

# **STABILITY PACT**

**SOUTH EAST EUROPE COMPACT FOR REFORM,  
INVESTMENT, INTEGRITY AND GROWTH**



## **BOSNIA AND HERZEGOVINA ENTERPRISE POLICY PERFORMANCE ASSESSMENT**

Prepared by

**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT  
AND EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT**

**SEPTEMBER 2003**

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**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

**The Stability Pact for South Eastern Europe** is a political declaration and framework agreement adopted in June 1999 to encourage and strengthen co-operation among the countries of South East Europe (SEE) and to facilitate, co-ordinate and streamline efforts to ensure stability and economic growth in the region. (see [www.stabilitypact.org](http://www.stabilitypact.org))

**The South East Europe Compact for Reform, Investment, Integrity and Growth (“The Investment Compact”)** is a key component of the Stability Pact under Working Table II on Economic Reconstruction, Development and Co-operation. Private investment is essential to facilitate the transition to market economy structures and to underpin social and economic development. The Investment Compact promotes and supports policy reforms that aim to improve the investment climate in South East Europe and thereby encourage investment and the development of a strong private sector. The main objectives of the Investment Compact are to:

- Improve the climate for business and investment.
- Attract and encourage private investment.
- Ensure private sector involvement in the reform process.
- Instigate and monitor the implementation of reform.

The participating SEE countries in the Investment Compact are: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Moldova, Romania and Serbia and Montenegro. Building on the core principle of the Investment Compact that “ownership” of reform rests within the region itself, the Investment Compact seeks to share the long experience of OECD countries. It provides region-wide peer review and capacity building through dialogue on successful policy development and ensures identification of practical steps to implement reform and transition.

The work of the Investment Compact is actively supported and financed by seventeen OECD member countries: **Austria, Belgium, Czech Republic, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Norway, Sweden, Switzerland, Turkey, United Kingdom and United States.** (see [www.investmentcompact.org](http://www.investmentcompact.org))

This report has been jointly produced by the OECD Investment Compact Team and the EBRD Office of the Chief Economist in co-operation with expert regional consultants. It draws on the extensive experience and work of both organisations in transition economies including the countries of South East Europe. The Enterprise Policy Performance Assessment process, highlighting feedback from SMEs as a key element of the analysis and assessment, was instigated by Declan Murphy, Programme Director of the Investment Compact (OECD) with support from Antonio Fanelli (Principal Administrator, OECD) and Ricardo Pinto (Administrator, OECD).

Background research and information was provided by Senada Keserovic (Business Development Centre Zenica, BiH, Zenica) and Majda Despotovic (Business Development Centre Banja Luka, BiH, Banja Luka), who prepared the first draft of the report. The analysis, assessment and preparation of the final report were undertaken by Ricardo Pinto (OECD), Francesca Pissarides (EBRD) and Peter Sanfey (EBRD) with advice from other colleagues in the OECD and EBRD. The final editing was undertaken by Declan Murphy, OECD and Georgiana Pop, OECD. The assessments and views expressed in this report are those of the Investment Compact Team of the OECD secretariat and the EBRD Office of the Chief Economist and do not necessarily reflect the views of the institutions participating in preparing this report or of OECD and EBRD member countries.

## FOREWORD

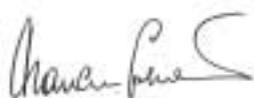
Starting a business in today's environment brings opportunities and challenges. Changing lifestyles demand greater choice of products and services. New technologies and better access to global markets have provided increased business opportunities. At the same time increased competition, insistence on quality and unremitting pressure for lower costs, just to mention some issues, represent major challenges for business. For Small and Medium-sized Enterprises (SMEs) the challenge is greater. They lack scale, resources and the capacity to handle complex business management. Typically, less than half survive more than five years and only a small proportion go on to become large companies. Entrepreneurship and enterprise development are important elements in creating dynamic market economies. SMEs are a vital source of new jobs, exports and economic contribution to countries. How to ensure the growth of the SME sector – a fundamental feature of all developed and growing economies - is a major policy challenge for all countries.

This Enterprise Policy Performance Assessment (EPPA) on Bosnia and Herzegovina (BiH) seeks to help address that challenge. The South East Europe (SEE) Compact for Reform, Investment, Integrity and Growth (Investment Compact), a key component of the Stability Pact, has consistently affirmed that the economic revitalisation of South East Europe is primarily dependent on private sector investment. Through the Investment Compact process, Stability Pact partners support and promote the structural policy reforms that will improve the climate for private enterprise and increase investment. This assessment aims to assist SEE countries in stimulating entrepreneurship and enterprise development.

Measurable progress has been made in various areas such as the creation of a state level organisation with an enterprise development brief, the business simplification reforms such as the target of 15 days for business registration and a greater degree of tax harmonisation, such as double taxation between the entities and the district of Brcko. Nevertheless, the report shows that the environment for creating and sustaining businesses remains underdeveloped in BiH. For example, the institutional environment remains highly fragmented and uncoordinated, the creation of an effective single economic space is a distant objective, company registration could be more simple, etc. Reforming and improving the environment for entrepreneurship remain a priority.

The EPPA draws on the practical experience and views of BiH SME representatives, expert advisors and the complementary experience and skills of the Organisation for Economic Co-operation and Development (OECD) and the European Bank for Reconstruction and Development (EBRD), two Stability Pact partner organisations that have been closely involved in the reform process in transition countries.

The analysis and assessments made, with significant input from research with SME owners and managers provide valuable insights into the key issues confronting the government in BiH. The Stability Pact, through the Investment Compact for South East Europe, will continue to contribute to establishing the enterprise framework in BiH and in the region as a whole through regular up-dates of the information contained in this report.



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## *Chapter 1.*

# **SUMMARY CONCLUSIONS AND RECOMMENDATIONS**

### **1.1. Summary Conclusions**

The authorities of Bosnia and Herzegovina (BiH) are increasing the levels of support to the SME sector, in recognition of its growing importance to the national economy. This political support is manifested in developments such as the:

- Creation of SME-oriented organisations at Federation of BiH, Republika Srpska and District of Brcko level.
- Approval of the Development Strategy Framework and the Interim Poverty Reduction Strategy Programme, both having an important private sector development focus.
- Recent legislative and regulatory changes to simplify and improve the business environment.

This Enterprise Policy Performance Assessment (EPPA) highlights a number of policy issues, raised by SME owners and managers and builds on recently published OECD-EBRD reports (2001 and 2002). It identifies a number of actions needed in order to continue the progress already made in improving the policy environment for SMEs.

In line with experience in other countries at a similar stage of transition to a market-based economy, there are issues emerging relating to policy implementation. It will take a persistent and determined effort to ensure that implementation is kept on track and momentum maintained. The best way to do this is with regular progress reviews to obtain feedback to identify areas requiring renewed focus.

The main issues identified in this assessment can be summarised as relating to:

- Communicating and consulting effectively with SMEs throughout the country.
- Co-ordinating the activities of the various bodies working to support SME development.
- Reducing complexity and ensuring coherency and consistency in policy, laws, regulations, procedures and support programmes, particularly between fiscal and developmental policies.
- Avoiding unnecessary changes in laws, regulations and programmes to facilitate planning of investments.

### **1.2. Summary Recommendations**

In the six years since the war, BiH has faced numerous transition challenges such as the establishment and development of a democratic society, the return of refugees and displaced persons estimated at 30% of population (Ministry of Foreign Trade and Relations of BiH, 2002), at the same time as transition to a market economy. The international community has played an important role in the post-war period, providing financial support and know-how to create the conditions for sustainability in both the democratic and economic processes.

More recently, the Council of Ministers of BiH has recognised the growing importance of SMEs to the economy. Its intention of developing a stable framework for SME development resulted in the adoption of the Development Strategy Framework (2003-2006) in March 2002. Likewise, the Interim Poverty

Reduction Strategy Programme (PRSP) foresees an entrepreneurial country where economic development will no longer depend on international assistance. A key pillar of the Development Strategy Framework is to increase the private sector's share of Gross Domestic Product (GDP), which currently amounts to around 35% (Ministry of Foreign Trade and Economic Relations of BiH, 2002). To achieve this, it will be essential to achieve and maintain macroeconomic stability, accelerate the process of privatisation, reform the financial sector and establish an enabling environment for investment. For the Development Strategy to succeed, the Government will need to put great effort in creating the right environment for SMEs to flourish. SME development is proceeding only slowly at present, hampered by numerous political, institutional and financial barriers, not least the fact that it consists of four levels of government, namely the state of BiH, Federation of BiH (F BiH), Republika Srpska (RS) and District of Brcko (DB), all with their own policy-making powers and legislative and institutional infrastructure.

This Enterprise Policy Performance Assessment (EPPA), produced by the OECD and EBRD, brings to the Government's attention a number of recommendations, based primarily on information and analysis of the SME perspective.

### ***Institutional Framework***

#### ***Policy Co-ordination***

- Co-ordinate SME policy and strategy at State level. BiH has a highly fragmented institutional structure, which means that no specific institution is directly responsible for providing support for SME development. The creation of a Department for Enterprise at the Ministry of Foreign Trade and Economic Relations, offers the prospect of a homogeneous strategy, co-ordination of SME-related legislation and dialogue with SMEs and other institutions involved in fostering SME development. The financial resources and human capital need to be commensurate with the scale of the task facing this new Department.

#### ***Consultation***

- Initiate regular and effective two-way dialogue between the Government and the business community. Consultation with the business sector has so far been poor in BiH and SMEs feel unable to influence SME legislation and policy. The Social-Economic Council in the Federation of BiH is an exception, but has a very wide remit, has only met once and it remains to be seen whether it can be an important part of meaningful partnership with Government. In policy spheres such as tax policy, new legislation and regulations affecting businesses, it is urgent to introduce permanent, regular mechanisms for consultation between the Government, the international institutions seeking to support SME development and the enterprise sector.

#### ***Single Economic Space***

- Create a single economic space as soon as practical. The existence of three independent economical entities (Federation, Republika and District), with their own independent and uncoordinated institutions and regulations for business activities, combined with the existence of ten Cantons (in the Federation) with their own institutions and numerous regulations applicable only on their territories, presents major barriers to strengthening the domestic market and the scope for SME development.

#### ***Co-ordination of Enterprise Initiatives***

- Co-ordinate SME projects and initiatives at the international institution/donor level. Various organisations are active in the fields of economic development, regional and SME development. Projects and initiatives have been and continue to be funded, often with insufficient consideration of what is already in place, of lessons learned from past experiences, of financial sustainability, etc. There is evidence of increasing co-ordination of these activities, however, more regular and effective Government-led co-ordinating should be instituted as a matter of urgency, especially among the key institutional players at state/entity/district levels, and with representation from the business community.

***Definitions and Statistics***

- Create a clear definition of SMEs, consistent with the EC definition, applicable to all levels and for all areas, including taxation and statistics. The available statistics are poor and incoherent, making it difficult to determine appropriate policies and evaluate their effectiveness.
- Co-operate with the State Statistics and relevant Ministries in order to systematically collect statistical information on the SME sector in order to analyse the underlying trends and determine appropriate policy responses. Both could be important objectives of the recently created Department for Entrepreneurship.

***SME Representative Bodies***

- Create an Advisory Council for SMEs (ACSME) at state level to enable it to become a regular forum for communication and consultation with a wide range of SME stakeholders. Adequate resources need to be devoted in order for the Council to be seen as an effective SME tool. This would have synergistic effects in terms of accelerating the process of creating a single economic space by co-ordinating SMEs interests and providing Government with input and feedback on relevant strategies, policies, laws, regulations, etc.
- Evaluate the need for the extensive network of Chambers of Commerce (there are 19 Chambers of Commerce at the state, entity and District of Brcko levels), as well as Chambers of Handicrafts and Self Employed (a further 19 of these, once created). The evaluation should cover their role and services offered, as well as the possibility of introducing voluntary membership, as in other SEE countries.

***Regulatory Environment******Registration, De-registration, Re-registration***

- Implement an electronic firm registration system in Courts covering the whole country.
- Introduce a single code number for each enterprise, in order to save time and costs to entrepreneurs submitting the same basic information to different bodies.
- Evaluate, simplify and publish the regulatory regimes that affect the setting-up phase of businesses. The same applies to procedures for re-registering and terminating enterprises. Work towards reducing the time and cost associated with business entry and exit.
- Move towards the creation of a “One-Stop-Shop” system throughout the country, as in the case of other SEE countries such as Romania (see OECD-EBRD, 2002).

***Regulations***

- Prepare a list of improvements to further reduce and standardise the procedures for SMEs to obtain licenses, permits and certificates and to set predetermined short time scales for each procedure.
- Take steps to ensure a greater focus on a “proactive” and “enabling” approach by introducing the principle of “silence is consent” as soon as practical (“silence is consent” is where if the relevant public body fails to answer within a prescribed period, it will be deemed that consent has been given).

***Communication with SME Stakeholders***

- Give an undertaking that SME stakeholders will be consulted on legislation and regulations affecting small businesses before proposals are converted into law.
- Build effective co-operation between the key SME stakeholders and disseminate information through web sites and forums to ensure that SMEs are aware of the latest developments and can provide feedback.

***Other Areas for Consideration***

- Allow for quick resolution of commercial disputes through “out of court settlements”.

## ***Tax Policy for Small Businesses***

### ***Policy Principles***

The Ministries of Finance in the entities, in co-operation with the Office of the High Representative (OHR) and the international donor community, to work together to ensure that:

- Simplicity, stability and clarity are achieved in tax policy.
- Fiscal administration is made more sensitive to the needs of the SME sector.
- Tax laws and regulations are consistently and fairly enforced.
- SMEs are able to obtain regular, simple and up-to-date information explaining the tax system to increase the levels of transparency.

### ***VAT***

- Introduce VAT at state level as soon as practical (planned for the 1 January 2005).
- Set the VAT refund period at the international standard of one month.

### ***Grey Economy***

- Widen the tax base as an important means of fighting tax evasion and supporting the integration with the financial system. The introduction of VAT will be an important step in this process.
- Strengthen efforts to collect tax arrears, regardless of firm size.

## ***Financial Instruments for Fostering New and Small Businesses***

### ***Promote a Healthy Banking System***

- Encourage restructuring/recapitalization of banks and stimulate consolidation. In both entities (Federation of BiH (FBH) and Republika Srpska (RS)) most banks are now private. However, serious concerns remain about the quality of their portfolio and their corporate governance, especially as regards banks in RS. The governments and banking regulators need to address these issues, as they discourage foreign investment and negatively affect the improvement of risk management. Liquidation of insolvent remaining state-owned banks is a top priority in both entities of BiH. The restructuring of the banking system in RS is a crucial step in the development of that entity's economy.

### ***Deepen Bank Intermediation***

- Push ahead with legal and judicial reforms. Despite the large number of banks in BiH, banking intermediation remains low. Legal and judicial reforms are a prerequisite to increase intermediation, as at present the unreliability of the court system has reduced creditors' faith in their ability to use the court system in the exercise of collateral rights and contract disputes.
- Use start-up microfinance banks and EBRD-related banks as role models for the rest of the system. Promote the broadening of products offered by the banks to increase intermediation. Encourage banks to be more prudent regarding mismatches of start-up companies and to seek additional long-term financing sources such as long term loans for SMEs.

## ***Advisory Services Supplied to New and Small Businesses***

### ***Long-Term Development***

- Prioritise the support to SMEs through national policy by focusing on subsidised business support services, especially targeting start-ups. In the long term, competitive private provision of business advisory services may reduce the need for government or donor-funded initiatives. However, this will only happen if the existing initiatives focus on achieving financial sustainability.

### ***Co-ordination of Support***

- Review the plethora of existing and future enterprise development initiatives by international bodies.

- Build on recent initiatives to ensure co-ordination of initiatives so as to increase the scope for financial sustainability.
- Ensure greater exchange of experience and information among the relevant bodies in the entities.

#### *Quality Standards*

- Evaluate the possibility of creating a representative body for business advisory services and consultants as a way of strengthening support and services, as well as ensuring co-ordination of activity for the benefit of the enterprises. This would be a useful step towards raising standards and assisting the process of financial sustainability.
- Introduce of a system of certification and accreditation of advisory bodies to set quality standards and improve confidence in the benefits of services. A credible representative body should carry out the certification and accreditation. Business advisory centres should be encouraged to develop and publish customer charters, setting out the range of services, the costs and the standards they promise to adhere to. Entrepreneurs need to be better informed of the potential gains from receiving professional advice before they may become more willing to pay for them.

#### ***Implementation of Business Incubators***

##### *National Policy*

- Develop a policy with respect to business incubators in BiH, including responsibility for implementation and securing commensurate national and international resources in order to promote business incubators effectively.
- Disseminate information and promote the role of business incubators to BiH entrepreneurs with departments and ministries of economy, as well as leaders of business associations, such as Chambers of Commerce and others.
- Develop training and education programmes for business incubator managers in order to ensure greater compliance with best practice in transition and OECD member countries.
- Evaluate the possibility of using business incubators to support the agribusiness and high-tech sectors.
- Evaluate effectiveness and financial sustainability of small business incubators of less than 2,000 m<sup>2</sup>.



