

# **Bosnia and Herzegovina**

## ***The Priority Reconstruction Program: From Emergency to Sustainability***

Volume 2

The Economic Vision and Near-Term Tasks  
Towards Sustainable Recovery and Growth

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**INTRODUCTION**

In the aftermath of the elections, Bosnia and Herzegovina has to face the tripartite economic challenge of building a new governance structure, undertaking structural reforms, and implementing the reconstruction program *on a coordinated, country-wide basis*. Particular emphasis needs to be placed on developing institutions and policies, within a reasonably short period, that will maximize the potential for sustaining reconstruction and economic revival on Bosnia's own resources, and for the emergence of an open and integrated economy.

It is not an easy task. The two Entities of Bosnia and Herzegovina have had, until now, only minimal institutional linkages. In the Federation, tax, budget, and banking systems are still not fully unified. While significant recovery has already happened, much of the economy remains in a dilapidated state due to extensive physical damages to infrastructure and productive capacity, and the prolonged economic embargo of the last four years. Current economic activities are only a fraction of pre-war levels; and the unemployment rate, which exceeds 50 percent of the labor force in both Entities, is expected to worsen as demobilization of soldiers takes place. The old economic system of social ownership and self-management, while much weakened during the last four years, has yet to be replaced by an alternative mechanism that will allocate resources on a more efficient basis.

**VISION**

Policies can be effectively formulated only on the basis of a proper assessment of reality, as well as a clear vision for the future of the country. The vast majority of Bosnians agree that the future of their country lies with Europe. Joining the European Union and becoming increasingly integrated with the rest of Europe is the common vision shared by the people of Bosnia. It is a vision of prosperity for every citizen of Bosnia, and a vision of a modern market economy, underpinned by a flourishing private sector and complemented by a small but effective government. It is a vision in which the pursuit of individual prosperity goes hand in hand with freedom of religious and cultural tradition. In this vision, there is a new economic structure based on private ownership and private initiatives for trade, production, and finance, and a new market-based mechanism for making the decisions concerning investment, marketing and production, replacing the old, inherited system of social ownership and government control. It is a vision in which the economy is open both internally and externally, with minimal barriers on trade, finance, and labor mobility to facilitate integration and to promote growth. Finally, in the new system, public expenditure is substantially reduced and is very targeted in scope, and governments at all levels become smaller and more efficient.

To realize this vision of integrating with Europe would require forward-looking policies and reform. It is neither possible nor desirable to reconstitute the old systems that have failed, such as large socially-owned industrial systems, or to recreate the policies of the past, such as the policy of cross-ownership between banks and enterprises. With appropriate policy and reform

measures, Bosnia's economy can continue the recovery that started in late 1995, and the standards of living for people of Bosnia can improve rapidly within a reasonably short period. The strong recovery could in turn usher in, on an increasing scale, voluntary inflow of private capital from abroad that helps to sustain continued growth and expansion, leading Bosnia closer integration with Europe.

This is a grand but feasible task, as already demonstrated by progress in several other Eastern European countries. For Bosnia and Herzegovina, first efforts in this undertaking will have to be focused on the dual tasks of building a new governance structure as called for by the Peace Agreement, and of transforming the economic system through privatization and a new way of macroeconomic management. The following part of this paper discusses the key aspects of these tasks under three headings: (a) framework for macroeconomic management; (b) privatization, private sector development, and banking sector reforms; and (c) reform of the labor market and social safety net.

#### **A. BUILDING A FRAMEWORK FOR MACROECONOMIC MANAGEMENT**

Establishing a framework for macroeconomic management requires, first and foremost, putting in place an institutional structure within which to formulate and implement appropriate policies. It also requires the adoption of consistent policies throughout the country.

During 1996, progress was made in establishing the Federation's economic institutions. However, the country-wide institutional framework is still largely absent. Absence of common institutions makes it impossible to conduct efficiently macroeconomic management on a country-wide basis. Furthermore, policies in tax, customs, banking supervision and other areas have also diverged during the course of the last four years between the Entities, and, in some instances, within the Federation.

Key tasks in this area, therefore, include creating common institutions called for by the Dayton/Paris Peace Agreement and strengthening the functioning of institutions in the Entities, particularly those in the Federation, and ensuring consistent and harmonized policies between the Entities and within the Federation. Specifically, they include the following **TEN** tasks:

##### **1. Ensuring Financing of the State Administration**

The Peace Agreement calls for a small, efficient State government that is responsible for foreign affairs, monetary policy, customs policy, debt management, and citizenship. Unless mandated otherwise by the State Parliament, the State will have no responsibility for delivery of social affairs, defense, and most other services. The State is granted no capacity to tax or collect customs duties on its own, and is dependent on the Entities for its funding. The Peace Agreement indicates that the Federation is to finance two-thirds of the State's budget and the Republika Srpska is to provide the other one-third. The specific means by which the Entities will raise the money and the mechanisms for transferring the funds to the State need to be determined. Options could include assigning all or part of specific taxes (such as the customs duties), or a part of the total tax revenue from the Entities, to the State; or having direct and periodic transfers of funds from the Entity budgets to the State on the basis of a State budget agreed in advance; or a combination of the above. While in the longer run it is desirable that the State be given independent sources of revenue on the basis of some taxes or customs revenues, the 1997 State budget could be on the basis of revenue transfers from the Entities as a transitional arrangement.

