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MASTER'S THESIS

**ROLE OF REGULATORY REFORM IN IMPROVEMENT OF
INVESTMENT CLIMATE IN BOSNIA AND HERZEGOVINA**

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TABLE OF CONTENTS

INTRODUCTION.....	1
1 LITERATURE REVIEW.....	7
1.1 Foreign Direct Investment.....	7
1.1.1 Definition	7
1.1.2 Motives of FDI.....	8
1.1.3 Effects of FDI.....	9
1.2 Theories of FDI	11
1.2.1 Comparative Advantage Theory	13
1.2.2 Industrial Organization Theory	13
1.2.3 Internalization Theory	14
1.2.4 Product Life-Cycle Theory.....	14
1.2.5 Monopolistic Advantage Theory.....	15
1.2.6 Eclectic Theory of International Production	15
1.3 Regulatory Reforms	18
1.3.1 Administrative Barriers	22
1.3.2 Regulatory Framework.....	23
1.3.2.1 Regulation Impact Assessment (RIA).....	25
1.3.3 Institutional Framework	28
2 PATTERN OF FOREIGN DIRECT INVESTMENTS IN B&H	30
2.1 FDI Inflows in Period 1994 - 2013	32
2.2 FDI Inflows by Country	34
2.3 FDI Inflows by Sectors	35
3 REGULATORY REFORM IN BOSNIA AND HERZEGOVINA.....	35
3.1 Administrative barriers in B&H.....	38
3.2 Regulatory Framework in B&H.....	47
3.2.1 Regulatory Impact Assessment (RIA) in B&H.....	52
3.2.1.1 RIA on State Level.....	52
3.2.1.2 Entity level	59
3.2.1.3 External Stakeholders of RIA in B&H.....	60
3.3 Institutional Framework in B&H	61
CONCLUSION.....	66
REFERENCE LIST	70
APPENDIX	

TABLE OF FIGURES

Figure 1: Foreign Direct Investments in Bosnia and Herzegovina (1994 - 2013).....	33
Figure 2: Investor Countries in B&H (May 1994 - December 2013).....	34
Figure 3: Foreign Direct Investment Stocks in B&H by Industry (May 1994 - December 2013).....	35
Figure 4: Regulatory Reform in SEE* Countries.....	36
Figure 5: How B&H and Comparator Economies Rank on the Ease of Doing Business.....	39
Figure 6: Doing Business rankings 2009 - 2014 in Bosnia and Herzegovina.....	40
Figure 7: How B&H and Comparator Economies Rank on the Corruption Perceptions Index 2013.....	43
Figure 8: Corruption Perceptions Index of B&H (2009 - 2013)	44
Figure 9: Comparison economic Freedom Scores of B&H and Other Countries in 2013.....	45
Figure 10: Global Competitiveness Index of B&H (2009 - 2013).....	46
Figure 11: Worldwide Governance Indicators of B&H (2009 - 2013).....	47
Figure 12: IRI Scores for Investment Promotion Agency and Programmes in B&H and Comparator Countries.....	63

TABLE OF TABLES

Table 1: Effects of FDI to the Host Country.....	10
Table 2: Incorporating Institutional Assets into the Eclectic Paradigm.....	17
Table 3: Guidelines on the Quality and Performance of Regulations.....	20
Table 4: Legal basis for Regulatory Impact Analysis (RIA) in OECD countries.....	27

INTRODUCTION

Regulatory reform can be defined as a process of simplification and improvement of regulation in certain areas. Simply put, regulatory reform is used to improve the quality of regulation. Regulatory policy and reform are a significant part of the overall reform and the process of the development of modern society, which are complex, multidisciplinary, dynamic and ongoing activities. Due to its aforementioned characteristics, regulatory reform is inevitably an integrated area of public administration reform, public sector capacity building and economic development as a service to the citizens and the economy, in order to create conditions for better regulation, that improve investment climate and results with larger inflow of foreign direct investment(hereinafter: FDI) in country. It is based on established international standards and principles as well as comparative experience in managing programs of "better regulation". All governments are responsible for adoption of regulations in the country that will ensure economic and social prosperity of their citizens. Vietor (1994, p.313) found that regulation framework is "an evolving system of market governance, embedded in the changing macroeconomic and political context". Today's economic regulation was initiated as a response to the Great Depression (1930s and 1940s). The regulatory system that emerged from the New Deal worked well during the prosperous decades following World War II, but developed problems in the late 1960s and early 1970s, as macroeconomic performance and political values shifted. These problems, now attributed to government regulation, stimulated a series of legislative and administrative reforms to reduce regulation or to redesign it with aim of encouraging competition.

