



“Are free zones in BiH really free?”

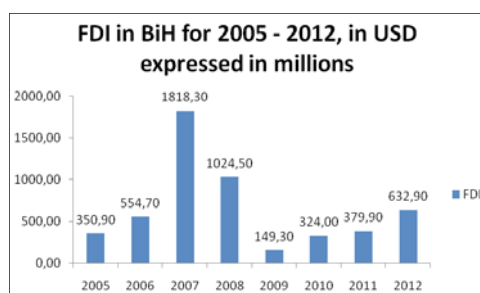
How to improve the attractiveness of BiH free zones to foreign direct investments?

Azra Pilavdžić and Emir Skopljak

BiH and drop in FDI

High external trade deficit amounting to slightly less than 7 billion BAM in 2013 and an export import ratio of 55% are the two main indicators when describing BiH economy. Foreign financial capital was used to cover such external deficits. However, the inflow of foreign capital has decreased abruptly since the beginning of the economic crisis. Volatile inflow of FDI in BiH, seen as an unsecure source of capital to compensate for existing external deficits, is a clear sign that BiH needs a long term and strategic solution in attracting FDI.

The following chart illustrates the volatile FDI inflow to BiH for the period 2005 – 2012 in USD expressed in millions:



Source: United Nations Conference on Trade and Development, World Investment Report 2013.

Economic impact of Free Zones

Free zones or special economic zones are usually defined as spatially delimited areas within an economy that function with typically more liberal regulatory, administrative, and fiscal regimes than those of the overall economy. Free zones exist in most EU countries, as well as in most developed countries of the world, such as

the United States of America. Direct benefit of free zones is an increased level of investments (foreign and domestic). However, free zones also boost creation of jobs and public income usually generated through direct taxes.

According to the International Labour Organisation, the number of new free zones has been increasing since the mid-1980s. The International Labour Organisation database registered 176 free zones in 1986, and 3.500 in 2006. Overall, these free zones account for 68 million jobs worldwide.

Why free zones in neighbouring countries attract more FDI than the ones in BiH?

Foreign Trade Policy in BiH was the first and main pillar developed within EU and WTO integration processes, resulting in a modern free zones legislation compliant with relevant EU provisions. However, the lack of consistent and comprehensive implementation of such legislation caused benefits granted by the BiH Law on Free Zones to become irrelevant.

On the other hand, neighbouring countries in the Western Balkans (especially Croatia and Serbia) have implemented a modern free zones legislation. These countries are promoting their free zones through relevant state bodies or associations, and record important amounts of FDI in free zones, resulting in additional creation of jobs. The fact that Croatia and Serbia have several free zones listed in worlds' top 50 zones for the future indicates how serious the BiH neighbouring countries are about the development and perspective of their free zones.

Summary

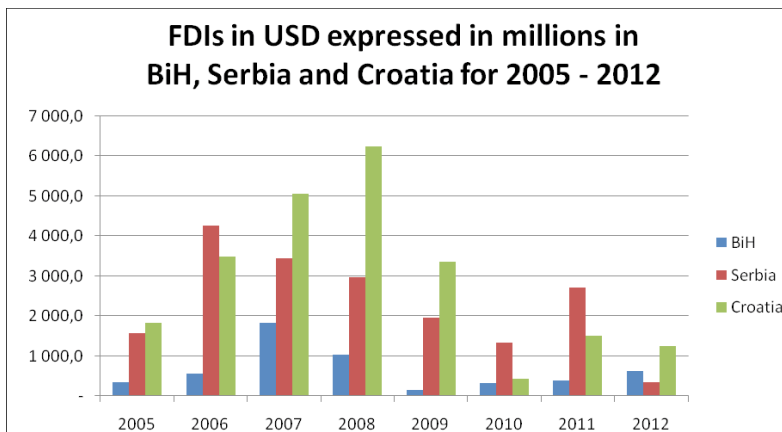
Slow progress of Bosnia and Herzegovina towards integration into European and global economic flows through EU and WTO accession, recently combined with the global economic crisis, resulted in a low level of foreign direct investment in BiH. In the current situation, free zones in BiH represent a tool whose potential is not used enough when it comes to attracting foreign direct investment (FDI). The experiences from the countries in the Western Balkan region indicate that free zones attracted a number of foreign investors who are currently playing a big role in their economies. The free zones regime in BiH is regulated on state and entity levels, and the implementation of the current legislation is not creating additional value for foreign investors. Improvements to the BiH free zones regime will not only bring more foreign direct investments, but indirectly it should influence additional job creation, increased export performance, and an increase in direct tax revenue. The BiH Council of Ministers has affirmed the importance of free zones several times, and regularly monitors their functioning. Certainly, there are improvements that can be made to the regime and promotion of free zones in BiH, which would have long term and sustainable effect. The aim of such improvements is to increase the attractiveness of BiH to foreign direct investment. This would certainly lead to overall FDI growth, in addition to other indirect economic benefits.