## *Chapter 2.*

### **INTRODUCTION**

Private investment by Small and Medium-sized Enterprises (SMEs)<sup>1</sup> is a key generator of economic growth and social change in OECD member country economies. In most countries, over 90% of all enterprises are SMEs. It is now widely accepted that the contribution of SMEs to new jobs, exports, innovation and regional development is vital to national development. How to benefit from and maximise this contribution is a continuous challenge for all countries. This Enterprise Policy Performance Assessment seeks to help address that question for Bosnia and Herzegovina (BiH) and highlight issues that require attention and priority action.

The State has a fundamental role to play in providing a favourable framework and environment for private sector development in OECD member countries. In the transition economies of South East Europe (SEE), where private investment levels lag behind those of developed countries, the necessity to create an enabling environment for SMEs and private investment is more urgent. Reform of the business and investment environment leading to the creation of a dynamic entrepreneurial culture is crucial to drive the process of change in industrial structures and the transition to market economy structures.

The OECD and the EBRD have undertaken a series of Enterprise Policy Performance Assessments (EPPAs) in all SEE countries in order to monitor the development of policies and infrastructures to support the SME sector. Substantial emphasis has been placed in eliciting the views of private SMEs on their past experience and perception of the key barriers to business and new investment, and their assessment of progress in implementing policies to encourage the development of SMEs.

Previous OECD research has identified six broad dimensions of the framework and environment supporting SME growth and development, which are particularly important for governments to get right:

- Institutional framework for SME policy.
- Rule of law and the regulatory environment.
- Tax policy for small businesses.
- Financial instruments for fostering small businesses.
- Advisory services supplied to new and small businesses.
- Implementation of business incubators.

The Investment Compact, endorsed by the countries of SEE including BiH, explicitly acknowledges that the revitalisation of the SEE region must rely primarily on private sector development and investment (Investment Compact Charter, 2001). This EPPA captures private sector insights measured against the above six dimensions of good practice. They present views on performance and progress made on the basis of good practice indicators developed for transition economies and take into account other OECD and EBRD studies for BiH and other countries moving towards market based economies (see Chapter 5 - Information Sources).

Bosnia and Herzegovina (BiH) has gone through a decade of democratic, economic and social transition. The first part of the decade (1992-1995) was characterised by war and the associated changes to the economy and society. The war destroyed a major part of infrastructure and devastated the economy.

The state of BiH, according to the Peace Agreement signed in Dayton (USA) in December 1995, consists of three parts: the Federation of BiH (F BiH), Republika Srpska (RS) and District of Brcko (DB) created in 2000. F BiH itself consists of 10 Cantons. Small and medium-sized companies (SMEs), as in other countries have enormous potential to play a key role in the post-war recovery and prosperity of BiH by providing jobs and stimulating economic growth.

The EPPA research provides a qualitative “snap-shot” of the SME perceptions of the business and investment environment. It highlights issues in need of policy attention and indicates a number of recommended actions. This report is presented as a contribution to enhance policy dialogue between the key SME representative associations and the supporting State and entity institutions. It will be up-dated on a regular basis, thus allowing a fuller picture of progress to be developed over time.

The methodology employed in the EPPAs is set out in Box 2-1.

### Box 2-1. EPPA Methodology

- I. The EPPA methodology has been designed to provide insights and assessments of the performance in the implementation of policies to improve the investment environment for business. The EPPAs have been conducted on a standard basis in all countries of the region and provide a benchmark for (a) highlighting key reform issues (b) measuring private sector insights and assessments of the business environment (c) assessing progress on a country by country basis and (d) comparative cross-country review for the SEE region.
- II. The main components of the EPPA undertaken in BiH are as follows:
  - A question template was derived from extensive case study work on good practice in transition economies and OECD country experience (OECD-UNIDO, 1999) and used in the research.
  - Country-based experts/consultants were selected for their enterprise policy knowledge and experience.
  - Focus group discussions were held with SME representatives.
  - Individual SME interviews to validate the focus group research and to provide insights on key issues.
  - Expert interviews to cross reference information from the focus groups and contribute to views.
  - Desk research involving examination of existing reports, databases, documents, etc.
  - Expertise from OECD, EBRD and experts from OECD countries.
- III. Under the guidance of OECD, the focus group research with the private sector in BiH was carried out by local consultants, *Business Development Centres in Zenica and Banja Luka*, using a structured brief and template of questions developed by OECD and EBRD. The focus group research commenced in July 2002 and other interviews and desk research extended through 2002/early 2003. It focused on six dimensions of good practice in the following policy areas:
  - The Institutional Framework for SME policy.
  - Rule of Law and the Regulatory Environment.
  - Tax Policy for Small Businesses.
  - Financial Instruments for Fostering New and Small Businesses.
  - Advisory Services Supplied to New and Small Businesses.
  - The Implementation of Business Incubators.

**Box 2-1. EPPA Methodology (cont.)**

- IV. Four focus group discussions took place to reflect the structure of BiH. The first was in the capital city of RS Banja Luka, involving participants from the economically dynamic area of Banja Luka Region (north-west part of RS). The second was in the capital city of the State and Federation of BiH, Sarajevo attended by participants from five Cantons of the north-central part of F BiH, as well as participants from DB. The third took place in Jajce, attended by participants from the less economically dynamic area of the five Cantons to the southwest F BiH. The last focus group took place in Srpsko Sarajevo, attended by participants from the less dynamic regions of the south eastern part of RS and participants from DB. In all, 30 entrepreneurs took part in the discussions covering the following sectors of activity: agriculture, manufacturing, services, trade, tourism, building and transport. The participants included representatives of micro, small and medium-sized companies, ranging from start-ups to established firms. Standard templates were used for the discussion and the collection of ratings.
- V. In addition, 12 individual interviews were carried out with SME owners and managers and local SME experts. Representatives of six SMEs, as well as six institutions (including the Chamber of Foreign Trade of BiH, Foreign Investment Promotion Agency of BiH, Association of Entrepreneurs of Dobož (a regional business organisation), World Vision (international micro-finance and development organisation), Brcko District Development Agency, World Lutheran Union (NGO providing advisory services and technical assistance), took part in the research, allowing for a wider perspective than the focus group discussions and to cross-reference the information that was obtained in the focus group discussions. The same templates were used for the discussion and the collection of ratings.
- VI. The findings from the focus groups and interviews obtained were complemented with additional information provided by the EBRD. The EBRD's Office of the Chief Economist has assessed progress in structural and institutional reform across the region since 1994. The EBRD jointly with the World Bank launched the Business Environment and Enterprise Performance Survey (BEEPS) in 1999. The BEEPS asks enterprises to evaluate economic governance and state institutions and assess the extent to which the business environment creates obstacles to the operation and growth of their businesses. In 2002, a second stage of the BEEPS was undertaken, surveying close to 6,000 firms across 26 countries of the region.
- VII. The analysis in this EPPA is based on the methodologies described above (focus group research, expert interviews and secondary data collection) and is complemented by the EBRD assessment and the BEEPS 2002 results. All information has been analysed by the OECD and EBRD, resulting in the assessment presented in this EPPA report.

**NOTE**

1. The notations SME and small enterprise in this report also include micro-enterprises, which according to the EU definition ([http://europa.eu.int/comm/enterprise/enterprise\\_policy/sme\\_definition/index\\_en.htm](http://europa.eu.int/comm/enterprise/enterprise_policy/sme_definition/index_en.htm)) are independent enterprises with up to 9 employees and whose turnover or balance sheet asset value are  $\leq$  €2 million. Small enterprise are likewise defined as having between 10 and 49 employees and turnover or balance sheet asset value of  $\leq$  €10 million and medium sized companies as having between 50 and 250 employees and turnover of  $\leq$  €50 million or balance sheet asset value of  $\leq$  €43 million.



## INSIGHTS FROM SME OWNERS, MANAGERS AND REPRESENTATIVE BODIES

### 3.1. Introduction

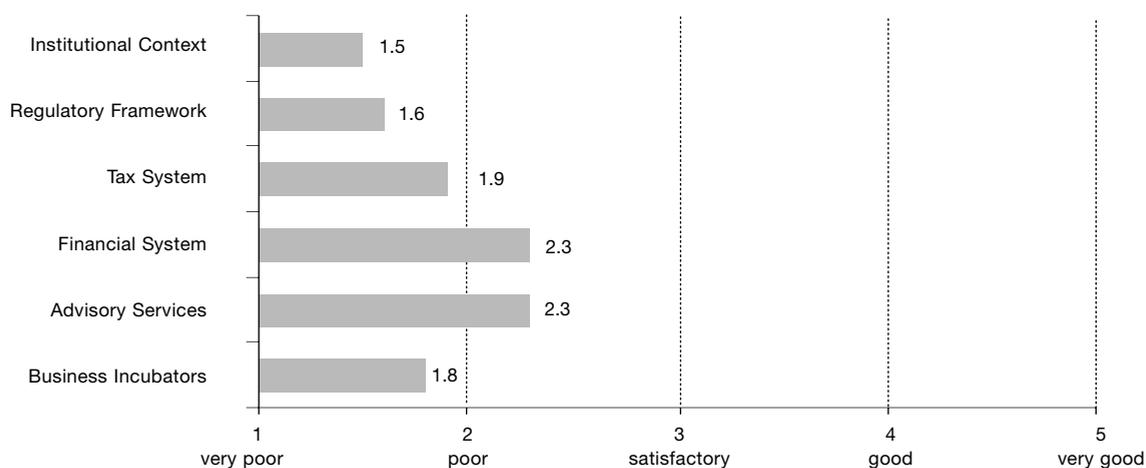
The analysis of the results of the research with the SME focus groups is presented under six framework dimensions of good practice for the business environment:

- Institutional framework for SME policy.
- Rule of law and the regulatory environment.
- Tax policy for small businesses.
- Financial instruments for fostering small businesses.
- Advisory services supplied to new and small businesses.
- Implementation of business incubators.

The analysis highlights the main issues arising from the discussion with the private SMEs participating in the EPPA research. The key questions dealt with in the focus group research are summarised at the beginning of each section. The average ratings used to represent the views of the entrepreneurs range from 1 to 5 and can be read as follows: 1 = very poor, 2 = poor, 3 = satisfactory, 4 = good and 5 = very good.

The average ratings per dimension of good practice are highlighted in figure 3-1. In general, the EPPA research shows that the SMEs participating in the research assessed all six dimensions of the framework and environment supporting SME growth and development as “poor”, especially the institutional context, which is assessed between “very poor” and “poor” (rating: 1.5). The best ratings were obtained for the financial system and advisory services supplied to new and small businesses, both with a rating of 2.3.

Figure 3-1. Average Ratings of the Six Dimensions of Good Practice by SME Owners and Managers



The main points made by the participants during the focus groups are reported verbatim and the quotations most relevant to the analysis are highlighted. Each section concludes with a summary of the issues emerging from the research.

In addition, this chapter presents selected analysis of the Business Environment and Enterprise Performance Survey (BEEPS) 2002 survey. The BEEPS is a survey of 182 BiH enterprises and, like the focus groups, was carried out in 2002. Of these, 151 were considered to be SMEs (of which 50% micro, 23% small and 27% medium-sized) according to the EU definition for employment (i.e. they had less than 250 employees). The results presented in this document refer only to the responses provided by the SME sub-sample. The BEEPS research is based on a sample survey and provides additional insights. The BEEPS analysis is presented in separate text boxes (for example, see box 3-1. below) and a summary of main results is contained in Appendix 1.

**Box 3-1. Obstacles to Doing Business (BEEPS, 2002)**

The entrepreneurs were asked to rate the severity of obstacles pertaining to several aspects of the business environment (the scores can be interpreted as follows: 1 = no obstacle; 2 = minor obstacle; 3 = moderate obstacle; 4 = major obstacle). Three areas of analysis overlap with the areas investigated through the focus groups methodology: regulation, taxation and provision of finance. On average they are rated between minor and moderate obstacles. A direct numerical comparison between the two types of analysis is not possible, due to the very different formulations of questions asked, however, the results are broadly consistent. It should be noted that the BEEPS included other areas of investigation in which obstacles of greater severity were identified, such as crime, land (title and access), labour regulations, etc.

**3.2. Institutional Framework for SME Policy**

The issues researched under this heading:

1. Clear assignment of organisational responsibility for the development of SME policy.
2. The effectiveness of organisation/s in developing an environment to encourage entrepreneurship and the development of SMEs.
3. The quality and effectiveness of the SME development strategy.
4. The local and regional governments' mandate and resources (funding, people and skills) to promote SME development.
5. The information provided and awareness by business people of the government's institutions, policy and programmes to support new entrepreneurs and develop existing SMEs.
6. The quality and regularity of consultation between government and the private sector on SME policy and its performance and assessment.

**Organisational Responsibility**

1. Has the government assigned clear <b>organisational responsibility</b> for the development of SME policy?	No
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The SMEs participating in the focus group discussions argue that organisational responsibility has not been clearly assigned by the Governments of the entities for the development of SME policy and that no single organisation is currently actively promoting the sector. Entrepreneurs think that every possible level of government administration seems to have some responsibility for SME development, but none of their activities are co-ordinated, consistent or clear.

According to the SMEs' view, there are a number of basic obstacles that need to be tackled before clear organisational responsibility can be assigned for the development of the SME sector. Not least among these, is the perception of poor awareness among politicians and responsible civil servants about the role played by the SME sector in the economic development of the country:

***“Many government members simply do not understand the problems of the private sector.”***

***“The staff in charge of creating the institutional framework for SMEs, at all levels of government, have inadequate professional experience and skills to perform their job.”***

The SME managers and owners participating in the focus groups emphasise the other problems that exist, the most significant of which is:

***“The existence of a huge bureaucratic government machinery, and especially the high level of corruption that exists within it, result in an inefficient institutional framework for SME development.”***

**Issues:** The multiplicity of organisations combined with the quality of the human capital of the civil service were the main concerns raised by the participants in the focus group discussions. There is perceived to be a high degree of institutional confusion about the SME institutions across the 14 levels of government in BiH, and a high degree of corruption is perceived to be associated with this bureaucracy.

### Effectiveness of the Organisation/s

2. Rating given to the <b>effectiveness of the organisation/s</b> in developing an environment to encourage entrepreneurship and the development of SMEs	1.3
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Following on from the previous discussion, the participants rate the effectiveness of the numerous organisation/s in developing an environment to encourage entrepreneurship and the development of SMEs as “very poor”. Some even concluded that:

***“The existing institutional framework actually has a destructive affect on the development of the SME sector.”***

The exception appears to be the District of Brcko (DB) (rating: 2.5), where organisational responsibilities for the development of SME policy have been assigned to a Regional Development Agency (BDDA). In addition to the regional strategy created by BDDA, the DB Government has established mechanisms enabling entrepreneurs to have some influence on SME policy through the Chamber of Commerce of DB, a body able to attend the Parliament of DB. Generally, the institutional structure is complex and inconsistent, though there is some prospect for improvement in 2003.

**Issues:** The effectiveness of the SME organisation/s in developing an environment encouraging entrepreneurship and development of SMEs is rated “very poor”, mainly due to the institutional complexity and lack of co-ordination.

### SME Development Strategy

3. Rating given to the <b>quality and effectiveness</b> of the SME development strategy	1.6
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The participants in the focus group discussions were not aware of the existence of any strategy focusing on SME issues at government level, though in fact such strategies exist for the DB and RS. As a consequence, they rated the quality and effectiveness of SME development strategy as “poor”. This rating is supported by the view that the lack of strategy results in issues such as highlighted below:

***“There is an absence of laws as well as measures to protect domestic production, especially in agriculture and food sector.”***

***“Several mills [were allowed to be] developed in a small area, resulting in very strong competition between them.”***

**Issues:** The quality and effectiveness of the SME development strategy is rated “poor”, reflecting the fact that the participants were generally not aware of any such strategies.

### Local and Regional Governments

4. Rating given to the <b>local and regional governments’ mandate and resources</b> (funding, people and skills) to promote SME development	1.5
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There was also a perception on the part of the SME owners and managers that there was a lack of strategy at the regional and local levels, with the result that most local administrations are perceived as neither having a vision nor an aim as to how they should act with respect to enterprise support. As a consequence, the respondents rate the local and regional governments’ mandate to promote SME development as “poor”. The entrepreneurs also think that municipal Economic Departments / Secretariats do not currently provide them with sufficient support. Similarly, the participants rate the local and regional governments’ resources (funding, people and skills) to promote SME development as “poor”.

The most frequent problems encountered by entrepreneurs include the lack of financial support, unqualified personnel, lack of awareness of the significance of the SME sector’s role in the development of local economy, regulations in force at the local level that: ***“do not help, but on the contrary, hinder investment activities”***, and lack of mechanisms for communication between authorities and enterprises:

***“For four years we have been submitting ... requests to increase prices [controlled by the local authorities], but so far we have received no answers.”***

Although the logic of the above quotation may be questioned in the context of market economies, overall the perception of entrepreneurs is that enterprises do not obtain much assistance from local authorities, ***“financial or verbal.”***

**Issues:** A mandate and resources to promote SME development exist at the local and regional levels, however, the support is very limited, highly variable and generally perceived to be of poor quality.