Regulatory reform has been present for years now and is constantly changing and evolving. The history of regulatory reform is not a result of some government strategy, but emerged in response to the crisis and changes in countries and industries. The most significant crisis of 90's like oil shocks in the 1970s, currency volatility, environmental changes etc, led to rigid, outdated and expanding regulations. The process of regulatory reform as an essential element of regulatory policy began with the deregulation in the 1970s, which later in the 1990s was the basis for the development of regulatory reform towards regulatory management, which meant more government commitment to regulation improvement. Today, deregulation has disappeared from the agenda of regulatory reform in the EU (Radaelli, 2004a).

In last two decades, regulatory reform has been recognized as crucial to economic and social development and as a hallmark of good governance. Modern regulatory reform began in United States in 1970s. It was based and developed on the analytical approach in the preparation of regulations and the assessment of their possible effects and later on was changed to consider the overall beneficial effects of regulation for the country in general and the costs that may occur (cost-benefit analysis). In this regard the U.S. Regulatory Impact Analysis Program was developed and based on it further advances of the regulatory reform

program were realized, which present a significant segment of the economic policy of the USA.

In the early 1990s, considering the importance and possibilities of structural economic reforms, other countries and international organizations were introducing similar programs. Thus, the Organization for Economic Co-operation and Development (hereinafter: OECD) launched a program to encourage Better Regulation, in order to improve the economies of member states and their adaptation to changes, which led to the further development and expansion of the application of this program. Also in 1993 the OECD launched the Programme on Public Management Committee, so-called PUMA program, which has contributed to the exchange of experiences on the development of managerial capabilities and skills and the development of comparative analyses, in order to support the OECD members in improving the public sector. In 1995 the OECD Council defined the Recommendation on Improving the Quality of Government Regulation, which represented the first international regulatory standards of quality and was based on the public policy of the member states. The European Union has developed and implemented policy programs for better management and regulation, such as Regulatory Impact Assessment (hereinafter: RIA) which is used as a method and an instrument. RIA has a special role for the Member States as well as for the countries in transition since it is used in the assessment of the effects of their European integration processes.

At the beginning of the twenty-first century, during the process of democratization of public policy advanced regulatory quality programs were developed. On the other hand, the quality regulation is a successful tool for ensuring sustainable development in the countries in transition and those with lower economic capacity. Thus, even the countries that are not member states of OECD or European Union (hereinafter: EU) have shown interest or have introduced these principles in 2005 and have implemented the regulatory reforms in order to improve the development of overall social relations, particularly the public sector. Regulatory reforms are now in progress worldwide, most importantly in Eastern Europe and the former Soviet Union (Armstrong, Cowan, & Vickers, 1995).

According to OECD (2006), there is no fixed model of regulatory reform. Design and implementation of regulatory reform program is a hard task which involves actions on three areas: legislative, institutional and organizational, therefore the process of regulatory reform requires three integrated elements: legislation, institutions and tools. The laws are the most important form of regulation. The most important factor of investment climate in developing countries is regulatory framework. Developing economies usually have complex regulations that prevent investment and growth. Compared with other elements of the investment climate e.g., physical infrastructure, regulatory framework is relatively easy and less costly to improve and soon we can see the results. Also, improving of regulatory framework leads to better investment climate of the country and thus influence on investors' decision where to invest. World Bank (2005) emphasized that effective regulatory framework is crucial to

business climate of country, affecting investments and economic growth. This relation between quality of regulation and economic growth according to World Bank (2005, p. 10) is "of utmost important since it is generally agreed that sound regulation addresses market failures that inhibit productive investment".

The main tool for improving quality of new regulation or an existing regulation is Regulation Impact Assessment. RIA is instrument used for assessment of positive and negative effects of a regulation. Also, it is a tool for the increase of regulatory transparency. The need for RIA arises from the fact that impacts of regulation are difficult to predict without detailed study and consultation with affected parties, especially considering that the regulation affects everyone in country. However, regulatory reform involves not only reforms to specific laws, rules, procedures and standards but also improvement of the processes through which laws and policies are made. Regulatory reform helps build the institutional capacity to drive, coordinate, oversee and monitor results of the reform agenda; hence the institutional framework is a key to improving the quality of new and existing rules. Overall regulatory reform should be adopted at high political level and it is essential to establish institutions that will support reform and ensure its implementation. Regulatory reform is integrated in government systems of many OECD countries and the best sign are established regulatory oversight bodies in these countries.

