

Open Market Integration in the Balkans: Slovenia's Success, Bosnia's Failure

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Abstract: Dissolution of the former Yugoslavia resulted in creation of newly formed states in Balkans. The stories of market transition of two Balkan countries: namely, the success of Slovenia and the struggle of Bosnia and Herzegovina are examined here. Several aspects of these two economies are investigated such as current regional overview, regional economy, conditions for direct foreign investment, government incentives for FDI, and economic and social reforms required in order to draw interest of global foreign investments.

Keywords: Bosnia and Herzegovina, Slovenia, Market Integration, Economy Overview, Investment Climate

1. Introduction

The globalization of the world economy resulted in the rapid growth of industrial production, which in effect generated higher levels of Gross Domestic Product (GDP) among many developing countries. However, the shift in the economic systems of the countries in transition toward a market economy meant global changes and a new quality in the overall social relations. The transition process has affected most intensely the post-socialist countries. Under the influence of the "Velvet Revolution" in 1989-1990, totalitarian socialist regimes collapsed throughout Europe, including the Balkans region of the former Yugoslavia.

With the collapse of the social order and the disintegration of the Eastern bloc, the newly created independent countries faced challenges that were unprecedented in many respects. After the change of regime, the independent societies of the former Yugoslavia decided in favor of a pluralistic democratic social order and market economy. However, the transfer of the development model of the Western European democracies has encountered greater obstacles in some regions of the former Yugoslavia. The newly established countries in transition had a beginner's problem of being recognized as independent countries. In the region of former Yugoslavia, Slovenia had established its independence within a couple of weeks, while in Bosnia and Herzegovina the desire for independence has escalated into four years of brutal war. The war has had a destructive impact on the overall economy of Bosnia and Herzegovina. With the establishment of independence and the decentralization of power, all the countries of the former Yugoslavia were facing issues of economic renewal, becoming accustomed to the rules of the market economy, and incorporation into the European Union. This paper will compare two Balkan countries – the prosperous nation of Slovenia, and the struggling Bosnia and Herzegovina, with respect to successful integration into Open Market Economy, specifically the development of conditions necessary to draw interests of Globalizing Foreign Investments.

2. Current Regional Overview

2.1 - Slovenia -

Slovenia is a high-income country with a gross national income per capita of \$17,290 in 2005. Strategically located at the gateway to Balkans, Slovenia has been a star performer since its independence in 1991. With a population of 2 million, the country is strategically located at the crossroads between Eastern and Western Europe and is endowed with highly skilled human capital. It is considered an important model of success and stability for the neighboring countries in the former Yugoslavia. Slovenia joined the European Union in 2004 and is set to become the first among the new EU member states of Central and Eastern Europe and the Baltics to adopt the euro in January 2007.

2.2 - Bosnia & Herzegovina -

On the other hand, Bosnia and Herzegovina is a lower middle-income country with an official gross national income per capita of US\$2,440 in 2005. Approximately 62 percent of GDP is created in the services sector, 29 percent in industry, and 9 percent in agriculture. Since the Dayton Peace Agreements ended the war in the former Yugoslavia in 1995, Bosnia and Herzegovina has made tremendous progress in post-conflict reconstruction, social integration, and state building. It is now working towards accession to the European Union (EU), membership in the World Trade Organization (WTO), and membership in NATO's Partnership for Peace program. Based on its impressive economic recovery and sustained social stability, which have been supported by high levels of international assistance, the country can be considered a post-conflict success story. The country was among the last of the republics of the former Yugoslavia to declare independence, following a referendum in 1992. The Dayton Peace Agreements set the current administrative framework for Bosnia and Herzegovina. The framework is comprised of a central state government and two separate and distinct entities that enjoy substantial autonomy - the Federation of Bosnia and Herzegovina and Republika Srpska. The war caused extensive destruction of physical capital and a huge loss of output. Real GDP plummeted by 80 percent and over 2 million people - nearly half the prewar population - became refugees, either abroad or internally. In 1996, a major donor assistance program set the stage for reconstruction and economic recovery. According to the World Bank, overall donor commitments are estimated at US\$5.4 billion. (World Bank, 2003).

