personnel.¹¹¹ This weakens further the position of the tender commissions.

Conflicts of interest exist between the processes of preparing independent tenders and making decisions to accept or reject bids. For example, in

¹⁰⁶ Opinions voiced during ICG interviews with RS-based businessmen, 4 May and 26 June 2001.

¹⁰⁷ ICG interview with a foreign privatisation adviser, 19 July 2001.

¹⁰⁸ Data obtained in ICG interviews with RS businessmen, 4 May 2001.

¹⁰⁹ See A. Omeragic, 'Kupili vise od 200 kompanija', *Oslobodjenje*, 17 June 2001 [on a Slovene-run trust's experiences in the RS and Federation].

¹¹⁰ 'Uredba o izmenama i dopunama uredbe o nacinu konstituisanja novih organa upravljanja i nacinu rada preduzeca u kojima je izvršena prodaja drzavnog kapitala', *Sluzbeni glasnik Republike Srpske*, Broj 35, 17 October 2000.

¹¹¹ ICG interview with high ranking foreign privatisation adviser, 3 July 2001.

the Federation two members of each privatisation agency are also members of the tender commission. In the RS, executives of enterprises also sit on the tender commissions.¹¹² This overlapping membership ensures conflicts of interest in both planning and implementing privatisation.

No appeals body yet exists to examine contested or dubious cases. This deficiency can defeat and/or retard the process. For example, four timber companies in Republika Srpska have not been privatised because an efficient mechanism does not exist to deal with the appeals and complaints of bidders and investors. In the case of the timber firms, an American company had sought to invest, but is now appealing the adverse privatisation decision before the RS courts.¹¹³ This is a long and tortuous process. Moreover, despite the fact that privatisation legislation in both entities allows for the sale of parts of enterprises, the entity governments and privatisation agencies have consistently sought to sell them as single units. This preference – amounting almost to dogma – reduces the number of would-be investors and delays privatisation.¹¹⁴ It also militates against the rescue of potentially healthy components of failing firms by spinning off those assets that retain value. Such deals require flexibility, imagination and acumen; but as matters stand, these qualities are discouraged, and the salvageable parts of dying companies are usually condemned to death as well.

F. THE ETHNO-POLITICS OF PRIVATISATION

Privatisation in Bosnia went badly wrong for a number of reasons. First, the very nature of Bosnia's post-Dayton system of divided government meant that each entity (or sub-entity, in the case of 'Heceg-Bosna') was free to pursue its own privatisation policies. Second, due to the interlocking directorates composed of ruling politicians and management, entity governments lacked incentives to push privatisation since whatever benefits it might confer in the long run

were offset by losses in power, perquisites, patronage and cash in the here and now. The short, two-year term between elections has exacerbated this tendency. Third, the international community – which could and should have played a more decisive and intelligent role – imposed an inappropriate model and then failed to ensure that even this was properly implemented.

In order to obstruct or circumvent privatisation – and to limit the damage it would do to vested interests – local governments dragged their feet, stripped assets, accorded preferential treatment to favoured buyers, and devised means to maintain their control over companies even after their privatisation. In addition, in creating privatisation packages, local politicians often scared off potential investors by insisting that an unreasonably large number of workers must be kept on the payroll.¹¹⁵

Political obstruction was and is most apparent in profitable, publicly owned companies enjoying monopolies or particularly favourable market positions and whose boards consist of government appointees. The power utilities (Elektroprivreda), tobacco factories, telecommunications firms, water companies (Vodoprivreda), and forestry commissions serve as sources of cash and patronage for the ruling parties and offer perches for colleagues currently 'resting' from the rigours of office. Given the huge revenues generated by such enterprises, it is not surprising that, following the November 2000 elections, the new entity governments should have moved quickly to install their loyalists on the governing boards.

The two highest profile cases of problematic privatisation are in western Herzegovina. Aluminium Mostar and Eronet illustrate what happens when the difficulties inherent to privatisation are exacerbated by local politicians' attempts to cling to their traditional control over economic resources in a highly polarised ethnic environment.

¹¹² ICG interview with a foreign privatisation adviser, 20 March 2001.

¹¹³ Ibid.

¹¹⁴ All legislation on privatisation in Bosnia can be obtained from the following websites: for the RS (www.rsprivatizacija.com) and for the Federation (www.apf.com.ba).

¹¹⁵ For example, Frutona, a Banja Luka bottling company, employs 300 people where 90 would suffice. Frutona currently has exclusive rights to bottle Pepsi-Cola products. By demanding that Frutona keep all 300 on its payroll, management ensures against the appearance of any serious bidder, including Pepsi. ICG interview with an international agency official, 4 May 2001.

1. Aluminium Mostar

One of the most controversial – and continuing – cases of political warfare over privatisation has centred on Aluminium Mostar (AM),¹¹⁶ a state-owned smelter and fabricator of aluminium that has been a focus of contention since 1993. Located on the southern outskirts of Mostar, the factory employed a multiethnic staff prior to the war. In 1993 the Croats seized control and expelled most non-Croats from the workforce. Since 1997, when AM resumed full-time operations, this highly profitable firm appears to have served as one of the financial mainstays of the HDZ parastate in Herzegovina.¹¹⁷

In 1997 the HDZ leadership engineered a murky and dubious co-capitalisation of the firm with TLM Sibenik from neighbouring Croatia.¹¹⁸ Following this co-capitalisation, neither AM nor TLM was able to state what percentage of the ownership the latter had acquired and what remained in public hands. To date no one in AM, TLM or the Bosnian HDZ has been able to elucidate. This co-capitalisation was followed by several other suspect deals involving AM, some of which appear to have been fronts for money laundering. The most curious is the scheme whereby AM purchases electricity from the Bosniak-controlled Elektroprivreda via a Berlin-based middleman, Debis DaimlerChrysler. No satisfactory answers have been offered as yet to why electricity must travel (at least on paper) from Mostar to Berlin before returning to Mostar.¹¹⁹

Passage by the Federation parliament of a privatisation law in 1998 did nothing to clarify the status of AM. The new law required each enterprise to distribute privatisation vouchers to its

pre-war employees. AM's HDZ-appointed management blatantly ignored the law, refusing to distribute shares to approximately 2,000 non-Croat, prewar employees, and apparently hoping by this means to confirm wartime ethnic cleansing. The AM director and sometime HDZ chieftain, Mijo Brajkovic, stated openly that the factory was Croat and would remain so.¹²⁰

After a year of intense pressure from the Bosniaks and the Americans, in spring 2000 U.S. envoy Richard Sklar persuaded the HDZ to permit an audit of AM to determine both the firm's value and ownership. The audit began in summer 2000. As of this writing, it has yet to be completed, although preliminary results have provoked new controversy.¹²¹ AM had a pre-war valuation of KM 1.4 billion. In 1997 Brajkovic's board assessed AM's worth to be just KM 310 million. According to the Federation government, the auditors appear ready to accept this lesser figure. A member of the Federation government has expressed deep disquiet to ICG over these preliminary results since they appear to represent a 75 per cent devaluation of the company. Meanwhile, although the Federation government recently appointed a new board of directors for AM, the HDZ has refused to allow it to take control of the company.

Although it is clear that AM suffered damage during the war, inherited outdated equipment and technology, and lost numerous domestic and foreign customers – all of which will have reduced its value – there is an enormous discrepancy between what the Federation government thinks AM should be worth and what its management (and, it seems, the auditors) claim its value to be. Federation suspicions on this account are reinforced by the fact that the auditors have apparently accepted the legitimacy of the laws of the wartime 'Herceg-Bosna'. These served to legalise the ethnic cleansing of AM, as well as to justify subsequent decisions made by Brajkovic's board. The Federation government fears that a dangerous precedent would be set if 'Herceg-Bosna' laws were accepted as a valid basis for

¹¹⁶ See ICG report No 90, *Reunifying Mostar: Opportunities for Progress*, 19 April 2000, which discusses the problems of Aluminium Mostar at some length.

¹¹⁷ 'High Representative appoints provisional administrator for Hercegovacka Banka', OHR press release, 6 April 2001.

¹¹⁸ 'Novac za obnovu Hrvatske završio u Mostaru', *Tjednik*, 6, 21 July 1998.

¹¹⁹ Dragan Covica and Velenitinn Marincic, 'Novi organizacijski koncepti u tranzicijskim gospodarstvima', *Znanstveni glasnik, Sveuciliste u Mostaru*, No 9, 2000. An alternative explanation is that the Bosniaks were simply unwilling to sell electricity to the Croats, thereby allowing a middleman to profit from their irreconcilable differences. ICG interview with an OHR official, 24 July 2001.

¹²⁰ Mijo Brajkovic, interview on Croat TV Oscar, 28 May 2001.

¹²¹ Ivica Milivoncic, 'Federalni udar na ekonomsku snagu hrvatskog naroda u BiH', *Slobodna Dalmacija*, 13 June 2001.

capital transformation, since this would amount to endorsing asset stripping, the theft of state capital, and ethnic discrimination in employment. The Federation government also continues to dispute the transformation of some KM 100 million in state assets into private shareholdings through the ethnically exclusive distribution of shares.¹²² As the audit drags on, the HDZ continues to divert company revenues, block privatisation, and perpetuate ethnic cleansing by maintaining a 'Croats only' policy on jobs. This state of affairs raises questions, at the very least, about the sincerity of HDZ co-operation with the auditors and the seriousness of the international community in pursuing the issue

2. Eronet

The telecoms firm Eronet offers another instance of local politicians working actively to frustrate privatisation in order to preserve their control over company revenues. Eronet was founded in 1996 as a joint venture between HPT Mostar (51 per cent), the publicly owned post and telephone provider of 'Herceg-Bosna', and Croatia's Hrvatske Telekomunikacije (49 per cent).¹²³ In 1998, after the passage of the law on privatisation, HPT sold its majority stake, without a public tender, to three companies (Hercegovina Osiguranje, Croherc and TGP Alpina Komerc), some of which have been mentioned as key sources of financing for the HDZ parastate in Herzegovina.¹²⁴

Hrvatske Telekomunikacije (HT) disputed the sale, claiming violation of a contract clause that forbade the sale of shares without its consent. HT sued. In spite of the high profile of the case, the Federation Supreme Court took seven months merely to pronounce that the sale was procedurally in order, a ruling later upheld by the state Constitutional Court.¹²⁵ Interestingly, the rulings of both the Federation Supreme Court and the Constitutional Court were confined to procedural questions regarding the re-registration of the company. They did not address whether a breach

of contract had occurred and whether the Federation privatisation law had been violated.¹²⁶ The two courts thus ducked the main issue, which was that the sale of HPT's shares in Eronet seems to have been a blatant violation of the letter and spirit of the Federation law on privatisation. Because HPT, with 51 per cent, was the majority shareowner, Eronet was also – both *de facto* and *de jure* – publicly owned, which would appear to make it subject to the Federation privatisation law. That law states explicitly that publicly owned companies can only be privatised through a public tender.¹²⁷ No such tender was issued in this case.¹²⁸ The mystery surrounding the interpretation of the privatisation law by the courts will continue to deter potential investors, who cannot now be certain if the rule of law on which they depend will be enforced. Demystification of the Eronet privatisation would offer the international community an opportunity to demonstrate that attempts to steal public companies through dodgy privatisations will not be tolerated.

¹²² ICG interview with a member of the Federation government, 15 June 2001.

¹²³ Higher Court Mostar decision U/I-711/96, Registration roll No. 1-8621, 9 August 1996.

¹²⁴ 'Bankarski rat hrvatskih politicko-poslovnih lobija u BiH', *Nacional*, 18 November 1998.

¹²⁵ BiH Constitutional Court Decision U-13/00, 29 September 2000.

¹²⁶ Based on court documents provided to ICG: Federation Supreme Court Decision Gz-41/99, 12 April 2000; and BiH Constitutional Court Decision U-13/00, 29 September 2000.

¹²⁷ 'Prodaja dijela HPT Mostar proglašena neustavnom', *Dnevni avaz*, 13 June 2001.