The success story of Fiat Automobiles Serbia

Fiat Automobiles Italy were the biggest investor in Serbia in the last decade. With an investment of approximately one billion Euros in the Kragujevac free zone (67% by Fiat Italy and 33% by the government of Serbia), Fiat Automobiles Serbia now employs over 2.000 workers in Kragujevac. This company is currently the biggest exporting company in Serbia, with exports amounting to 1.46 million Euros from January 2013 to November 2013.

Competitive advantages in attracting FDI to free zones developed by the neighbouring countries significantly changed the rules of regional competition in attraction of FDIs. Such development in regional free zone regimes seriously threatens BiH to become isolated on the map of FDI, especially in free zones. BiH, already the country with the lowest level of FDI inflow in the region, needs to undertake comprehensive activities in order to be able to compete with neighbouring countries in attraction of FDI into its free zones. However, the real question asked here is why BiH does not attract FDI to its free zones, despite having proper legislation and zones in place?

The following chart shows a comparison of FDI inflows in BiH, Serbia and Croatia in USD expressed in millions for the period 2005 – 2012.

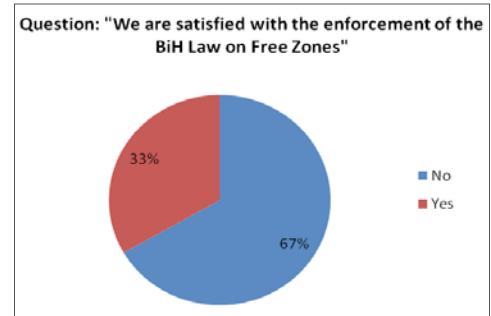


Source: United Nations Conference on Trade and Development, World Investment Report 2013.

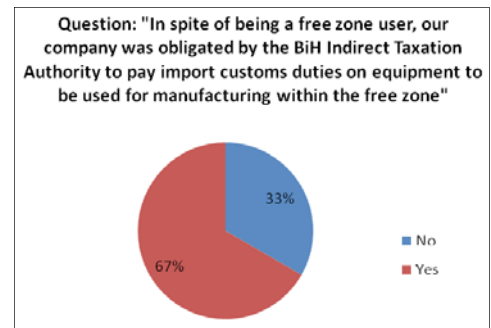
What is wrong with the BiH free zones regime?

There are currently four free zones in BiH, namely, in Visoko, Mostar, Vogošća, and Puračić. There are 81 companies operating in those four free zones. The free zones legislation in BiH was motivated by the aim to create a favourable, stable, and transparent legal environment for domestic and foreign investments. All free zone regimes, including the one in BiH, provide for duty-free and VAT-free imports of raw, intermediate input and capital goods necessary for the production. Nevertheless, free zone regimes in Serbia and Croatia offer other non-negligible advantages such as, among other things, exemptions from certain local taxes.

The free zones regime in BiH is in line with the EU and WTO rules. However, the existing regime lacks proper implementation as demonstrated by the replies of the conducted survey of companies operating in BiH free zones.



According to the feedback gathered from the companies on whether is it possible to use the privileges granted by the BiH Law on Free Zones, the ratio of replies was shocking and negative. 67% of companies replied "No" and "33%" replied "Yes", thus questioning the validity of existence of this legal entity.



Moreover, privileges and incentives of free zones have been diminished by the fact that, during the recent years, the Customs Authorities, and especially the BiH Indirect Taxation Authority, have begun levying customs duties and VAT for equipment and raw materials imported into the free zones, contrary to the provisions of the BiH legislation.