## **2. Clarifying Responsibilities for Foreign Borrowing and Ensuring Debt Service**

The division of responsibilities between the State and the Entities needs to be established by a Law on External Debt, to be adopted as soon as possible. The Entities, holding the ability to tax and collect customs duties, have greater fiscal capacity. On the other hand, many creditors, particularly for those holding old claims, may be obliged in one way or another to conduct their financial relations through the State-level institutions. Borrowing arrangements, therefore, need to take into account both the fiscal arrangements in the country as well as preference of the creditors. Furthermore, clear budgetary mechanisms for debt service need to be set up for both new borrowings and restructured old debts, in order to ensure the maintenance of normal financial relationship between Bosnia and foreign creditors.

## **3. Assignment of Revenue and Expenditure Responsibilities within the Entities**

Under the framework of the Peace Agreement, the intergovernmental arrangements will be different in Republika Srpska and the Federation. In the Federation, the canton structure was developed to accommodate different demands for services and to allow for greater local control over selecting service levels. Thus, there will be a fairly decentralized fiscal system with significant taxing and spending authority devolved to the cantons (and possibly the municipalities). A more centralized approach is expected in Republika Srpska. Assignment of service delivery functions to the different levels of government (Entity, canton, or municipality) needs to be based on a balance between the desire for local decision-making and the higher costs that can result from service delivery by small governments. However, costs can be kept low even when small governments are responsible for decisions on service delivery. Governments (Entities, cantons, or municipalities) can band together to deliver those services where economies of scale exist. For example, several small municipalities could cooperatively provide a high school. Alternatively, one municipality can contract with another municipality to deliver high school education. Privatization of services is another way to take advantage of economies of scale. Private companies could be hired to operate and maintain water and wastewater systems in a number of municipalities.

The Entities must decide how to assign tax revenues across the different levels of government. Normally, the key determinant for assigning taxes is that each level of government is provided with the revenues needed to finance the services for which it is responsible. However, whatever set of revenue and expenditure assignments is made, imbalances in some municipalities and cantons between the ability to collect revenues and expenditure needs are unavoidable. The Entity governments will need to consider developing a means for limiting the resulting differential ability to finance services. Greater responsibility for service delivery at the Entity level or some type of intergovernmental grants formula are options for reducing the imbalances.

## **4. Addressing Outstanding Claims**

Significant outstanding claims of citizens on government arise from frozen foreign exchange deposits, unpaid pensions and wages, and certificates issued to ex-soldiers. The value of such claims is estimated to exceed more than DEM 13 billion in the Federation alone, or about 10 years of current tax revenues. Settlement of these claims by forgiving tax payments or by direct government payments would devastate budgets, monetary policy, and ultimately macroeconomic stability. The most feasible method for resolving the claims that has no implications for the recurrent budgets of the State, Entities, cantons, or municipalities is to limit their value to the purchase of assets from privatization. Even here, it must be recognized that there is a cost to

government, that otherwise could use the revenues from privatization to help finance reconstruction. It is best if the matching of claims to assets is performed as a one-time, coordinated decision that settles all claims. The claims are best handled in aggregate to avoid promises being made independently to a number of different claimants when there is no capacity to meet all of the claims.

In each Entity, a Claims Coordination Working Group should be established with representatives of the Ministry of Finance and privatization agencies. Their first task would be to communicate to key decision-makers the seriousness of the claims problem for budgets and macroeconomic stability. The major substantive functions of the Working Groups are to devise means for matching claims with assets, and to make specific recommendations on the mechanism for their redemption and cancellation. To achieve these objectives, the specific claims and assets that will be used in the settlement must be identified.

## **5. Unifying Foreign Trade Policy and Tariff Structure**

Currently, there are separate trade and tariff policies in the two Entities. Under the Peace Agreement, the State is responsible for setting trade and tariff policies. The State should assume this responsibility and initiate a set of reforms at the earliest possible opportunity. Major goals for reform include: (a) establishing a common external tariff structure with close to uniform rates and a low average rate; (b) enacting a new foreign trade law that drastically limits quantitative restrictions on trade flows; and (c) negotiating accession to membership in the World Trade Organization and agreements on trade liberalization with other trading partners.

## **6. Harmonizing Customs Administration**

Because customs administration is the responsibility of the Entities under the Agreement, there is a clear need to harmonize, to the greatest extent possible, administrative procedures and enforcement capacity of the two Entities to avoid tax evasion and arbitration. Within the Federation, further integration of customs administration and strengthening of the Federation Customs Administration is still needed. One option to ensure consistency throughout the country would be for the Entities to delegate, during the interim period, the function of customs administration to the State.

## **7. Reforming and Harmonizing Tax Policies**

Carefully chosen tax reforms would create an environment that is conducive to growth and private sector expansion. Wage tax rates (including both wage taxes and contributions) and customs and other foreign trade tax rates are excessive, particularly in the Republika Srpska, by international standards. Revenue losses from lowering these rates can be offset with better enforcement and less evasion, broader bases for wage and income taxes, and higher excise tax rates on both domestic and foreign produced commodities. Harmonization of tax rates and definition of a tax base between the Entities would be particularly useful, given the agreement on freedom of movement in goods and people. Coordination of policies between the Entities can offset the tendency for tax competition that otherwise will occur and that will result in significant opportunities for tax avoidance and evasion.