3. Regional Economy

3.1 - Slovenia -

As the most prosperous republic of the former Yugoslavia, Slovenia emerged from its brief 10-day war of secession in 1991 as an independent nation for the first time in its history. Since that time, the country has made steady but cautious progress toward developing a market economy. Economic reforms introduced shortly after independence led to healthy economic growth. Slovenia's economic success clearly illustrates the benefits of embracing liberal trade, following the rule of law, and rewarding enterprise. This success, however, is not unprecedented for Slovenia. Although it comprised only about one-thirteenth of Yugoslavia's total population, it was the most productive of the Yugoslav republics, accounting for one-fifth of its GDP and one-third of its exports. The country already enjoyed a relatively prosperous economy and strong market ties to the West when it gained independence in 1991. Since independence, Slovenia has pursued diversification of its trade toward the West and integration into Western and transatlantic institutions vigorously. In so doing, it has made substantial progress in its transition to a market economy, particularly becoming party to a number of bilateral and regional free trade agreements

Slovenia is one the best economic performers in Central and Eastern Europe, with a GDP per capita in 2005 estimated at U.S. \$17,008 (Shane,ERS 2008) - slightly more than 75% of the EU-15 average. Slovenia benefits from a well-educated and productive work force as well as dynamic and effective political and economic institutions. Although Slovenia has taken a cautious, deliberate approach to economic management and reform, with heavy emphasis on achieving consensus before proceeding, its overall record is one of relative success.

Slovenia's economy is highly dependent on foreign trade. Statistics by Eurostat favorably reflect performance of Slovenian economy. Economic management in Slovenia is relatively good. Public finances showed modest deficits on the order of 1.5% of GDP in 2003. The budgets for 2004 and 2005 constrain public deficit to 1.7% of GDP. The current account balance has improved significantly as a result of stronger exports and a changed composition of imports by economic purpose. In 2003, the current account balance showed a surplus for the second year in a row. Controlling inflation remains a top government priority. The authorities have been successful in stabilizing the Slovenian currency and in bringing inflation down from more than 200% in 1992 to just 3.6% in 2006. (Eurostat 2008). Due to its macroeconomic stability, favorable foreign debt position, and successful accession to the EU, Slovenia consistently receives the highest credit rating of all transition economies.

KEY ECONOMIC RATIOS and LONG-TERM TRENDS				
	1984	1994	2003	2004
GDP (US\$ billions)	..	14.4	27.7	32.2
Gross capital formation/GDP	..	20.6	25.3	26.8
Exports of goods and services/GDP	..	58.9	56.5	59.9
Gross domestic savings/GDP	..	23.2	25.3	26.2
Gross national savings/GDP	..	25.0	25.0	26.0
Current account balance/GDP	..	4.0	-0.4	-0.9
Interest payments/GDP
Total debt/GDP
Total debt service/exports
Present value of debt/GDP
Present value of debt/exports
	1984-94	1994-04	2003	2004
<i>(average annual growth)</i>				
GDP	..	3.8	2.5	4.6
GDP per capita	..	3.8	2.5	4.6
Exports of goods and services	..	6.8	3.2	12.6
			2004	2004-08
				..