Also, one of the most shocking findings was that 50% of the respondents replied that they would not recommend becoming users of free zones in BiH to foreign companies.

Considering these developments, it is not a surprise that the attractiveness of free zones in BiH is reduced, and that BiH falls behind its regional competitors in terms of attracting FDI.



In spite of the fact that the attractiveness of free zones in BiH for their existing and potential users (i.e. the investors) has been reduced, free zones are still a significant foreign trade policy tool for BiH.

Testimony of a company operating in a BiH free zone

“Free zone users pay additional costs for the import of equipment to be used during production, even though the regulations stipulate otherwise. The Court decision on the reimbursement of these costs is not implemented. By an internal act of the Indirect Taxation Authority – Instructions on the customs procedure in free zones, the normal work of foreign companies has been rendered impossible, and trade in goods in the free zone between users of the free zone, without the payment of customs duties, has been rendered impossible.”

In the present state of development of BiH, the good implementation of the free zones regime is necessary in order to attract FDI. The country needs this institution in order to keep its competitiveness with other locations for investment in the Western Balkans region. In order to keep up with its closest competitors for FDI, BiH needs to bring certain improvements in the implementation of its free zone regime and start promoting its free zones.

What should BiH do to leverage the potential of free zones in attraction of FDI?

In order to join the competition for FDI in the region, BiH needs a long term, sustainable solution to problems occurring in the implementation of the free zones legislation, as well as better promotion of the potential of BiH free zones. This solution needs to be comprehensive and should take into consideration a wide number of stakeholders.

- The first step to achieve this sustainable solution is to have an agreed understanding of the interpretation of the free zones legislation by all competent and involved bodies, namely the BiH Ministry of Foreign Trade and Economic Relation and the BiH Ministry of Finance and Treasury as legislative bodies, and the BiH Indirect Taxation Authority as the implementing body. Such

interpretation would be in the form of a Decision on Implementing Provisions of the BiH Law on Free Zones.

- Having unified the implementing provisions of the BiH Law on free zones, the next step would be to create a Strategy for the Improvement of Free Zones Foreign Direct Investment Attractiveness. The creation of such strategy would involve a wider audience from different sectors. The most important stakeholders are: companies already operating in free zones, the BiH Ministry of Foreign Trade and Economic Relations, the BiH Ministry of Finance, the BiH Indirect Taxation Authority, and the BiH Foreign Investment Promotion Agency. Also, a number of other government bodies from different administrative levels should be included according to their respective competences.
- In order for this strategy to be implemented, new bodies would need to be established. Firstly, BiH free zones should establish the Association of free zones in BiH. The purpose of this Association would be to enable the constant development of free zones. Secondly, a Unit or an Office should be established in the BiH Foreign Investment Promotion Agency which would be exclusively responsible for the promotion of free zones to foreign investors.

By putting this solution into practice, the infrastructure would be in place for the implementation of the Strategy for Improvement of Free Zones Foreign Direct Investment Attractiveness. The implementation of this strategy, combined with proper implementation of the existing BiH Law on Free Zones, would ensure increased competitiveness of BiH when it comes to attraction of FDI in free zones. Also, BiH would become included in global value chains and would benefit from additional job creation, increased export performance, and direct tax revenue. Moreover, free zones could have the potential to become the driver of the BiH industrial strategy or even the focal point for promotion of entrepreneurship.



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This policy brief is based on the OSF BiH Policy Development Fellowship Program Policy Study entitled: "Free zones as a tool for attracting foreign direct investment in Bosnia and Herzegovina" by Azra Pilavdžić and Emir Skopljak.



A "Policy Development Fellowship Program" has been launched by the Open Society Fund BiH in early 2004 with the aim to improve BiH policy research and dialogue and to contribute to the development of a sound policy-making culture based on informative and empirically grounded policy options. The program provides an opportunity for selected fellows to collaborate with the Open Society Fund in conducting policy research and writing a policy study with the support of mentors and trainers during the whole process. Over hundred fellowship have been granted since the starting of the Program. All policy studies are available at www.osfbih.org.ba