¹²⁸ A. Omeragic, 'Epilog, najvjerojatnije, pred sudom: nakon ponistenja prodaje Eroneta', *Oslobodjenje*, 13 June 2001.

IV. REAL IMPROVEMENTS IN THE FINANCIAL SECTOR

Of all the areas where economic reform has been mooted or attempted, the most significant progress has been made in the financial sector. This relative success has come as a result of the effective cooperation (otherwise rare in Bosnia) of a range of international agencies (including USAID, the U.S. Treasury Department, the IMF, the World Bank, the European Bank for Reconstruction and Development, and OHR), participating in the International Advisory Group (IAG). Established to tackle the job of eliminating the payments' bureaus, the IAG later spawned groups to deal with privatisation and taxation issues as well.

In the early stages of Bosnia's post-war reconstruction, the international community was very keen to promote the growth of small and medium-sized private enterprises. Efforts to promote this growth included high profile business loan programs by a number of international agencies -- including EBRD and USAID -- and numerous other smaller donors. Unfortunately, such programs -- although providing much needed capital infusions -- proved premature in the absence of a receptive and business-friendly regulatory environment. So too, the local Bosnian banks on which the international community relied heavily for loan disbursement and repayment were structurally and managerially incapable of servicing these programs, even though much international advice was also on offer.

The first successful step, however, was the establishment in 1997 of the Central Bank of Bosnia and Herzegovina, which, in 1998, introduced a stable and desirable common currency, the *Konvertibilna marka* (KM), pegged to the Deutsche mark, that rapidly won acceptance throughout Bosnia.¹²⁹ The second step was

¹²⁹ Bosnian dinars, Croatian kunas and Yugoslav dinars had circulated previously in the territories controlled by the constituent nations' respective armies. The only common currency was the German mark. Confidence in the KM has been boosted by rising Central Bank reserves. These have increased from KM 135 million in 1998 to over KM 1.2 billion in July 2001. Bank deposits (mainly in the foreign-owned banks) nearly quadrupled in the first half of 2001. ICG correspondence with World Bank official, 27 July 2001. See also, 'Early Warning System in

abolition of the socialist-era payments' bureaus¹³⁰ - the fruit of a project sponsored by USAID and implemented in close collaboration with the IMF, World Bank and OHR. Their elimination put Bosnia in the unaccustomed position of leading the rest of the former Yugoslavia and removed the biggest obstacle to the development of a healthy banking sector while making fiscal management in banks and businesses easier.¹³¹ Although local politicians, fearing transparency and loss of control over illicit revenue flows, resisted the efforts of the international community to eliminate the payments' bureaus, coordinated action overcame their opposition. The High Representative's December 2000 decision to shut down the bureaus in the RS signified the successful end of a well conceived, two-year process.¹³² On the other hand, the increased prominence of Hercegovacka Banka in Croat-majority areas of the Federation and of Zepher Komerc Banka in the RS may signify that their leaders are seeking to re-establish parallel financial systems in order to maintain control over revenue flows.¹³³

Bosnia and Herzegovina', *UNDP Quarterly Report*, October-December 2000.

The Dayton Peace Accords provided for the creation of a central bank. For the positive, stabilising effects of the KM and other general information on the Bank, see the websites of the Central Bank of BiH (www.cbbh.gov.ba) and of OHR (www.ohr.int).

¹³⁰ Payments' bureaus were the centralised, state-controlled institutions in charge of all financial flows in the country. Stringent regulations required businesses, banks, government bodies, et al, to make daily cash deposits, thereby monopolising cash, reducing liquidity and severely limiting business operations. In addition, this non-transparent system for controlling financial flows was easy to abuse by the party (or, later, parties) in power, enabling them to siphon off funds for various illegitimate purposes.

¹³¹ Businesses are facing cash flow problems in the continuing transition period. Although banks and post offices are now collecting taxes and other giro payments, it often takes them twelve to thirteen days to process transactions, whereas the old payments' bureaus managed to do so in 48 hours. Some banks are alleged to have been holding on to funds in order to reap extra profits. ICG interview with Bosnian businessman, 23 February 2001.

¹³² The RS government appears not to have believed that the international community would go through with the abolition of the bureaus, and was unready when the change took effect in January 2001. The result was substantial losses in tax and other revenue collections. ICG interviews with RS business people, June 2001.

¹³³ Hercegovacka Banka was raided and taken over by an OHR-appointed administrator in April because of its suspected use for illegal transfers.

The reform of the banking sector laws and regulations brought several reputable banks to Bosnia. Raiffeisen Bank, Volksbank and Zagrebacka Banka all voted with their pocket books and either invested in existing banks or founded new ones. This has significantly boosted public confidence in the banking sector, while improving service levels and providing real competition for Bosnia's banks. The Turkish Ziraat Bank has also opened offices in the Federation, and several other foreign banks have expressed interest in entering the market.¹³⁴ Besides bringing cash dispensers and MasterCards to Bosnia, financial sector reforms have resulted in an influx of private and commercial deposits in the foreign banks and have helped push down interest rates. From their previously prohibitive levels of 25 to 30 per cent per annum, rates have now fallen to as low as 11 per cent, and may fall further.¹³⁵ Along with lower interest rates, banks are for the first time offering home and auto loans to their customers,¹³⁶ as well as major credit cards. There can be no doubt that, from a purely commercial perspective, the financial sector reforms have had a positive impact.

Since reforms began, the state-owned banking sector has been reduced significantly in the Federation. Currently only 30 per cent of Federation banks are state-owned, as compared to 90 per cent in RS.¹³⁷ Before 1996, there were 55 banks in the Federation, most insolvent and state-owned. Since then 20 banks have closed, reducing the total to 35.¹³⁸ Given the size of the Federation's population and economy, further privatisation and liquidation of both state-owned

and private banks can be expected to reduce the number of institutions to approximately ten.¹³⁹ Nonetheless, the privatisation of state-owned banks has moved more slowly than the international community has desired, especially in Republika Srpska, and pressure has been exerted on the entity governments to set deadlines for their privatisation or liquidation. The deadline has now been extended – for the third time – to 31 December 2001.¹⁴⁰ Because the Federation government is unable to resolve the sector's problems on its own, the World Bank is considering the creation of a holding company to help restructure insolvent state-owned banks.¹⁴¹

The Federation Deposit Insurance Agency, established in February 2001 with the help of GTZ, USAID, and the U.S. Treasury, is another positive step. Its purpose is to safeguard exiting depositors, attract new ones, and build banking confidence. The requirements for membership are stringent. A bank must demonstrate capital liquidity, good corporate governance, quality of assets, continuous profitability, application of international accounting standards, and secure reserves. So far, only four banks (all foreign-owned and based in the Federation) have met these tests, thereby guaranteeing their depositors for up to KM 5,000. Republika Srpska has only recently passed a law on deposit insurance, which has yet to be implemented. Therefore, no RS bank other than Raiffeisen (which is registered in the Federation) provides deposit insurance.

A. THE ANAEMIC RS BANKING SECTOR

Effective financial sector reform has thus far been limited almost exclusively to the Federation. Political obstruction of banking law reform, reinforced by the parlous state of the economy, has left the Serb entity far behind the Federation. Although banking legislation has been harmonised to a large extent between the two, implementation in the RS has lagged.

The value of Federation bank assets is some KM 3.256 billion, whereas RS banks dispose of just

¹³⁴ The Kuwait Investment Agency plans to invest KM 7.5 million in the Federation's BOR Banka, while the CIMC Corporation of the U.S. has bought 51 per cent of Investicijska Banka for KM 11.5 million. 'Amerikanci i Kuvajcani ulazu 19 miliona KM', *Dnevni avaz*, 11 July 2001.

¹³⁵ The Federation government has lately announced further reductions in interest rates for commercial and personal loans. BiHTV, *Dnevnik* 3, 29 May 2001.

¹³⁶ An excellent pilot home loan project was launched by USAID at the end of 2000. Loans were first offered to Bosnian nationals working in international organisations and embassies, but the scheme is now being expanded to embrace the general public through commercial banks. ICG interview with USAID official, 2 March 2001.

¹³⁷ ICG interview with banking adviser, 4 April 2001.

¹³⁸ *Ibid.*

¹³⁹ *Ibid.*

¹⁴⁰ 'Produzen rok za privatizaciju banaka do kraja godine', *Dnevni avaz*, 6 July 2001.

¹⁴¹ Reuters, 8 June 2001.

KM 1.102 billion.¹⁴² In simpler terms, Federation banks control approximately 75 per cent of the country's banking assets, and banks in RS only 25 per cent. In the last quarter of 2000, commercial bank assets grew in the Federation by 2.6 per cent, but in RS by only 1 per cent.¹⁴³ This translates into annual asset growth rates of 10 per cent in the Federation and 4 per cent in the RS. Should this trend continue, within three years the assets of the Federation's commercial banks will rise to 80 per cent of the whole. Moreover, of approximately KM 2.04 billion in bank deposits in Bosnia, Federation banks hold 86 per cent and RS banks just 14 per cent. As for personal deposits, Federation institutions hold 91.5 per cent of the KM 503 million on deposit.¹⁴⁴ These figures are alarming in view of the fact that one third of Bosnia's population lives in the RS.

Not only is Republika Srpska falling far behind the Federation, but its outlook in the medium and long term is dire.¹⁴⁵ The anaemic state of the RS financial sector will preclude economic growth. Less and less money will be available for loans, thus starving firms of working capital and compromising systemic liquidity. Overall economic activity will be sluggish at best, thereby exacerbating its relative impoverishment. As the downward spiral continues, existing revenue shortfalls, unemployment and social distress will mount ever higher. In turn, the already noticeable trend towards economic migration from the RS to the Federation will become more prominent.

The RS government recently annulled a regulation requiring banks based in the Federation to make an equal capital investment in the entity if they wish to set up shop there. Soon after the removal of this provision, Raiffeisen Bank opened a branch in Banja Luka, having acquired a licence in just two months. It is too early to tell what the impact on

the RS economy will be of the arrival of its first international and non-politicised bank, but this development does seem a step forward.

Another significant difference in banking culture between the RS and the Federation lies in the ferreting out of bank fraud. Unlike the Federation, where the implementation of new banking laws has led to high profile revelations and prosecutions, no such cases have been brought by the RS authorities.¹⁴⁶ This reflects the highly politicised state of RS banking, as well as politicians' fears that any cleansing of the banking stables will spark social unrest. Yet without such a clean up, the large number of illiquid state-owned banks will continue to inhibit growth and deter investors.

RS governments have thus far been more concerned with maintaining the status quo – whether social peace or party political control over financial flows – than with reforming, culling and reviving the banking sector. In one instance, rather than consolidating two sick, state-owned banks – one with 200 and the other with 667 employees – the RS banking agency left the two problem banks intact, as a merger would have provided no more than 200 real jobs.¹⁴⁷

Such attempts as have been made to sell off domestic banks in the RS have largely failed.¹⁴⁸ The principal foreign banks now represented in RS – Raiffeisen, Zagrebacka Banka and the Medium Enterprise Bank (MEB) – are all based in the Federation. If the banking sector is to be revived and some entity-based banks preserved, the RS government will have to take urgent steps to implement banking laws and attract potential investors.¹⁴⁹ This will mean following in the footsteps of the Federation by liquidating and consolidating unhealthy banks. Yet to do so the RS banking agency must either free itself or be

¹⁴² 'Early Warning System in Bosnia and Herzegovina', *UNDP Quarterly Report*, October-December 2000.

¹⁴³ *Ibid*, p 8.

¹⁴⁴ Data obtained during ICG interview with Agency for Banking, 4 April 2001.

¹⁴⁵ According to recent press accounts, the RS banking sector is largely illiquid and unable to support the economy. Fear of the political and social consequences should they go bust keeps them artificially afloat. 'Hoce li Dodik zamijeniti Ivanica ili ce PDP formirati skupstinsku vecinu sa sadasnjom opozicijom?!', *Slobodna Bosna*, 7 June 2001.