Figure 1: Slovenia Key Economic Ratios, % change on previous year, 1994-2004

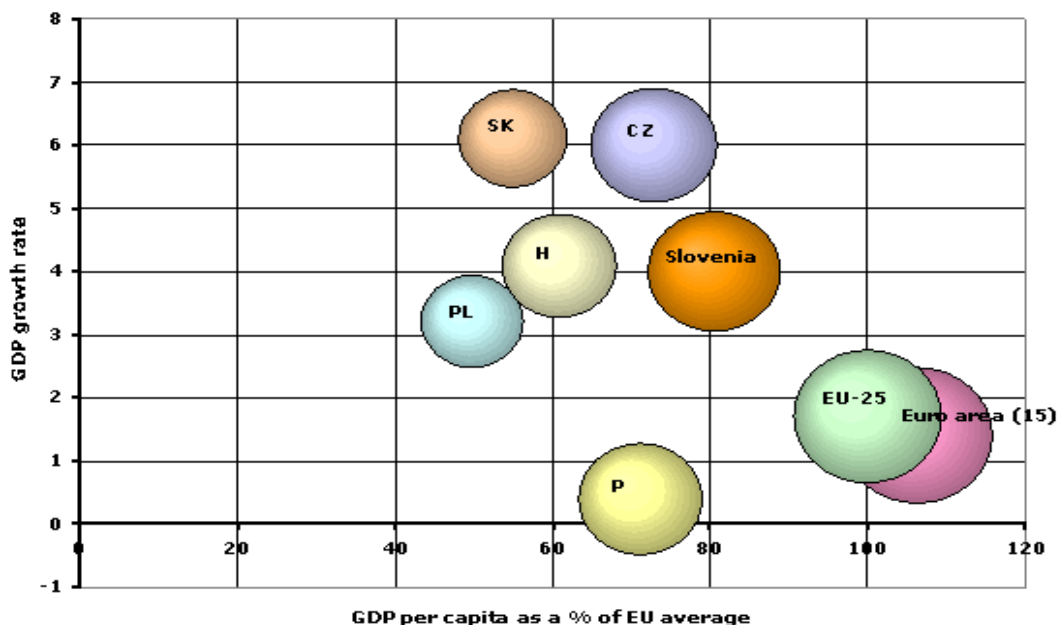


Figure 2. Slovenia's Growth, GDP and GDP per capita as a % of EU-25 average 2005

Source: Eurostat, 2006

3.2 - Bosnia & Herzegovina -

To understand the state of the current Bosnian economy, one must look at the state of the region even before the war. Before the war, Bosnia and Herzegovina ranked next to Macedonia as the poorest republic of the former Yugoslavia. Although industry accounted for over 50% of GDP, Bosnia and Herzegovina was primarily agricultural. Farms were small and inefficient, thus necessitating food imports. Industry was greatly overstaffed, with Bosnia and Herzegovina accounting for much of the former Yugoslav's metallic ore and coal production. Timber production and textiles also were important. The destructive impact of the war on the economy led to a 75% drop in GDP. Since the Dayton Accords, reconstruction programs initiated by the international community financed the construction of infrastructure and provided loans to the manufacturing sector. External aid amounted to \$5 billion from 1995 to 1999. This aid caused growth rates to increase to 30%, but as of 2003, that rate had stabilized to around 6%. Actual GDP growth by that year had reached half its pre-war level. Bosnia has made significant progress in achieving microeconomic stability. On the monetary side, Bosnian central bank guarantees the most stable currency in the South Eastern Europe, which contributed

to near-zero inflation rate of 0.2%. Economic stability is reinforced by a treasury system which is sustained by budgets which are kept within required limits. The GDP has risen steadily since 1997 and for 2006 is estimated at 5.5%. Even if this is considered a slowdown compared to 25% average of post-war reconstruction, the rate of 5.5% is more sustainable and in line with the neighboring countries.

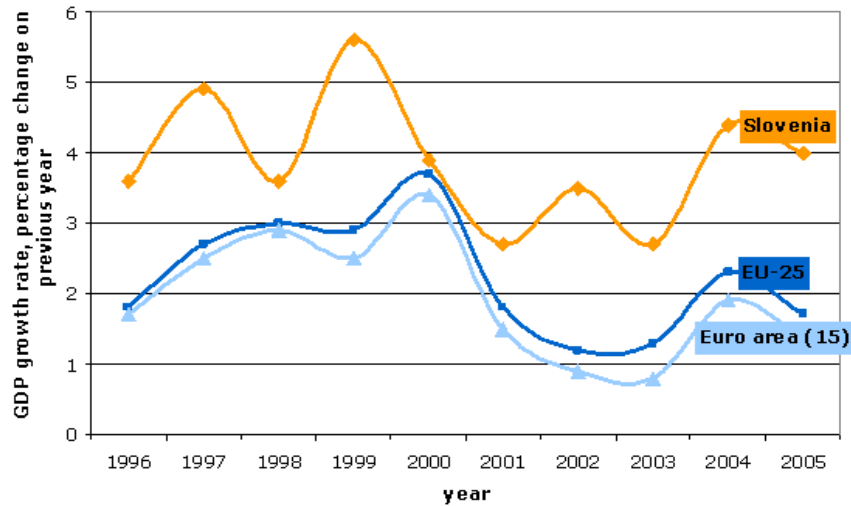


Figure 3. Annual growth rate, percentage change on previous year, 1996-2005
Source: Eurostat, 2006