## **8. Coordinating Tax Collection**

Tax collections are currently enforced with offices in each municipality that are responsible for most tax collection. The effectiveness of this structure for collecting taxes in a modern economy is questionable, and should be carefully reconsidered as the tax administrations are reformed and modernized. While in principal tax administration in each Entity can be conducted on a centralized, decentralized, or intermediate basis and any of the approaches can be made workable, a centralized structure will ultimately be much more efficient for collecting the major taxes, including the customs, excise, corporate income, personal income, and sales or value-added taxes. Maintaining uniform tax bases and rates would be much more difficult with decentralized administration. Like in the area of tax policies, there is a clear need for coordination and harmonization of tax collection efforts between the two Entities to avoid tax evasion and competition.

## **9. Creating a New, Independent Central Bank**

At the earliest possible date, a new, independent central bank should be established as the sole agency for monetary policy and currency issuance in Bosnia and Herzegovina. A stable and convertible currency is the first requirement for promoting macroeconomic stability, trade and investment. As in the Peace Agreement, the central bank should operate as a currency board for its first six years, after which the State Parliament may decide to expand the bank's mandate and authority. As a currency board, the central bank will issue currency that is fully backed by hard currency reserves and is pegged to a fixed exchange rate vis-a-vis a major foreign currency (such as the Deutsche Mark). The result will be a central bank that can develop a stable, credible currency, but with constrained capacity to conduct monetary policy in the early years, including extending credit to public and private entities. While this may be restrictive, it also enhances the credibility of the new currency.

## **10. Unifying the Payments System**

With the introduction of a new country-wide currency and central bank, it is desirable to move towards *further unification and reforms of the payments system*, both within the Federation and between the Entities. Clearing of accounts, payment of taxes, transmittal of taxes to the proper government, implementing government budgets, and other financial transactions will be greatly facilitated by having a unified payments system. Additional reforms of the payments systems can focus on removing non-essential functions from the payments systems, such as tax collection and auditing, and modernizing operations to improve efficiency.

## **B. THE BUSINESS ENVIRONMENT, PRIVATIZATION AND FINANCIAL SECTOR REFORMS**

A key goal of economic reform in Bosnia and Herzegovina is to continue the transition to a private sector dominated market economy. Regional experience has shown that progress in this respect requires simultaneous effort in three critical areas: (a) development of a supportive business environment for existing and new private businesses; (b) privatization of state-owned and socially-owned assets; and (c) development of a disciplined and competitive financial sector.

## **1. The Business Environment**

Bosnia and Herzegovina shares with the other former Yugoslav republics the institutional legacy of heavy control of economic activity. These controls were embedded in the legal and regulatory framework. During the last four years, administrative control over the economy and property further expanded, and nationalization, expropriation and centralization took place in varying degrees. Nevertheless, restricted private sector activities have always been permitted, and most of the necessary legal and institutional ingredients for private business do exist - including a workable commercial code, as a result of the liberalization and reform efforts that were taken in the former Yugoslavia during the late 1980s.

Further revision of this framework will need to be undertaken by the Entities, as they have authority over property law, competition law, labor law as well as a substantial portion of domestic trade and tax laws. This work has already begun and needs to be completed. In addition, in order to identify the areas where the existing framework constitutes a barrier to private sector activities, the Governments of the Entities need to establish a regular dialogue with private business people. This will send a signal that the Governments consider the interests and needs of the private sector a key policy priority. The openness of the dialogue will serve to alleviate concerns that powerful political interests (in the public or private sector) can obtain special treatment or financing, and help create the needed "level playing field".

## **2. Privatization**

The privatization effort requires the preparation and approval of laws regulating and mandating privatization, including the methods to be used and the means of payment that can be accepted. It also requires an implementing agency charged with full responsibility for effecting privatization.

*Privatization Legislation in the Federation.* In the Federation, preparations for privatization have been moving ahead under the guidance of the Government-appointed privatization Expert Team. In most respects, the basic concepts have been agreed upon and embodied in four laws: (a) the *Privatization Agency Law*; (b) the *Law on the Privatization of Enterprises*; (c) the *Law on Restitution*; and (d) the *Law on the Sale of Apartments with Tenant's Right of Tenure*. This legislation sets the basic framework for most privatization transactions envisaged for the Federation. The Privatization Agency Law was passed in August and made effective in October of this year. The other three laws had first and second readings in Parliament prior to the September elections and are at the top agenda of the new Federation Parliament.

Other legislation related to privatization includes: (a) a *Settlement Law*; and (b) a *Law on the Privatization (or Liquidation) of Banks*. The Settlement Law is an umbrella of legislation that details the process by which claims on the Federation Government are turned into a form of certificate which can, in turn, be used to purchase assets being sold by the government through privatization. While the Settlement Law will be useful in clarifying the concepts and the overall framework within which the Government is conducting this process, and may eventually be helpful in resolving disputes that may arise as the process unfolds, it is not essential for the start of privatization.