With this master thesis we want to explain how regulatory reform can improve the investment climate of a country. By term "investment climate" we mean on regulatory, policy and institutional framework in which firm operate and which influence investors' decision where to invest. This positive relationship between investment climate and investments clearly proved Dollar, Hallward-Driemeier, and Mengistae (2004) which found that sound investment climate attracts foreign investments.

Investment climate is complex term that includes many factors like economic, natural, social, institutional and all other factors that influence business decisions. However, one of the most important elements of investment climate are public policy regulations. Complex and numerous regulations as well as low quality of regulations or constant changes lead to investors' insecurity and lack of trust and these are some of the main difficulties that investment climate has to overcome in many countries. Improving the investment climate will lead to a greater inflow of FDI. Greater inflow of FDI has a positive effect on the development of the country and it is the best indicator of a good investment climate which impacts the state, investors and citizens.

On the one hand the state aims to improve its competitive position and attract FDI which would accelerate economic growth. Many studies have confirmed the positive impact of FDI on the development of the host country (Lyroudi, Papanastasiou, & Vamvakidis, 2004; Campos & Kinoshita, 2002; Asteriou, Dassiou, & Glycopantis, 2005; Zhang, 2001). Therefore, it is necessary to execute the regulatory reform that will improve the investment

climate and facilitate the investors to invest. Regulation also affects public sector workers that are deemed ineffective because of the unnecessary bureaucracy that takes up too much time. By reducing the demands placed on public sector workers, they will be able to focus on their jobs, and provide better service to the public.

Multinational corporations (hereinafter: MNEs) are the biggest investors in a country. Their decision where to invest is very complex and depends on many factors. One of the most important factors affecting their decision is the country's investment climate, which is especially relevant in the developing countries. The investment climate includes a legal framework that provides incentives and transparency, simple registration procedures, low costs of starting a business, a low level of corruption, and so on. From investments in general, and particularly of investments by MNEs, the host country as well as its citizens has a huge advantage. Large investments contribute to the increase of employment and improvement of living standard. Also, MNEs increase the skills and wages of workers and in long term improve the lives of the citizens of that country. All the citizens of one country be it employees of public or private sector or consumers, at the end benefit from good investment climate.

We take the Bosnia and Herzegovina (hereafter: B&H), as an example since the need for investment and growth is particularly strong in developing countries such as B&H. According to Doing Business Report 2013 (World Bank, 2014b), B&H is on the 131st place concerning the ease of starting business, which is behind all the neighbouring countries. For such a bad rating, there are three basic reasons: globalization, transition and war. Today in the time of globalisation, FDI increased in many countries and this played important role in economic growth of these countries. But the problem is that the distribution of FDI is uneven in the world and this is one of the reasons why some countries attract less and some more FDI (Rahman, 2008). Usually the poorest countries like B&H are disappointing in attracting FDI.

In 2002 the World Bank defined Bosnia and Herzegovina as transition economy. Transition affects the country on many aspects and also affects the inflow of FDI. According to Bevan and Estrin (2000), countries that are not successful in implementing transition will receive less FDI and this will further limit their transition progress. The result is increasing concentration of FDI into the more successful transition economies and deeper differences in per capita income between countries in the region. This could be one of the reasons why B&H is, on the ranking of Doing Business, behind all neighbouring countries.

However, the most important reason for the bad rating of B&H is the war which lasted from 1992 to 1995 and which degraded the country in every way as well as in terms of attractiveness for FDI. Bosnia and Herzegovina has still not recovered from the war and the effects can still be noticed. Although the help came from all over the world, it was not enough for the country to recover. Bosnia and Herzegovina has a bad reputation because of the war and that is one of the main reasons of the reluctance to invest. However, B&H is a country

that has much to offer and that should be emphasized and developed as much as possible. According to Madura (2007) MNE's are increasingly investing in Eastern Europe. The reason for this is the low cost of labour, land and raw materials, but in order for the investors to show interest in the country above all else, there should be political stability, simple procedures and regulations for investors. Also, if Bosnia and Herzegovina wants to repair its competitive position in Europe, the accession negotiations should be followed by an extensive regulatory reform, especially in the parts where we want to accelerate our economic growth and attract foreign direct investment. Therefore, it is necessary to create a modern regulatory framework that will improve the investment climate and lead to greater FDI inflows. The inflow of FDI will lead to accelerated development of the country through positive effects such as the increase of the capital in the country, the increase in imports, an increase in jobs and wages, introduction of new technologies, and foreign companies will bring new know-how and managerial skills into the host country.