### Information and Awareness

5. Rating given to the <b>information provided and awareness</b> of the government’s institutions, policies, programmes to support new entrepreneurs and develop existing SMEs	1.5
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The availability of information to business people on government institutions, policy and programmes to support new entrepreneurs and develop existing SMEs is assessed as “poor”. The entrepreneurs participating in the research do not consider that such information systems exist at any level:

***“We only found out through training programmes that there was a law on financing new employees. This was about five months after the law had been adopted.”***

The SME owners and managers participating in the focus group discussions consider that part of the reason for this may be because the Chambers of Commerce and Entrepreneurs’ Associations, which act as a link between governmental institutions and the private sector, are not sufficiently effective. They maintain that in BiH, useful business information typically flows through informal sources such as personal networks, contacts and meetings rather than other, formal channels such as business representatives.

**Issues:** The level of information and awareness of the government's institutions, policies and programmes to support new start-ups and develop existing SMEs is very low and fragmented. Business representative bodies are not viewed as being effective in conveying useful business information to their members.

### Consultation between Government and the Private Sector

6. Rating given to the <b>quality and regularity of consultation</b> between government and the private sector on SME policy and its performance	1.4
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The quality and regularity of consultation between government and the private sector on SME policy is generally assessed as being “very poor”:

***“Proposals about laws are simply not available for discussion.”***

The exception appears to be District of Brcko, where consultation mechanisms between government and the private sector have been established through the Chamber of Economy. The participants from DB rated the quality and regularity of these consultations as “satisfactory” (rating: 3.3).

The participants argued that no meaningful dialogue system has been established with the government at any level, especially between the local and entity authorities. Again, participants from DB and Dobož have more positive experiences, pointing to the communication between authorities and economic sector through the Economic Chamber and the State Agency where, for example:

***“Not a single meeting of the Customs and Fiscal Assistance Office is held without representation from the Economic Chamber.”***

Entrepreneurs are particularly critical of one of the institutional players in the SME policy community. The participants argued that although membership of the Chambers of Commerce is obligatory at state, entity and cantonal levels:

***“The Chambers of Commerce are passive, ineffective and do not offer adequate services to SMEs. They need to be transformed to focus more on our needs.”***

This appears to be the main reason why a new Chamber of Commerce for Handicrafts and the Self-Employed is about to be established, funded through compulsory membership. This means that a parallel Chamber system is about to be created.

**Issues:** The quality and regularity of consultation between government and the private sector on SME policy is so poor that it is generally perceived to be non-existent.

### 3.3. Rule of Law and Regulatory Environment

The issues researched under this heading:

7. The formalities for new company registration and comment on the process.
8. The procedures for obtaining licenses, permits and certificates necessary for business operations.
9. The existence of a government approved programme for reducing the legal / administrative barriers for business and rating of the quality and effectiveness of this programme.
10. The efficiency of the programme for reducing the impact of corruption.
11. The quality and regularity of consultation between government and the private sector / SME policy community on draft legislation and regulations that affect business.

### Company Registration

7. Rating given to the <b>company registration</b> procedure	1.8
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The procedures for registration of new companies are also rated “poor”, mainly because of the high costs, bureaucracy and corruption involved in this process at present. The participants from the RS perceived the process of registration as being: **“quite quick but very costly”**, and rated it better (rating: 2.1).

The very slow and complicated procedures in F BiH meant that the registration process is rated lower (average rating: 1.5). The participants in the discussion emphasised the need for better co-ordination, for example through a networked database for the key institutions involved in the process of registration, namely courts, municipalities, statistics office and customs.

In the District of Brcko the registration process is required by law to last no longer than eight days. Not surprisingly, the SME representatives from DB assessed the company registration procedure much more positively (rating: 3.5).

Initiatives are underway to accelerate the process of registration to a target of 15 days in both the F BiH and RS BiH. At the same time, the participants confirmed that the procedures for establishing “crafts” and self-employment was, in fact, pretty efficient and involved relatively little cost and time for registration.

**Issues:** The procedures for the registration of a new company are assessed as being “poor”, due mainly to the high costs, bureaucracy and corruption involved in this process at present. The registration process in District of Brcko lasts eight days, demonstrating that it is possible to streamline the process. Indeed, the target of 15 days is being worked towards in the two entities.

### Licenses, Permits and Certificates

8. Rating of procedures for obtaining <b>licenses, permits and certificates</b>	1.9
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The entrepreneurs in the focus groups rated the process and procedures for obtaining licenses, permits, certificates necessary for business operations as “poor”, due mainly to the long procedures, delays, corruption and general bureaucracy:

***“Obtaining urban, water and building permits is a Sisyphian task that lasts for months.”***

The general perception is that: **“A lot of unnecessary information is needed”**, suggesting scope for streamlining the processes. The respondents also discussed the problems with the custom administration, involving:

***“... long delays for the goods at the borders and high levels of corruption, as there are no clear customs procedures.”***

By contrast, the participants from DB expressed very different opinions, stressing the efficiency regarding obtaining licenses, permits, certificates and rated this accordingly (rating: 3.0).

Further business regulation issues identified in the BEEPS survey are discussed in box 3-2.

**Box 3-2. Business Regulations (BEEPS, 2002)**

According to the BEEPS, the aspects of the business environment for SMEs pertaining to regulation (labour regulations, customs and trade regulations, title or leasing of land, access to land and business licensing and permits) are considered in general to be a less severe obstacle than the focus groups analysis suggests. However, variance in the rated severity of various aspects of the regulatory environment is significant, with issues related to customs and trade regulations seen as the most difficult for entrepreneurs, followed by business licensing, labour regulations, issues related to titles or leasing of land and to access to land.

**Issues:** Entrepreneurs rate the process for obtaining licenses, permits and certificates necessary for business operations as being poor because of long procedures, delays, corruption and general bureaucracy. The ratings for DB were much more positive.

**Simplification Programme**

9. Rating given to the efficiency of the <b>programme for reducing administrative barriers</b> for business	1.3
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The majority of the participants were not aware of the existence of any government programme designed to reduce the administrative barriers for business. They maintained that if such programmes did exist, they had yet to result in any noticeable improvement of the business environment. The respondents in DB rate the efficiency of any such programme as “very poor”. By contrast, the participants from DB consider that, due to support by the international community, especially the EU, a fairly good programme for reducing administrative barriers for business had been implementing in DB and they rated it as close to “satisfactory” (rating: 2.8).

**Issues:** The participants were unaware of programmes to reduce administrative barriers for business and had yet to notice any improvement. The respondents in DB rate both the efficiency of the process higher.

**Anti-Corruption Programme**

10. Rating given to the quality and effectiveness of the <b>Government’s programme for reducing the impact of corruption</b>	1.4
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The majority of participants are not aware of the existence of government programmes for reducing the impact of corruption. Although some participants are aware of the anti-corruption programme prepared by the World Bank within the framework of the “Interim Strategy for Poverty Reduction Programme”, the respondents rate the efficiency as “very poor”. They maintain that: “***There is no anti-corruption programme.***” and that: “***They [civil servants and politicians] do not really intend to reduce corruption.***” and furthermore that: “***Even if such programmes exist, nobody really intends to implement them.***”

This sceptical view was driven by perceptions that public officials do not believe in the notion of: “***public good, public benefit***”, and are motivated purely by: “***personal gain***”.

The constantly changing regulatory environment discussed above contributes to this situation by creating ambiguity and uncertainty, thus generating scope for rent-seeking activities (see box 3-3.).

**Box 3-3. Corruption (BEEPS, 2002)**

Some evidence of corruption affecting the SME sector also emerged from the BEEPS analysis. It found that SMEs pay 2.1% of total annual revenues in unofficial payments/gifts to public officials. This percentage is lower than the one in the 1999 BEEPS (3.2%). Also, a slightly smaller percentage of firms are affected by corruption with respect to 1999, according to the same sources. In 1999, 34.4% of those interviewed admitted to having made frequent bribe payments, whereas in 2002, 34.3% of firms did so. Corruption is the sixth most severe obstacle to doing business (out of 21) and is rated 2.6 (i.e. between minor and moderate).

**Issues:** Participants are unaware of programmes for reducing the impact of corruption. They are highly sceptical of both government intentions and the public officials' motivations in respect to combating corruption in BiH.

**Consultation between Government and the Private Sector**

11. Rating given to the <b>quality and regularity of consultation</b> between government and the private sector on draft legislation and regulations that affects business	1.4
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The SME participants in the focus groups rate the quality and regularity of consultation between government and the private sector on draft legislation and regulations that affect business as being "very poor". The participants think that:

***"There are no contacts and communication between government and private sector."***

***"There is no consultation with the private sector and the government usually does not hold public hearings."***

Once again, the exception is District of Brcko, where the representatives emphasise that there is greater co-operation between the authorities and private sector. They indicate that the Chamber of Commerce, representing SMEs, has a permanent place in the Parliament of DB and scope to influence policy regarding the regulatory and legal framework via active participation in the procedures for adoption of legislation. The DB representatives thus rated the quality and regularity of consultations as close to "satisfactory" (rating: 2.7) in comparison with the situation in the entities.

One of the commonly expressed views is that there should be a formal method of obtaining the opinion of the enterprise sector during the process of developing and reforming laws and regulations that affect businesses:

***"Without a compulsory mechanism by which governments at all levels are required to obtain our opinions and suggestions during the process of adopting new laws, our professional and business needs will continue to be considered as a 'dead letter'."***

Furthermore, there was a view that private sector representation in such mechanisms should not automatically fall to the usual organisations:

***"Neither the Chambers of Commerce nor the Association of Entrepreneurs protect the interests of the private sector with respect to rules and regulations. They are very passive in their behaviour"***

The BEEPS survey examined other aspects of interest. Box 3-4 deals with issues to do with contractual rights and changes to the legal system.

**Box 3-4. Legal System: Contractual Rights and Impact of Unforeseen Changes (BEEPS, 2002)**

Entrepreneurs asked to what degree they agree with the following statement: "I am confident that the legal system will uphold my contract and property rights in business disputes", mostly tended to agree, as can be seen from the table below.

Strongly disagree	8%
Disagree in most cases	9%
Tend to disagree	17%
Tend to agree	33%
Agree in most cases	11%
Strongly agree	11%
Don't know	11%

Also relatively more entrepreneurs found that an unforeseen change in laws and regulations would occur in 2003 and would have a significant impact on their business. The following table shows the specific results for the SMEs interviewed.

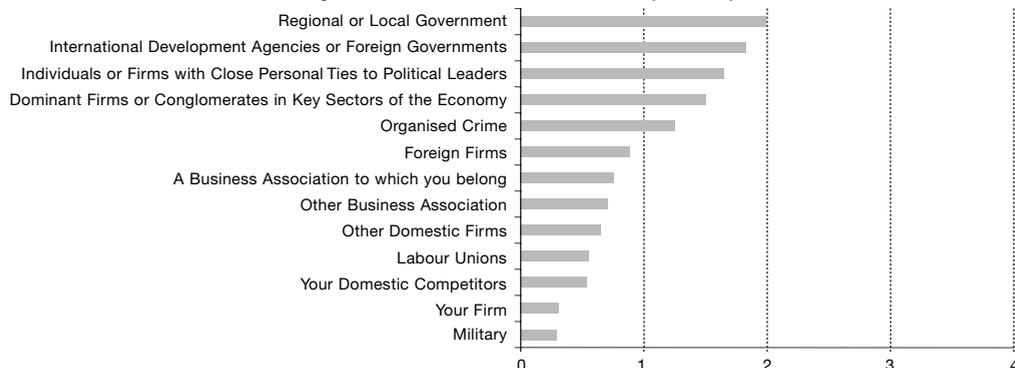
Extremely unlikely	5%
Highly unlikely	7%
Fairly unlikely	17%
Fairly likely	33%
Highly likely	19%
Extremely likely	11%
Don't know	8%

Box 3-5. examines the private sector's perceptions of the lobbying power of various organisations on the making of laws and regulations.

**Box 3-5. Private Sector Perception of Lobbying Power of Various Entities (BEEPS, 2002)**

The entrepreneurs were also asked about the link (in terms of lobbying power) between the legislative powers and regulatory authorities with various organisations and economic agents (the scores can be interpreted as follows: 0 = no impact; 1 = minor influence; 2 = moderate influence; 3 = major influence; and 4 = decisive influence). As can be seen from the chart below firms with ties to political leaders, large firms and conglomerates in key sectors of the economy, organised crime, international development agencies and regional or local government are believed to be able to exercise, to a minor degree, some sort of lobbying power on the legislative and regulatory authorities. The entrepreneurs interviewed in the BEEPS believe that SMEs and their business associations have almost no impact on the making of laws and regulations.

**How much influence do you think the following groups actually had on recently enacted national laws and regulations that have a substantial impact on your business?**



**Issues:** The quality and regularity of consultation between government and the private sector on draft legislation and regulations that affect business is believed to be good as non-existent, but should be a priority for Government.

### 3.4. Tax Policy for Small Businesses

The issues researched under this heading:

12. Whether the present tax policy encourages new enterprise and rating of the tax system in terms of the encouragement, support and ease of use that it provides to new and existing SMEs.
13. The stability and transparency of the tax system for small enterprises.
14. The consultation and communication between government and the private sector on tax rates and incentives for enterprises.
15. Co-ordination of tax policy with other government policies.

#### Encouragement of Enterprises

12. Rating given to tax policy in terms of the <b>encouragement, support and ease of use</b> that it provides to new and existing SMEs	2.0
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The main recent development has been the reduction of tax rates and establishment of new institutions for tax administration in both entities. Discussions with the private sector reveal that there is a degree of satisfaction with the new tax legislation and that the new tax policy is seen as moving in the right direction. The fact that the tax rates have been reduced (such as profit tax, sales tax and social contributions) is seen as being positive for existing enterprises:

***“Finally somebody in government has understood that tax policy can help us to develop our activities by assisting us to use our own money for re-investment, [with the consequence that] ... we are able to sell more and pay more taxes to the Tax Office.”***

The SMEs participants consider that the reduction in the profits tax does provide some incentive to invest, nevertheless, they still rate the overall tax policy as “poor” in terms of stimulating new and existing SMEs.

A further issue discussed with the entrepreneurs, was the type of changes to the tax system that small enterprises would like to see introduced. The discussions focused on the following issues:

- Transparency in the tax payment (who pays, who does not and under which circumstances).
- Equity and fairness to ensure that there are no privileged enterprises in the implementation of tax laws (e.g. state owned enterprises and large private enterprises).
- Reduction in the levels of corruption associated with the tax system.
- Creation of tax incentives for start-ups.
- Need for stability in the tax system.

The entrepreneurs feel that tax authorities exhibit a distinct degree of mistrust as far as SMEs are concerned. There is a perception amongst the SMEs participating in the research that there still exists an attitude in BiH public administrations that all private businessmen are basically dishonest.

SME participants from F BiH are of the opinion that tax policy is soundly based and that the legislation is not problematic. In their opinion, the problem lies in the poor implementation, such as the collection of the sales tax. Some of the participants estimate that 65-70% of sales are generated in the informal economy and that this results in high levels of unfair competition vis-à-vis enterprises that do pay their taxes. Entrepreneurs are particularly critical of the perception that the state does not penalise tax evasion sufficiently strongly, partly because of corruption within the tax authorities themselves. SMEs think that is quite common for certain enterprises to bribe tax officials in order to

avoid paying tax. The behaviour of the tax and financial inspectorates is also perceived as being misguided:

***“Instead of punishing large enterprises for evasion of millions’ worth of taxes, excises, customs duties ... and finding and punishing numerous unregistered businesses, they punish [legally registered firms for] trivial matters.”***

The SME participants from the RS strongly emphasise the need for harmonisation of tax policy between the entities and District of Brcko. According to them, tax policy currently does not encourage the development of new enterprises, as evidenced by the lack of incentives for start-ups. Whatever tax incentives may have existed for start-ups have now been dismantled in RS, partly it is argued as a result of the International Monetary Fund (IMF) loan conditionality. The participants in the RS rate tax policy as “poor” (rating: 2.3) in terms of the encouragement and support that it provides to new and existing SMEs.

**Issues:** The participants note some improvements, but rate the tax policy as being “poor” in terms of the encouragement and support that it provides to new and existing SMEs. They argue that tax administration authorities mistrust SMEs and implement tax policy inefficiently and inequitably vis-à-vis certain “privileged” firms. Tax evasion is criticised, partly due to the unfair competition that it generates.

### Stability and Transparency

13. Rating given to the <b>stability and transparency</b> of the tax system for small enterprises	2.0
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The participants did not perceive the tax system to be stable, as evidenced by the frequent changes in the tax legislation that they experience:

***“There are so many rules and regulations that change very often and confuse us even more.”***

Several participants express the wish for greater transparency regarding the enterprises that do not respect their tax obligations. In particular, some respondents are strongly of the opinion that government officials have a “**tendency to protect certain businesses**”, such as large trade companies, from paying their taxes.

**Issues:** The participants did not perceive the tax system to be stable or transparent due to frequent changes and the uneven application of tax rules.