KEY ECONOMIC RATIOS and LONG-TERM TRENDS					
	1985]	1995	2004	2005	
GDP (US\$ billions)	..	1.9	8.6	9.4	
Gross capital formation/GDP	..	20.0	20.7	21.5	
Exports of goods and services/GDP	..	20.4	26.0	28.9	
Gross domestic savings/GDP	..	-31.1	-8.3	-7.6	
Gross national savings/GDP	..	9.6	4.0	4.3	
Current account balance/GDP	..	-10.3	-16.7	-17.2	
Interest payments/GDP	0.6	..	
Total debt/GDP	37.4	..	
Total debt service/exports	5.3	..	
Present value of debt/GDP	29.2	..	
Present value of debt/exports	74.9	..	
	1985-95	1995-05	2004	2005	2005-09
(average annual growth)					
GDP	..	11.8	6.2	5.3	5.5
GDP per capita	..	10.0	6.4	5.4	4.7
Exports of goods and services	..	13.7	8.9	18.1	11.4

Figure 4. Bosnia Key Economic Ratios, % change on previous year, 1995-2005

However, even with almost ten years of heavy reconstruction and a significant number of structural reforms, the Bosnian economy is still lagging. 20% of the population lives below poverty line while 30% are on or just above it. Official unemployment is around 40%. GDP per capita is one of the lowest in Europe. Bosnia is burdened with a total debt of 2.5 billion Euros (U.S \$3.2 billions).

EXTERNAL DEBT and RESOURCE FLOWS

(US\$ millions)	1985	1995	2004	2005
Total debt outstanding and disbursed	3,202	..
IBRD	..	472	527	481
IDA	..	0	927	921
Total debt service	176	..
IBRD	..	0	39	41
IDA	..	0	6	7
Composition of net resource flows				
Official grants	277	..
Official creditors	218	..
Private creditors	39	..
Foreign direct investment (net inflows)	613	..
Portfolio equity (net inflows)	0	..
World Bank program				
Commitments	117	..
Disbursements	..	0	209	56
Principal repayments	..	0	24	24
Net flows	..	0	184	32
Interest payments	..	0	21	25
Net transfers	..	0	163	7

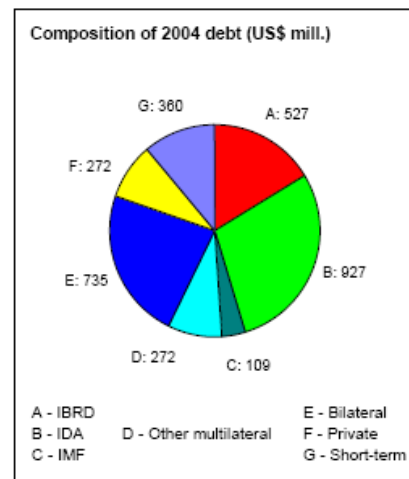


Figure 5. Composition of Bosnia's National Debt, 2004-2005

The value of exports in 2006 equaled 25% of its imports. With foreign aid decreasing, Bosnia faces a mounting current deficit which could threaten economic stability in a matter of years. Current reduction in donor financial inflows is occurring for three reasons: 1) There is a sense of accomplishment among most donors that Bosnia has successfully moved beyond most difficult post-conflict reconstruction phase; 2) Many bilateral donors have other priorities and demands; 3) There is a sense of disillusionment among most donors with the slow pace of reforms and lack of commitment to improving governance.

4. Investment Climate

4.1 - Slovenia -

Since independence in 1992, the foreign investment climate has steadily improved, despite constraints that have inhibited investment in Slovenia. The small domestic economy has been viewed by many prospective investors as the least risky of the former Yugoslav republics, but to date Slovenia's share of world foreign direct investment(FDI) flows as been well below its share of world GDP.