Given all these benefits, it is necessary to simplify the regulatory system in the country as much as possible and thus create a good investment climate. An unfavourable investment climate is one of the many hindrances faced by underdeveloped nations. According to Hallberg (2006) in order for the investment climate to have a proper quality, several factors need to be taken into consideration: risks and transaction costs of investing in a business and also operating a business, which, on its own, is determined by several other factors like legal and regulatory framework, barriers to entry and exit, etc. Governments are the ones that influence that quality through policies, institutions and through their relationship with the private sector. Regulatory reform is tool for improving regulatory quality and is a key component for removing the barriers to investment. Improvement of investment climate in B&H should be key driver for regulatory reform.

Because of the advantages of FDI, the topic of improving the investment climate through regulatory reform is very important for B&H. The literature on regulation are generally more advanced, but there has been little attempt to link the literature on regulatory reforms and investment climate. In this thesis we will try to bring these two fields together by reviewing some of the main contributions in each of them. We will describe how regulatory reforms are implemented in practice, and discuss some of their effects and implications on investment climate and foreign direct investment in B&H.

This thesis aims to determine whether regulatory reform in B&H can improve investment climate. Hence, this thesis aims to answer the following research questions:

- What is relation between regulatory reform and improvement of investment climate?
- How can regulatory reform in B&H improve investment climate?
- What projects of regulatory reform were done until today and what can be done in the future to improve investment climate?

The goal of this thesis is to show how regulatory reform, the elimination of administrative barriers, improving the regulatory and institutional framework in B&H can improve the investment climate and thus increase the inflow of FDI and lead to higher growth and progress of the country.

The research methodology will be based on qualitative aspects of research strategy. We collect data primarily from secondary sources such as:

- Annual reports made by local and international institutions: Foreign Investment Promotion Agency of B&H(hereinafter: FIPA), Foreign Investors Council B&H (hereinafter: FIC) or international institutions: World Bank, Organization for Economic Co-operation and Development (OECD), International Monetary Fund (hereinafter: IMF), United Nations Conference on Trade and Development (hereinafter: UNCTAD), World Economic Forum.
- Website research on local and international public institutions, agencies, organizations and data bases like: Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina (hereinafter: MOFTER), Foreign Investment Promotion Agency (hereinafter: FIPA), Foreign Investment Advisory Service (hereinafter: FIAS), Audit Office of the Institutions of B&H, Transparency International, The Heritage Foundation and Dow Jones & Company, APEC Economic Committee(hereinafter: APEC-EC),World Bank and Wikipedia.
- Documents and laws related to investments in Bosnia and Herzegovina: Law on the Policy of Foreign Direct Investment in Bosnia and Herzegovina, Decree on Conditions and Implementation of the Investment and Employment Support Program, Ex-post and Ex-ante Regulatory Impact Analysis (RIA) on B&H FDI Policy Legislation, Report on the Regulatory Impact Analysis of Implementation Acts Related to the Registration of Foreign Investment with Ministry of Foreign Trade and Economic Relations contained in the Law on Foreign Direct Investment Policy in B&H.
- E-books, official journals and articles.

Also, we will use method of description, analysis and synthesis, detection method, statistical method, and tabular and graphical representation of statistical data.

This master thesis begins with an introduction in which will show: description of the problem, purpose of the thesis, objective of the thesis, methods of the thesis and structure of the content. The first chapter presents the theoretical understanding of the concept of foreign investment, its definitions, motives and the main theories of FDI.

The second chapter explains what regulatory reform is and presents four segments of regulatory reform. These segments are administrative barriers, regulatory framework, Regulation Impact Assessment (RIA) and institutional framework.

The third chapter describes the current situation in Bosnia and Herzegovina regarding foreign direct investments. There are tabular views of FDI inflows by countries and by sectors in period of 1994 - 2013. Additionally, the biggest investors, potentials of country and the problems that B&H faces in attraction of FDI are shown.

In the fourth chapter of this master thesis are described projects of regulatory reform in B&H that are done until now. There are also showed rankings of country on investment climate and competitiveness indicators, B&H investment laws and Regulatory Impact Assessments (RIA) that were conducted on the Law on Policy of FDI of B&H. At the end of this chapter are shown institutions in B&H that are essential to design and implementation of regulatory reform.

1 LITERATURE REVIEW

1.1 Foreign Direct Investment

1.1.1 Definition

Foreign direct investment plays an extraordinary important role in global business today. According to Javzandorj and Dehong (2012) all countries but especially developing countries are trying to attract more FDI because it is considered as a driving force of economic growth. Large international institutions gave different definitions of FDI. UNCTAD (2007, p. 245) defined FDI as “an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) to an enterprise resident in another country (FDI enterprise)”.