***Privatization Process in the Federation.*** The procedures by which privatization will be effected in the Federation have been generally agreed upon and are as follows:

- A Federal Privatization Agency will first be created. Cantonal Privatization Agencies will be established to handle privatization transactions within their respective cantons, with oversight of, and under guidelines established by the Federal Agency. The Federal Agency will have additional implementation responsibility for privatization transactions that involve more than one canton.
- Citizens will be given compensatory certificates related to four kinds of claims on the State: (a) claims related to frozen foreign exchange deposits; (b) validated restitution claims, where these cannot be settled by restitution of the actual property involved; (c) claims related to unpaid salaries and (possibly) other payments during the recent conflict; and (d) a general claim, which may be allowed to all citizens, similar to the universal "vouchers" utilized in other transition economies. The actual amounts of some of these claims will not be finalized until the legislation is passed. The certificates issued in compensation for these claims can be used, together with cash, in bids for assets being privatized. The legislation proposes some differentiation among the various certificates for certain transactions (particularly housing). And for some transactions, a cash component may be required or given preference.
- Enterprises are responsible for preparing their "initial balance sheets" on which the privatization transaction will be based. This process includes such actions as: (a) confirming the extent of privatization that took place under the Markovic laws in Yugoslav times; (b) removing some of the social assets from the enterprises' books to be disposed of by the municipal authorities; and (c) assessing remaining bank indebtedness, both in local and foreign currencies, so as to determine how much of this still needs to be dealt with and thus left on the books of the enterprise. An Asset Liquidation Agency can be established to take over the bank loans off the balance sheet of the enterprises, with the aim to liquidate most of these loans within a very limited period. Enterprise privatization will generally be through open auction or sealed tender, depending on the size of the enterprise. For "strategic enterprises" (as determined by the Federation Parliament), special procedures may be adopted.

***Privatization in the Republika Srpska.*** Republika Srpska passed the *Law on the Privatization of Enterprises* on June 25, 1996. The goal of this legislation is broad and rapid privatization of industrial enterprises in the social/state sector. The fundamental approach envisaged is a rather complex distribution of shares among seven social funds (55 percent), citizen voucher-holders (30 percent) and--where possible--a strategic investor (15 percent). Strategic investment would be achieved through public auction where possible, but otherwise through a negotiated tender process which would include conditions on business activities, investments, employment, etc.

Improvements in the Republika Srpska scheme are essential. The 15 percent stake will not give the strategic investor strong enough motivation to do what's best for the company, due to all the other "free riding" owners. The other owners will be either passive (the funds) or too small to undertake serious monitoring efforts. Conditional tenders have proven problematic in many of the countries where they have been tried. They tend to be unnecessarily restrictive,

unenforceable and non-transparent. Provisions for the privatization of the funds should be quickly and clearly outlined. When privatized, they should be allowed to concentrate their ownership in specific enterprises, so they will have both the incentive and capacity to monitor management. At a minimum, funds should be given clear rights to information and voting on key company decisions. It is critical that the framework for privatization should support foreign investment, which can bring in financial resources, access to markets and current technology, and managerial know-how.

**Issues in Privatization.** While preparations for privatization are underway in all parts of the country, a number of policy issues must still be resolved. Most critical among these are:

- *Coordination.* The treatment of the outstanding claims, as well as property claims, for citizens who have moved across the inter-Entity boundary line needs to be dealt with in a coordinated fashion. It is helpful that the administration of the Federation and Republika Srpska establish a workable framework for discussing these issues, as well as coordinating the operation and subsequent privatization of infrastructure.
- *Restructuring and privatization of large industrial conglomerates* will be a key challenge facing the governments. There are approximately a dozen such operations in Bosnia and Herzegovina. Most of these conglomerates were broken into constituent enterprises and heavily damaged during the conflict. While it is generally neither feasible nor desirable to reconstitute them back to their original structures, it is conceivable that some of the parts with a more global focus (such as distribution and marketing) could be usefully salvaged. While eventual privatization would still be the goal, it may be appropriate to initiate some up-front organizational restructuring that would facilitate preservation of those parts of the structure that could continue to add value. The potential for such programs in each of the conglomerates should be investigated without delay. In most cases this need not delay privatization of individual manufacturing subsidiaries as future relationships between most of the component parts would almost certainly be commercial and contractual rather than based on common ownership. Legislation is needed to ensure that privatization of individual plants or enterprises that belong to a conglomerate will not be thwarted by legal complication that may be inherited from the past. To that end, a legal review of the legislation governing the operations of conglomerates may be required.

### **3. Financial Sector Reform**

The banking system is currently burdened in both Entities as a result of: (a) legal, regulatory and ownership structures that remain from the former Yugoslavia period; (b) the financial consequences of hyperinflation and imprudent lending during that period; and (c) damages from the war period. Most of the country's 17 non-private banks are in weak financial condition (nonperforming and unrecoverable assets; and foreign currency-denominated liabilities that cannot be serviced or repaid), while its 33 private banks are small, inexperienced, and currently incapable of meeting the country's deposit and lending needs for economic recovery.