¹⁴⁶ ICG interview with the RS Chief Public Prosecutor, 4 May 2001.

¹⁴⁷ Data obtained during ICG interview with a foreign banking adviser, 3 May 2001.

¹⁴⁸ Some investors from Italy and Slovenia have shown interest, but nothing has yet come to fruition. ICG interview with RS Banking Agency, 11 July 2001.

¹⁴⁹ The EBRD has indicated its willingness to commit funds to help the RS government revive a number of state-owned banks in the course of a three to five-year program. The aim would be to create saleable banks. EBRD, 'Strategy for BiH', 2001.

freed from undue political influences. Unlike its counterpart in the Federation, the RS agency is not independently funded by licensing fees that grow with the size of the sector. Rather, it depends on subsidies and cronyism. This was obvious from the recent dismissal by the government of five of the agency's senior staff, the effect of which was to diminish even further its already low institutional capacity.¹⁵⁰ The Federation parliament, on the other hand, recently raised a different issue, claiming that its agency has too much independence and too little accountability.¹⁵¹

B. THE IRRESISTIBLE RISE OF ZEPTER KOMERC BANKA

The continuing and pervasive influence of Republika Srpska's wartime elite makes close supervision and disinterested regulation of the banking sector extremely problematic. The example of Zepter Komerc Banka is instructive. Founded by Zepter International of Basel in 1999, shortly after NATO's air war against Yugoslavia ended and when there was no obvious economic reason to open a new bank in the RS, Zepter was reputedly capitalised at KM 40 million.¹⁵² It is unclear where the money came from, or what the bank was intended to do with it. But as the bank's website notes, it quickly grew 'to rank among the most successful banks in Bosnia and Herzegovina.'¹⁵³ Rumours swept the Banja Luka

business community that Zepter had been set up as a front to launder money or to take part in the arms trade.¹⁵⁴ The current RS Minister of Finance, Milenko Vracar, was initially the director of the new bank.¹⁵⁵

Since taking over the Finance Ministry, Vracar has reportedly encouraged numerous state agencies to move their accounts from the wholly state-owned Razvojna Banka to Zepter Banka, including those of the Bosnian Serb Army (VRS).¹⁵⁶ Some state companies also appear to have found it advantageous to transfer their accounts to Zepter, either under pressure or because they know what is good for them politically. Other observers, however, attribute the bank's success to its relative efficiency in processing payments as compared to its competitors. Whatever the reasons, Zepter Banka has been able within a relatively short period to take control of approximately 10 per cent of the total assets in the RS banking system.¹⁵⁷

Vracar recently took steps to speed up and enforce the collection of taxes in the RS. His ministry blocked the bank accounts of all companies owing taxes,¹⁵⁸ thereby collecting KM 50 million at a stroke. This amounted to some 60 per cent of their outstanding obligations. He allowed the remainder

¹⁵⁰ ICG interview with a foreign bank adviser, 3 May 2001.

¹⁵¹ At its July 17 session, the Federation House of Representatives voted not to accept the annual report of the Federation Banking Agency because it failed adequately to address the SAB, Komercijalna Banka Tuzla, and Hercegovacka Banka scandals. The fact that agency officials enjoy legal immunity was seen by some MPs as *carte blanche* for corruption and non-accountability. 'Vlada jedinstvena u odluci da isplati zaostale penzije i invalidnine', *Oslobodjenje*, 18 July 2001; and 'Ponovo povucene izmjene i dopune Zakona o stanovima', *Dnevni avaz*, 18 July 2001.

¹⁵² For a survey of the RS economy at the time, see ICG Balkans Report No 71, *Republika Srpska in the Post-Kosovo Era: Collateral Damage and Transformation*, 5 July 1999. Zepter Komerc Banka has declined to confirm the capitalisation figure provided here, despite claiming on its website that such information is available to the public.

¹⁵³ See www.zepterkomercbanka.com. By 30 June 2000, Zepter ranked sixth among the 18 RS banks in both assets (KM 32.4 million) and capital (KM 11.58 million), but third in profitability (KM 427,000). Banking Agency of

Republika Srpska, 'Report on Conditions of RS Banking System in the Year 2000', March 2001.

¹⁵⁴ ICG interviews with RS businessmen in 2000 and 2001.

¹⁵⁵ Vracar is not a member of the SDS, but of Ivanic's PDP. According to one well-informed international source in Banja Luka, Vracar has delegated supervision of RS banking to a deputy in order to insulate himself from charges of conflict of interest. Other informants take it for granted that Vracar still exercises considerable influence in the councils of Zepter Banka. ICG interviews, 29 June 2001.

¹⁵⁶ Zepter officials confirmed that the VRS keeps its monies with the bank. ICG interview with Zepter Banka, 11 July 2001. In 2000 the VRS share of the entity budget amounted to KM 88.6 million. Rebalans budzeta Republike Srpske, document provided to ICG, 26 June 2001.

¹⁵⁷ ICG interview with RS Banking Agency, 11 July 2001. This means that Zepter's share of RS banking assets apparently doubled between June 2000 and June 2001.

¹⁵⁸ 'RS Government Financial Police to block accounts of delinquent taxpayers', *BHPress* (www.bhpress.ba), 16 February 2001. A source in the RS Ministry of Finance told ICG that at least 40 companies had their accounts blocked because of unpaid taxes. The exact number is allegedly known only to Minister Vracar. ICG interview, 11 July 2001.

to be paid in instalments.¹⁵⁹ Companies with blocked accounts had to open new accounts in other banks to stay in business. Many appear to have seen the wisdom of choosing Zepter Banka. RS businessmen have told ICG that some companies' accounts, already lodged in Zepter, were not blocked, regardless of whether or not those companies owed back taxes.¹⁶⁰

It seems that the rise of Zepter Banka has been assisted in other ways as well. Agroprom Banka of Banja Luka has alleged that its former director – none other than Milenko Vracar – provided soft loans which clients were then encouraged to take their time in repaying. The suggestion is that Vracar was aiming to reduce Agroprom's liquidity – and value – in the run up to its scheduled privatisation. The fact that the RS privatisation agency has recently annulled, without explanation, the tender offering 33 per cent of the shares in Agroprom Banka has led to speculation that Vracar is still endeavouring, on behalf of Zepter Banka, to beat down the eventual sale price of Agroprom.¹⁶¹ Both Agroprom and businessmen have told ICG that they interpret Vracar's recent decisions and policies as attempts to reduce competition in the banking sector and to route a significant portion of RS financial flows through Zepter Banka.¹⁶² Such a stratagem, if true, would mean that RS politicians were doing what the HDZ has done with Hercegovacka Banka, and recreating, in effect, a politically controllable payments' bureau.¹⁶³ Lack

of transparency in the RS makes this information and these deductions impossible to confirm. Yet there can be no doubt that Zepter Banka is acquiring an important and favoured role in the RS economy.

C. LESSONS LEARNED IN THE FEDERATION

In contrast to the enfeebled and opaque RS banking sector, the far stronger Federation system has experienced substantial turbulence, resulting in seven bankruptcies, three liquidations, the privatisation of several state-owned banks (with more to come), and four major bank fraud cases. All provided valuable lessons on how to improve a banking system. It was largely as a result of the government's application of its new banking laws that the two Austrian banks, Raiffeissen and Volksbank, were lured to the Federation. The partially Italian-owned Zagrebacka Banka later bought Komercijalna Banka Tuzla and Sarajevo's Universal Banka. The Islamic Development Bank invested U.S.\$60 million in Bosna Bank International to support the Bosnian economy and develop regional ties.¹⁶⁴ Slovenia's Ljubljanska Banka now owns a majority of Commerce Bank (the former Sahinpasic Bank). Raiffeissen bought both Market Banka and Postanska Banka, thus effectively acquiring 10 per cent of the Federation market. As a result of these purchases, foreign banks now control 40 per cent of Federation bank assets.

The accumulated experience of the Federation banking agency and of the incoming foreign bankers and advisers provided by USAID has meant that valuable lessons on remaking a banking sector have been taught and learned. This process has been somewhat haphazard, but the effect has been to improve banking in Bosnia beyond recognition.

D. FIGHTING BANK FRAUD

The first bank fraud case in Bosnia to come to light involved malfeasance at the very top of the system. In 1996 and 1997 officials of the subsequently

¹⁵⁹ ICG interview with economic advisers to RS government, 4 May 2001.

¹⁶⁰ ICG has been unable to confirm this assertion with the RS Ministry of Finance. Nor were Zepter Banka officials willing to discuss the matter. However, RS businessmen interviewed by ICG in June and July 2001 were certain that Zepter customers were spared.

¹⁶¹ Minister Vracar's continued influence in Zepter Banka and its increasing significance in the RS financial sector have been noted in the local press. 'Zasto Republika Srpska postaje filijala Cepter kompanije?', *Nezavisne novine*, 21 February 2001; 'Nule Milenka Vracara', *Nezavisne novine revija*, 23 February 2001.

¹⁶² Companies were reportedly 'encouraged' to open accounts with Zepter Banka. According to an ICG source in Banja Luka who prefers to remain anonymous, some 70 companies and the RS Ministry of Defence opened new accounts with Zepter. ICG interview with RS businessmen, Banja Luka, 4 May 2001, and Sarajevo, 4 June 2001.

¹⁶³ For detailed description and analysis, see ICG Balkans Reports No 106, *Turning Strife to Advantage: A Blueprint to Integrate the Croats in Bosnia and Herzegovina*, 15

March 2001 and No 90, *Reunifying Mostar: Opportunities for Progress*, 19 April 2000.

¹⁶⁴ 'Osnivacki kapital \$60 miliona', *Dnevni avaz*, 24 May 2001.

liquidated National Bank of Bosnia and Herzegovina transferred all the country's foreign exchange reserves from accounts held in Deutsche Bank (the sixth-largest bank in the world) to the small and shady Promdei Bank of Zagreb (owned by the since assassinated Ibrahim Dedic). Allegedly motivated by Promdei's offer of higher interest rates – which apparently earned the National Bank DM 1.6 million in the short run – the transfers resulted in a loss to the Federation of DM 13.6 million when Promdei went bust in 1998.¹⁶⁵

In the second high profile case, SAB Banka went under in 1998 due to misuse of loans and credits. The bank's executives had made loans to their business partners and cronies, most of whom never repaid. The principal debtor, would-be tycoon Alemko Nuhanovic, owed the bank KM 6.85 million when it folded. He was later acquitted of criminal charges of bank fraud in circumstances that, at the very least, raised suspicions of a fix by the then ruling Party of Democratic Action (SDA). The Federation Supreme Court has since referred his case back to a civil court to determine how his debt might be repaid.¹⁶⁶ In the three years that have since elapsed, none of the assets of Nuhanovic's empire have been seized to pay off his debt.¹⁶⁷

The SAB Banka case highlighted the inadequate understanding of bank fraud then prevailing in Bosnia, as well as gaps in the law. The former was to be remedied to a substantial extent, but the

seizure or sequestration of company and personal assets remains virtually impossible, even when there is reason to believe that such assets have been acquired by illegal means. On the other hand, the system of bank liquidation that disadvantaged both smaller creditors and the bank itself -- placing no premium on saving what could be saved and benefiting only the court-appointed liquidators as they did their highly paid and interminable work -- has been reformed thanks to the SAB Banka experience.