Until the late 1990s Slovenia retained several barriers to foreign investment. Any company incorporated in Slovenia was required to have a majority of Slovenes on its board of directors, or a managing director or proxy of Slovene nationality. Foreign companies and individuals of foreign nationality were prohibited from owning land in Slovenia. However, any company incorporated in Slovenia was permitted to purchase real estate, regardless of the origin of its founding capital. Liberalization laws enacted in 1999 lowered the threshold of foreign direct investment from 50% to 10%. This allowed more foreign investors to avert the custody account regime. Government efforts and reforms designed to attract foreign direct investment (FDI) have proven somewhat successful - FDI almost tripled from 2001 to 2002, accounting for nearly 6.5% of GDP. However, FDI fell sharply in 2003 due to a lack of any major privatization deal or foreign acquisition.

Slovenia's traditional anti-inflation policy in the past relied heavily on capital inflow restrictions. Its slow privatization process favored domestic investors and prescribed long lag time on share trading, complicated by a cultural wariness of being "bought up" by foreigners. As such, Slovenia has had a number of impediments to full foreign participation in its economy. However, a number of these barriers to FDI were fully removed in 2002. As a result, expected foreign takeovers of Slovenian blue chip companies, as well as EU membership, have fueled investors' interest in the country. The US Department of state reports positively about FDI in Slovenia saying that recent acquisitions by multinational companies - KBC of Belgium's takeover of Nova Ljubljanska Banka, and Swiss Novartis' takeover of Lek Pharmaceuticals - clearly demonstrate the attractiveness of the Slovenian economy, particularly to European investors seeking a platform to support expansion into southeastern Europe. U.S. investments in Slovenia have been more modest; Goodyear is the largest American investor. (US Dept of State/Slovenia, 2008).

4.2 - Bosnia & Herzegovina-

As a result of the political compromise needed to end the war, Bosnia and Herzegovina has been on a kind of international community life support. Since 1995, billions of dollars of assistance has poured in, primarily to rebuild destroyed infrastructure and homes of hundreds of thousands of refugees and displaced people. With much of the reconstruction work complete, Bosnia is now focusing on building a more stable economy. As with many other transitional economies, Bosnia is starting to recognize the potential of Foreign Direct Investment and has acknowledged the need for creating a more attractive environment for foreign investment. However, many economic problems, uncertainty, corruption, lack of information, insolvency, and the black market are standing in the way of rapid transition and domestic acceptance of FDI. The Bosnian government is trying to work on these issues and for the most part agreeing with foreign organizations that these problems exists, but it will take time to solve them.

In addition to some aspects of regulatory environment, the business environment as it stands now has several major issues that hinder foreign investment in Bosnia. According to the Index of Economic Freedom, the overall country rating for Bosnia in 2007 is 54.7 out of 100, or ranked 115th out of 157 countries included. (Index, 2007). This poor country rating, along with a very unfavorable country image by foreign investors, impedes foreign investment. Bosnia is perceived as an unstable country with high uncertainty. With present levels of perceived uncertainty and instability, many foreign investors are opting for business prospects in other less risky countries of Eastern Europe, such as Slovenia. According to Bosnia's Central Bank Statistics, FDI in 2004 totaled \$2.4 billion. The manufacturing industry had the highest percentage of the FDI, followed by the banking sector. Investments from Austria and Croatia represent the largest percentages of the FDI at the end of 2004.

5. Government Incentives for Foreign Direct Investment

Some fiscally stable countries, such as Slovenia, sometimes provide additional incentives, start-up cost sharing programs, to attract foreign investors. Other less fortunate countries, like Bosnia and Herzegovina, although they may plan to provide similar start up support programs in the future, due to lack of monetary resources are usually not in a position to implement such a benefit for foreign investors. This section will evaluate additional benefits for foreign investors instituted by Slovenia's Government.