In addition to the weak financial condition of banks, other factors prevent the banking sector from meeting the intermediation needs of the economy. Banks remain closely held in both Entities, and incentives are still in place for lending to shareholders. Depositor confidence in banks' safekeeping capacity is limited. Accounting standards that more accurately reflect balance sheet values and income/loss streams are not in place due to the absence of suitable loan classification standards, loan loss provisioning requirements, and other regulatory guidelines needed for market-based banking. Laws and court procedures that protect property rights and provide incentives to banks to lend on a secured basis are not consistent with market requirements. Prudential regulations and supervisory institutions do not yet provide the needed underpinnings for proper licensing, on-site inspection, off-site surveillance, and bank resolution. Meanwhile, from the demand side, past banking practices failed to assert the discipline on enterprises needed to ensure creditworthiness, debt servicing, and sustainable lending and borrowing practices.

To achieve its economic objectives, the banking sector of Bosnia and Herzegovina needs to undertake reform in three broad areas: (a) restructuring and privatizing socially-owned banks; (b) supporting the development and growth of new private banks; and (c) strengthening the legal framework, prudential regulations, and institutional capacity for safe and sound banking.

***Restructuring and Privatizing Socially-Owned Banks.*** Restructuring will involve: (a) the netting out of claims and severance of enterprise ownership in insolvent banks; and (b) the clean-up of troubled bank balance sheets, including the transfer of non-performing assets and of frozen foreign currency deposits and other foreign currency liabilities to a separate "workout" agency. The privatization program is expected to involve several scenarios per bank based on: (a) attracting strategic investment from domestic and/or foreign sources; (b) merging restructured banks with other banks in the market; or (c) liquidation. International investment banks would be recruited to assist with the specific restructuring programs of socially-owned banks, and to prepare privatization scenarios and tendering documentation that can be implemented by the end of 1997.

***Supporting the Development and Growth of New Private Banks.*** More than 30 private banks have emerged in Bosnia and Herzegovina in the last several years. Most are small, with less than DEM 2.5 million in net capital and limited experience. However, as elsewhere in Central and Eastern Europe, many of these banks have generated strong fee income from transfers and remittances, trade finance, foreign exchange trading, and other off-balance sheet activities. While these activities are not sufficient to develop the country's economy, many of these banks possess the building blocks for future development and growth. Further, they are unburdened by the loan problems of the former Yugoslavia's period that hamper the socially-owned banks in both Entities. To promote their development in support of the broader objective of developing a private sector-oriented banking sector, technical assistance and line of credit resources from donors would be used to strengthen private banks' policies, procedures, management and systems. Such assistance would be modeled on the successes registered to date with existing line of credit programs. Furthermore, to promote the development of larger private banks, banks will be encouraged to merge and consolidate their activities through appropriate banking regulations.

***Improving the Legal, Regulatory and Institutional Environment.*** Improvements in the legal, regulatory and institutional environment are considered essential for long-term success in developing a competitive economy and a market-based banking system. To achieve these

objectives, improvements in the financial enabling environment are expected to include: (a) adoption of all needed legislation to establish the State Central Bank and the Banking Supervision Agencies in the Entities, to lay out commercial banking guidelines in both Entities, to provide the supervisory agencies with a mandate to enforce regulations and to produce the initial body of legislation required to address weaknesses in both Entities' collateral, mortgage, bankruptcy, insurance, and capital markets laws; (b) introduction of suitable banking sector regulations and institutional capacity to enforce prudential regulations in support of a safe and sound banking system, including new rules on connected lending, related party lending, loan classification, loan concentration, and exposure limits on a consolidated basis; and (c) introduction of a new accounting framework in concert with new regulations to generate more meaningful financial information for a market-based economy, to facilitate bank supervision, and to enhance financial disclosure for shareholders, depositors and consumers. To achieve these reforms, it is anticipated that Working Groups from both Entities and the State will continue to meet to develop a suitable legal and regulatory framework for the banking sector. The two Working Groups that have already formed should continue until the major building blocks of a financial sector enabling environment are established for the country as a whole.

### **C. REFORMS OF THE LABOR MARKET AND SOCIAL SAFETY NET**

Restrictive labor regulations and practices that inhibit labor mobility and discourage employment need to be removed as soon as possible. High payroll taxes which discourage labor force expansion need to be reduced as well. Training programs should be developed, private employment agencies encouraged, and the work of the Entities' Employment Institutes reoriented to promote employment. At the same time, fundamental reforms will have to be made in the existing social protection programs for the poor, the sick, and the old, which balance short-term financing needs against longer-term considerations.

#### **1. Reforming the Labor Market**

The growth of employment and earnings is an absolute priority for sustainable recovery in Bosnia and Herzegovina. In recent months, a number of priority measures have been taken by Entity Governments to encourage employment, including retraining, public service employment, and small business development; but much more could be done to improve the functioning of labor markets.

Employment generation is still impeded by restrictive labor laws which artificially drive up the real cost of labor, and a work force whose skills are incompatible with those demanded on the labor market. If measures are not taken in the short term, high rates of unemployment are likely to persist. Reforms to overcome disadvantageous conditions in the following areas are required to support the development of a buoyant labor market:

- Excessively high payroll and wage tax which discourage employment generation, lead to tax evasion and development of informal labor market that provides no protection to workers and undermines collection of taxes.
- Restrictive labor contracts limiting the flexibility of employment relationships;
- Inflexible or expensive procedures for dismissing workers due to technological change, economic restructuring, or malfeasance;

- Overly generous vacations and other types of leave;
- Arbitrary minimum wages and wage schedules that are not market driven;
- Restrictions on conditions for hiring unemployed workers and on the listing of job vacancies;
- Restrictions on labor-management relations that are bound by a collective bargaining contract; and
- Insufficient training for skills required in a market-oriented economy, such as marketing, financial planning and accounting, etc.