The International Monetary Fund (1993, p.86) defined direct investment as “the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the foreign direct investor and the enterprise and a significant degree of influence by the foreign direct investor on the management of the enterprise”. Although the IMF recommends a 10 percent threshold of ownership for the distinction between direct and portfolio investment, it explicitly leaves the choice to national discretion.

According to OECD (1996) the main objective of FDI is to maintain long lasting interest by direct investor in one country. By term "direct investment" OECD involves all transactions (initial and subsequent capital transaction) between entities and among affiliated companies.

Hayter (1997) defined FDI as activities performed by one or more companies outside of the home country, country where are headquarter or decisions makers of the company located. Operations of subsidiary company or branch plant are controlled by parent company that is based in another country.

Babić, Pufnik, and Stučka (2001) distinguish between two types of FDI. Foreign direct investment that creates new production assets is called "greenfield investment". The investment consisting of purchasing existing facilities and companies and taking over control in them so that the new owner could manage them more efficiently than the previous one is called "mergers/acquisitions (M&A) investment", "take-over investment", or "brownfield investment", which also includes foreign direct investment resulting from privatisation.

Dunning and Lundan (2008) made the distinction between foreign portfolio investment and FDI. Foreign portfolio investment is an investment by firms or individuals in financial instruments issued by a foreign government or a foreign company. Investors can get benefits but do not have any right to control the decision making process. FDI involves the transfer of a package of assets which includes financial capital, technology, management skills and organizational principles of the firm from one country to another.

1.1.2 Motives of FDI

Since FDI is mostly implemented by multinational corporations, the term "multinational corporation" can be used as synonym for foreign direct investment (Protsenko, 2004). Corporation has two motives for investing in another country: first is to serve a foreign market and second is to get lower cost inputs. Based on these motives we can differentiate horizontal and vertical FDI. According to Demekas, Horváth, Ribakova, and Wu (2005, p.2) "Horizontal FDI is market-seeking investment, aimed primarily at the domestic market in the host country, when local production is seen as a more efficient way to penetrate this market than exports from the source country. Vertical FDI is cost minimizing investment, when a multinational corporation chooses the location of each link of its production chain to minimize global costs". As a result of these differences we can distinguish two motives for investing in different countries. The most important motive for horizontal FDI would be market size that is usually measured by the gross domestic product (GDP) of the host country. First motive for vertical FDI would be cost of labour and also other factors of production in the host country. Scholars agree that horizontal FDI is more often used.

According to Kudin and Jubiak (2008) motives that stand behind the work of FDI can be divided into following four forms: resource, labour, market and efficiency seeking. First, since the presence of natural resources was not enough for the FDI, investment took place, especially when countries with an abundant level of resources either lacked the amount of capital required for the extraction of those resources, or lacked the technical skills required to extract or export raw materials worldwide. Second, labour seeking investment is largely stipulated by manufacturing and servicing multinational enterprises from countries with high and real labour costs. Third, market seeking investment is attracted by factors such as host country market size, per capita income and market growth. Third, market seeking investment is motivated by factors such as host country market size, market growth or income per capita. And finally, what triggers the efficiency seeking investment is concentrating production in a few locations to supply multiple markets by using advantages like culture, economic system, policies, institutional arrangements, etc.

1.1.3 Effects of FDI

The motives of the host (this is usually the country that receives a foreign direct investment, and not a specific company) comprise of comparing the social benefits and social costs caused by FDI, as well as of the efforts to maximize the social benefits. The social benefits or effects of FDI in the host country can form a wide palette of positive effects. Babić et al. (2001) also expounded on the most important benefits, which will be explained hereinafter. Such profit-making by a multinational company, which is then taxed (currently, profit is taxed at a rate of 10 per cent in B&H), guarantees significant cash flow into the country's budget. Moreover FDI leads to many opportunities such as creating new jobs, as well as ensuring the related transfer of technology, knowledge and management skills. In general, it can be said that foreign direct investment can improve the quality of labour force and the human capital in the host country, e.g. by training the workers for operating new machinery, utilising new production processes, etc.

According to Babić et al. (2001), another benefit is the use of the comparative advantages of domestic economy along with the economy of the foreign investor, which can be an important element for the breakthrough of the domestic production to the global market. In addition, the entry of foreign companies into the production sector can cause the strengthening of competitiveness, which increases the pressure for efficient business activities of the rest of the sector. Due to the fact that foreign companies possess the necessary knowledge, technologies and financial means, they are expected to contribute to increasing the efficiency of domestic companies (most of which use outdated equipment and production methods), but also improve the management of the company.