When a court-appointed expert was placed in charge of liquidating SAB bank in 1998, the Federation Banking Agency (FBA) had only limited authority to licence or regulate banks. But the SAB liquidation experience permitted the agency to win the exclusive right to take over, administer temporarily and, if need be, to liquidate any bank. This new power had a positive outcome in the case of Komercijalna Banka in Tuzla. That bank was taken over in 2000 and restored to health during a six-month, labour-intensive process that required the full-time commitment of two-thirds of the FBA's staff. As a result of its successful transformation, Zagrebacka Banka bought Komercijalna Banka's assets and 90 per cent of its deposits.¹⁶⁸

In a third major case that unfolded in 2000 – BH Banka – the director, Mirsad Delimustafic, allegedly misused deposits, some of which belonged to foreign embassies and international organisations based in Sarajevo, by providing loans to finance companies owned by relatives and their business associates. Alija Delimustafic, the head of the family empire, was arrested for misuse of office. He was released after four months by a decision of the Federation Supreme Court that there were insufficient grounds to hold him any longer.¹⁶⁹ He has since taken up residence in

¹⁶⁵ Three individuals are currently on trial at the Sarajevo Canton Court for the DM 13.6 million loss: former Bank Governor Kasim Omicevic, Vice Governor Enver Backovic and Executive Director of the Foreign Exchange Department Zuhdija Fetahovic. To make good the loss sustained by these dubious transfers, Bosniak majority cantons were assessed KM 23 per capita of population and Croat majority cantons KM 1.33 per capita, while DM 3 million was taken from the Federation budget. *Vecernje novine*, 6 September 1999.

¹⁶⁶ The case against Nuhanovic has been recently postponed because witnesses did not appear at a court hearing. 'Odgodjeno sudjenje Alemku Nuhanovicu', *Oslobodjenje*, 24 May 2001.

¹⁶⁷ Nuhanovic's hotel in Sarajevo regularly shelters would-be migrants and asylum-seekers on their way to Western Europe. He is alleged, in addition, to have more direct links to the trafficking trade through Bosnia. 'Bosnia's Corrupt Elite Grow Fat on Human Cargo', *The Observer*, 27 January 2001.

¹⁶⁸ ICG interview with a foreign bank adviser, 28 March 2001.

¹⁶⁹ The Federation Supreme Court dismissed a kidnapping charge brought against Alija Delimustafic by a German court and rejected prosecution arguments that he might suborn possible witnesses in both criminal cases, deciding there were insufficient grounds to keep him in jail. However, the Federation Interior Ministry later issued an arrest warrant for Delimustafic on the very kidnapping charges the Federation Supreme Court had dismissed. 'Raspisana potjernica za Alijom Delimustaficem', *Dnevni avaz*, 26 May 2001.

Republika Srpska, out of reach of Federation police. For his part, Mirsad Delimustafic, now rumoured to be in hiding in Montenegro, is being tried *in absentia* for his profligate loans to family-owned firms.¹⁷⁰ BH Bank is currently being liquidated by the FBA. As in the case of Alemko Nuhanovic and SAB Bank, however, no Delimustafic family assets have been seized, and there appears to have been high level political intervention on the family's behalf.

The case of BH Banka showed that political interference has not gone away and that the Federation Banking Agency still faces institutional limitations in trying to save, investigate or liquidate a bank. Its auditors encountered intense political pressure aimed at slowing down the investigation and covering up BH Banka's alleged role in laundering money and financing the SDA. A prominent international firm of auditors had to be hired to restore the bank's computer system after it had been destroyed by the bank's management. Despite the FBA's weaknesses in manpower and expertise – and its vulnerability to political pressures – the transfer of authority for liquidations from the courts to the agency has made a difference, and has enabled the return of deposits of up to KM 5,000 to small depositors.

The most recent, dramatic and in places violent instance of intervention in the banking sphere occurred on 6 April in Mostar and other Croat-controlled towns when the OHR and FBA sought to seize control of Hercegovacka Banka's headquarters and branches in order to carry out an audit. Suspected of both laundering funds and financing the operations of the HDZ parastate, Hercegovacka Banka was taken over by a joint team of specially engaged U.S. auditors and FBA officials. An American administrator was placed in temporary charge of the bank, all its accounts were frozen, and work commenced on analysing its books and records. However, the effective resistance mounted in some localities by rioters organised by the HDZ to the imperfectly prepared and policed raids testified to the risks involved in challenging the vested interests of one of Bosnia's

established mafias, as well as to the magnitude of such an undertaking.¹⁷¹

Unravelling the skein of accounts, transfers and credits will take many months, especially as only a part of the bank's computer records were salvaged. In the meantime, a large proportion of the bank's customers will be deprived of funds, pensioners will remain unpaid, and local anger over the seeming high-handedness of the international community will rise. Given these present and future complications – and the revelation on the day that the OHR and FBA, their subcontractors and their SFOR protectors had so much trouble working effectively together – it may well be that none of these organisations will have the stomach for another such confrontation.

E. WHAT REMAINS TO BE DONE

*Money laundering is the process of concealing the illegal source of the proceeds of criminal activity in order to put them into legitimate financial commerce. The ability of criminals to assemble and legitimise wealth has the potential to undermine democratic institutions and to pervert economic systems. Illegally derived proceeds permit criminals to develop political and economic power at the expense of honest citizens and legitimate businesses. Countries that have not dealt adequately with the issue of money laundering have found that their officials are subject to corruption and that legitimate international investment dries up.*¹⁷²

It is easy to launder money in Bosnia. Money laundering in the Federation is not a crime but an administrative offence,¹⁷³ and typically fines are the only penalty. This serves usually to exempt the party actually laundering money from any repercussions. The Federation Finance Police are in charge of enforcing the money laundering

¹⁷⁰ 'Pocelo sudjenje u odsustvu Mirsadu Delimustaficu', *Dnevni avaz*, 23 May 2001.

¹⁷¹ See ICG Balkans Report No 110, *No Early Exit: NATO's Continuing Challenge in Bosnia*, 22 May 2001.

¹⁷² 'Discovering the Money Trail: Money Laundering Prevention and Enforcement in BiH', Report prepared for OHR by Claire Daams and Stanley Morris, May 2000, p. 4.

¹⁷³ Zakon o sprjecavanju pranja novca, *Sluzbeni list Federacije BiH*, No. 8, 15 March 2000.

law.¹⁷⁴ In Republika Srpska, money laundering has been defined as a crime,¹⁷⁵ but no specific agency has been tasked with monitoring the financial system, and thus there have been no reported cases of prosecutions.

Experience in the Federation shows that the most common way of legalising ill-gotten gains is through purchasing real estate and investing in companies. In addition, individuals of Chinese and Yugoslav nationality have been known to deposit large sums of untraceable cash.¹⁷⁶

The near impossibility of seizing assets in fraud cases hinders efforts to deter and punish fraud, tax evasion, money laundering, and organised crime. If reforms of the banking sector and measures to combat fraud are to be successful, this problem must be solved. For example, the law on enterprises allows asset seizure to repay an outstanding bank loan. However, to seize assets, the debtor must be formally recorded as the owner of the assets. Registering a family member as the owner is an easy, effective and frequently used means of circumventing this legal requirement, thereby preventing timely seizures or legal proceedings against real owners.¹⁷⁷ As long as Bosnian law does not recognise the principle of 'constructive ownership', according to which a person effectively and continuously exercising control over certain assets is legally liable in a court of law, it will remain fairly easy to protect assets from seizure and to avoid legal liability in fraud cases. Changes must therefore be made so

that the law in both entities establishes criminal liability in bank fraud cases and allows the seizure of personal assets in accordance with European standards.¹⁷⁸

The current obstacles to repossession of assets in a liquidation process also point to the urgent need for improvements in the bankruptcy laws. The courts are in charge of repossessing assets, and the process is often long. During this period owners frequently strip all assets of value from the property or firm in question. At present the court is mandated to set a sale price for assets and is permitted an unreasonably long period in which to sell them. The price set often fails to reflect the real market value of the assets. During the privatisation of UPI Banka in 1999 the bank's assets were scheduled for sale within five years at a price determined by the court. But the price was set so high that no sale has proved possible. Such an arrangement seriously impedes the issuance of credits and loans, encourages rises in interest rates, fails to deter bank fraud, and slows down economic activity.

In addition, the facility with which borrowers can take out and repay loans – and the security with which lenders can make and recoup them – must be enhanced by introducing a mortgage-type system that will permit easier disbursements of credits and loans. Yet to implement this law effectively, a system to register collateral is urgently required. The establishment of such a system is complicated, however, by difficulties in entering and proving ownership titles in land registers. GTZ, in close collaboration with local experts, has drafted a land registry law and has a project in hand to improve the cadastral books. Yet, at the current rate of progress, these reforms will require many years to implement. This process must be speeded up. Provision for leasing also forms part of a modern banking structure.

¹⁷⁴ Since 2000, the Federation Finance Police have checked out more than 500 tips relating to suspicious transactions totalling KM 64.9 million, most of which involved cases of tax evasion. 'Zbog pranja novca podnesena 41 prijava', *Dnevni avaz*, 16 February 2001.

¹⁷⁵ The RS Criminal Code in force since October 2000 defines money laundering as a criminal offence.

¹⁷⁶ 'Zbog pranja novca podnesena 41 prijava', *Dnevni avaz*, 16 February 2001.

¹⁷⁷ The aforementioned Alemko Nuhanovic, the Sarajevo businessman who helped bring down SAB Banka, attempted unsuccessfully to found a bank of his own in 1999 by registering an elderly relative as its owner. The director of the executive board was to be Ramiz Delalic-Celo, a well known Sarajevo gangster and 'war hero' who was at that point due to serve a six-month jail sentence for assaulting a police officer. Another jail sentence for attempted extortion is being appealed before the Sarajevo Canton Court. ICG interview with a senior banking official, October 1998.

¹⁷⁸ The European agreement that regulates this sector is the Council of Europe's Convention on Laundering, Search, Seizure and Confiscation of Proceeds from Crime. Other international legal standards awaiting incorporation in Bosnian law include the Council of Europe's Conventions on Criminal and Civil Law on Corruption, which Bosnia signed in March 2000 but has yet to ratify. These Conventions require Bosnia to reform its criminal legislation to criminalise all forms of corruption. ICG interview with a former member of OHR's Anti-Fraud Department, 11 July 2001.

Such provision should be developed and included in the new law on obligations which has also been drafted by GTZ.

The Federation and RS banking agencies need to be merged and transferred to the state level to become a part of the Central Bank on the model of the U.S. Federal Reserve System. This would provide effective insulation from political pressures exerted by the entity governments and parties. It would also offer vital support for the establishment and maintenance of a truly common market across Bosnia, while enhancing the strength and stability of the banking system. As Bosnia's banking sector becomes more complex and developed, further institutional reform will be necessary. A unified and politically independent agency would have a greater chance of developing the institutional capacity to meet this challenge, not just because it would benefit from the accumulated expertise of its predecessors and foreign advisers, but because it would have sustainable sources of funding. Given that the banking laws of the entities have already been harmonised, there is little to stop such a merger taking place before the end of 2001 – save the transfer of authority over liquidations from the bankruptcy courts to the banking agencies and the requisite political will.

Bosnian governments and legislators must exercise greater responsibility for adapting the legal framework to facilitate economic growth. A Permanent Negotiating Table, a body that includes representatives from both entities and the state Council of Ministers, has been set up to discuss the actions and solutions required to create a single economic space. This body needs to push urgently for the implementation of existing laws and for the passage of the further legal reforms that will create this space.

V. CUSTOMS EVASION

Smuggling pervades Bosnia. Illegal, low cost imports create an uneven playing field for businesses seeking to operate legally since such firms are disadvantaged in competing with those enjoying the lower costs that follow from evasion. Either they follow suit or accept the penalty of possible ejection from the market. Customs evasion is also one of the principal reasons for the entities' budget deficits which, in turn, have obliged the international community to provide their governments with budgetary support.¹⁷⁹ Large-scale annual revenue losses of between KM 300 million (in the Federation) and KM 500 million (in the RS) to the black economy seriously compromise government capacity. Although the EU-sponsored Customs and Fiscal Assistance Office (CAFAO) has worked with OHR and other international agencies to assist the entities' tax and customs authorities to combat evasion, progress has been slow.¹⁸⁰

Bosnia now has regulatory legislation covering its customs administration that meets European standards. It was drafted and implemented with the assistance of CAFAO. Numerous training and technical assistance programs, the introduction of enforcement units in 1999 to improve compliance, and the ongoing installation of two modern customs data bases to centralise information and improve the slow and inconsistent exchange of customs information between the entities are all commendable and welcome.¹⁸¹ Yet to implement such reforms in a context of political obstruction and rampant corruption is a practically impossible task.¹⁸²

¹⁷⁹ Last year alone multilateral and bilateral donors allocated approximately KM 800 million to plug holes in the entities' budgets. ICG interview with a high ranking foreign official, 3 July 2001.