5.1 Slovenia's Government FDI Cost-Sharing Grant Scheme

In August 2005, the government published a Cost Sharing Grant Scheme, which invites investors initiating ventures of more than 1 million euros to negotiate an investment bonus package with the government.

Foreign companies making direct investments in Slovenia may apply for financial grants. The purpose of the Invitation for Applications is to boost attractiveness of Slovenia as a location for foreign direct investment by lowering entry (start-up) costs to the investors whose investment will have a positive impact on new employment, knowledge and technology transfer, facilitation of balanced regional development, and will foster alliances between foreign investors and Slovenian companies.

Grants are available for investments in industry, strategic services (Customer Contact Centers, Shared Services Centers, Logistics and Distribution Centers, Regional Headquarters) and R&D. Incentives are eligible for up to 40% cost of infrastructure and utility connections, cost of construction or purchase of buildings, as well as purchase of new machinery and equipment. In the year 2007, there are allocated approx. EUR 5.8 million. As stated in (Reform Programme for Lisbon goals 2008), the government heavily supports research and developments programs through the Structural Funds.

	Minimum investment value	Minimum of new jobs in 3 years time	Estimated Grant per new job created
Production	EUR 1. 2. 3 or 4 million (depends on region/municipality)	50	EUR 2,500 – 6,500
Strategic services	EUR 1 million	10	EUR 4,000 – 10,000
R&D	EUR 1 million	10	EUR 5,000 – 13,000

Figure 6. FDI Cost-Sharing Grant Scheme for 2006

Source: JAPTI, 2006

5.2 FDI Cost-Sharing Grant Eligibility

The program is open to foreign investors, registered in the Republic of Slovenia in which they hold an interest of at least 10 per cent of equity or foreign investors' subsidiaries. Applicable program requirements:

- Investment projects in the manufacturing
- sector that envisages the opening of at least 50 new jobs within three years of the grant allocation. The minimum value of the investment for which grants are allocated shall amount to:
 - 1 million euros in the regions classified on the regional list A considered to be underdeveloped (Pomurska, Podravska, Zasavska and Spodnje-posavska), and on the lists A, B, C and D territories of the municipalities coping with specific development problems;
 - 2 million euros in the regions classified on the regional list B (Savinjska, Koroška, Notranjsko-kraška and Jugovzhodna Slovenija);
 - 3 million euros in the regions classified on the regional list C (Goriška and Gorenjska);
 - 4 million euros in the regions classified on the regional list D (Obalno-kraška and Osrednjeslovenska).
- Investment projects in an internationally marketable service activity envisaging the creation of at least 10 new jobs within three years of the grant allocation. The minimum value of the investment for the grant allocation shall amount to 1 million euros. A service activity eligible for preferential treatment shall be among the following: Customer Contact Centers, Shared Services Centers, Logistics and Distribution, and Regional Headquarters.
- Investment projects in research & development activity envisaging the creation of at least 10 new jobs within three years of the grant allocation. The minimum value of the investment for the grant allocation shall amount to 1 million euros. An activity carried out by a company or a self-contained organizational unit whose core activity is the research and experimental development in the area of technology is considered a research & development activity.

The investment project and newly created jobs must be kept in the region for at least five years. The following costs shall be deemed eligible for grant allocation:

- Costs of providing utility connections and infrastructure facilities for the site,
- Costs incurred under the construction or purchase of premises,
- Costs incurred under the purchase of plant and equipment, and
- Costs of gross wages/salaries for newly employed staff (for a two-year period).

6. Necessary Economic and Social Reforms

When compared, Slovenia and Bosnia & Herzegovina, in similar ways are still in need of economic and social reforms in order to successfully complete the transition to free markets and to provide enough incentives for foreign direct investment.