### Consultation and Communication on Tax Policy

14. Rating given to the <b>communication between government and the private sector</b> on tax rates and incentives for enterprises	1.6
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The assessment of the degree of communication between government and the private sector on tax rates and incentives for enterprises is rated “poor”. The SME respondents think that there is a lack of government-business communication on the setting of tax rates and establishment of incentives for enterprises. They argue that they have no access to government in the preparatory phase of drafting laws, tax or otherwise, and that it is simply not possible for them to influence the formulation of laws and regulations. In their view, the process of proposing laws and formulating policy is unclear and the communication between the private sector and government institutions needs major improvement.

**Issues:** The assessment of the degree of communication between government and enterprises on tax policy, rates and incentives for enterprises is perceived to be “poor” and in need of major revision.

### Co-ordination of Tax Policy

15. Rating given to the tax policy <b>co-ordination with the overall government policy</b>	1.8
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The co-ordination of tax policy with the overall government policy is assessed as being “poor”. There was little discussion of this issue, other than the observation that the creation of a single economic space, starting with the proposed VAT system, is important to achieve as soon as possible.

According to the 2002 BEEPS, the two aspects of the business environment for SMEs pertaining to taxation, tax rates and tax administration are both rated at 2.7 on the BEEPS scale, indicating moderate/minor obstacles to doing business.

### 3.5. Financial Instruments for New and Small Businesses

The issues researched under this heading:

16. The stability, competitiveness and services of the banking system.
17. The commercial banks’ interest in extending credits to the SME sector and lending attitude with respect to the SME sector.
18. The SME access to the following main sources of finance:
  - Own/family capital.
  - Micro finance.
  - Venture capital/Equity.
  - Repatriation capital (from family / friends abroad).
  - Commercial banks.
  - Leasing.
  - Credit reference sources.
  - Bank personnel skills.
  - Others (e.g. credit unions).
19. The availability of finance for SMEs at local and regional level.
20. The availability of funding for all sectors including technology companies.

#### Stability, Competitiveness and Services

16. Rating given to the <b>stability, competitiveness and services</b> provided by the banking system	3.0
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The entrepreneurs think that the banking system has indeed stabilised in recent years in BiH, and that this is reflected in the fact that they now have much more “**confidence**” in the banks and the banking system than during 1996-2000. The respondents argue that this confidence has arisen from factors such as the entrance of foreign banks and financial expertise linked to the process of bank privatisation.

***“It is just an initial step, but a lot has been done to restore confidence in the state and the banks. The amount of savings [deposited in the banks] is increasing.”***

Linked to the above issue, the process of bank privatisation is coming to an end in BiH. Since foreign-owned banks made their appearance in the BiH market, the entrepreneurs argue that the degree of competition between the banks has increased dramatically. According to the entrepreneurs’ opinion, this is the principal cause of the notable reduction in the level of interest rates for loans.

In addition, the range of banking services that are on offer is also assessed as being “satisfactory”. The key concern of the participants related to the still high interest rates, the following comments being typical:

***“... the services are good but expensive.”***

***“There is a general lack of long-term credit... the maturities are such that they [the loans] cannot be considered as real long-term loans.”***

Nevertheless, the overall stability, competitiveness and services provided by the banking system in BiH were rated as being “satisfactory”.

**Issues:** Entrepreneurs believe that the banking system has experienced a noteworthy degree of stabilisation in recent years in BiH and that the influx of Foreign Direct Investment (FDI) has led to greater competitiveness and a wider range of banking services being offered.

### Banks’ Interest / Attitude to SMEs

17. Rating given to the commercial banks <b>interest in developing SMEs</b> and their <b>lending attitude</b> to the SME sector	2.2
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Overall, the entrepreneurs participating in the research are of the opinion that commercial banks are still not very interested in financing the SME sector. They do note that banks are beginning to lend more intensively for consumer credit and hope that the SME sector will become more of a target group in future. The participants connect the banks’ unwillingness to finance SME with their perception of the risk related to the weak legislative framework, for example to do with collateral and the operation of the court system:

***“Creditors are not adequately protected.”***

The participants assess the lending attitude of commercial banks to SMEs as “poor”, a problem that is perceived to be worse in RS due to the lower level of bank competition. The following quotation captures what entrepreneurs would like to work towards:

***“I’d like to have a bank that is a bit like a business partner; ready to share the risk with me. Instead, I have someone who is afraid of me.”***

**Issues:** Entrepreneurs think that commercial banks are not very interested in SMEs at present. Nevertheless, they are beginning to lend more and entrepreneurs anticipate similar trends in relation to the SME sector once the legislative system is enhanced and the banks’ risk assessment improves.

### Access to Finance

18. Rating given to the <b>access to key sources of finance</b> and guidance on financial matters to small businesses	2.2
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The majority of the focus group participants make use of own/family capital. This type of financing is rated highest compared to other sources of capital (rating: 3.6).

Repatriated capital (rating: 2.5) is also a very important factor in BiH, bearing in mind the proportion of inhabitants who became displaced or refugees, many of whom either worked or still work in western European countries.

The access to micro-finance is rated as the third most important source of credit (rating: 2.4). Participants think that these loans are quite small for their needs and that the interest rates are high, at 1.25% to 2.0% per month. Indeed, some participants view micro credits suspiciously, believing them to be used to support the informal economy by lending to unregistered enterprises. There currently appears to be a lack of information about micro-finance in BiH.

**Table 3-1. Relative Importance of Main Financial Sources Accessed by SMEs**

<b>Financial Sources</b>	<b>Rating</b>	<b>Ranking</b>
Family or individual capital	3.6	1
Repatriated capital	2.5	2
Micro-finance	2.4	3
Commercial bank loans	2.2	4
Leasing	1.7	5
Venture capital	1.7	6
Credit Unions	1.3	7

Note: The ratings used to represent the views of the entrepreneurs range from 1 to 5 and can be read as follows: 1 = very poor, 2 = poor, 3 = satisfactory, 4 = good and 5 = very good.

As a source of finance for SMEs, commercial banks were assessed as poor (rating: 2.2). Concerning access to bank capital, the participants highlight a number of problems such as: the lack of the investment and long-term credit; an over-concentration on short-term loans (up to 3 years); a perception of bias in lending practices in favour of larger firms; and the pervasive influence of corruption and connections in the processing of loans applications.

Venture capital is not used much by SMEs as a source of capital, partly due to a lack of knowledge by local entrepreneurs of this type of funding but also because of the early stage of development of local enterprises, which hardly makes them suitable targets for venture capital funds:

***“Our SMEs are not yet mature enough for this type of financing.”***

Consequently, access to venture capital is poorly (rating: 1.7) as is access to leasing (rating: 1.7). There is also little knowledge and access to credit unions (rating: 1.3) as a source of finance for SMEs.

Turning to more general issues, entrepreneurs consider the availability of information on financial sources in BiH to be fairly satisfactory (rating: 2.8). This is known to be one of the activities of a number of NGOs operating in BiH, though respondents still think that information could be improved, especially in the more remote, rural areas.

The skills of the bank personnel are assessed by entrepreneurs as close to “satisfactory” (rating: 2.8). The entry into the market of foreign banks is thought to have positively influenced the skill levels of the staff in commercial banks.

Boxes 3-6. and 3-7. examine respectively the sources of finance for SMEs’ needs and their perception of the ease of obtaining bank loans.

**Box 3-6. Sources of Finance for SMEs’ Needs (BEEPS, 2002)**

According to the BEEPS, the two aspects of the business environment for SMEs pertaining to finance (cost of and access to capital) are rated between modest and moderate obstacles to doing business (respectively at 2.8 and 2.5). They are ranked second and ninth in the set of 21 potential obstacles to doing business. Overall, the survey results highlight that the relative severity of the cost of capital obstacles appears to be secondary to economic policy uncertainty alone. Supporting this finding, an analysis of the sources of finance used by the Bosnian entrepreneurs in the past to finance both their working capital needs and new investments shows a high reliance on internal funds and loans from family and friends (such sources of finance account for 74.1% of working capital finance used and 73.5% of finance utilised for new investments). In particular local and foreign banks play

only a modest role in providing finance to SMEs (8.7% for working capital and 10.3% for new investment). However, only 68% of all firms interviewed managed to obtain finance (either internal or external) to fund new investments (most enterprises could find some source of finance to fund their working capital needs). The following table presents the relevance of sources of finance used by interviewed entrepreneurs for working capital needs and to finance new investments in percentage of total.

Source of Working Capital		Source of New Investment	
Internal	67.0	Internal	65.4
Family/Friend	7.1	Family/Friend	8.1
Private local	5.3	Private local	7.6
Supplier	5.1	State-owned	5.7
State-owned	4.5	Supplier	3.6
Foreign	3.4	Other	3.3
Other	3.3	Foreign	2.7
Equity	1.1	Leasing	1.4
Government	0.8	Equity	1.1
Leasing	0.7	Government	0.5
Money	0.7	Customer	0.3
Customer	0.7	Money	0.2
Credit cards	0.3	Credit cards	0.1

**Box 3-7. SMEs' Perception of Ease of Obtaining a Bank Loan  
for Working Capital/Investment Needs (BEEPS, 2002)**

A further question was asked regarding the entrepreneurs' perception of the ease with which they would be able to obtain a loan from a commercial bank for both working capital needs and for financing a new investment. The answers to this hypothetical question still point to difficulties in dealing with the banking sector. Only 41% of entrepreneurs think it would be easy to obtain a bank loan for working capital needs and less than 27% are of the same opinion as regards obtaining finance for new investments. It is worth noting that SMEs believe that accessing bank loans for the financing of new investments is more difficult than accessing working capital loans from banks. The entrepreneurs' responses to this question are presented below in percentage of total.

Accessing Bank Loans for	Working Capital	New Investment
Impossible	3%	6%
Very Difficult	15%	22%
Fairly Difficult	27%	31%
Fairly Easy	34%	23%
Very Easy	7%	4%
N/A	14%	14%

**Issues:** The majority of enterprises make use of own/family capital and repatriated capital also plays a very important role in BiH. Access to micro-finance is also rated highly, although there appears to be a degree of misunderstanding about the nature of this type of funding. Other forms of finance, such as equity and leasing, are practically non-existent.

**Access at Local and Regional Levels**

19. Rating given to the access to finance at <b>local and regional levels</b>	2.4
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The participants consider access to finance at the local/regional level to be quite poor. According to the participants:

***“In municipalities that have some funds, these are directed at the state owned enterprises.”***

The SME managers and owners would prefer that these resources were redirected to assist start-ups and small businesses. The DB participants were more positive about this issue. There is a high concentration of commercial banks (15 banks) in this relatively small geographical space (rating: 3.0). The situation was marginally better with respect to access to finance sources at the regional level, rather than the local level, since the majority of the leading commercial banks have opened regional branches.

**Issues:** The participants consider access to finance at local and regional level to be highly variable, despite the introduction of regional branches of commercial banks.

**Access by Sector**

20. Rating given to the access to <b>financial sources for all sectors</b> including technology companies	1.9
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Regarding the availability of bank loans for various sectors of activity, the entrepreneurs participating in the research emphasise the lack of finance for start-up businesses in general and primary agricultural production in particular. The loan programmes of international organisations such as the World Bank and USAID and the credit lines administered by commercial banks tend, not unnaturally, to target the most profitable sectors of activity, such as construction, trade, oil-import, production and wood processing. The banks are not perceived to be as willing to support activities in agriculture and tourism.

**Issues:** In the entrepreneurs' view, certain sectors with potential, such as agriculture and tourism do not benefit from commercial bank loans, and more finance could be focused on assisting start-ups.

**3.6. Advisory Services for New and Small Businesses**

The issues researched under this heading:

21. Satisfaction with the range and quality of advisory services available to new entrepreneurs and SMEs and rating of the present services and comment on the changes needed.
22. Efficiency of advisory services operations.
23. Responsiveness of advisory services provided to demand and the needs of enterprises.
24. The skills, experience and quality of the staff providing business advisory services.
25. The continuity of business advisory services available.

**Range of Advisory Services**

21. Rating given to the satisfaction with the <b>range of advisory services available</b> to new entrepreneurs and SMEs	2.2
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The participants are aware of the existence of business advisory services and know that they are mainly offered by either private consultancy companies or institutions sponsored by international organisations. The degree of satisfaction with the range of advisory services available to new

entrepreneurs and existing SMEs is assessed as being slightly better than “poor”. The participants felt that much depends on the kind of services being delivered and that the quality is satisfactory in certain areas, such as legal advice and book-keeping where:

***“... there have been improvements. The book-keepers follow the international accountancy standards and they also offer financial advice.”***

Nevertheless, the recurrent theme in the focus group discussions was that business consultants normally:

***“Deliver theoretical solutions and have a poor knowledge and awareness on the real problems faced by entrepreneurs.”***

**Issues:** The degree of satisfaction with the range of advisory services available to new entrepreneurs and existing SMEs is assessed as “poor”, though the quality is more satisfactory for basic services such as legal advice and book-keeping.

#### Efficiency of Advisory Services

22. Rating given to the <b>efficiency of advisory services</b> available to SMEs	2.4
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The efficiency of the business advisory services being delivered is rated in a slightly more positive manner, although the underlying problem remains:

***“The majority of consultants are not capable of delivering visible and measurable improvements and benefits.”***

The respondents consider the efficiency of advisory services by the various institutions in the market to be in need of improvement. The Chamber of Commerce, with its extensive network in BiH, was singled out for criticism. This reflects the fact that all enterprises pay for the services of the Chamber of Commerce through compulsory contributions and thus expect to receive efficient advisory services and support:

***“For example, the Chambers of Commerce could provide information on business legislation, interpretation of laws, information on financial sources, export-import regulations, etc. but they do not.”***

**Issues:** The services on offer are not yet considered to be satisfactory as regards their efficiency. The SME participants are particularly critical of the services delivered by the Chamber of Commerce network, since they must pay for these services.

#### Responsiveness to Demand

23. Rating given to the <b>responsiveness of advisory services</b> to demand and needs	2.4
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Overall, the perception of the extent to which the current business advisory services actually respond to enterprises’ needs is assessed as “poor”:

***“Sometimes our problems call for a much more sophisticated approach than they can provide.”***

The perception is that the business service advisors are not well geared to deliver the services that businesses really need. Given the early stage of development of such services, entrepreneurs often end up engaging institutions possessing only part of the portfolio of skills and knowledge required for the task. This means that not all their problems can be solved adequately, especially the more sophisticated or technically demanding requirements. The result is that they either obtain theoretical recommendations or partial solutions, hence the rating obtained.

**Issues:** The perception is that the current business advisory services are not very responsive to enterprises' needs. This may change as business advisors add to their knowledge and experience base and as competition in the provision of these services increases. The introduction of accreditation and certification could help ensure that a minimum range of services and quality standards are secured.

### Human Capital

24. Rating given to the <b>skills, experience and quality of the staff</b> providing advisory services	2.5
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The SMEs participating in the focus group research recognise that this is a difficult phase of the economic transition process for business advisors and consultants to work in, especially given the lack of funds and economic strategies to inform the work:

***“They can’t advise me properly if there is no strategic vision for the development of the country, region and municipality.”***

In addition, the quality and the skills of the staff providing business advisory services were not rated much higher than approaching “satisfactory”, linking up with the previous analysis of the inadequate skill set to meet all the demands of the enterprise sector at present. Although entrepreneurs appear to prefer advice from foreign consultants, rather than that provided by local firms, they think that both domestic and foreign advisors: ***“work superficially”*** and: ***“do not deal with the company’s concrete problem - they mainly theorise.”***

**Issues:** The quality, experience and the skills of the staff providing business advisory services were rated as approaching the “satisfactory” rating by the participants in the research. Quality standards and certification could lead to a better perception of business advisory services and a greater willingness on the part of enterprises in BiH to pay for those services.

### Continuity of Provision

25. Rating given to the <b>continuity of advisory</b> services available	2.2
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The respondents think that there is not much continuity to the advisory services being offered in BiH. This is assessed as “poor” mainly because of the short-term horizon of projects:

***“Many agencies established with the help of foreign donors terminate their activities when the funds run out.”***

Even if the intention is that the projects become financially sustainable, this does not always happen. Other problems may be created by the lack of sufficient project preparation:

***“The international community could spend resources in a more co-ordinated manner, avoiding overlaps in support to SMEs.”***

The international community needs to be focused more on achieving a financially sustainable business advisory sector, capable of meeting the market requirements in terms of standards and price. For example, the participants in the focus groups note that the donor-funded business services tend to be offered free of charge, where others are trying to operate on a semi- or fully commercial basis. This variance in approach may endanger the objective of becoming financial sustainable, while at the same time creating an uneven playing field in the market vis-à-vis commercially oriented organisations.

There is consensus among participating SMEs the State should support services to help entrepreneurs during the start-up phase of their business. Participants comment that without such support, commercial services could be too expensive, especially for small enterprises and potential entrepreneurs: ***“A two-day training course can easily cost €200”***. Nevertheless, some of

the services appear to have become cheaper due to the increase in competition between business consultants:

***“A few years ago, the price of assistance with a loan application was 3-4 times higher.”***

**Issues:** The continuity of the advisory services is assessed as being “poor” partly because of the lack of financial sustainability of many projects. Donors preparing new projects in this field should place greater emphasis on this consideration and ensure that new projects do not undermine the fragile sustainability of existing initiatives and business-oriented consultancies.