Furthermore, an important reason for attracting foreign investors rests upon the belief that foreign direct investment generates positive indirect effects (externalities) on other domestic

companies (operating in the same economic sector or in the branch incorporating their domestic suppliers/buyers, as well as in the rest of the economy), which influences their productivity growth. This can be explained by the host receiving modern technology from a certain market within the country after a branch of a multinational company is opened, which disrupts the existing market balance and forces domestic companies to take action in order to increase their efficiency and protect their market share and profit. However, one should have in mind that positive externalities generated by foreign investors could be lost if the growth of competition owing to foreign companies entering the market causes a decrease in the production of domestic companies.

An additional important motive of the host country is the fact that FDI is not included in the foreign debt of a country, so that countries have an extra motive to obtain as many direct investments as possible, taking into consideration other items on the capital and financial account of the balance of payments. This debt-equity swap, whereby the debt of a country is exchanged for stocks of a debtor country company, was one of the ways of solving the problems of the most indebted countries at the height of the 1980s debt crisis.

Also, Nourbakhshian, Hosseini, Aghapour, and Gheshmi (2012) as shown in the Table 1, highlights the positive effects of FDI to the host country:

Table 1.Effects of FDI to the Host Country

Effects of FDI	Explanation
Resource Transfer Effects	<ul style="list-style-type: none"> • Capital - MNE invests capital in foreign markets • Technology - Research supports that MNEs do transfer technology when they invest in a foreign country • Management - When MNEs invest and manage in a foreign country, they often transfer management skills to the host country's workforce.
Employment Effects	MNEs, by investing in foreign countries, can create employment opportunities for the local workforce.
Balance of Payment Effects	Balance-of-payment (B-of-P) is the difference between the payments to and receipts from other countries. FDI can have positive effects on country's B-of-P.
Effect on Competition	Efficient functioning of markets requires adequate level of competition between producers.

(table continues)

(continued)

Effects of FDI	Explanation
Initial Capital Inflow	When a company invests in a country, it brings capital into that country.
Substitute for Imports	To the extent that the goods/services produced by the FDI substitute for imported goods/services, there is a positive effect on B-of-P
Inflow of payments from export of goods and services	To the extent that the goods/services produced by the FDI are exported to another country, there is positive effect on the host country's B-of-P.

Source: Nourbakhshian et al., *The Contribution of Foreign Direct Investment into Home Country's Development*, 2012, p. 277.

According to several authors, the FDI has positive effects on the growth in developing countries. Among many others, Lyrouti et al. (2004) stated that the FDI positively affects the economy of host countries, through productivity gains, technology transfers, etc. Generally, the FDI represents a vital factor in modernizing those countries' economies and promoting their growth. Campos and Kinoshita (2002) investigated relation between foreign direct investments and economic growth for 25 countries of Soviet Union and Eastern Europe for the period 1990 - 1998. They found that FDI resulted in technology transfer in these countries and that FDI has positive effect on the economic growth of each country. Also Asteriou et al. (2005) examined impact of FDI on economic growth for ten transition countries for the period 1990 - 2003. The results of this research show that foreign investments have a positive and significant effect on the economic growth of these countries.

We can conclude that host countries in search of FDI inflows were mostly motivated by the social and economic benefits of FDI, which primarily stem from a transfer of technology, knowledge and skills and their spillover to the rest of the economy, as well as the positive influence of FDI on foreign trade, growth, employment and investments in the domestic economy. Due to these benefits, it is easily to understand why many transition and developing countries search for new methods to increase and attract FDI. To attract FDI country has to design economic policy taking into account motivations of investors to invest in other markets.

1.2 Theories of FDI

FDI have started to appear increasingly in the theoretical and empirical research of economists after the Second World War. The structure of the Bretton Woods International Monetary System has enabled the development of both trade and international finance.

Additionally, a growth of all forms of financing – from classic borrowing to foreign direct investment – has been recorded.

A particularly large growth of international financial flows took place during the 1980s and the 1990s. According to Babić et al. (2001), there are several reasons for this. The first is the development of theory and institutional investors in the U.S. (joint money market funds, investment funds, pension funds), as a response to the limitations in the banking sector. The second one is the increased networking of global financial markets and globalisation, which enabled the portfolio optimisation at the global financial market. The third one is the liberalisation of financial markets, especially of the markets of European countries at the beginning of the 1980s. Taking into account all of this, as well as the enormous increase in international financial flows, which greatly surpassed foreign trade flows in the 1990s, and it seems became independent from them, the entire area of international finance, and especially of foreign direct investment, has become the subject of numerous studies and research.