**Wage Taxes.** Labor market expansion may be more seriously constrained by high wage-tax rates than by restrictive protective legislation. Overall taxation on payroll needs to be reduced, while still protecting payroll contributions to pension, health, and unemployment insurance. The payroll tax base needs to be broadened to ensure all employers and employees, private or public, are paying required taxes.

**Labor Contracts.** With the introduction of a market economy, private sector employers are likely to begin to avoid legal labor contracts, especially when requirements for legal labor contracts are excessive and restrictive. With a growing informal labor market, tax avoidance will spread and minimal standards of worker protection will be eschewed. To reduce this tendency, labor contracts have to be simpler and employment practices less restrictive.

**Wage Setting.** Employment will be lower if higher minimum wage rates are required by the government. If a minimum wage is to be continued, it should only affect a small percentage of the work force, and it should not be subject to frequent changes, be set arbitrarily at Ministerial discretion.

**Unemployment and Job Search Mechanisms.** The development of a variety of job placement avenues, including both public and private agencies, needs to be supported. The Employment Institutes in the country should be unified (for the Federation) and be linked (across the Entities) to provide maximum information to job seekers.

**Training and Education.** The need for retraining is acute, particularly for those skills relevant to a private sector economy, such as entrepreneurial expertise and management techniques including marketing, accounting, financial planning, and human resource management. In addition, workers need to develop skills to adapt quickly to changing market conditions, including job-search and personnel marketing. Programs should only be developed and implemented, however, if they are demand-driven and cost-effective. New educational facilities focused on adult education need to be developed regionally and also through the private sector. In the longer term, curriculum reform and improved teacher training will be needed to help developing the skills required for a market economy.

## **2. Providing a Social Safety Net**

In the area of social safety net, the following changes are of top priority in both Entities within the next six to twelve months:

- Establishment of a minimum pension to provide basic protection for all pensioners;
- Design and implementation of an affordable second-tier pension system tier related to earnings and contributions;
- Redesign of the health care financing system to provide an affordable, minimum level of benefits; and
- Establishment of other poverty-alleviation programs which could provide a minimum social safety net and are affordable within anticipated budgetary resources.

***Old Age, Disability and Survivors' Pensions.*** Pension reform needs to proceed more rapidly than the pace currently set by either of the Entities. The reasons for concern are as follows: (a) payroll tax rates are too high, leading to reduced employment growth or reduced compliance; (b) benefits are inadequate and do not provide a floor of protection; and (c) current legislation is unaffordable, even with strong employment growth.

A straightforward three-tier-system could be developed for each Entity that would be affordable, provide a floor of protection, and eventually provide the risk diversification afforded by investment-based pension plans. The first tier would consist of a flat-rate pension granting minimum benefits for all pensioners. The second tier could be earnings-and service-related. While this second tier could be similar in form to current practice, eligibility and benefit provisions would need to be revamped significantly to make the system affordable. The third tier, to be instituted several years in the future, would consist of investment-based pension plans. Legislation to implement the first and second tiers should be proposed and enacted within the next six months. The new pension system should be designed to start with a clean slate and the issue of arrears should not be addressed within the rubric of the pension system.

From the viewpoint of funding stability, the best solution would be to have a pooled pension fund for the whole country, as each of the current pension systems is relatively small. The next best solution would be to have two pension funds -- one in Republika Srpska and one in the Federation. The size of the system matters for three reasons. First, studies have shown that there are substantial economies of scale in pension fund administration. Second, demographic risks are greater for a smaller population. Finally, more than one pay-as-you-go system would restrict labor supply decisions and/or encourage employment to flow where taxes are lower, to the detriment of retirees in the less-preferred plan. If cantonal systems are favored, however, the decision should be made quickly so as not to impede the adoption of financially sound pension policies.

***Health Care Financing and Insurance.*** The challenge for each Entity is to develop a strategy to phase out reliance on outside aid and fund a health insurance system that provides a package of basic essential care services at an affordable cost. Both Entities need to find immediate sources of financing, to determine future financing arrangements, and to normalize health care. Tax rates must remain sufficiently low to facilitate employment growth, thus policy proposals will be constrained by limited resources. The Federation faces the specific problem of having two health care funds. While it is agreed that basic health care should be provided at the cantonal level, there needs to be some mechanism developed to provide for cross-cantonal subsidies as required.

***Poverty Programs and the Social Safety Net.*** The needs throughout Bosnia and Herzegovina for assistance to the poor are enormous. Yet there is little capacity to self-finance a program of cash transfers at this time. Emergency relief, especially donations of food, which sustained most of the population in recent years, will soon end. Consequently, a general review of social welfare programs should be undertaken to determine whether funds are well utilized, and whether proposed or enacted social programs are affordable and targeted towards to the poor. To help evaluate the efficacy of current welfare expenditures and to develop a plan for the future, a poverty assessment should be undertaken quickly.

## SPECIFIC RECOMMENDED POLICY MEASURES FOR 1997

### I. TEN TASKS FOR MACROECONOMIC MANAGEMENT

#### 1. 1997 State Budget

The 1997 State budget needs to be prepared in two parts: for administration; and for external debt service.