### 3.7. Business Incubators

The issues examined under this heading were:

26. Experience with business incubators and importance to new entrepreneurs and existing SMEs.
27. The efficiency of the government policy and programme encouraging business incubators.
28. The state of the business incubators’ governance structures.
29. The locations, the infrastructure and facilities of business incubators.
30. The extent to which the business incubators’ activities are focussed on the needs of the local entrepreneurs.
31. The extent to which the operating conditions, services and charges are transparent and clear.

#### Experience of Business Incubators

26. Rating given to the <b>business incubators’ importance</b> to new entrepreneurs and existing SMEs	3.5
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Given that there is only one business incubator operating in BiH, the great majority of focus group participants are not familiar with the concept, purpose and potential of incubators. Therefore, information to follow should be treated with due caution.

Based on their limited knowledge, the participants assessed business incubators to be important to new entrepreneurs and existing SMEs. The participants rapidly grasped the scope offered by business incubators for new job creation, especially given the labour market consequences of the privatisation and enterprise restructuring process underway in BiH:

***“This would be a chance for the authorities to help generate employment opportunities.”***

The majority of participants consider business incubators as a potentially vital tool to assist start-up business but believe that it would be impossible for them to work effectively in BiH:

***“... in such a bureaucratic and corrupt environment as ours, you cannot expect organised business development to take place.”***

**Issues:** Given that there is only one business incubator operating in BiH, the information presented has to be treated cautiously. Nevertheless, the participants rated positively business incubators’ importance to start-ups and existing SMEs.

#### Government Policy

27. Rating given to the <b>efficiency of the government policy</b> encouraging business incubators	1.3
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The efficiency of government policy for encouraging business incubators is assessed as being close to “very poor”. The participants think that they have not spread in BiH because of a general lack of knowledge about them at all levels of public administration, as well as a lack of understanding the

potential of incubators as a tool for assisting start-ups. The participants do not believe that there exists a policy for implementation of business incubators:

***“The authorities do not even understand that it is a useful tool.”***

The participating SME owners and managers perceive an urgent need for further information and training provision for both Government officials and entrepreneurs, linked-up with the higher education sector:

***“The Government could easily co-ordinate the link between universities and businesses with the intention of forming ... modern and effective business incubators and technology parks. The issue is whether the authorities are ready to do that and to acknowledge that they need training on these matters.”***

**Issues:** The efficiency of the government policy encouraging business incubators is assessed as being “poor”, as, in the entrepreneurs’ opinion, there is a gap in policy in this area which is partly due to a lack of knowledge of incubator and related initiatives.

### **Governance Structures / Locations, Infrastructure and Facilities**

Due to the lack of specific knowledge by participants no feedback was obtained on this question.

#### **Focus on Needs**

30. Rating given to the extent to which the business incubators’ activities <b>satisfy the local entrepreneurs’ needs</b>	1.1
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The extent to which the business incubators’ activities satisfy local entrepreneurs’ needs is rated “very poor”. The single existing business incubator is located in a building still “decorated” with bullet pock-holes in Gradacac. The general environment and facilities are rudimentary. The focus group participants maintain that there are many empty public buildings, such as factories that are no longer operational, that could be used by local authorities to establish business incubators. These could either be sold or rented out at relatively low cost in order to stimulate employment.

**Issues:** The extent to which the business incubators’ activities satisfy the local entrepreneurs’ needs is assessed as “very poor”, for example in terms of facilities and the very limited access.

#### **Transparency**

31. Rating given to the extent to which the operating <b>conditions, services and charges</b> are transparent and clear?	1.1
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Finally, the extent to which the operating conditions, services and charges are transparent and clear is also rated “very poor”. The entrepreneurs emphasise that in addition to finding the funds required to adapt empty buildings into workable business incubators, a key problem remains the lack of qualified and skilled staff to manage them. These statements should be treated with caution, given the participants’ general lack of first hand experience with business incubators

**Issues:** Business incubators’ existing governance structures are rated “very poor” as exemplified by perceptions of their unclear operating conditions, services and charges.

## Chapter 4.

### ANALYSIS AND ASSESSMENT

This chapter presents the OECD-EBRD analysis and assessment of the six dimensions of good practice for the business environment to complement the analysis of the discussions with the owners and managers of SMEs presented in the preceding chapter of this report. It reviews the current situation in each of these areas, takes into account other OECD and EBRD studies and analyses of good practice, and the private sector views, based on the preceding qualitative research with the owners and managers of SMEs. The assessment of the current situation leads to a series of recommendations by the OECD and EBRD presented in Chapter 1.

#### 4.1. Implementation of the Institutional Framework for SME Policy

##### ***The Situation on the Institutional Framework***

The development of an *institutional framework* to support of SMEs and enterprise development is still in its infancy and its development is constrained by the complex constitutional structure of BiH. However, in recent months important steps have been made which may result in a more coherent institutional structure to support SMEs.

*Federation of BiH:* The Ministry of Energy, Mining and Industry created a *Department for Entrepreneurship (and Production Handicrafts)* in 2001, with a staff complement of four, whose mandate is to develop the SME sector. The scope and resources are very limited given its wide-ranging mandate. The proposed draft law on SME incentives, designed to stimulate the sector, has not yet been approved. The Ministry of Energy, Mining and Industry plans to create a separate Ministry of SMEs. This is in line with the decision of the High Representative (October 2002 Decision) to increase the number of Ministries in the Federation from 13 to 16 at the entity level. No new ministry had been set up at the time of the focus groups but all three new ministries were subsequently created in February 2003 (see Appendix 2). This decision stems from the government's belief that this is the only way of raising the profile of the SME sector and of ensuring the necessary co-ordination of issues such as finance, institutional environment, business advisory services, etc. in the Federation.

*Republika Srpska:* The Ministry of Industry and Technology in the RS has had some institutional arrangements for a longer period, focused around the activities of the *Department of Private Entrepreneurship*. The main achievement to date has been the preparation and adoption by the government of the *SME Strategy* for the period up to 2005. The strategy focused on issues such as the definition of SMEs (two types of enterprise: SMEs and handicrafts, similar to EC definition but with lower turnover levels) and included a consultation exercise prior to government approval of the strategy. Although recent initiatives to provide incentives to foster SME growth in the RS have (as in the Federation) been blocked, it is anticipated that an *Agency for SMEs* will be created in 2003, in order to implement the SME strategy. It is expected to have a budget of €75,000 in 2003 and a staff complement of 14 when fully operational. In addition, the Department of Private Entrepreneurship is expecting to create a Revolving Credit Fund for SMEs in 2003, with €7.5 million start-up capital from the state budget.

*District of Brcko:* The *Department of Economy* of the Government of DB is responsible for SME development. Since the creation of the District three years ago, much of the focus has been on establishing the

necessary legislative framework for economic activity including laws such as: bankruptcy, tax, company, etc. The privatisation process will be one of the key areas of activity in future, as will be the focus on attracting greater Foreign Direct Investment (FDI) into the District. With respect to enterprise development, the relatively new (April 2001) *Regional Development Agency of Brcko District (BDDA)* is the main institution for making economic progress in the District, based on its approved *Regional Development Strategy*. With regards to enterprise development, the RDA is focusing its activities on issues such as: development of a “one-stop-shop” for business registration on a commercial basis; business support services on a subsidised basis; trade and investment promotion; credit guarantee fund for export oriented firms, etc. The RDA is based on a broad regional partnership and the budget is expected to come partly from the Government of the DB.

*BiH State:* The Ministry of Foreign Trade and Economic Relations in BiH is the state level organisation with the economic development brief, including enterprise development. The Council of Ministers recently adopted a proposal to create a new *Division for Development and Entrepreneurship*, under the guidance of an Assistant Minister. Within this Division, there will be four departments: Economic Development, Co-ordination of Reconstruction and Development Projects, Co-ordination with International Institutions and *Promotion and Development of Entrepreneurship*. The new department focusing on entrepreneurship will have 12 staff members and will focus on developing an “umbrella” law on SMEs, including SME definitions. The four departments have since been established, however, their budgets for 2003 simply cover salaries and office costs, leaving limited scope for operational activities.

Some progress has been made in relation to the development of *SME strategies*. At the entity/district level, the *Regional Development Strategy* for the District of Brcko (2002-2006), adopted in June 2002, contains an SME development strategy as a priority development goal and refers to the establishment of a sound business environment, supported by adequate institutional infrastructure. Also, following the initiative of the Ministry of Industry and Technology, a *Programme of Development of SMEs (2002-2005)* was adopted in December 2001. On the basis of this programme, the Law on Incentives for SMEs was adopted in September 2002, according to which an *Agency for SMEs* and a *Fund for SME Development* will be implemented. There is no corresponding strategy for the Federation. Both strategies relate to their respective geographical territory and there is precious little co-ordination between the entities/district and the State level.

There is currently a strategy gap at the national level. However, the Economic Development Strategy Global Framework: *Poverty Reduction Strategy Programme* is at the public discussion phase and will be approved in the near future. The Strategy covers a wide range of areas: macroeconomic stability, privatisation, strengthening the financial sector, creating an enabling environment for investments and SME development. Finally, at the local level, certain Cantons/Regions and Municipalities in both entities have initiated the development of *Regional/Local Development Strategies*.

Other SME institutions also exist, the most important of which are listed below and the remainder are presented in Appendix 2.

The international community, especially the European Commission (EC), is actively promoting the establishment of Regional Development Agencies (RDAs). The Brcko (BDDA) and Sarajevo (SERDA) RDAs are already active, while the Upper Drina Valley (REDRIN) RDA is being set up. Two other RDAs are being established in Mostar (MEDA) and Tuzla. It is expected that two additional RDAs will be established in 2003/2005: one covering Central BiH (probably in Zenica) and the other covering North West BiH (probably in Bihac), though the plans remain to be finalised. The RDAs focus on creating a regional partnership covering all key players, including the business community, in creating a favourable business environment, strengthening the economy of the region and its linkages with surrounding regions, including different entities, as in the case of Sarajevo. The RDAs' mandate is to provide direct support to SMEs in their respective regions.

The *Foreign Investment Promotion Agency (FIPA)* was established in July 1999 as a state level agency and is answerable to the Council of Ministers of BiH. FIPA specialises in providing services to foreign investors

and improving the country's image in order to attract new investors. FIPA has close business relations with government institutions, entity governments and their institutions, as well as the business community.

The main problem affecting all public institutions responsible for SMEs development, regardless of spatial level, is a chronic shortage of funds. Money is not the only issue. Skilled staff capable of both developing appropriate strategies for SMEs development and implementing them effectively is missing.

There is no shortage of *Chambers of Commerce* representation at various spatial scales: the Foreign Trade Chamber of Commerce of BiH (state), Chambers of Commerce of Entities and District (F BiH, RS and DB) and Cantonal (10 in F BiH) / Regional (5 in RS) Chambers of Commerce. Over and above these 19 Chambers of Commerce operating at three spatial levels, there will shortly be a parallel set of Chambers of Commerce focusing specifically on Handicrafts and whose members are to be craftsmen and the self-employed. The Handicrafts and Entrepreneurship Chamber of Commerce for the RS was established in May 2002 and the law has been passed in F BiH. It is anticipated that there will be a similar structure for handicrafts and self-employed throughout the country, whose membership will likewise be on a compulsory basis.

Until recently, there was not a single body responsible for ensuring effective *communication* between government and the business community. However, in F BiH a Social and Economic Council consisting of Government, Employers and Trade Unions was created at the end of October 2002. The Council will co-ordinate social dialogue between the partner institutions and focus on collective bargaining agreements. It is anticipated that the Council will have an active role during the process of discussion of drafts of laws regulating socio-economic issues. In January 2003 funds worth €75,000 were approved for the activities of the Council. The Council had only met once at the point when this analysis was carried out, so it is premature to try to assess its effectiveness.

In the District of Brcko, consultation mechanisms between government and the private sector have been established through the Chamber of Commerce, which has the right to permanent attendance (without voting rights) to the Parliament of DB. It uses this right to express the views of SMEs and protect their interests during the procedures for preparation, discussion and adoption of laws and regulations.

Finally, the *international community* plays a particularly important role with respect to enterprise development in BiH. The Economic Department of the Office of the High Representative (OHR); the EC Delegation; the World Bank; the South East Europe Enterprise Development (SEED) Programme; and bilateral donors such as USAID, GTZ and DFID are particularly active in BiH, compared to other countries of SEE. Given the resources involved and the complexity of the policy environment in BiH, the necessity for effective donor co-ordination is increasingly recognised in order to ensure effective use of resources and address "donor fatigue".

### **Assessment**

A number of improvements have taken place in BiH, such as: progress in developing the institutional system related to SMEs since 2000 (due largely to the initiatives of the international community); the creation of the Foreign Investment Promotion Agency at the end of 1999; the approval of the BiH "Economic Development Strategy Global Framework: Poverty Reduction Strategy Paper"; the need to establish a single BiH economic space. All these are seen as positive developments, which are also recognised and welcomed by the SME owners and managers participating in the research. However, this is still long way from satisfying the needs of the small business sector in BiH.

BiH has 14 governments on three territorial levels, with 187 Ministries (see Appendix 2), none of which has been made directly responsible for providing support for SME development so far. The most obvious feature of the BiH institutional context for SME development is its complexity and lack of co-ordination and coherence. The SME institutions currently do not, bar a few exceptions, co-operate with each other. The creation of a Department for Enterprise Development, including an SME Development and

Promotion Unit at the Ministry of Foreign Trade and Economic Relations, offers the prospect of state level co-ordination of SME policy. This is to be welcomed, as it will focus on issues such as: co-ordination of legislation, SME strategy (all levels), SME dialogue (SME policy community, including the international organisations - see below), etc.

Regular and effective dialogue between government and the business community has been conspicuous for its absence. This is a major weakness and remains a key source of complaint by the entrepreneurs, since they feel unable to influence SME legislation and policy and thus conclude that their views are ignored. The fact is that there is not a single body responsible to achieve effective dialogue except for the recently established Social and Economic Council in F BiH, the top tripartite economic body in the entity. The Council consists of 15 members (5 representatives of each of the three partners - the Government of F BiH, the Trade Union of BiH and the Association of the Employers of F BiH) according to the Agreement signed in August 2002. The Council had only one meeting by the end of 2002 but it is meant to co-ordinate social dialogue between the partner institutions and evaluate the collective bargaining agreements. It is also anticipated that the council will discuss drafts of laws affecting the socio-economic sphere and will provide recommendations to the Government of F BiH. Despite being a notable development, the Social and Economic Council has a very wide remit, has only met once and it remains to be seen whether it can be part of a meaningful partnership with the government.

For the moment, initiatives and proposals made by SMEs and their representatives are regularly submitted at the national, entities and cantonal levels of Government, designed to help create of a more suitable environment for SME development. They typically receive no feedback. This appears to apply especially in the case of tax policy where businesses are not consulted, changes are made almost irrespective of consequences to businesses and changes and rules are introduced so late that they result in confusion and unnecessary compliance costs to business. The most problematic situation arises when rules and regulations are designed to apply retroactively, causing major disruption to enterprises. There is an urgent need to introduction representative, regular, permanent mechanisms for two-way dialogue between government, the SME policy community and the enterprise sector.

The existence of three independent economical entities (Federation of BiH, Republika Srpska and District of Brcko), with their own independent and uncoordinated institutions and regulations, and the existence of ten Cantons in the Federation of BiH, with their own institutions and numerous regulations applicable only on their territories, constitute major barriers to SME development. The most notable problems caused by this fragmented situation include: double taxation, double registration of enterprises, incentives to operation in the informal economy, etc. The private sector shares the view that the establishment of certain institutions operating at state level (e.g. Chamber of Foreign Trade; Foreign Investment Promotion Agency; Deposit Insurance Agency; State Boundary Office, etc.) are good examples of the benefits to be derived from operating at the state level. Following the High Representative's introduction of the excise tax allocation mechanism and removal of double excise taxation in July 2002, it became easier and less costly for manufacturers and traders in excisable goods to do business inside BiH. However, much remains to be done before an effective single economic space is created.

A source of confusion and inefficiency in administering SME programmes and implementing laws and regulations in BiH, relates to the lack of definition of SMEs. This needs to be defined at state level and applied on a consistent basis in the entities and the district. The same applies with respect to statistical information, which is poor and incoherent, making it difficult to determine appropriate policies and evaluate their success. Both elements could be an important function of the recently created Department for Development and Entrepreneurship.

There is a proliferation of Chambers of Commerce in BiH. The current 19 Chambers of Commerce (1 state, 2 entities, 1 DB, 10 cantonal in F BiH and 5 regional in RS) are expected to be shortly doubled in number, once the Chambers of Handicrafts and Self Employed are created. Given the entrepreneurs' scepticism of the value for money gained from the existing Chambers of Commerce and the likely proliferation of such institutions, consideration should be given to evaluating their role and services, as

well as the introduction of voluntary membership, as in the case of other SEE countries such as Romania. This would be a significant step in stimulating these institutions to deliver services much more in tune with the needs of small businesses than may currently be the case.