In addition, the breakdown of the socialist planned concept of economy and the transition of most former socialist countries to market economy have awakened an additional interest in foreign direct investment as an instrument for a faster increase of efficiency of the existing companies, a decrease of technological backwardness, a transfer of new knowledge (especially in terms of management) and the new ways of doing business in countries in transition, as well as accessing new markets. It is through such a context that we should look at the nature of FDI development, i.e. through a close link between investment and the privatisation strategy of the host country on the one hand and the meaning of FDI in a post-privatisation period, on the other hand. All this has opened up the process of creating an exhaustive theory of foreign direct investment, which encompasses parts of the already developed segments of economic theory, such as the theory of comparative advantage, industrial organisation theory, internalisation theory and industrial organisation theories, etc.

As elsewhere in economics, when it comes to foreign direct investment, both the buyer and the seller, i.e. the recipient and the foreign direct investor (supplier and demander) should have an interest in foreign direct investment. In other words, if FDI were implemented according to the principles of market economy, supply and demand should be levelled at the direct investment market (as a partial balance) in order to reach a balance between the quantity and price of FDI.

The theory of foreign direct investment is created by explaining the motives and behaviours in the market – the motives and behaviour of the supplier (foreign multinational enterprises and countries that encourage the export of goods and services through FDI), as well as the motives and behaviours of the demander (the firms established through foreign direct investment, the FDI host countries and their governments) – and also their expectations and economic policy measures used to attract the said investments, as well as a large number of determinants that cause long-term investment flows.

Determinants that could explain FDI flows can be divided in two categories: micro and macro dimensions. Micro dimensions explain motivations of investors to invest in other country taking into account factors characteristic to the company itself, such as cost reduction, ownership advantages or economies of scale. Macro dimensions try to explain FDI flows through market specific factors like political stability, availability of resources, market size, country risks, etc (Denisia, 2010; Faeth, 2009).

In the past few decades, extensive research took place on the behaviour of multinational companies and determinants of FDI. According to Dunning (2001) existing theories did not manage to explain all cross-border transactions, but there are few theories that are useful in clarifying the factors determining global FDI flows.

1.2.1 Comparative Advantage Theory

One of the first attempts to explain the FDI was David Ricardo's theory of comparative advantage. In 1817, David Ricardo proposed the theory of comparative advantage, due to his reasoning that absolute advantage is not essential condition for trading. According to his theory, if a country produces goods or services at lower opportunity costs than its trading partners, it has a comparative advantage of those goods and services. There are countries which have the absolute advantage in producing certain goods, while there are others that are inefficient in producing compared to their trading partners. Ricardo's theory argues that country which is inefficient at producing goods and services should specialize production of a good it is the least inefficient at, compared to production of other goods. All in all, comparative advantage determines the potential welfare gains from specialization and trade, and not absolute advantage (Musonera, 2008).

FDI cannot be explained with this theory of comparative advantage because it is based on unreal assumptions that there are only two countries and two products. It also assumes perfect mobility of factors at local level, full employment, free trade without barriers, and complete specialisation in the production, as well as fixed quantity of resources in country, but the theory ignores transport costs (Denisia, 2010). In spite of all limitations, comparative advantage theory is still the basis for explaining international trade.

1.2.2 Industrial Organization Theory

Presented by Hymer, the Industrial organization theory was one of the earliest theories based on the assumptions of an imperfect market. Hymer argued that FDI flows are not accidentally distributed among industries, but there are some competitive factors that affect that distribution. If FDI firms are identical to the host firms, there is no profit in entering the host market, due to the additional costs like transport costs, labor costs, cost of doing business, costs incurred due to different customs, language etc. But if FDI firms possess specific

advantages which include advanced technology, trademark, patents, economies of scale, management and marketing knowledge, which are together referred to as intangible assets, it will compensate the advantages that local competitors have and it will motivate FDI firm to invest abroad (Babić et al., 2001).

1.2.3 Internalization Theory

This theory examines the multinational enterprise as an institution. It seeks to explain why firms instead of using different kinds of agreements with local business in the foreign market, choose to involve in international production.

According to Graham (1995) in order to utilise specific benefits at the international level, it is not necessary for a certain company to own a company in another country and manage its business activities, but that the benefits could be used through exporting or making a licensing contract with domestic companies at international markets. According to this theory, in order for a company to become multinational, the so-called internal economies need to exist, in addition to possessing specific intangible assets. Through internalisation, i.e. through internal transactions, a company replaces a market in order for the transactions to be conducted in a more efficient and cost-effective manner. Technical and marketing knowledge is thus spread while property rights are maintained. Internalisation is implemented in order to avoid the high costs of conducting certain transactions on the market, e.g. informing, negotiations on closing deals, the act of closing a deal itself, acquiring property rights, monitoring, amending the contract, etc. By utilising specific advantages through foreign direct investment, it is possible to achieve significant savings due to the internalisation of transactions, while this is not possible by selling licences or exporting the finished products. Internalisation also emerges because there is no market for specific goods and then they can only be sold internally – within the company (Vidas-Bubanja, 1998).