¹⁸⁰ CAFAO has been operating in Bosnia since 1996. Supported by an annual budget of some Euro 8 million, its mandate is to reform customs and tax administration in Bosnia. ICG interview with CAFAO official, 14 February 2001.

¹⁸¹ CAFAO's reforms are set out in its *Annual Report 2000*.

¹⁸² FIAS reports that the business community perceives the customs administrations of both entities as extremely corrupt. FIAS, 'Commercial Legal Framework and Administrative Barriers to Investment', March 2001, p 146.

Although Bosnia's constitution (Annex 4 of the Dayton Peace Accords) empowers the state to make customs policy, its enforcement is delegated to the two (or, in practice, three) entities.¹⁸³ This arrangement is highly ineffective, as the entity governments seem to decide on customs issues as it suits their passing political interests. They, moreover, are in charge of all other aspects of taxation. Until recently, they have neither proved competent at collecting taxes nor seen the wisdom of reducing unreasonable rates to encourage compliance, collection and economic growth. Rather, they have used their power to tax as a means of ensuring that the party line is toed and the effective monopolies of party-friendly firms in particular markets are maintained.¹⁸⁴

As noted above, this vicious circle of evasion, impunity, and empty government coffers must be broken if Bosnia's economy is to prosper. Strong enforcement of reasonable imposts will give businesses and ordinary citizens an incentive to respect the law. Failure to act aggressively in clamping down on tax and customs evasion has discouraged both private investment and legal business practices. The road to recovery starts from here.

A. CORRUPTIBLE POLITICIANS AND OTHER WEAKNESSES

Revenue shortfalls have a variety of causes. Many politicians and officials are unwilling to enforce the customs laws because they can make a great deal of money by breaking them. Such law breaking is often simply a case of acting in cahoots with the smugglers and traffickers. Bosnia's borders are so porous largely for this reason. Devolution of responsibility for customs administration to the entities facilitates criminality, as does the existence of four more or less distinct economic spaces: the Federation, 'Herceg-Bosna', Republika Srpska, and the Brcko District. The entity governments, however, have been the main

culprits thus far – and at the very highest levels. In both the RS and Federation, politicians have participated in robbing their own budgets by offering their cronies and favoured firms illegal exemptions from customs duties.¹⁸⁵ This not only costs hundreds of millions of marks in lost revenues, but also sets an example that everyone feels entitled to emulate.¹⁸⁶ For example, in 1999 then RS Premier Milorad Dodik gave the Bosanski Brod oil refinery a windfall tax break by permitting it to sell petrol as if it were heating oil, at a cost of over KM 15 million to the RS exchequer.¹⁸⁷ Not to be outdone, Federation Prime Minister Edhem Bicakcic authorised the duty-free import of 900 cars.¹⁸⁸

The fact that the entity customs services – especially in the RS and 'Herceg-Bosna' – consistently fail either to make their expected contributions in revenue or to uphold the letter of the law is an indictment of the rapacity of their political leaders as much as it is of their own incompetence.¹⁸⁹

Given the substantial efforts made by the international community to train, equip and empower Bosnia's customs administrations, their 'productivity' should be much higher than it is. Yet the corrosive effect of corruption from the top is exacerbated by continuing weaknesses at the bottom. These include low and irregular salaries (which invite peculation), poor logistical support,

¹⁸³ Constitution of Bosnia and Herzegovina, Annex IV, Article III, paragraph 1 c.

¹⁸⁴ In July 2000, the High Representative removed Ramiz Dzaferovic as head of the Federation Tax Administration for abuse of office in connection with his persecution of *Dnevni avaz*, a newspaper which had dared to desert the ruling SDA to take an independent editorial line.

¹⁸⁵ On 20 December 2000 the High Representative imposed amendments to the Law on Customs Policy which, among other things, stipulated that customs exemptions may only be granted in accord with EU regulations, thus quashing the free and easy granting of favours. ICG interview with CAFAO official, 24 July 2001.

¹⁸⁶ On 21 December 2000 the High Representative annulled the decision of former Federation Premier Edhem Bicakcic to allow the import of some 900 private vehicles on fraudulent papers exempting them from customs duties. In February 2001 he dismissed Bicakcic from his new post as head of the state electricity utility, Elektroprivreda, for actions during his term as Federation premier. For these decisions, see: www.ohr.int.

¹⁸⁷ 'Uhapsen direktor rafinerije Bosanski Brod', *ONASA news agency*, 12 October 1999; '7.5 miliona DM prodati - nema kupca', *Nezavisne novine*, 20 October 1999.

¹⁸⁸ See note 186.

¹⁸⁹ For an account of the gap between revenue collection and prosecutions for tax evasion in the RS see: 'Utaja poreza: Nabijanje rogova poreskom sistemu', *Nezavisne novine revija*, 27 April 2001.

and abuse of power by the highest officials of the customs services. In the Federation, the government recently removed the head of the customs administration because he openly supported the proclamation of Croat 'self-government' and refused to carry out orders. It was subsequently discovered that he had also abused his position by selling personal property to the service he ran.¹⁹⁰ In another characteristic instance, the head of the RS customs and five other senior customs officers are currently being investigated for corruption and fraud in the fuel trade.¹⁹¹ Perhaps they had understandable cause. The RS government did not pay its customs officers between September 2000 and January 2001. When RS customs enforcement units seized a consignment of 15,000 bottles of bootleg liquor and KM 40 million-worth of cocaine in Banja Luka in November 2000, they had to pay their own transport costs, since the customs office did not have the funds to cover expenses.¹⁹² As long as the leadership is corrupt and neglectful of its duties, the effectiveness of the institution and everybody working in it will be compromised.

One of the primary devices employed for tax evasion is the fictitious company. Such companies are relatively easy to register using false identity documents.¹⁹³ Once established, they can import goods. When the merchandise arrives at the border, the company to which it is consigned is required to deposit a sum equivalent to the customs duty payable on the goods. Problems arise, however, after customs clearance, during the collection and distribution of sales taxes on high tariff goods. As these are collected at the point of sale, the phoney company can avoid declaring, remitting or being chased for them by virtue of its phantom existence. Such undeclared and unremitted taxes are lost forever. It has been

estimated that taxes are being paid on only 59 per cent of domestically produced goods.¹⁹⁴

Anti-smuggling measures are ineffective because the chances of getting caught are slim. Poachers and gamekeepers are too often working together. When a smuggler is caught, the risk of punishment is similarly low. A judicious bribe will frequently expunge the offence.¹⁹⁵ It is difficult to apprehend or prosecute a company that exists only on paper. Even when the company is legitimate, its owners often flee or are already living abroad.¹⁹⁶ When a lorry driver is caught smuggling, he does not normally face a criminal charge, only an administrative fine. In cases where the duty evaded is higher than KM 5,000, fines can range from the amount evaded up to ten times that sum. Criminal charges for smuggling and customs fraud involving goods on which more than KM 5,000 would be payable – and possible prison sentences of between three and eight years – were introduced in both entities only a few months ago. It will be some time, however, before any severe penalties are actually meted out and any deterrent effect observed.¹⁹⁷ In most cases a smuggler will only forfeit the cargo; he will rarely risk losing his truck. Such a system offers an incentive to smugglers to continue their trade, but not to government to stop it. When a lorry and its contents are seized and the goods destroyed, the smuggler, if not detained, has an incentive to repeat the offence to recoup his losses.¹⁹⁸

¹⁹⁰ 'Otkaz direktoru Carinske uprave, Filipu Andricu', *Dnevni avaz*, 24 March 2001; 'Filip Andric prodao Carinskoj upravi F BiH svoju i bratovljevku kucu u Tomislavgradu', *Oslobodjenje*, 27 March 2001.

¹⁹¹ 'Krivicna prijava protiv direktora Uprave carina RS', *Oslobodjenje*, 7 July 2001.

¹⁹² ICG interview with CAFAO official, 14 February 2001.

¹⁹³ GTZ has drafted a law on public notaries, the primary purposes of which are to facilitate contracts and the registration of companies, making sure that all legal preconditions are met before a company is established. The public notary would be liable in case a company proved fictitious. ICG interview with GTZ, 5 April 2001.

¹⁹⁴ 'Na prodaji cigareta Fabrike duhana Sarajevo utajeno 10m KM', *Dnevni avaz*, 23 February 2001.

¹⁹⁵ FIAS reports that the entities' customs administrations differ in the extent to which they enforce the law. Traders apparently prefer importing through the RS, as its customs officers tend to be more lenient and do not always demand a customs duty guarantee. FIAS, 'Commercial Legal Framework and Administrative Barriers to Investment', March 2001, p 140.

¹⁹⁶ In several customs fraud cases tried recently before the Sarajevo Canton Court the drivers found guilty were sentenced to prison and their lorries seized, but the ringleaders who owned the goods and had set up the operations remained beyond the reach of the law, as they reside in Austria and Croatia. 'Ovaj posao je u velikoj mjeri izmjenio moj zivot: Salem Miso, sudija Kantonalnog suda u Sarajevu', *Express magazin*, 12 July 2001.

¹⁹⁷ ICG interview with RS and Federation customs administrations, 9 July 2001.

¹⁹⁸ ICG interview with RS and Federation businessmen, May and June 2001.

B. CAN THINGS BE FIXED?

If overall responsibility for collecting customs duties belonged to the state, and if the proceeds were only later disbursed to the entities – the opposite of what happens now – the entity governments would have more incentive to make sure that revenues due to them were in fact collected and fewer opportunities to cheat themselves for political ends. This, however, would require Bosnia to unify its two customs agencies and remove them from the purview of the entities. Since the constitution assigns authority to determine customs policy to the state, there is ample legal justification for such a transfer of functions. The merger of the two entity customs agencies could be accomplished in short order, as customs regulations have already been reformed and harmonised.¹⁹⁹ Both agencies have identical structures and have benefited from the same technical assistance programs. Additional reasons for unifying the customs agencies are that this would be a step towards both complying with EU association requirements and providing Bosnia with a central government.

VI. UNREFORMED TAXES

The international community has rightly devoted much time, money and effort to strengthening Bosnian government institutions by making them more efficient and effective in collecting revenue.²⁰⁰ But little attention has been paid to the arguably even more important issue of making Bosnia's tax codes friendly to business and growth. Badly written, regressive and arbitrarily enforced, they are a primary cause of Bosnia's rampant tax evasion. (See Appendix 1 for a list of current taxes and rates.)

Every Bosnian business finds it necessary to evade taxes at least some of the time. Unlike customs evasion, whose perpetrators seek to gain unfair commercial advantages, tax evasion can be virtually compulsory if a business aims to survive. This is the case because the tax laws are so poorly written and the tax administration so chaotic that obeying every last provision and regulation can put a company's very existence at risk.²⁰¹

Because it has seen taxation as a function of state-building, the international community has neglected tax reform as a precondition for creating an attractive business and investment environment. The consequence is that the reform agenda of the international community is likely to falter in a variety of spheres as it comes up against the corruption that is induced and sustained by unreasonable, burdensome and often contradictory tax codes. Until the international community sets its sights on helping Bosnians to establish intelligent and intelligible taxes, massive tax evasion will continue, and no amount of structural reform will provide a remedy.

¹⁹⁹ ICG Interview with CAFAO senior officials and the Federation and RS Customs officials on 14 February and 9 July 2001, respectively.

²⁰⁰ For example, since 1997 the U.S. Treasury has spent U.S.\$15 million on tax policy and administrative reform projects. It has also seconded officers to serve as enforcement advisers to the financial police in both entities. In its efforts to reform the tax and customs administrations, CAFAO has been spending some Euro 8 million per year. ICG interviews with the respective organisations, 28 February 2001 and 10 March 2001.