Various organisations are active in the economic development, regional development and SME development agendas. Many projects and initiatives are funded, often with little consideration of what exists on the ground, what has been tried and worked/failed, the absolute necessity to secure financial sustainability, etc. There is evidence of greater co-ordination of activities, including discussion of the possibility of SEED and the EC Delegation taking the lead in co-ordinating respectively activities affecting SME development and regional development. Regular, government-led co-ordination does not yet exist, but should be instituted as a matter of urgency, including the key institutional players at state/entity/district level, with representation from the business community.

This co-ordination is particularly important now that the international community has indicated its intention to reduce the donor support flowing into BiH, unless the track record of implementation is improved. At the same time, the SME policy community in BiH appears to be increasingly critical of the efforts of the international community and the perception of overlapping activities and projects. There are good reasons for ensuring regular donor co-ordination with regard to regional economic development.

#### **4.2. Implementation of the Rule of Law and the Regulatory Environment**

##### ***The Situation on the Rule of Law and the Regulatory Environment***

The general legal framework, including that affecting the SME sector is complex and highly variable with at least *four key levels* (state BiH; the two entities and the district; and cantons in F BiH), all of which have their own powers and responsibilities:

- According to the Constitution, the *state BiH* level has certain responsibilities such as: foreign policy, foreign trade policy, customs policy, monetary policy, immigration, refugee and asylum policy, criminal law enforcement (between entities and international), international communications, air traffic control and finances of its institutions and international obligations. Recent state level laws include: foreign direct investment, customs policy, central bank, commercial banks, deposits insurance, income tax, foreign trade, free trade zone and property and ownership issues.
- At the *entity level*, numerous laws have been passed by their respective parliaments with varying degrees of compatibility. Since DB was created in 2000, it has also passed a number of its own laws, often choosing between the best of what the other two entities have to offer, such as laws on: commercial banks, registered pledges, excise tax, land register and rights, enterprises, register of enterprises, etc.
- The *lack of internal harmonisation* is one of the major barriers to doing business in BiH (see FIAS, 2001). In addition, the approach to the regulation of business reflects an attitude of controlling rather than monitoring and penalising rather than enabling compliance. The associated lack of transparency in enforcement of law and regulations contributes to the creation of a business environment characterised by mistrust and suspicion.

Although the F BiH and the RS have their own company legislation, both allow for the following legal forms of business: sole proprietorship; general partnership; limited liability company; and joint stock company (see Law of Business Companies, Federation of BiH, Article 3; and Enterprise Law, Republika Srpska, Article 2).

The *company registration procedure* involves a number of steps: payment of the founding deposit into a temporary bank account; preparation of the founding acts and statute of the enterprise; court verification of the foundation or contract; verification by local municipality the signatories to the enterprise; registration with the Ministry of Foreign Economic Relations (of the relevant entity) if the founder is foreigner; payment of the court registration fee and delivery of completed forms to the court for

registration; obtaining the official seal; opening of giro bank account; registration with the statistical register; registration with the tax administration; registration with the custom register (if enterprise wants to export-import); and municipal decision on the fulfilment of all the conditions necessary for business activity. This amounts to a complex registration process, which can discourage business start-up and expansion. The entry of a new firm involves an average of 14 steps (applicable in both entities); an average period of *56 days in the RS* and *124 days in F BiH*. Turning to the average costs of new business registration, this is about €200 in standard fees (in both entities) but typically involves considerable *other official fees* (legal, notary, levies, licences, etc.) amounting to between €250-€1,620 in F BiH and €650-€2,605 in RS (FIAS, 2001).

It is now widely recognised that the *permissions and licenses* required to start operating often present unnecessary barriers to new business and the existing enterprises. The procedures of obtaining permissions and licences are laborious, expensive and are often connected with bureaucracy and corruption. World Bank Diagnostic Surveys of Corruption (World Bank, 2002) demonstrate that the managers of new firms typically spend more than 20% of their working time dealing with government officials and that the average business spent 10% of its time resolving bureaucratic issues with public officials. Over and above these issues, there is a lack of institutions dealing with certification and quality control. Customs procedures are complicated and opaque, often resulting in delays at border crossings and additional costs to businesses.

The entity governments maintain a complex and often conflicting set of laws regulating business activities. As a result, the common perception amongst entrepreneurs is that even businesses willing to comply with all laws and regulations may be faced with situations where adhering to the requirements of a particular law means breaking the requirements of another (ICG, 2001). Furthermore, as many regulatory functions are the responsibility of *local government*, laws are often inconsistently and arbitrarily enforced.

Following the publication of the Foreign Investment Advisory Services (FIAS, 2001) study on administrative barriers for investment in BiH, which was highly critical of the existing problems, in February 2002 the BiH Council of Ministers and the Entity Governments prepared and approved an *Action Plan on the Removal of Administrative Barriers for Investments* (The BiH Ministers' Council and Entity Governments, 2002). At the same time, and linking-up with the Action Plan, the Office of the High Representative (OHR) published a "*Jobs and Justice*" reform agenda (OHR, 2002a) that was agreed between the government of BiH and the international community, such as the WB, EU and IMF, involving five pledges around the themes of economy and justice. These two documents represent the framework for activity supported by the international donor community (USAID, GTZ, DFID etc.), designed to streamline the regulatory and legal environment. They focus on the components highlighted in table 4-1.

The High Representative has been vigorous in proclaiming a number of laws affecting SMEs, such as the Law on Amendments to the Law on Central Registers and Data Exchange (28 June 2002). Moreover, the international community, led by OHR, is seeking to ensure the implementation of the economic reforms. In November 2002, it announced the formation of the *Bulldozer Committee* (composed of OHR, WB, EC, IMF, and USAID) in consultation with local stakeholders and other international agencies. The intention is to help cut as much red tape as possible, thus stimulating economy growth. The Bulldozer Committee has two main goals: to back-up the set of economic recommendations endorsed by the government and to eliminate job-destroying legislation through economic micro-reforms. These goals are to be achieved through a process designed to achieve consensus among the business community, politicians and the international community. By the end of 2002, the first three steps included formation of the Committee; gaining international community / local support; and consultation with the key stakeholders. The aim is to deliver 50 economic reforms within a short timeframe. According to the latest information, the vast majority of these reforms is well on the way to being implemented in accordance with the timetable and represents a turning point for policy reform in BiH.

The previous RS Law on Compulsory Settlement, *Bankruptcy Procedures* and *Liquidation Procedures* (Official Gazette of RS 21/92) was based on the former Yugoslav Republic's "social ownership" structure

Table 4-1. Framework of the Reform Agenda

Action Plan (BiH commitments)	Agenda for Reform (BiH jobs “pledges”)
<p>1. <i>Economic legal framework - rationalisation of functions and harmonisation of laws and regulations</i> (including Law on Commercial Companies; Company Law; Law on Crafts; Law on Direct Foreign Investment; Law on Bankruptcy; Law on Registered Pledges).</p>	<p>1. <i>Support private enterprise, privatisation and removal of business barriers</i> (including business registration in 15 days, enabling small firms to borrow, reforming land ownership registry and laws and continuing the process of privatisation).</p>
<p>2. <i>Judiciary</i> (including strengthening the capacity of judiciary to implement laws; alternative system of resolving business disputes; reform the Code of Civil Proceedings and Law on Execution Procedures; strengthening Commercial Departments within courts).</p>	<p>2. <i>Make government more efficient and cut waste</i> (including increasing revenue collection, introducing VAT and cutting bureaucracy).</p>
<p>3. <i>Registration and operation permits</i> (including simplifying registration procedures; single system of identification numbers; co-ordinating registration procedures).</p>	<p>3. <i>Creation of a single economic space: free movement of goods, services, people and capital</i> (including eliminating double taxation within BiH, certifying exported products and further economic reform).</p>
<p>4. <i>Real estate</i> (including ownership and land management - legal framework for transfer of ownership; integrated cadastre; land commission on use of land; Law on Concessions; Infrastructure activities).</p>	<p>4. <i>Deliver high quality and affordable public services and utilities</i> (including modern road, rail and air services, better public utilities and improving information and access for citizens regarding services and benefits).</p>
<p>5. <i>Employment</i> (including foreign labour – residence and permits, domestic labour – salary tax and social contributions, labour inspection, reduction of corruption).</p>	<p>5. <i>Develop an affordable social safety net</i> (including health insurance, unemployment benefit and pension system).</p>
<p>6. <i>Business operations</i> (including taxation, tax evaluation and payment, customers and their administration; Code of Conduct for tax inspectors; information dissemination; simplify custom administration; reduction of corruption; timely information of customs regulations, etc.).</p>	
<p>7. <i>Inspections</i> (including rules for inspections, such as number, co-ordination and revision of penalties).</p>	
<p>8. <i>Corruption</i> (including Laws on Criminal Legislation; Prevention of Money Laundering; Anti-Corruption; Public Procurement; Strengthening the Role of Public Prosecutors; Financing Political Parties and Obligations).</p>	

Sources: OHR (2002a) and World Bank (2002)

and tended to protect debtors more than creditors. It was replaced by the Law on Bankruptcy and Law on Liquidation (October 2002), but implementation only started in January 2003. The equivalent law is expected to be adopted in the F BiH in the near future.

*Payments to SMEs* in the RS are subject to the Law on Obligation; Code of Civil Proceedings and Law on Execution Procedures; and in the Federation Code of Civil Proceedings. These laws allow interest to be charged as a penalty for delayed payment, however, they are typically not implemented in practice. Enterprises are critical of the lengthy court process (lasting 2-3 years) and the lack of inter-entity co-operation regarding protection of inter-entity payments and exports. These obstacles have been recognised by OHR, which is supporting reform of the system for resolving business disputes. The parliaments of both entities have before them new and harmonised drafts of the Code of Civil Proceedings and a Law on Execution for approval.

The *court system* is seen by businesses as being slow, inefficient, expensive and corrupt. Businesses generally seek to avoid legal challenges as do not trust courts to reach a fair resolution of commercial

disputes. The F BiH and RS are currently in the process of reforming their courts, which should also result in the establishment of courts specialising in commercial disputes.

*Procurement* opportunities are theoretically open to all companies, regardless of size, though the business community does not expect fair and transparent evaluation of bids at the present time.

*Corruption* is recognised as one of the main problems affecting businesses in BiH. The Interim Poverty Reduction Strategy Paper (Ministry of Foreign Trade and Economic Relations of BiH, 2002) places the fight against corruption as the second most important priority, after improvement of the business environment for domestic and foreign investors. Corruption is facilitated by the inconsistent and opaque regulatory framework for business operations in BiH. The main sources of corruption are customs officers, tax administration officers, inspectors, the registration and licensing regime. This has been estimated to reduce tax revenues by as much as one-third per year (Tomas, 1998). The World Bank's Diagnostic Surveys of Corruption (World Bank, 2002) show that the average firm pays bribes to public officials amounting to 18% of their monthly expenses.

The Law on Money Laundering has recently been adopted, however, a Law on Corruption was withdrawn from the agenda at State level. An Anti-Fraud Unit has been active since 1998 within the Office of the High Representative seeking to implement a "Comprehensive Anti-Corruption Strategy for Bosnia", working together with other international organisations under the Anti-Corruption and Transparency Group. The entities have formed Anti-Corruption Groups comprising high-level government officials and published Anti-Corruption Implementation Plans. These various strategies and institutions have had mixed results (World Bank, 2002) in terms of combating corruption thus far.

The BiH *Civil Service Agency* (CSA) was established in January 2003 (High Representative Decision, May 2002) and is responsible for the transparent recruitment of civil servants at state level, including the appointment of heads of key agencies and institutions. It is tasked with making sure that civil service positions are filled on the basis of merit, rather than political connections. It also has an important role to play in relation to the "Job and Justice" reforms previously discussed.

There are many estimates of the *grey economy* in BiH. An UNDP survey (Tomas, 1998) estimated it at 68% of GDP in the RS, and concluded that the situation was very similar in the entire BiH. A more recent estimate of the informal economy in over 100 countries in the world (Schneider, 2002) concluded that the informal sector in Bosnia and Herzegovina in 2001 is the region 34% of GDP. The main forms of expression of the informal economy in BiH include tax fraud and tax evasion, illegal import and export, inaccurate and/or incomplete bookkeeping and hiring staff without paying income taxes and social contributions.

#### **Assessment**

The regulatory environment is both highly complex and fast changing. The analysis contained in this report does not attempt to be extremely up-to-date, but it does attempt to highlight a number of major themes. SMEs strongly advocate for initiatives to improve the business environment, such as simplification of company registration and licensing; fight against corruption; harmonisation of rules and regulations, including tax regimes; and ultimately the creation of a single economic space.

Progress has been made since 2000 in the reform of the legal system related to SMEs, partly as a result of the international community's support regarding reform of regulatory framework. An Anti-Corruption Action Plan exists, which is in line with the recommendations of World Bank studies on the causes of corruption in BiH, as well as with the activities of OHR and other international organisations. However, corruption is pervasive and the associated cost to businesses is significant. Various steps have been taken to counteract this activity in BiH but the private sector remains sceptical about the level of success achieved thus far, including the willingness of the various levels of public administration to really stamp-out corrupt practices. This issue, combined with the large role of the grey economy, create an almost intolerable burden for enterprises, especially the resulting unfair competition.

The key barriers and constraints on the regulatory side in BiH have been discussed in detail in other studies. The analysis in this report suggests that it is essential to maintain the pressure for reform of the business registration process. The 15 days target advocated by OHR is based on a realistic commitment on the part of the BiH governments, even though it is not a demanding target by international standards. The experience of DB demonstrates that it is possible to register a company in 8 days in a similar environment. Indeed the relative lack of bureaucracy in the DB combined with its status is assisting rapid enterprise development to occur compared to the two entities. Attention should also focus on the overall costs and complexity of business registration, which remain excessive. Not unreasonably, entrepreneurs expect the registration process to be simplified and the submission of documents in electronic form to be possible in future.

Previous research has demonstrated the problems caused by the inefficient procedures and this report highlights the frustration, the cost and the corruption practices that arise from the current system. There is now a Government approved Action Plan (on the Removal of Administrative Barriers for Investments) and OHR's (Jobs and Justice) reform agenda. The latter in particular, appears to have made substantial progress since being created. Nevertheless, there is a high degree of criticism emanating from the SME sector of the time and costs involved in the current licensing regime. There is little confidence that any proposed improvements will be translated into real action and it is believed that it will be a long time before the benefits are felt "on-the-ground" by entrepreneurs. SMEs will have to see beneficial effects if they are to be convinced of the Government's determination to address the regulatory reform issues. In this context, the introduction of the principle of "silence is consent" needs to be expedited. Under this arrangement, if a response is not made within a predetermined period by the public body concerned, permission is deemed to have been granted.

The business community feels largely cut out of the process of regulatory and legal reform. There is currently no mechanism for regularly obtaining feedback on draft laws or proposed reforms to existing laws, even though this has become standard good practice elsewhere. Consultation with SMEs and their representatives on new laws that have direct impact on the activities of SMEs is rare. On the occasions when it does occur, there is little confidence that entrepreneurs' views will be taken on-board seriously. SMEs would welcome more consultation, for example, on harmonisation of laws within BiH. The government of BiH needs to implement the mechanisms to consult private sector representatives on legal and regulatory changes as a matter of course, since this directly affects businesses. This would also help to overcome the perception that government is not actively engaged in reducing regulatory barriers to doing business.

### **4.3. Implementation of Tax Policy for Small Businesses**

#### ***The Situation on Taxation Policy for Smaller Businesses***

The determination of *tax policy and tax administration* is the exclusive competence of the entities (Federation, Republika and the District of Brcko). The specific laws governing customs, taxation and tax administration in each of the two entities are as follows: corporate income tax, personal income tax, property tax, sales tax, excise (six laws in the case of the F BiH, one in the case of the RS BiH), wages tax, social contributions, customs service and customs policy.

In order to develop a meaningful *single economic space*, however, there is a strong move, supported by both the international community and the business sector, to harmonise tax policies and rates, resulting ultimately in a unitary tax policy and administration system. Although this is far from being achieved, some activity has taken place in harmonising the tax system between two entities and District of Brcko. In August 2002, an agreement was signed between the entities and DB on avoiding double taxation with regard to excise duties. Further harmonisation efforts on Excises and Sales Taxes within the entities and the District of Brcko are progressing, however, this remains one of the main barriers to doing business in BiH and is highly criticised by the private sector. Key business laws remain incompatible between entities, causing further complexity, cost and delays in a small and fractured market. A European

Commission / OHR / State and Entity Government *Consultative Taskforce* is addressing harmonisation of laws between entities with EU Directives. USAID, the WB and OHR also work on these issues.

Regarding *audit and inspection* institutions, there are organisational differences within the entities. In F BiH there are two departments within the Ministry of Finance: the Tax Administration Department and the Financial Police Department. However, in the RS, the Public Income Administration and Financial Police have been merged into a new Tax Administration institution, partly in response to the FIAS report, which argued that: "... **the actions of the Financial Police [in both Entities] were often arbitrary, subject to political manipulation and highly corrupt**" (FIAS, 2001, p.111). The business sector's view of the matter has not changed much since the publication of the above report.