There is considerable uncertainty concerning the size of the administrative budget as the political agreement on the size and scope of the new State Administration is yet to be reached. There is also uncertainty concerning the start-up cost of the new central bank, particularly with respect to the cost of printing the new notes. However, excluding the cost of starting the central bank, and on the basis of assigned functions to the State as outlined in the Dayton Agreement, the size of the administrative budget is estimated to be on the order of DEM 40 million, and can be financed by three sources: (a) the State's own revenue from consular fees and other charges, estimated at DEM 15 million (the State, under Dayton, has no independent taxing powers of its own); (b) contributions by the Federation of DEM 16.7 million (2/3 of the remaining DEM 25 million); and (c) contributions by the Republika Srpska of DEM 8.3 million (1/3 of the remaining DEM 25 million).

The debt service budget, estimated to be on the order of DEM 70 million, is also to be financed by three sources: (a) the remaining funds of the State's borrowing in 1996 from abroad of DEM 45 million; (b) debt service channeled to the State from the Federation of DEM 16.7 million; and (c) debt service channeled to the State from the Republika Srpska of DEM 8.3 million. Division of debt service shares in 1997 is tentative, and the eventual share of debt service burden for each Entity will be on the basis of debt allocation between the two Entities on the principle of final beneficiary. Once the debt is allocated, adjustment of debt service by each Entity will be made retroactively to reflect the allocation ratio.

*Laws Required:* 1997 State Budget Law

*Timing:* Adopted by end December 96.

For the future, the possibility for the State having a share of individual taxes or a share of total tax revenues should be explored.

#### 2. 1997 Federation Budget

The 1997 Federation budget incorporates military and social expenditures. The total amount of budgetary expenditures is estimated to be on the order of DEM 600 million, of which about DEM 65 million is for administration, about DEM 300 million for military expense, and the remaining DEM 235 million for social programs, higher education, a number of hospitals, judiciary system, and grants to cantons. On the revenue side, in addition to 100 percent of customs and excise taxes as in 1996, the Federation is to receive 50 percent of wage and income taxes, and 50 percent of the profits tax.



The draft Law Regarding Allocation of Public Revenues needs to be amended before adoption by the Parliament to allow the Federation to participate in sharing wage and incomes taxes, and the profits tax.

Certificates issued to ex-soldiers should not be allowed to be used for paying taxes, customs duties, and utility fees. In general, claims on government should be settled through privatization.

Cantonal Budgets prepared and adopted in accordance with the assignment of revenue and expenditure responsibilities for 1997.

*Laws Required:* 1997 Federation Budget Law  
Law on Allocating Public Revenues

*Timing:* Adopted by end December 96.  
Amended and adopted by end  
December 96.

New Law on Expenditure  
Responsibilities and Revenue Allocation

Prepared and adopted  
during 1997.

### **3. 1997 Republika Srpska Budget**

The 1997 Republika Srpska (RS) budget needs to be passed, taking into account the requirements of the State budget, and should be based on reasonable expenditure and revenue estimates.

*Laws Required:* 1997 RS Budget Law

*Timing:* Adopted by end December 96.

### **4. Foreign Trade and Tariff**

One single uniform customs tariff rate of, say 8 percent, should be adopted for all imported goods. Very few exemptions should be allowed. For example, exemptions could be given for imported investment goods and goods for reconstruction purposes financed by donors.

All trade restrictions, such as import licenses, import quotas, export permits and duties should be eliminated through the adoption of a new State Law.

*Laws Required:* Foreign Trade Law  
Customs Tariff Law

*Timing:* Adopted by end December 96.  
Adopted by end December 96.

### **5. Foreign Debt Management**

Renegotiate and settle old debts with bilateral and commercial creditors in Paris and London Club, with the aim of achieving maximum debt reduction.

*Timing:* During 1997.

Divide restructured or reduced debts between the two Entities on the final beneficiary principle. The proportion of debt service by each Entity should follow the division of the restructured/reduced debt stock.

*Timing: Ongoing*

Establish an escrow account mechanism to ensure timely servicing of restructured/reduced debts.

*Timing: Before end December 97.*

Set up debt management units at the State and Entity levels in the Ministries of Finance to keep the accounts of all external debts, to negotiate the new credits/loans, and to formulate proposals for debt policies.

*Timing: by April 1997.*

Debt servicing for new borrowing should follow the principle of final beneficiary.

Adopt the laws on foreign debt to establish the permanent framework for debt management.

*Laws Required: State Law on Foreign Debt  
Entity Laws on Foreign Debt*

*Timing: Passed by end March 97.*

## **6. Harmonizing the Customs Administration**

International trade policy is a responsibility of the State. With no borders between the Entities, efficient control of international trade and collection of customs tariffs requires that the customs administrations (procedures, manuals, and enforcement) be harmonized and fully cooperative.

*Timing: Initiate Immediately.*

## **7. Harmonizing the Tax Policies**

Tax base and tax rates for goods and capital should ideally lie within a narrow range to minimize competition between the Entities for revenues and to reduce distortion to resource allocation.

*Timing: Initiate Immediately.*

## **8. Harmonizing Procedures and Enforcement of the Tax Administrations**

Information sharing, auditing and collection will be greatly facilitated by full cooperation and similar practices by the two Entities. These pertain to similar administrative structures, forms and contents of information requirement of tax payers, collection and auditing procedures.