²⁰¹ ICG interviews with numerous Bosnian businessmen during 1999, 2000 and 2001.

A. TAX COLLECTION AND COMPLIANCE MONITORING

Tax reform which aims to reduce exorbitant and prohibitive taxes, to broaden the base for tax collection, and to put in place effective enforcement and deterrence mechanisms to ensure compliance with the law is vital to a healthy economic environment. Unfortunately, such tax reform has yet to take place. The IMF and World Bank have produced studies outlining the direction that tax reform should take, and recommending simplification and reduction of the rates and number of taxes in both entities so as to create a viable common market.²⁰² Yet reform has been slow to follow. For example, the sales and corporate taxes essential to creating a single economic space have still not been harmonised. On the other hand, some of the harmonisation that has occurred is now coming unstuck. As matters stand, the collection of sales taxes is inefficient because they are collected only once, at the last stage,²⁰³ and are thus relatively easy to evade by setting up a bogus company that is untraceable.

The International Advisory Group on Taxation (IAGT) is an international body established specifically to plan and implement tax reforms. It links OHR, the World Bank, IMF, USAID, CAFAO, the U.S. Treasury, and GTZ. Their collective efforts have to date focused on post-payments' bureau reforms to assure a smooth transition and uninterrupted revenue flow. Future plans include introducing Value Added Tax (VAT) by mid-2003 and setting up databases that will identify each taxpayer with a unique number in order to monitor compliance. These databases will be based on the entity level, with Brcko District having its own. But this U.S. Treasury-led project

will take at least two years to complete. The other weakness of this system is that it envisages three databases rather than one. Given that inter-entity information sharing to prevent tax or customs evasion has been largely ineffective, it can be confidently predicted that, left to the entities, the information collected will be under-utilised.

To improve the registration of companies, a system already weak in itself, it will be necessary also to strengthen the hand of the courts that register them, since it is currently easy to register fictitious firms. This problem is exacerbated by the fact that courts do not share information. The identification of companies to assure tax compliance is further complicated by the fact that each company has several identification numbers for different purposes (e.g., for customs, sales taxes, etc.) which differ according to the location of the issuing office.²⁰⁴

Another project focusing on information exchange as a means to deter tax and customs evasion has been piloted by CAFAO. The entities' customs services are now obliged to report weekly to the tax administrations on goods that have entered or left the country, so – in theory – enabling the tax men to track down traders and enforce compliance. Although regular controls by customs enforcement units are an important deterrent, as is the seizure of smuggled goods,²⁰⁵ the latter practice does not collect revenue. In each entity, out of tens of thousands of registered traders, only a few hundred are responsible for over half the total tax revenue.²⁰⁶ The policing of such large-scale importers is the key to successful tax collection in both entities. As CAFAO acknowledges, the RS and Federation governments have focused more on small taxpayers than on large ones. In order to broaden the tax base, CAFAO, the U.S. Treasury and OHR are planning to create large trader control units within the tax administrations.

Until recently, the entity governments have concentrated on revenue collection as a means of relieving their acute budget deficits, rather than on

²⁰² The IMF prepared a study entitled 'Bosnia and Herzegovina: Taxation of Consumption and Inter-Entity Trade' in February 2000. It identified the obstacles to creating a single economic space. The FIAS study provides a comprehensive outline of tax rates, collection and enforcement procedures, and the way ahead in 'Commercial Legal Framework and Administrative Barriers to Investment', March 2001.

²⁰³ In the Federation, taxes are paid to the canton where consumption takes place. In the RS, 70 per cent of the sales tax revenue accrues to the entity government budget, and 30 per cent is allocated to the municipalities. FIAS, 'Commercial Legal Framework and Administrative Barriers to Investment', March 2001, p. 117.

²⁰⁴ ICG interview with an international tax adviser, 10 March 2001.

²⁰⁵ In Western European countries smuggled high tariff goods are destroyed, not sold. ICG interview with CAFAO, 28 February 2001.

²⁰⁶ CAFAO Annual Report for 2000, p. 11.

tax reform per se. In the Federation, the exclusive focus on revenue collection recently broadened to embrace meaningful tax reforms. In May 2001 the government cut wage taxes,²⁰⁷ a move the RS has yet to emulate. Having recognised the importance of thoroughgoing tax reforms for both providing incentives to investment and boosting payment compliance, the Federation government has now forged ahead of the international community and announced plans to introduce VAT by the end of the year.²⁰⁸ The system will not only simplify taxes and reduce rates, but also assure more effective collection by applying VAT each time goods are sold.

B. ENFORCEMENT AND CORRUPTION

The agencies in charge of enforcement are the tax administration and the finance police. (For the division of responsibilities between the two, see Appendix 2.) Across Bosnia, tax collection and enforcement have not been conspicuously successful. Endemic corruption in the entities' tax administrations is exacerbated by the irregular payment of salaries, favourable treatment of businesses with connections in high places, and harassment of businesses deemed to be 'politically incorrect'. These factors diminish what are already limited incentives to comply with the tax regulations.

The ruling political parties control the institutions in charge of revenue collection and often use them to achieve their political and economic goals by driving out politically 'unfriendly' businesses and favouring 'friendly' ones. This is a very important tool of political control, and has been used widely throughout Bosnia to discourage dissent. On 27 July 2000, The High Representative removed the head of the Federation tax administration, Ramiz Dzaferovic, for abusing his official position.²⁰⁹ A close associate of the then premier, Edhem Bicakcic (who was himself later to be dismissed as

director of Elektroprivreda for corruption), Dzaferovic sought to use the tax administration to shut down the newspaper *Dnevni avaz* because of its desertion of the SDA.

The Federation finance police, supported by the OHR's Anti-Fraud Department, have largely concentrated on investigating corruption and financial crime in the Federation over the past two years. Police investigations have been decisive in bringing major corruption cases to court. High profile cases involving alleged corruption on the part of the leader of the Tuzla cantonal government, Hazim Vikalo, former army general Mehmed Alagic, and staff of the Federation employment bureau have all been investigated by the finance police. When then Prime Minister Bicakcic sought to purge top officials and appoint more compliant ones, the High Representative overruled him.²¹⁰

The RS finance police have been far less successful in fighting corruption than their counterparts in the Federation. Nor have they enjoyed as much support from the international community.²¹¹ The High Representative has thus far removed twelve officials for abuse of office and corruption. Nine have been sacked from Federation institutions and three from state level bodies, but the High Representative has dismissed no RS officials for abuse of office or corruption. Nor has the RS yet to see any major corruption cases come to court. Until these things happen, OHR's anti-corruption policy in the RS will continue to look like appeasement. Without the support of the international community in general – and of OHR's Anti-Fraud Department in particular – corrupt RS officials will continue to enjoy immunity.

²⁰⁷ Zakon o smanjenju poreza na plate, *Sluzbene novine Federacije BiH*, No 16, 7 May 2001.

²⁰⁸ Federation Finance Minister Nikola Grabovac has called for the introduction of VAT by the end of 2001, proposing a flat rate of 20 per cent for non-essential goods and 5 or 6 per cent on food and other basics. 'Bunde nece pojeftiniti: Dr. Nikola Grabovac o uvodjenju PDV-a', *Oslobodjenje*, 5 July 2001.

²⁰⁹ Decision of the High Representative, 27 July 2000.

²¹⁰ OHR Decision suspending Edin Suljic without pay from the post of Chief Inspector of the Financial Police and banning him from taking any other post therein; Decision suspending Dragan Zelinka without pay from the post of Deputy Chief Inspector of the Financial Police and banning him from taking any other post therein, 15 November 2000. See: www.ohr.int.

²¹¹ In July 1999, OHR imposed several laws strengthening the role of the Federation public prosecutor and protecting the identity of witnesses testifying in serious criminal cases, including organised crime. The use of these laws resulted in the conviction (and sentence to 23 years' imprisonment) of the infamous Sarajevo gangster Ismet Bajramovic. ICG interview with a former member of OHR Anti-Fraud Department, 17 July 2001.

As noted above, numerous and arbitrary controls enforced by a variety of different agencies represent barriers to investment and contribute to making Bosnia unwelcoming to business. Having recognised this, CAFAO, the U.S. Treasury and OHR are now working to define and delineate the respective powers and responsibilities of the tax administration and the financial police. The former will concentrate on enforcing the tax laws, while the later will focus on investigating corruption and money laundering. On 20 December 2000, the High Representative imposed or amended several laws strengthening the authority of the entities' customs administrations and of the Federation tax administration.²¹² However, the results of this ongoing reform have yet to be seen.

In contrast to the Federation finance police, the entities' tax administrations and the RS finance police have proved to be generally ineffectual.²¹³ Their failures are clearly visible from the huge revenue losses sustained by the entities and their frequently hostile approach to the business community. In an effort to improve revenue collection in June 2001, the Federation government gave tax inspectors new powers of surveillance, search and prosecution in tax evasion and fraud cases.²¹⁴ Nevertheless, corruption in – and the arbitrary use of powers by – the tax agencies bear witness to the legacy of the previous socialist system, with its preference for state-owned companies and suspicion of the private sector. The powers now won by the tax authorities must be used prudently and correctly, and not to persecute businesses lacking political connections. What the

²¹² Three decisions of the High Representative, 20 December 2000: (1) Decision amending the BiH Law on Customs Policy, introducing EU standards in the field of customs policies and procedures, excluding returning refugees from the payment of customs duties on their belongings, and prohibiting duty free shops at border crossing points; (2) Decision amending the Federation Law on Contributions, giving the Federation Tax Administration greater powers to enforce the payment of social contributions; (3) Decision amending the Federation Law on Wage Tax, giving the Federation Tax Administration greater powers to enforce tax collection.

²¹³ ICG interviews with international tax advisers from several international agencies between March and June 2001.

²¹⁴ 'Poreska uprava zaviruje pod krevet', *Oslobodjenje*, 29 June 2001.

tax agencies need are accountable leaders, honest employees – and a reformed mindset.

C. THE FIGHT AGAINST TAX AND CUSTOMS EVASION

In an effort to halt rampant cross-border smuggling, on 13 January 2000 the High Representative imposed the State Border Service Law,²¹⁵ ending a long period of opposition and obstruction by local politicians, particularly in Republika Srpska. The Border Police created under this law now employ 1,100 officers, cover 35 border crossings, and patrol 60 per cent of Bosnia's borders. In the first third of 2001, the Border Service seized some KM 800,000-worth of smuggled goods, prevented 34 stolen vehicles from crossing the border, and apprehended at least a few of the illegal immigrants who use routes across Bosnia to get to Western Europe.²¹⁶ Like market inspectors, the regular police, the finance police and customs officers, the Border Service has targeted smugglers of high tariff goods, pirate CDs and frozen meat. Their efforts have resulted in a number of seizures, almost all of which have been in the Federation.²¹⁷

Although welcome, such successes are of negligible significance in comparison to the estimated revenue losses to smuggling (amounting to hundreds of millions of marks) and the

²¹⁵ Decision imposing the Law on State Border Service, 13 January 2000.

²¹⁶ 'Naježda kod Trebinja i Kamenska', *Reporter*, 6 June 2001. During one routine patrol near Bileca in the south-east RS the Border Service seized 5,500 boxes of cigarettes with a retail value of some KM 8,300. The Border Service also discovered a tanker truck attempting to transport 31 Kurds across the border near Velika Kladusa. 'Zaustavljen "Nisan" s 11 kartona cigareta', 3 March 2001, and 'U cisterni pokusao prevesti Kurde iz BiH u Hrvatsku', *Oslobodjenje*, 16 May 2001.