Tax reforms are a constant feature in the entities. In the *F BiH* major reductions of the tax rates were made in 2001. The latest Law on Tax Administration, valid since August 2002, increased the powers of tax officers regarding the inspection procedures. Also the latest changes in sales tax have decreased rates of both tariffs (from 24% to 20 % for most products, from 12% to 10% for so called "favoured" products such as food, clothing, electricity, etc.; and from 12% to 10% for services). In the RS, the tax policy has focused on reducing and harmonising tax rates, broadening the tax base, simplifying procedures for tax payment and strengthening the capacities of tax agencies and monitoring mechanisms. Tax laws have been in effect since January 2002 concerning a new *profit tax rate* of 10%. The regressive taxation system of RS of two years ago is no longer in operation. *Tax incentives* to support existing SMEs focus on reinvested profit, however, the incentives planned for encouraging new enterprises have been removed from the legislation.

The maximum rate of *income tax and salary contributions* (gross salary) has been reduced from 74.4% to 52%. Reforms have also been made in the field of the *Special Republic Fee* (paid annually by registered companies in Republika Srpska) and the *Municipal Fee* (for company signs). Instead of being determined on a "case-by-case" basis, the amounts of both fees are fixed and depend of the firms' particular sector of activity.

Finally, a new law enables each enterprise to define the base for profit tax in a *tax statement*, which has to be accepted by the Tax Administration (following checks of the accountancy books, if necessary). The powers of the tax administration in RS are harmonised with the F BiH through legislation. For example, 31.12.2002 was the deadline for re-registration of businesses in both entities and DB.

The *Value Added Tax* (VAT) has yet to be introduced in BiH. The IMF has undertaken a feasibility study on introducing VAT in BiH, however, the original expectation that it would be introduced in July 2003 proved to be too optimistic and is now anticipated in January 2005. The Agenda for Reform (OHR, 2002a) agreed between the international community and the Council of Ministers of BiH, foresees the replacement of the current sales tax regime with VAT. The main outstanding issue is whether this should operate at entity or state level, with the balance of opinion, including business opinion, firmly on the side of implementation at state level. The jobs pledges seek to provide greater transparency, such as providing taxpayers with a clearer picture of how tax revenue is spent; the creation of an inter-entity / State VAT Working Group; and agree on the functional level of VAT and the revenue allocation system.

Over and above the VAT issue, the Agenda for Reform (OHR, 2002a) aims to:

- Improve revenue collection (enforcement, tax administration, introduce a taxpayers' identification number and seek consensus on the allocation of excise and VAT duties).
- Eliminate double-taxation within BiH borders, resulting in a single economic space for all taxes.

Intensive efforts are being made by the international community to introduce both VAT and Customs administration at state level.

## **Assessment**

The government's efforts to streamline the tax system (such as the reduction in the overall tax burden; the harmonisation of the excise and sales tax within the entities and the intended introduction of VAT) are very positive developments. At the same time, SME owners and managers in BiH, appear to mistrust tax authorities mainly because of their perception that tax administration is unfair and non-transparent. Overall, although the private sector is grateful for the recent tax reforms, entrepreneurs point to the extensive degree of tax evasion, which raises important issues, not least to do with fair competition.

The tax system remains a major hindrance to doing business in BiH. The urgent necessity to create a simple, clear and stable tax system is even more important in BiH than any other SEE country. The lack of harmonisation of business taxes between entities and the district in a small market creates major administrative and financial costs to domestic businesses and acts as a major barrier to FDI. Whilst recognising the nature and powers in the BiH Constitution, from a business development perspective, the key business taxes should operate in a unified manner, preferably at state level in future.

The tax system increases uncertainty and makes it difficult for enterprises to plan their activities. This adds to the compliance cost on firms and leads to lower investment and less job creation. To avoid discouraging entrepreneurship and hindering SME development, and to reduce the "grey economy" the Government needs to continue to widen the tax base by relentlessly tracking down undeclared income. VAT should be introduced as soon as practicable (planned for 1 January 2005) since experience elsewhere in SEE indicates that this has an influence on the levels of the informal economy. The VAT refund period should be set at the international standard of one month.

Businessmen, especially SMEs, fear and mistrust the tax authorities. They perceive tax administration as non-transparent and unfair. Since tax rules are complex, frequently changing and overlapping in scope, it is problematic for firms to work with the inspection service. As a result, inspections are seen by businesses as intrusive, time consuming and punitive, as confirmed by other studies. There have been some moves to reform and merge the tax administration system in the entities and district, however, more efforts must be made to reform the institutions, build capacity, introduce clear procedures and rules and generally stamp out unfair and corrupt practices.

The extensive degree of tax arrears and evasion raises important issues relating to competition: between state owned enterprises and private firms, between large and small firms, between legal and illegal firms, etc. The large, mostly state-owned companies, tend to be in a better position vis-à-vis the Tax Office than SMEs for a variety of reasons, including political connections and social concerns in case failure to repay tax arrears leads to bankruptcy or down-sizing. Renewed efforts must be made to ensure procedures are applied consistently to all firms, regardless of nature, and to reduce the level of tax evasion, for example through the introduction of the VAT system.

There is almost no consultation between enterprises and the Government on tax policy and its administration. The absence of mechanisms for consultation means that unexpected or aggravated cash flow problems can jeopardise start-ups and investment plans. Experience elsewhere suggests that both the Government and the business sector would benefit from a mechanism allowing for more effective, regular and timely consultation on proposed changes. Representatives of SMEs point out that the tax policy has to be focused on creating a simple, clear and stable tax system. The Government should consider establishing the tools of regular consultation with the business sector on proposed tax changes through the Ministries of Finance and Economy/Industry/Trade. The Government also needs to regularly inform the business sector of the expected benefits that will accrue from the tax changes.

#### 4.4. Implementation of Financial Instruments for Fostering Small Businesses

##### *The Situation on Financial Instruments*

The banking system in Bosnia and Herzegovina is quite developed relatively to that of some other countries in the region. The significant progress in financial sector reform in the last two years, including the amendments to the banking law in F BH, the new banking law in RS and the entry of new foreign banks, have been reflected in increased confidence in the banking sector. With many foreign banks present in the country, competition for some financial instruments is strong and banks are starting to offer an extended product range (credit cards, consumer loans, mortgages, etc.). However, the level of bank intermediation remains low, due to the slow progress with privatisation and restructuring in the rest of the economy. SMEs are still experiencing difficulties in accessing long-term credit. These problems are compounded by inadequate secured transaction regulations and an inefficient court system, making collateral foreclosure difficult.

As of end-2002, there were 40 commercial banks in the country, down from 75 in 1997; 28 in the Federation and 12 in the Republika Srpska (RS). The number of banks in the country has been reduced in recent years but is still large relative to the size of the country and the market. Nine banking licenses were revoked in 2002 alone. Further consolidation is ongoing in the light of the new minimum capital requirement of €7.5 million as of 31 December 2002. A number of banks remain to be privatised (or, for those under administration, liquidated), although it is unclear if there is sufficient investor appetite to do so. The successful sale of Central Profit Banka, the third largest in the country, to a strategic investor is particularly important for the sector. Ten banks in BiH have deposit insurance as of early-2003, despite the legal requirement for all banks to insure their deposits by August 2003.

Notwithstanding recent improvements in financial sector reform, the EBRD's rating for Bosnia and Herzegovina on banking reform and interest rate liberalisation has remained at 2+ since 1998 (see table 4-2). This reflects the fact that banking intermediation to private sector remains low. Access to long-term financing remains a significant problem. Local investment is constrained by a low savings rate, itself a reflection of lack of confidence in the banking sector, while potential foreign investors are wary of the volatile political climate and the poor investment climate. Domestic credit to the private sector increased in 2002 but most of the increase was to households rather than enterprises, prompting the IMF to raise concerns in June 2003 (in an otherwise positive assessment of the country's progress under the stand-by arrangement) about a credit boom. Moreover, the credit expansion has resulted in uncovered currency positions on the balance sheet of some banks (in excess of 100% in some cases), in violation of supervisory regulations. Although this does not appear to be a problem to the banks under the current currency board system, in the long run it may cause instability in the system given that currency boards are not meant to be permanent institutions. Interest rates on commercial loans (see table 4-3) have decreased to an annual rate of around 10% to 12% (similar rates in real terms as inflation is close to zero in both entities).

Table 4-2. EBRD Score for Financial Sector Reform

Financial Sector		1997	1998	1999	2000	2001	2002
Banking Financial Institutions	Banking reform & interest rate liberalisation	1.0	2.3	2.3	2.3	2.3	2.3
Non-banking Institutions	Securities markets & non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	1.7

Source: EBRD Transition Report 2002.

Access to bank finance for SMEs in the Republika Srpska was even more difficult than in the Federation, as local banks until 2001 had only access to limited short-term funds. The World Bank and

USAID programmes partly compensated for this market failure. A number of programmes intended to benefit SMEs through their improved access to finance, such as political risk guarantees, export financing, performance bonds, have proven to be less efficient than desirable, due to the lengthy and complex procedures to release funds.

**Table 4-3. Domestic Credit to the Private Sector (in % of GDP)**

1996	1997	1998	1999	2000	2001	2002
N/A	40.1	37.1	31.9	31.0	31.6	36.3

Source: IMF Staff Report (2002 figure is end-September).

Non-bank financial institutions are in their infancy. However, new stock exchanges opened during 2002 in both entities. The Banja Luka stock exchange started trading on 14 March 2002 and the Sarajevo exchange opened on 12 April 2002. Market capitalisation of both exchanges is small and the impact on the economy is likely to be minimal for the foreseeable future. The leasing and insurance sectors in particular require development and improved regulatory frameworks. The EU supported the preparation of modern insurance legislation, which was submitted to State and Entity Parliaments but is not yet enacted. The IFC-SEED programme co-ordinates the efforts of the international community to work on updating the leasing legal framework. The pension system is largely unreformed and a multi-pillar system with private pensions is not yet in place.

**Table 4-4. Cost of Credit Available from Official Sources**

	MEB Bank	Foreign Currency Denominated Loans	
		Other providers	
		Banks	NGOs/Programmes
	<b>Interest Rate</b>		
Micro loans	12-24%	N/A	18-36%
Small loans	11-18%	N/A	9-12%

Source: Group for Small Business, EBRD.

At the small and micro-lending end of the spectrum, the Micro-Enterprise Bank (MEB) has had a significant impact. Until December 2002, MEB made nearly 15,652 loans for a total of USD 78.2 million to micro and small businesses in BiH. In 2003, amongst other developments, MEB will launch an agricultural lending programme and plans to introduce a leasing product.

### **Assessment**

A healthy, profitable financial sector is the key pre-requisite for providing access to finance for SMEs on a sustainable basis. Profitable private financial intermediaries are the necessary link between domestic savings and investment by private sector enterprises, in particular SMEs, and the only way to ensure sustainable SME access to finance and other financial services. Reflecting the perception of the private sector, the aggregate data on the banking sector shows a low degree of bank intermediation, and limited lending to the private enterprise sector. Coupled with the extreme underdevelopment of the non-banking financial sector, this leaves micro-finance programmes and dedicated credit lines as the major formal source of external finance for the SME sector.

#### 4.5. Implementation of Advisory Services to New and Small Businesses

##### *The Situation on Advisory Services*

The business advisory service environment in BiH is fairly complicated, consisting principally of business centres and agencies, as well as regional development agencies (RDAs). These are discussed below.

A key mechanism for providing business advisory support is through the *25 business centres and agencies* that have been formed in recent years, focusing primarily on support to the SME sector. The majority of them are based on international donor support:

- Enterprise Development Agencies established by UNDP/ILO in Banja Luka, Livno, Mostar, Brcko and Bihac.
- Regional Business Development Centres established by UNDP/UNIDO in Zenica and Banja Luka (the third in Bihac closed down due to lack of financial sustainability).
- Chambers of Commerce business support departments (Sarajevo, Tuzla, Banja Luka, Chamber of Trade of BiH, etc.).
- Business Support Centre Brcko (part of Brcko District Regional Development Agency - BDDA).
- Business Centre in Srebrenica (support for return of refugees).
- Agency for Local Development Initiatives (ALDI Gorazde).
- Tuzla Agency for Local Development Initiatives (TALDI).
- Central Bosnian Economic Development Agency (CeBeda).
- Development of Women Entrepreneurship Programme, EG development society Tuzla.
- Others including EG Tuzla, LINK Mostar, NBR (Independent Bureau for Development) Gradacac and Forma-F Mostar and Economic research institutes (mainly linked to universities).

The business support centres and agencies listed above typically offer the following services:

- Business consulting.
- Enterprises development.
- Business planning.
- Access to credit and investment.
- Market surveys.
- Marketing.

One of the key issues of concern about the network of donor-funded initiatives is that SMEs are generally not willing to pay commercial rates for the services on offer. This is both because of a general lack of awareness of the benefits of using commercial business support services to assist their business, and because of the presence of donor-subsidised businesses centres, which initially offered services for free or at highly subsidised rates. When the subsidies ended, major difficulties arose in attempting to charge for services that had been hitherto provided free of charge.

The 25 or so business support centres listed above provide similar services and are in competition with each other. There are few cases where they seek to co-operate. The majority of these initiatives continue to operate with donor funding, although they all seek financial sustainability by charging for some or all their services. The SMEs' attitude to the quality of services delivered is that these organisations have typically skilled and experienced local staff (also international staff, in some cases), though they are often considered to work superficially.

The European Commission has increasingly focused its business support programme on the development of a network of *Regional Development Agencies (RDAs)*. Two RDAs have been formed (Brcko and Sarajevo), three are in the process of being formed (Mostar, Tuzla and Foca) and a further two are expected to be formed in 2003 in Bihac-Prjedor and probably in Zenica. RDAs, such as Brcko, typically offer the following services:

- Strategic economic development.
- Support for the activities of public administration.
- Strengthening intra- and inter-regional co-ordination.
- "One-stop-shop" for business registration.
- Business support centre.
- Info-centre.
- Job Centre.
- Promotion of investment activities, etc.

Various international donors support business advisory services to improve their capabilities:

- *South East Europe Enterprise Development (SEED)* works to strengthen SMEs through enterprise-level investment services, capacity building of enterprises and local service providers, and improvement of the business-enabling environment.
- *European Commission - Quick Impact Facility (QIF)* addresses the issue of sustainable return of refugees through support to local economic development and job creation. It provides grants and consulting/training to SMEs in key return areas, strengthening the network of business service providers; assistance to local authorities to improve the business environment and development of public-private partnerships.
- *European Commission - EU Programme for Enterprise Revitalisation (EUPER)* aims to revitalise about 40 medium-sized companies through turn-around management and restructuring support, facilitation of access to finance, development of markets (domestic and foreign), mitigation of the social costs of restructuring, particularly vocational training and support for start-ups.
- *US Agency for International Development's (USAID) Business Development Programme (BDP)* focuses on providing commercial credit to businesses, as well as training and technical assistance to borrowers. The loans are processed through Bosnian banks, thus strengthening their capacity to operate successfully with enterprises.
- *Department for International Development (DFID) - Post-Privatisation Enterprise Restructuring Project (PPERP)* provides restructuring support to about 80 SMEs to secure viability and profitability. It provides assistance to the unemployed following restructuring and disseminates best practice from the process of restructuring.
- *Business Advisory Services (BAS) Programme* assists SMEs to obtain consulting services from local consultants, thus strengthening the quality of local consultants. It also co-operates with SME development institutions, such as Chambers of Commerce, Professional Business Associations, Associations of Entrepreneurs, etc.

There are numerous small or *one-person consulting companies*, often run by academics or other experts with full-time jobs as their primary economic activity. Also, firms specialised in business services such as bookkeeping, accounting, tax, legal, quality control and quality certification services help businesses to meet the complex and dynamic legal requirements. There are a limited number of local auditors but the "Big Five", such as PricewaterhouseCoopers and Deloitte & Touche, are also present in co-operation with local firms.

There are many *training providers* of business services, such as business schools; business development centres; NGOs; Chambers of Commerce, etc. They cover such topics as business management, sales and marketing, financial management, accountancy, quality control and quality assurance. These tend to be highly variable in quality and standard. International donors sponsor much of this training with varying degrees of co-ordination.

### **Assessment**

BiH has experienced a significant expansion of international donor-funded, as well as other advisory services with a view to promote start-ups and growing SMEs in last five years. In addition to 25 business centres/agencies, there will probably be six RDAs and numerous private sector providers of business advice, training and other, more specialised skills and services.

There remains a major concern about the extent to which the donor-funded initiatives are likely to be financially sustainable. Many started by providing services free of charge and are finding it difficult to persuade entrepreneurs to pay commercial rates. The SMEs participating in the research are quite critical of the range, efficiency and appropriateness of the services on offer. In addition, the quality of the human capital (business consultants) on offer, including the assistance received from international consultants, is rated between “poor” and “satisfactory”.

The market might correct itself since a reduction in donor funding is anticipated in the next few years. Competition between service providers is likely to become more intense, placing a premium on quality and price. Good practice suggests that introducing standards with respect to advisory services (qualifications, membership of relevant bodies, confidentiality principles, charging policies and other quality standards such as service charters) could go some way towards generating greater confidence and thus willingness by the private sector to use and pay for such advisory services in BiH.

