

BOSNA I HERCEGOVINA
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BOSNA I HERCEGOVINA
МИНИСТАРСТВО ФИНАНСИЈА
И ТРЕЗОРА

BOSNIA AND HERZEGOVINA
MINISTRY OF FINANCE
AND TREASURY

Mr. Jim Yong Kim
President
The World Bank
1818 H Street, N.W.
Washington, D.C., 20433

August 26, 2014

REF: Letter of Development Policy
Bosnia and Herzegovina Business Environment Development Policy Loan

Dear Mr. Kim:

This is to request, on behalf of Bosnia and Herzegovina (BH), a Business Environment Development Policy Loan of US\$ 50 million to support our economic reform program. This draft letter presents the general background and summarizes critical aspects of the program that the authorities of are committed to undertake over the short and medium term to implement reforms for improvement of the business environment and sustainability of economic growth and jobs.

Macroeconomic framework

Authorities in BH remain focused on ensuring sustainable economic growth and financial stability, and supporting a better business environment. Five years after the crisis began, its lingering effects are still visible but the latest indicators suggest a modest economic recovery in 2013, primarily supported by exports. The currency board continued to support monetary stability and inflation remained low throughout 2013. Industrial production and manufacturing grew indicating a revival in the manufacturing sector, supported by export growth, with goods exports up by 8.7 percent in 2013. Overall, economy is estimated to have grown by 1.8 percent in 2013 and contract by 0.7 percent in 2014 due to recent floods.

The impact of the recent floods on the BH economic activity is placing additional pressure on an already weak economic recovery. Bosnia and Herzegovina's (BH) economy performed poorly in recent years due to weak internal and external economic environments but a surge in exports supported a modest economic recovery in 2013. Industrial production picked up by 6.4 percent in 2013 with manufacturing growing by 9.7 percent and intermediate goods by 4.7 percent. Inflation remained low in 2013 and at the end of the year BH experienced deflation. Internal and external risks to the recovery remained, including a high unemployment rate (27.5 percent) and a slow recovery in the EU. Even though a surge in exports supported modest growth, a slow recovery in the EU could hurt export growth, and a slow-down in fiscal revenues, impacting the 2014 budget.

Damages and losses from the floods are estimated to have cost the equivalent of nearly 15 percent of GDP. Ensuring the sustainability of the fiscal framework is the key to macro-economic stability. We began fiscal consolidation in 2010 and reduced the fiscal deficit to 2.6 percent in 2012 (in line with the IMF program requirements) from 5.5 percent of GDP in 2009. Hence, even before the floods BH was facing significant fiscal challenges exacerbated by declining revenues. To maintain a sustainable fiscal stance in the face of declining revenues, the authorities took some measures to reduce expenditures. The floods are expected to put further strain on public finances, bringing the fiscal deficit to 4.5 percent of GDP in 2014. Given the state of public finance in BH, there is little fiscal space to address even the most urgent humanitarian needs. Therefore the fiscal consolidation will have to be on hold in the near term as revenues are expected to fall and spending needs are increased as a result of the recent floods.

The authorities will work at ensuring sustainability of the fiscal framework as a pre-requisite to macro-economic stability. The authorities have an ongoing dialogue with the IMF team and full support of the direction in which reforms are going. We are taking a conservative approach to revenue estimation and have based our budgets on revenue forecasts below those of the IMF. Following the floods, with little room to raise further financing from domestic markets, external financing needs have increased to an estimated 4.6 percent of GDP. Some potential sources of financing have been identified to partially close this gap while additional financing sources (1.7 percent of GDP) are expected to be secured from the funds raised at the recently held Donors' conference organized in Brussels on July 16, 2014. We very much appreciate the World Bank's fast approval of the US\$100 million Emergency Recovery Loan, which together with the US\$50 million for this development policy loan will provide material help during these difficult times. The implementation of necessary fiscal measures and structural reforms will be underpinned by a strong partnership which we are seeking with the World Bank and the IMF in the remaining of the year. We are committed to work on implementing the additional structural reforms which will bring the country closer to a fully functioning market economy in the medium term.

Program of Reforms in the Business Environment

Our commitment is to transform BH into a fully functioning market economy with a vibrant private sector. BH's business environment is considered to be lagging behind its neighbors, with the latest Doing Business ranking at 131. Reforms that are currently being carried out and supported by this operation make it possible to respond and restructure the business environment, improving the governance and efficiency of the public administration while ensuring conditions are created to nurture private sector development and growth.

Facilitating Business Start-up

Our main objective of this set of reforms is to address the critical issues impeding business creation. The time and costs for starting a company have not improved evenly across BH in a long while, making BH the least business friendly country in the region. To this effect, the entity governments initiated reforms that will enable quicker and more affordable business registration. RS initiated a two-phased approach for establishing a One-Stop-Shop (OSS) for business registration. Phase 1, the subject of this operation, involves legislative reform to cut the cost and time of starting a business by more than 50 percent. The reform involves changing a package of 13 different laws and regulations, most notably the Business Registration Law, Law on Agency for Intermediary, IT and Financial Services, Company

Law, Law on Court Taxes and Fees and Law on Administrative Taxes, and changing Regulation on Notary Fees. The laws have already been adopted, and the RS has proceeded to Phase 2 with establishing the OSS on December 1, 2013. The reform process significantly decreases the number of necessary procedures for starting a business in the RS. In parallel, the FBH prepared the new Company Law, introducing modern corporate management practices, streamlined and improved registration policies, reduction in capital requirements, and associate enterprises practices. The Company Law is in its final adoption stage. The FBH is committed to enact the law as soon as possible, the latest during August 2014. In addition, FBH amended the Business Registration Law to enhance the registration process and reduce registration costs by 50 percent.