²¹⁷ 'Zapljenjeno samo 1350 kilograma kahve, 3800 steka cigareta, i 1500 litara alkohola.', *Dnevni avaz*, 21 December 2000; 'Tri miliona kilograma piletine nelegalno u BiH', *Dnevni avaz*, 22 December 2000; 'Zapljenjeno sest tona robe bez porijekla', *Dnevni avaz*, 20 December 2000;

'Zapljenjeno vise od deset hiljada kaseti i CD-a', *Dnevni avaz*, 25 February 2001; 'Otkriveno 38,990 litara alkoholnog pica', *Oslobodjenje*, 13 March 2001; 'Prokrijumcarili kafu vrijednu oko deset miliona maraka', *Oslobodjenje*, 3 June 2001.

suspected volume of human trafficking (involving thousands of people each month). As in the case of the customs agencies, corruption, understaffing and inexperience sap the effectiveness of the State Border Service. Four border police officers from Trebinje have been accused of smuggling high tariff goods, and one officer in Doljani has been charged with dealing in stolen luxury cars. All have been suspended.²¹⁸

Bosnia's borders are 2,400 kilometres long and offer 420 road crossings. Both factors make for easy smuggling. If Bosnia is to take control of its frontiers it will have to make a serious effort to employ enough people, pay them regularly and well, and punish those who betray their trust. As matters stand, the far-flung and numerous border crossings dissipate scarce resources, leaving a modest complement of officers to attempt to control only a portion of the country's frontiers. One result is that long queues of lorries build up at crossings, so creating incentives to offer and accept bribes to reduce the wait.

This is why the state government, supported by CAFAO, has cut the number of freight crossing points from 35 to 21 to allow for more effective law enforcement. In addition, after the HDZ's declaration of Croat 'self-government' on 3 March 2001, the Federation took steps to assure its exclusive right to customs duties collected in the affected regions. As a result, the number of customs offices in the Federation is to be cut from one in each of ten cantons to just four (Sarajevo, Tuzla, Mostar, and Bihac), thereby tightening customs clearance controls.²¹⁹ The recent agreement between Croatia and Bosnia to close physically some of the minor road crossings in western Herzegovina (which SFOR is helping to implement) is also having an effect.²²⁰ On the

other hand, RS customs enforcement appears lately to have become more vigorous than that of the Federation, resulting in more and bigger seizures. Another consequence of Bosnia's division into entities is, however, now apparent. Unless both entities and Brcko District all take serious action to control their frontiers and enforce the law, smuggling will simply shift among them according to the prevailing regime. For example, a lorry belonging to the Venera company from Siroki Brijeg, which imports alcohol and other high tariff goods, arrived not long ago at the Orasje border crossing into the Federation on the River Sava, where it was assessed to pay KM 450,000 in customs deposits. Rather than pay this sum, the driver turned away and went on to the Brcko crossing, where he paid only KM 2,000.²²¹

Two years ago, customs and tax evaders frequently used counterfeit documents to show that the goods being imported into one entity had cleared customs or been purchased legally in the other entity. Today importers are required to deposit at the border crossing the equivalent (usually in the form of a bank guarantee) of the customs duties which may be payable. Since excise taxes have been harmonised between the two entities, trading companies are no longer able to capitalise on the difference in rates. Moreover, cooperation between the entities' customs and tax administrations in combating fraud and evasion has improved. But it remains far short of what it should be – that is, automatic, quick and professional.²²²

To improve the quality and flow of information, CAFAO launched a major anti-smuggling campaign in 1999. During its first four months, the customs services seized smuggled cigarettes worth KM 15 million. Telephone tips by anonymous callers began to feature in some further successes. This has led to speculation that smugglers aiming to remove their competitors have

²¹⁸ "Naježda kod Trebinja i Kamenska", *Reporter*, 6 June 2001.

²¹⁹ This proposal is currently awaiting approval by the Federation government and parliament. ICG interview with CAFAO official, 24 July 2001.

²²⁰ ICG recommended in March 2001 that SFOR and the State Border Service should work together to close illegal border crossings between Croatia and Bosnia as an anti-smuggling measure that would also deny funds to the architects of Croat 'self-rule'. This recommendation was adopted, despite the objections of HDZ leaders such as Ljubo Cesić-Rojs. ICG Balkans Report No 106, *Turning Strife to Advantage: A Blueprint to Integrate the Croats in*

Bosnia and Herzegovina, 15 March 2001. See also, Fahro Memic, 'Blokera', *Oslobodjenje*, 16 April 2001.

²²¹ 'Fiktivne firme iz Brckog na milionske prihode placaju 300 KM pausalnog poreza', *Dnevni avaz*, 10 June 2001.

²²² Although significantly improved, the co-operation between the two customs administrations still impedes business operations, especially in the RS, where customs officers often refuse to accept documents issued in the Federation as valid. FIAS, 'Commercial Legal Framework and Administrative Barriers to Investment', March 2001, p. 146.

been responsible, and even that 'state sponsored' smugglers have been endeavouring to preserve their monopolies.²²³

Despite improved inter-entity co-operation and the several schemes to enforce revenue collection, the use of fictitious companies in scams to evade taxes and duties has yet to be addressed. For example, Ming Impex, a company from Bijeljina in the north-east RS, allegedly created phoney companies under the names 'Cenga' and 'Hrgovka' to import more than one ton of coffee valued at KM 4 million, claiming that the coffee had been purchased legally in the Federation. The Federation finance police established that the two companies did not exist, which meant that excise tax on the coffee had never been paid. Similarly, the firm Parma Trejd is alleged to have sold three tons of coffee, 10.5 million bottles of beer and other high tariff goods to five companies in Croat majority cantons in the Federation. The finance police discovered that not only did some of the five companies not exist, but that the goods were never delivered.²²⁴ To put an end to this sort of practice, the registration of companies must be fraud-proof, as well as simple and quick. Once companies are registered, their particulars must be accessible automatically and throughout the country.

VII. CONCLUSION

Bosnia's economic situation is bleak. Growth is slackening and budget deficits are rising. The entity governments have proved unable or unwilling to find a way out, failing either to collect the revenues required to maintain decent public services and their own bloated apparatuses or to liberate and energise the economy. In fact, without continuous infusions of international financial support, Bosnia would be ungoverned and ungovernable. Yet donor support is ebbing away as the interests and commitments of the international community are directed elsewhere.

Bosnia's viability depends on its ability to generate autonomous growth. Unfortunately, the business environment is still encumbered with barriers impeding investment and discouraging enterprise. Bosnia has, nonetheless, managed to attract several substantial investors. But in comparison with other countries in the region, this investment has been both paltry and inadequate. If the foreign investment on which the country must rely is to flow, the numerous obstacles to setting up businesses, making money legally and enjoying the fruits of success must be removed.

Until relatively recently, the international community has focused its attention on strengthening government structures and improving government's capacity to collect revenue. It has not devoted equivalent attention to the microeconomic reforms that are also essential if Bosnia is to develop a business sector capable of sustaining the very existence of the state and its people in the long run. Happily, by autumn 2000, the principal international organisations and agencies had come to recognise that Bosnia's economic decline might prove terminal in the absence of large-scale foreign aid and investment. They thus refocused their efforts, seeking to instil discipline in government spending, to create the preconditions for a healthy banking system, and to initiate social security and labour law reforms. All these initiatives have had positive effects. Unfortunately, the privatisation program – the speedy conclusion of which is essential for enduring economic growth – still requires considerable attention if the misuse of Bosnia's most profitable resources and assets for political purposes is to be curbed.

²²³ ICG interviews with RS and Federation businessmen conducted between March and June 2001.

²²⁴ 'Firma u Banjoj Luci, "koferi" u Hercegovini', *Reporter*, 18 April 2001.

Domestic political discourse has also changed for the better. The Federation and RS governments are increasingly putting their minds to serious issues of economic reform and regeneration. The Federation government has demonstrated by concrete steps that it is in earnest. The RS government, however, has yet to choose between economic survival and its costly rhetoric of 'national sovereignty'. Rather, it continues to regard the establishment of a common economic space in Bosnia not as the only route its citizens can take to Europe and prosperity, but as a plot to deprive them of their notional 'statehood'. As a result, the economic situation in the Federation – including the fiscal performance of the government itself – has improved, and is markedly better than that in the RS. Unless the RS government gets its act together, that entity will continue to sleepwalk towards an economic and political abyss. The repercussions of RS collapse would affect all of Bosnia and Herzegovina.

To capitalise on the real victories won thus far in the financial, legal and tax sectors, the international community must work ever more energetically and urgently with the local governments to reform the business environment, offering clear incentives to both domestic and foreign investors to put their money to work in Bosnia. The country must open up for business if it is to survive.

SPECIFIC RECOMMENDATIONS

A. REFORMS OF THE POLITICAL ECONOMY

1. The entity governments and the international community should seek to rationalise further the size and structure of entity institutions, including the merger of the entities' customs administrations and banking agencies and their subordination, respectively, to the Council of Ministers and the Central Bank.
2. The World Bank and IMF should continue to assist the entity governments to reduce and clarify military spending and to create alternative employment opportunities for redundant military personnel.
3. Republika Srpska should be compelled to demonstrate its political and financial commitment to existing state-level institutions. In particular, the RS should ensure that the Institute for Standardisation becomes fully operational by autumn 2001.
4. The Peace Implementation Council and Steering Board should introduce mechanisms to enhance the transparency and accountability of the international community's work in Bosnia.

B. LIFTING BARRIERS TO INVESTMENT

5. A state-wide 'one-stop shop' aiming to register companies in no more than one week should be established without delay.
6. The World Bank and OHR should work with local governments to streamline the number, frequency and intrusiveness of the controls and inspections to which businesses are subjected. Moreover, the criteria for such inspections and controls should be clear in advance and the inspectorates held accountable for their application.
7. The international community should encourage the formation of independent and voluntary chambers of commerce as elements of a civil society through which businesses can articulate their interests.
8. International agencies and Steering Board governments need to work together to ensure greater continuity in their staffing and consistency in their engagement in Bosnian economic reform by reducing the rapid rate of turnover and increasing periods of secondment to at least one year.
9. Bosnian and international officials should adopt and implement without delay the agenda set out by FIAS for eliminating other bureaucratic barriers to business.

C. LEGISLATION FOR BUSINESS

10. GTZ, the U.S. Treasury, World Bank, and OHR should assist the entities to reform their bankruptcy laws to enable both efficient liquidation of companies and the salvage of viable components and assets. The FIAS report should also be used as a guide in this respect.
11. The entity parliaments should enact by autumn 2001 the following laws which have been drafted by GTZ in collaboration with local legal experts:
 - Law on Land Registry. (In addition, the project to couple land registry and cadastral books in an electronic database should be completed by the end of 2002.);
 - Law on Obligation;
 - Condominium Law (to regulate the purchase, sale and upkeep of real estate);
 - Law on Public Notary (to prevent the registration of fictitious companies).
12. The state-level parliament should adopt urgently a new Law on Foreign Investment to replace the current and inadequate act. This new law should clearly define foreign investors and investments, and take precedence over entity legislation.
13. OHR and the World Bank should work with the entity governments to improve labour legislation and to draft laws regulating the operation of employment bureaus and labour commissions, taking the recommendations of FIAS as their starting point.
14. Both entities should prepare and enact new procurement laws by early 2002. Such laws should be fully harmonised and consonant with EU directives in order to regulate the allocation and expenditure of public money, reduce opportunities for corruption and enhance accountability.
15. The entities should amend their criminal legislation regarding corruption,

enhancing its clarity and deterrence value. In particular, the law should permit effective seizure of the proceeds from money laundering, bank fraud, racketeering, trafficking, and customs and tax evasion and conform to the standards prescribed by the Council of Europe's Criminal and Civil Law Conventions, signed by Bosnia in March 2000.

D. JUDICIAL REFORM

16. The Independent Judicial Commission, GTZ, and other international agencies involved in legal reform should work with the entity justice ministries to improve the courts' – and the judges' – capacity to resolve commercial disputes, bankruptcies and liquidations efficiently and efficaciously.