Achieving the financial sustainability of the sector is likely to require other changes. For example, the SME entrepreneurs participating in the research raised the point that better co-ordination of the international community is needed with respect to enterprise policy. Without improved co-ordination, donor-funded projects may overlap (e.g. in terms of locations) or result in unfair competition and market distortion (e.g. some services delivered free of charge in areas where existing initiatives rely on charging in order to continue delivering services and be sustainable). Care must be taken to ensure that future projects build-in sustainability as a primary objective and that, for example, the network of RDAs do not overlap with existing services, though a degree of competition is both inevitable and desirable.

Finally, the Government also has a role to play in the establishment of appropriate infrastructure with respect to business advisory services, something that the lack of an approved national SME strategy hinders. For example, there is currently no counterpart to ensure co-ordination and integration of business support initiatives. Raising the quality of the services and increasing the confidence in them is a necessity. This could be achieved by introducing quality standards and certification, in partnership with government, however, there is currently no counterpart for this.

#### **4.6. Implementation of Business Incubators**

Business incubators are generally defined as special facilities for new and young developing businesses that provide such businesses with premises, infrastructure, a comprehensive range of services and support that can improve their ability to initiate and run their operations during the early developmental period. The combined features of provision of physical facilities, focus on start-ups and SMEs and “soft” advisory and support services provided, are what distinguish business incubators from other industrial centres or industrial estates (OECD-UNIDO, 1999, pp.51-53).

##### ***The Current Situation on Business Incubators***

Incubator activity in BiH has been initiated, financed and supported by foreign donors. The EC Quick Impact Facility (QIF) project published the “Step-by-Step Guide to Setting up Business Incubators in BiH” in an endeavour to disseminate the concept of business incubators.

Thus far, only one business incubator has been set up in BiH. The *Gradacac* business incubator targets manufacturing activities and is designed specifically to assist displaced persons from the town of Modrica. The business incubator occupies a former school building extensively damaged during the war and scheduled for demolition. The municipality-owned building has been leased for a token sum of €0.5 per month for a period of one year, subsequently extended. The business incubator is run by an NGO, the Independent Bureau for Development (NBR), which is seeking to extend the contract for a minimum period of five years in order to secure medium-term sustainability for the initiative.

The business incubator supports the tenants with a range of services such as legal advice, company registration, low rents (€1 per m<sup>2</sup>), business and financial planning, access to finance and various forms of business training. It currently supports 26 businesses, some entirely export-oriented, employing about 250 people. Approximately 2,000 m<sup>2</sup> (out of the total 6,800 m<sup>2</sup>) is currently taken-up with sufficient scope for expansion of the tenants. Since it started operating in 2000, only two tenants have gone out of business, representing in a very high survival rate.

NBR employs seven staff (four fully employed in Gradacac) and is looking to establish a smaller business incubator and business support centre in *Modrica*. This business incubator is also intended to support displaced individuals returning home in starting-up companies or developing small existing companies. The second business incubator is expected to make available 1,000 m<sup>2</sup> to accommodate 6-8 businesses generating about 100 jobs.

According to its Economic Strategy and Action Plan, the city of *Mostar* is expecting to develop a business incubator in 2003 accommodating 23 start-ups and small businesses in 1,000 m<sup>2</sup> of business space. This business incubator will have on-site business advisory support, common facilities such as a conference and reception areas and flexible tenancy terms. The business incubator is expected to generate 60 new jobs within the first year of operation. Partners include the City of Mostar, the Railway Company (owner of the premises to be leased at a token rent), an Implementing Agency (still to be determined) and QIF. The latter will provide financial support to refurbish the premises and technical assistance throughout the project.

The institutions responsible for determining enterprise policy in the two entities and District of Brcko (RDA) plan to develop further business incubators in future. In addition, certain local authorities (for example Gradiska and Laktasi in the RS BiH) have prepared development strategies on the establishment of business incubators, but these plans remain on paper only.

### **Assessment**

The lack of a Government policy and strategy with respect to business incubators, as well as the lack of efforts to raise awareness of the potential for business incubators and make commensurate funds available, mean that the SMEs participating in the research remain largely unaware of their scope and benefits. They argue that very little information of this nature gets through to the enterprise level or to potential entrepreneurs.

Once informed of the main principles and function of business incubators, entrepreneurs grasped the potential offered by business incubators and argued that they should be used to foster sectors such as agribusinesses, high-tech, tourism and energy. Nevertheless, only one business incubator exists at the time of writing, focusing on displaced persons returning to Gradacac and though plans exist for others, it is unclear whether a network of business incubators may emerge in the near future. The very small size of the proposed new incubators raises sustainability concerns.



## Chapter 5.

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## Chapter 6.

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*Appendix 1.*

**OBSTACLES TO DOING BUSINESS**

The main results of the 2002 Bosnia and Herzegovina Business Environment and Enterprise Performance Survey (BEEPS) are summarised in the following table. It contains the average score assigned by respondents to each aspect of the business environment, where the scores can be interpreted as follows: 1 = no obstacle; 2 = minor obstacle; 3 = moderate obstacle; 4 = major obstacle.

**Rating of Severity of Obstacles to Doing Business (BEEPS, 2002)**

---

Economic policy uncertainty	2.8
Cost of financing	2.8
Tax administration	2.7
Tax rates	2.7
Corruption	2.6
Functioning of the judiciary	2.5
Macroeconomic instability	2.5
Anti-competitive practices of other producers	2.5
Access to financing	2.5
Contract violations by customers and suppliers	2.3
Organised crime	2.2
Customs and trade regulations	2.2
Street crime	2.1
Business licensing and permits	2.0
Labour regulations	1.9
Skills and education of workers	1.8
Transportation	1.8
Electricity	1.7
Telecommunications	1.6
Access to land	1.5
Title or leasing of land	1.5

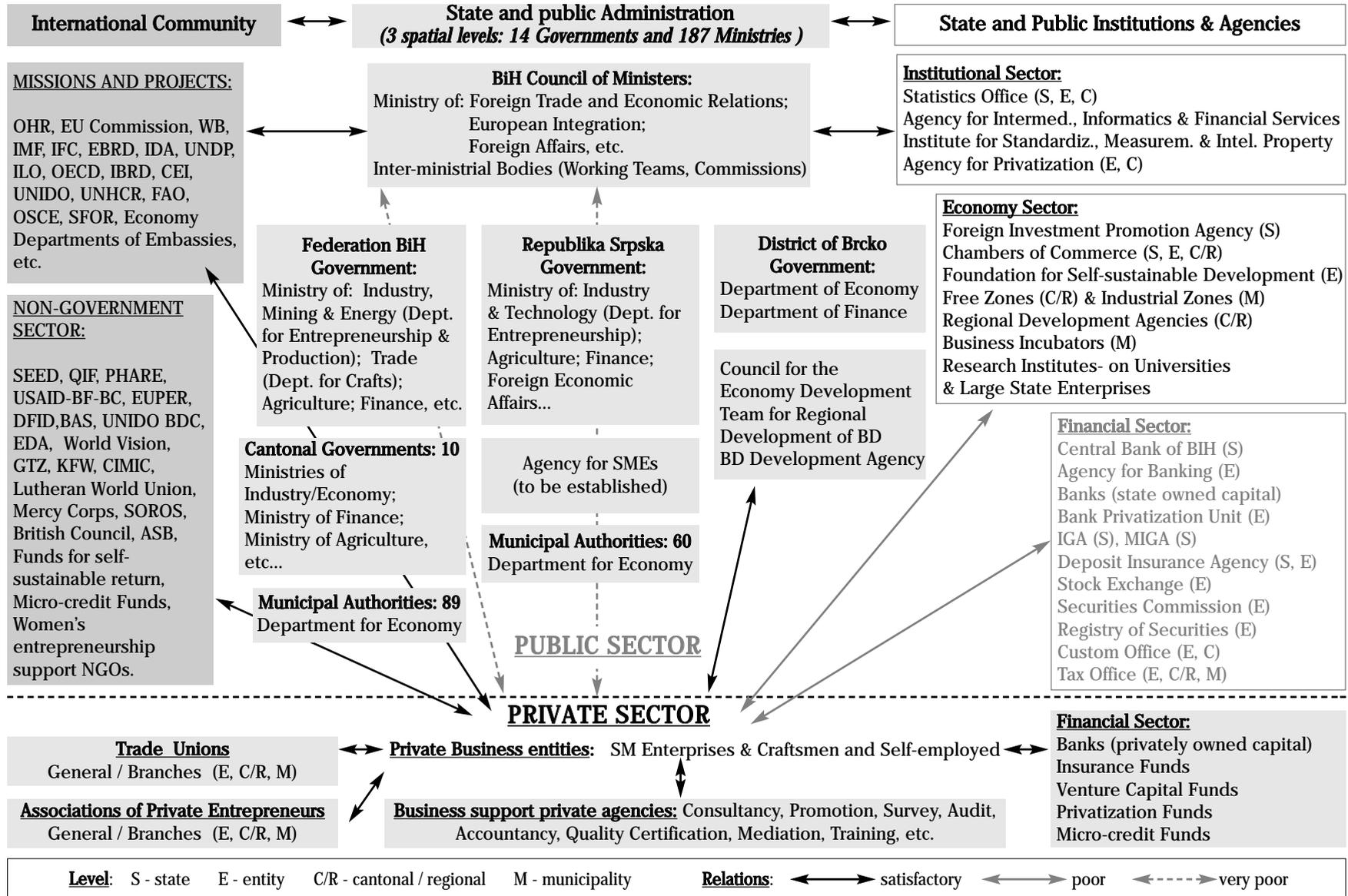
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*Source:* EBRD

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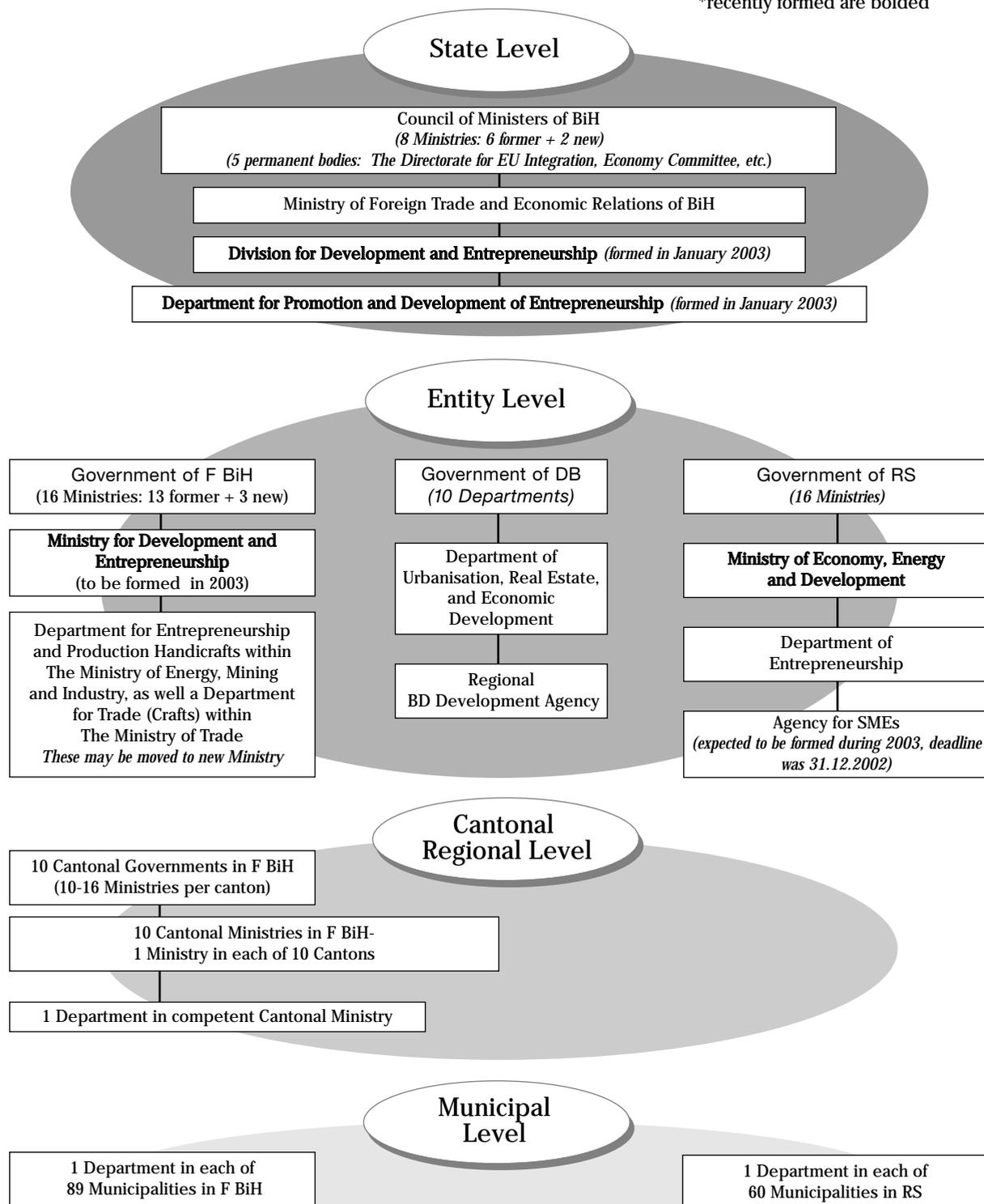


**Appendix 2. SME INSTITUTIONAL FRAMEWORK (Dec. 2002)**

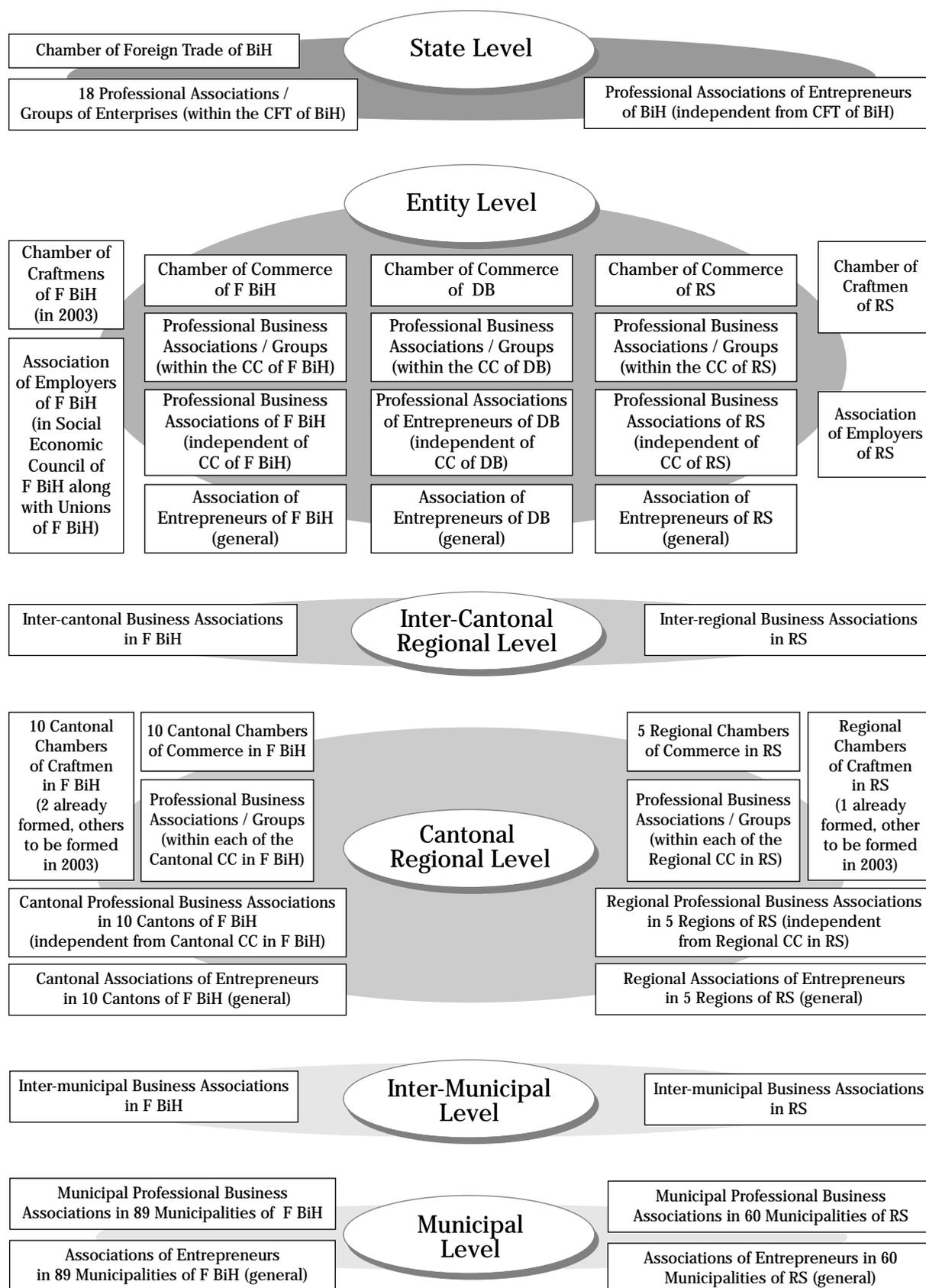


## Governmental Bodies with SME Development Responsibilities (Feb. 2003)

\*recently formed are bolded



## Institutions and Associations Representing SMEs (Feb. 2003)





*Appendix 3.*

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