6.1 - Slovenia –

Owing to the slow pace of change, Slovenia started to lose its advantage in global competitiveness. Other Central and East European transitional economies, mainly those that have implemented more courageous and radical structural reforms such as Poland, are catching up and even overtaking Slovenia's potential markets in certain areas. Following is a list of possible areas for improvement of Slovenia's position in the competitive global market:

1. Tax reform in the direction of introducing a flat tax rate and simplification of tax regulations could unburden Slovenia's economy. The abolishment of the payroll tax and introduction of a flat tax rate, while keeping net earnings unchanged, will greatly reduce gross labor costs, especially of the more skilled employees.
2. New reforms should be introduced for the university system and research and development, which will create incentives to use current and new capabilities for economic growth, technological development, and innovation.
3. For efficient and quicker productivity growth, it is necessary to implement the second wave of privatization. This time, the best Slovenian enterprises will be subject to privatization, being more suitable for dispersed privatization and diversified financial investors. The domestic non-transparent consolidation of ownership at low prices must be replaced with a process that will be open to international participation and that will ensure the respect of small shareholders' rights. This reform calls for transparent withdrawal of the State from the economy.

4. For effective financing of future development priorities a reduction in general government spending is necessary in addition to overall restructuring of public expenditure. To narrow the gap between the needs of the State for investment in infrastructure and the available traditional financial sources, additional private capital be engaged in the form of a Public Private Partnership.

6.2 - Bosnia and Herzegovina -

One of the biggest burdens on the Bosnia's economic development, in addition to overwhelming government debt, is a dysfunctional bureaucratic system. This section evaluates some necessary changes, reforms required for successful regional ergonomic growth and for creation of attractive environment for foreign investors.

1. Disassemble the Payments Bureau - Rapidly reform all existing forms of Payments Bureau (PB). The transfer of PB activities to commercial banks will both invigorate the banking sector and encourage other economic activity to move gradually from the black market into the legal economy, strengthening the government's tax base. This reform is necessary for removal one of the major disincentives to foreign investors.
2. Reform of Corporate Legal System is required. The question of Rule of Law in Bosnia and Herzegovina affects all aspects of society, and economic activity is no exception. In neither entity does the court system protect legitimate business interests, nor does it work in the interests of good business practice and common sense. The reform of the judicial system is a massive undertaking, but some reforms could be made quickly which would improve the climate for business.
 - When inspectors seize goods or shut down firms without due process, institute a right of appeal, with a guarantee of a court hearing within two days;
 - Create an effective and quick system of appealing court decisions;
 - Create a network of economic courts to handle small claims quickly and with a minimum of procedure.
3. Reform Taxes – since efficient tax policy is crucial to the economic growth of Bosnia, as well as vital to the revenues of the municipality, tax reform should be urgently considered. A sustainable tax regime might be:
 - Abolish all current business taxes (except the year-end tax on profit);
 - Replace business taxes with a sufficient VAT tax.
 - Lower the level of payroll contributions from 87% to 35% of salaries;
 - Lower the tax on profit from 36% to 20%.
4. Streamline Business Registration Procedures - Governments should reform business registration procedures, so that they are similar to those in Western countries. The new registration system should have the following characteristics: relatively quick, transparent, inexpensive, standardized paperwork to be completed in when applying for business license, abolish the requirement to declare all areas of business activity to the smallest detail, abolish the requirement for detailed company statutes.
5. Reform the Customs System and Increase Control over the Borders - two entity-level customs agencies should be merged into a single central government customs agency. Revenues from the customs tariffs should accrue to the central government, and not the entity governments. A portion of the revenues could be recycled back to entity governments in accordance with a formula to be agreed.
6. Remove Barriers to Inter-Entity Trade- There is no economic advantage to either entity in erecting barriers to trade within Bosnia and Herzegovina. Internal hidden taxes on inter-entity trade should be abolished. As a result, inter-entity trade will increase, so raising revenues, and incentives to smuggle will be removed. Businesses attempting to operate legally (and pay taxes) will get welcome relief from illegal tax-free competition.
7. Proceed with Privatization - Privatization should not be further delayed, despite the risk that some enterprises will fall into unscrupulous hands. Greater transparency in the ownership of enterprises will help to revitalize the economy and force business to work efficiently for profit rather than simply to keep going through inertia.
8. Ensure priority spending within transport sector – by placing the priority on improving the conditions of the current transport network. Develop a comprehensive strategy and policy for the transport sector to identify proprieties and to ensure that all debt-financed public investments are consistent with available fiscal envelope, especially focusing on the development of corridor 5c.

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