E. TAX REFORM

17. The IAGT (comprising the World Bank, IMF, GTZ, CAFAO, USAID, the U.S. Treasury and OHR) should work with the state and entities to introduce Value Added Tax no later than the end of 2002, ensuring at the same time that a portion of VAT revenue is earmarked for the support of state-level institutions.
18. The IAGT should likewise encourage the harmonisation and reform of corporate taxes and the reduction and/or elimination of miscellaneous non-transparent taxes that masquerade as fees.

F. CUSTOMS AND TAX ADMINISTRATION REFORM

19. The international community should work with entity governments to merge their customs administrations into one state-level customs administration by the end of the year. This would enhance administrative efficiency, save money, provide greater accountability, and reduce opportunities for corruption and political meddling.

20. The resulting state customs service should pay regular, competitive and incentive-driven salaries to its officers, so reducing the risk of corruption and enhancing professionalism.
21. CAFAO should assist the entities' tax administrations to establish specialised units to monitor and deal with large-scale import-export firms.
22. CAFAO and UNMIBH should further endeavour to institutionalise effective cooperation between the customs administration and the State Border Service.
23. IAGT and OHR should develop, with the entity and local governments, plans either to regulate or to close down rogue markets. If properly regulated, places like Arizona Market can make a contribution to inter-entity trade. But shutting down one market will, in the absence of a regulatory framework, merely result in the market – and the problem – shifting to another venue.
24. The state should set penalties for customs offences at a level sufficient to deter smuggling and to reduce incentives for recidivism.
25. The new state customs service should merge existing databases, creating a centralised system for the issuance of individual customs numbers to importers and exporters. This would serve to fight fraud and improve efficiency.
26. CAFAO should work with the Federation government to rationalise the number of cantonal tax administration offices and to strengthen the Federation's central tax office.
27. IAGT in general – and the U.S. Treasury in particular – need to work with the entities to establish a taxpayer database as quickly as possible. Centralisation of data would simplify the registration of taxpayers, the collection of taxes, and the creation of deterrents to fraud and evasion.

G. ENHANCED REVENUE COLLECTION AND LAW ENFORCEMENT

28. The state administration and the UN Mission should enlist the assistance of donors to strengthen the State Border Service.
29. OHR and the U.S. Treasury should work with the RS to empower and reform its finance police – and with the Federation to complete the reform of its finance police – by early 2002. The entities' forces must be able to collaborate on an equal basis in combating corruption, money laundering and other financial crimes.
30. OHR's Anti-Fraud Department should expand its presence and activities in the RS, working closely with prosecutors and law enforcement agencies to tackle organised crime and corruption cases and helping to improve RS criminal legislation. In particular, the office of the public prosecutor needs to be strengthened and a witness protection program established.

H. PRIVATISATION MEASURES

31. OHR and IAGP should ensure that RS legislation is redrafted to secure the assets of enterprises being privatised during the transition from public to private ownership, thus abolishing the current legal vacuum. The transition period should be as brief as possible.
32. The RS government should provide consistent and adequate funding for its privatisation agency in order to accelerate efficacious privatisation.
33. The Federation government should – in co-operation with IAPG and OHR – cut the number of privatisation agencies, either merging the cantonal agencies into one Federation agency or streamlining the tender process to eliminate overlapping competencies, reduce confusion and liberate the resources

necessary to move on to the privatisation of large or strategic enterprises.

34. OHR and IAGP should aim to provide the privatisation agencies with the authority to consider joint ventures between private businesses and public enterprises earmarked for privatisation.
35. OHR and IAGP should seek the amendment of the entities' privatisation laws to establish a state-level appeals body to deal efficiently with complaints and to assure due diligence and the rule of law.
36. The international audit of Aluminium Mostar should be completed and published. Only then will it be possible to clarify the firm's ownership and prepare it for privatisation. Publication of the audit should go some way, as well, to revealing how it has been used to sustain the HDZ-run parastate.
37. OHR, IAGP and other relevant agencies should ensure that audits are completed and published before major strategic companies in the state sector are privatised.
38. The state and entity parliaments should enact by the end of 2001 the OSCE draft Law on Conflict of Interest, thereby regulating the conduct of public officials managing public resources.

39. The entity governments should accept the IMF proposal, worked out with the privatisation agencies, on the distribution of the proceeds from privatisation.

I. BANKING REFORM

40. OHR should press the entity governments to merge their respective regulatory and deposit insurance agencies and to subordinate them to the Central Bank of Bosnia and Herzegovina by the end of 2001. This would enhance their professional capacity and reduce the scope for the exertion of undue political influence.
41. OHR should complete the drafting of a law on the prevention of money laundering and seek its early passage through the entities' parliaments. The law should make money laundering a criminal offence and incorporate preventative, monitoring and enforcement provisions, as recommended by the recent expert report ('Discovering the Money Trail: Money Laundering Prevention and Enforcement in BiH') prepared for OHR.
42. USAID should assist Republika Srpska to draft and enact – and the Federation to implement – laws on collateral that will facilitate the guarantee and registration of bank loans.

Sarajevo/Brussels, 7 August 2001

APPENDIX A

TAXES IN BOSNIA

Tables taken from the FIAS report 'Bosnia and Herzegovina: Commercial Legal Framework and Administrative Barriers to Investment', March 2001

Taxes presented on the basis of the then current entity legislation

Table 1: Tax Rates – Republika Srpska

| Tax | Rate |
|-----------------------|---|
| Corporate Income Tax | 20 per cent, 15 per cent, 12 per cent, 10 per cent, depending on the amount of profit generated |
| Sales Tax on Goods | 18 per cent or 8 per cent, depending on type of goods |
| Sales Tax on Services | 10 per cent |
| Railroad Tax | 2 per cent, paid along with sales taxes |
| Customs | 0 per cent, 5 per cent, 10 per cent or 15 per cent, depending on goods |
| Customs fee | 1 per cent |
| Surcharge tax | Levied on a specific (per unit) basis, paid along with customs duty |
| Excise | Levied on a specific (per unit) basis |

Table 2: Tax Rates – The Federation

| Tax | Rate |
|-----------------------|--|
| Corporate Income Tax | 30 per cent |
| Sales Tax on Goods | 24 per cent or 12 per cent, depending on type of goods |
| Sales Tax on Services | 12 per cent |
| Customs | 0 per cent, 5 per cent, 10 per cent or 15 per cent, depending on goods |
| Customs fee | 1 per cent |
| Surcharge tax | Levied on a specific (per unit) basis, paid along with customs duty |
| Excise | Levied on a specific (per unit) basis |

Table 3. Wage Tax – Republika Srpska

| Tax | Rate (gross) |
|-----------------------------------|--|
| Income tax | 9 per cent |
| Contributions paid by an employee | Health - 7.5 per cent Pension – 11 per cent Child care - 1 per cent Unemployment - 0.5 per cent Total – 20 per cent |
| Contributions paid by an employer | Health - 7.5 per cent Pension - 11 per cent Child care - 1 per cent Unemployment - 0.5 per cent Other – 1.1 per cent |

| | |
|--|---------------------|
| | Total - 21 per cent |
| Contribution for charity/solidarity (<i>sredstva solidarnosti</i>) | 2 per cent |
| Profit tax | 20 per cent |

Table 4: Wage Tax – The Federation

| Tax | Rate (gross) |
|-----------------------------------|--|
| Income tax | 3.4 per cent |
| Contributions paid by an employee | Health - 13 per cent Pension - 17 per cent Unemployment - 2 per cent Total – 32 per cent |
| Contributions paid by an employer | Health - 4 per cent Pension - 7 per cent Unemployment - 0.5 per cent Total: 11.5 per cent |
| Profit tax | 20 per cent |

APPENDIX B

TAX ADMINISTRATION AND FINANCIAL POLICE

Division of responsibilities

Taken from the FIAS report 'Bosnia and Herzegovina: Commercial Legal Framework and Administrative Barriers to Investment', March 2001

**Table 1. Division of Responsibilities between
 Tax Administration and Financial Police**

February 2001

| | Federation | Republika Srpska |
|---|---|--|
| Federation Taxation Administration And RS Public Revenue Administration | Receiving tax returns Recording tax liabilities and payments Tax assessments Control, audit and collection of tax liabilities <u>Being established:</u> Investigation and Intelligence concerning tax evasion Systematic control of Large Tax Payers Enforced Collection | Receiving tax returns Recording tax liabilities and payments Tax assessments Control, audit and collection of tax liabilities from physical persons <u>Being established:</u> Investigation and Intelligence concerning tax evasion Systematic control of Large Tax Payers Enforced Collection |
| Financial Police | Investigation of suspected cases of corruption, misappropriation of public funds, money laundering and other cases of economic crimes. ¹ | Control, audit and collect legal entities' tax liabilities. ² |

Source: CAFAO, February 2001.

APPENDIX C

ABBREVIATIONS

| | | | |
|--------------|---|---------------|--|
| AM | Aluminium Mostar | IMF | International Monetary Fund |
| BAFI | Bosnian Association of Foreign Investors | JSAP | UN Judicial System Assessment Programme |
| BIH | Bosnia and Herzegovina | KIA | Kuwait Investment Agency |
| CAFAO | EC Customs and Fiscal Assistance Office to Bosnia and Herzegovina | KM | Konvertibilna Marka |
| EBRD | European Bank for Reconstruction and Development | OHR | Office of the High Representative |
| EC | European Commission | OSCE | Organisation for Security and Co-operation in Europe |
| EIB | European Investment Bank | PDP | Progressive Democratic Party |
| EU | European Union | RS | Republika Srpska |
| FBA | Federation Banking Agency | SDA | Party of Democratic Action |
| FIAS | Foreign Investment Advisory Service | SDP | Social Democratic Party |
| FIPA | Foreign Investment Promotion Agency | SDS | Serb Democratic Party |
| GDP | Gross Domestic Product | SFOR | NATO Stabilisation Force |
| GTZ | German Society for Technical Co-operation [Deutsche Gesellschaft für Technische Zusammenarbeit] | SMEs | Small and medium-sized Enterprises |
| HDZ | Croatian Democratic Union | SZBiH | Party for Bosnia and Herzegovina |
| IAG | International Advisory Group | UNDP | UN Development Programme |
| IAGP | International Advisory Group on Privatisation | UNMIBH | United Nations Mission in Bosnia and Herzegovina |
| IAGT | International Advisory Group on Taxation | USAID | United States Agency for International Development |
| ICG | International Crisis Group | VAT | Value Added Tax |
| IJC | Independent Judicial Commission | | |

APPENDIX D

ABOUT THE INTERNATIONAL CRISIS GROUP

The International Crisis Group (ICG) is a private, multinational organisation committed to strengthening the capacity of the international community to anticipate, understand and act to prevent and contain conflict.

ICG's approach is grounded in field research. Teams of political analysts, based on the ground in countries at risk of conflict, gather information from a wide range of sources, assess local conditions and produce regular analytical reports containing practical recommendations targeted at key international decision-takers.

ICG's reports are distributed widely to officials in foreign ministries and international organisations and made generally available at the same time via the organisation's internet site, www.crisisweb.org. ICG works closely with governments and those who influence them, including the media, to highlight its crisis analysis and to generate support for its policy prescriptions. The ICG Board - which includes prominent figures from the fields of politics, diplomacy, business and the media - is directly involved in helping to bring ICG reports and recommendations to the attention of senior policy-makers around the world. ICG is chaired by former Finnish President Martti Ahtisaari; former Australian Foreign Minister Gareth Evans has been President and Chief Executive since January 2000.

ICG's international headquarters are at Brussels, with advocacy offices in Washington DC, New York and Paris. The organisation currently operates or is planning field projects in nineteen crisis-affected countries and regions across four continents: Algeria, Burundi, Rwanda, the Democratic Republic of Congo, Sierra Leone, Sudan and Zimbabwe in Africa; Burma/Myanmar, Indonesia, Kyrgyzstan, Tajikistan, and Uzbekistan in Asia; Albania, Bosnia, Kosovo, Macedonia, Montenegro and Serbia in Europe; and Colombia in Latin America.

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July 2001

APPENDIX E

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