Streamlining Investment Procedures in Inspections and Construction

The inspections and construction regimes are greatly influencing the functioning of our economy. FBH has embarked on inspections reform, given its significant impact on businesses and the EU accession. Vertical coordination in official controls has become a critical element in the overall system of requirements that BH must meet in order to be able to export to EU. Additionally, FBH is committed to the introduction of risk-based inspections, certification of inspectors, and organizational changes aimed at improving its service to the private sector. Risk-based inspections alone is expected to yield up to 10% savings for the businesses.

The Doing Business 2014 report ranks BH at 175th place on obtaining construction permits, with 17 procedures, 170 days, and at a cost of 1,100 percent of income per capita. The RS therefore prepared a new construction law introducing risk-based approach and streamlined and cost efficient procedures. The Law provides for faster and more efficient administrative processing of major infrastructure projects. The process and documentation for issuing construction and usage permits have been streamlined, and the timeline for obtaining both types of permits is not going to exceed 15 days irrespective of building size. The RS government estimates that this will enable up to BAM 17 million savings annually for businesses.

Simplifying Processes of Cross-Border Trading:

FBH development strategy and RS economic program clearly define commitment and focus towards improvement of framework aimed at strengthening openness of BH's economy. Bearing in mind the divided competencies between state and entities, the import/export procedures represent a burden for the business community due to the unclear requests for documentation, time and costs needed to address any issue. The authorities are therefore carrying out measures aimed at improving the import/export procedures by simplifying procedure, reducing the necessary steps, defining numbers and forms of the necessary documentation, and defining the manner in which fees are determined. This reduction of direct and indirect costs to obtain licenses, permits and approvals, related to import/export procedures for seven key exports (wood; fruits and vegetables; meat; basic materials; dairy; electrical appliances and metal), is estimated to amount to a one-off 4 percent (2 mln BAM) for both entities.

Future considerations

The authorities are committed to improve business environment and attract more investment in BiH. In order to achieve higher investments, there is a high degree of commitment to a series of medium term reforms aimed at improving investment climate and enabling investments and re-investments, creation of common economic space in BH and level playing field for investors by reducing costs of business entry and operations in BH, and enabling faster corporate restructuring of private enterprises and putting unproductive assets into productive use for investors.

The authorities will work together on furthering these reforms in the medium term. They are therefore committed to further improve the business environment and are planning to advance the following reforms:

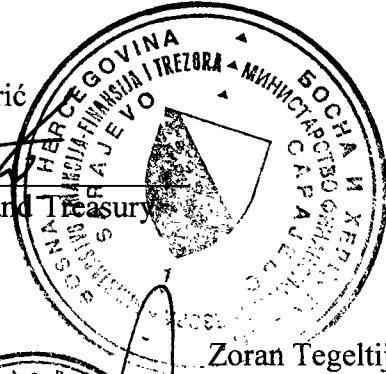
- i) Harmonized quality control of imports and exports applicable throughout BH, ensuring harmonized procedures, goods and processes for imports and exports on any border crossing in BH.
- ii) Streamlining and improving business registration and creating a transactional E-Registration platform(s) for ease of registration. To enable this, preparations for E-Signature platforms will have to proceed in both entities.
- iii) Improvement in inspections and their closer alignment with EU practices through full implementation of risk-based inspections, better sampling and controls, use of check lists and risk-planning, and capacity building of inspections in prevention and corrective actions.
- iv) Improving transfer pricing and tax related regulations. These reforms should enable faster entry and less burdensome operations in the country.

To unlock potential of unproductive assets and enable more agile and resilient private sector, entities will engage in improving corporate insolvency frameworks and related practices. Revisions of insolvency regulations and introduction of faster out of court settlements and pre-packaged bankruptcies, should enable faster corporate restructuring and putting unproductive assets into productive use. This would require revising entity level financial consolidation and restructuring regulations, as well as streamlining and speeding up court bankruptcy restructuring processes to ensure greater success of restructuring companies and making them viable. This would entail improving works of trustees and judges, as well as reducing costs of these operations.

Finally, works on improving entity contract enforcement and collection on delinquent contracts through faster court and out of court settlements and enforcement's will have to be completed.

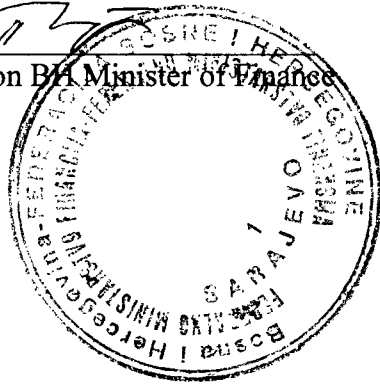
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