*Timing: Initiate Immediately.*

## **9. Operationalizing the Central Bank and Issuing the New Currency**

*Laws Required: Central Bank Law*

*Timing: Adopted by end December 96.*

## 10. Linking the Payments Systems Between the Two Entities

Smooth operation of financial transactions and the State budget requires close linkage between the payments bureaus in the two Entities. The system that has been designed should be implemented and improved.

*Timing:* Implement Immediately.

## II. ENTERPRISE AND BANK PRIVATIZATION

### *In the Federation*

Establish and operationalize Federation Privatization Agency and Cantonal Privatization Agencies.

*Timing:* Immediately.

Pass legislation now before the Parliament (Enterprise Privatization, Apartment Privatization).

*Timing:* Adopted by end December 96.

Complete the preparation of and approve the law on Preparation of Balance Sheets of Enterprises and Banks, and the law on Bank Privatization. These laws should contain provisions allowing severing ownership links between banks and enterprises, and provisions for the removal from the balance sheets of banks and enterprises those foreign liabilities that are to be assumed by the government for debt negotiations.

*Timing:* Prepared by end December 96.  
Adopted by end March 97.

Begin privatization of enterprises immediately and complete at least 500 privatization transactions by end 1997.

Prepare the restructuring and privatization plans for at least three big conglomerates by September 1997, and privatize or liquidate, by the end of 1997, at least one big conglomerate, by employing experienced international investment bankers or merger and acquisition experts.

Complete privatization of apartments in 1997.

Adopt banking law and regulations on the basis of the agreed general legislative framework for the whole country.

*Laws Required:* Banking Law  
Banking Supervision Regulations

*Timing:* Adopted by March 97.  
Adopted by May 97.

Prepare detailed privatization/liquidation plans for the three largest socially-owned banks by September 1997, and liquidate or privatize at least one socially-owned bank by the end of 1997, by employing international investment bankers.

*In the Republika Srpska*

Revise the current privatization framework to ensure more transparent privatization transactions and to transfer a larger share of capital to private ownership.

*Laws to be Revised:* Privatization Law

*Timing:* Immediately.

Complete the preparation of and approve the laws which provide for the severing of all ownership links between banks and enterprises, and removal of those foreign liabilities that are to be assumed by the government for debt negotiations.

Prepare the restructuring and privatization plans for big enterprise groups by September 1997, and privatize or liquidate, by the end of 1997, at least one big enterprise group, by employing experienced international investment bankers or merger and acquisition experts.

Create an independent Banking Agency to be responsible for licensing and supervision.

*Timing:* by end June 97.

Adopt banking law and regulations on the basis of the agreed general legislative framework for the whole country.

*Laws Required:* Banking Law

*Timing:* Adopted by March 97.

Banking Supervision Regulations

Adopted by May 97.

Prepare detailed privatization/liquidation plans for the three largest socially-owned banks by mid-1997, and liquidate or privatize at least one socially-owned bank by the end of 1997, by employing international investment bankers.

### III. LABOR MARKET AND SOCIAL SAFETY NET

*In the Federation*

Pension Management

Separate all public pension programs from the government budget and manage these as off-budget funds.

*Timing:* by end December 96.

Prepare 1997 budgets for public pension funds on a cash-flow basis as self-financing programs that are based on a realistic projection of payroll contributions.

*Timing:* by end December 96.

Establish Federation Pension Agency to coordinate administration of pension funds and to administer resources from external sources.

*Laws Required:* Law on Pension Agency

*Timing:* by end March 97.

Decide definitively on the number of public pension funds in the Federation.

*Timing:* by end September 97.

#### Labor Market

Prepare and adopt a new Labor Law that limits the scope of restrictions and permits more flexible labor market practices concerning employing and firing workers.

*Laws Required:* Law on Labor

*Timing:* Prepared by end March 97.  
Adopted by end June 97.

Revise the draft Act on Employment before sending it to the Parliament to: (a) permit both public and private forms of labor intermediation; (b) reduce unwarranted reporting burden on employers and employees; and (c) formulate eligibility for unemployment compensation benefits to meet budgetary constraints and encourage job search.

*Laws Required:* Law on Employment

*Timing:* Revised by end February 97.  
Adopted by end May 97.

Separate payroll contribution for the unemployment fund and programs from the government budget, and manage the contributed resources as off-budget funds.

*Timing:* by end December 96.

Prepare 1997 budgets for unemployment benefits and labor programs on a cash-flow basis as self-financing programs based on a realistic projection of payroll tax contributions.

*Timing:* by end December 96.

Reduce the payroll tax burden, and increase excise and sales taxes to compensate potential revenue losses.

*Timing:* by end December 96.

#### *In the Republika Srpska*

Initiate a pension reform program that aims at providing affordable pension coverage and better management of the pension system on a long-term basis.

*Timing:* Initiate Immediately.

Prepare and adopt a new Labor Law that limits the scope of restrictions and permits more flexible labor market practices concerning employing and firing workers.

*Laws Required:* Law on Labor

*Timing:* Prepared by end March 97.  
Adopted by end June 97.

Reduce the payroll tax burden, and increase excise and sales taxes to compensate potential revenue losses.

*Timing:* by end December 96.