1.2.4 Product Life-Cycle Theory

Vernon (1966) in his paper “International Investment and International Trade in the Product Cycle” tried to explain foreign direct investment made by U.S. companies in Western Europe in period 1950 -1970 in the manufacturing industry. Vernon argued that whole life cycle of one product can be seen as following a pattern - from home production of the product to its export and host production.

Xinzhong (2005) explained three stages of product cycle:

- At the first stage in the home country new product is invented using advanced technology and innovatory capability.
- Second stage is called maturing product because in home country expanded demand and sufficient supply lead to intensive competitiveness in the market of the home country, and

that is why the product is exported to other countries similar to the home country in demand patterns and supply capabilities.

- Third stage is standardized product and in this phase product is produced in other country at lower costs than the ones at the home country.

Vernon's concept of product cycle is first dynamic interpretation of the determinants of FDI flows and trade patterns. But this concept can provide only partial explanation of FDI flows because there is a still phenomenon of developing country investing in a developed country and because Vernon's concept merely regards the FDI as a simple substitute of trade activities (Xinzhong, 2005).

1.2.5 Monopolistic Advantage Theory

Stephen Hymer in 1960 was initiator and founder of monopolistic advantage theory as well as theory on the multinational enterprise and FDI. According to monopolistic advantage theory, MNE can operate abroad more profitable by using monopolistic advantages than local competing firms can, although MNE has some weaknesses compared to local firms which are called "liabilities of foreignness" (Klug, 2006). These weaknesses are:

- higher costs caused by less knowledge about economy, culture, society, language, etc.;
- higher costs caused by discriminating regulations on employment and taxation;
- exchange risk during transferring earnings;
- transportation and communication costs caused by distance between parent company and subsidiary.

Using monopolistic advantages MNE can overcome these weaknesses. Monopolistic advantages are based on defective markets and these advantages are:

- superior knowledge in managerial skills or production technologies that local competing firms cannot copy;
- MNE are usually larger than local firms and have chance to achieve economies of scale.

1.2.6 Eclectic Theory of International Production

All before mentioned theories consider a single view to explain FDI flows. This is why John H. Dunning formed complete theoretical framework of FDI flows, the one derived from various theoretical approaches, i.e. the eclectic theory in which ownership advantage, location advantage and internalization advantage (OLI) are integrated. Eclectic paradigm has changed over last two decades but still remained crucial framework for testing a variety of economic theories of the determinants of FDI and the foreign activities of multinational enterprises (MNEs). Dunning specifies three conditions: ownership advantages (O), location advantages

(L) and internalization advantages (I) that determine whether or not a company will internationalize through FDI. This framework is called OLI paradigm (Dunning, 2000).

Ownership advantages are characteristic of the individual firm and works on the concept of monopolistic advantages. This advantage can present itself in various forms like technologies, know-how, skills, low costs, ability to coordinate assets across borders, human capital, networking skills, etc. This advantage is specific for foreign firm and it is difficult to copy by competitors. The location advantage is based upon the host country specific features that affect foreign investor. These advantages can be: cheap workforce, natural resources, market or legal and cultural environment. The internalization advantage is based on the principle of lowering transaction fees. If the transaction fees are done cheaper within the company than through overseas transactions, then the company function should be internalized. So by internalization advantage Dunning refers on exploitation advantages of own production rather than producing through some arrangement such as licensing, joint venture or management contracting (Dunning, 2001).

Overall, the eclectic paradigm explains FDI in a more comprehensive way, unlike theories mentioned above such as the product life-cycle theory, the monopolistic advantage theory, or the internalization theory. This theory combines and integrates location-specific, ownership-specific and internalization-specific factors and thus explains logic and benefits of international production. Although eclectic paradigm first emerged twenty years ago and science than international business environment and MNE behaviour have changed a lot, the OLI advantages are still crucial in explaining FDI and MNE activity.

Although this theory is comprehensive and it does have some limitations. Even Dunning himself acknowledged some of the limitations of his theory and incorporated several extensions and changes over time. Dunning (2006) in its article have outlined the need to incorporate institutional variables into the eclectic paradigm because of their effect on FDI and MNE activity (Table 2). He argued that, in this time of globalisation, the quality of institutions is becoming more important determinant of the competitive advantages of firms and the locational attractions of countries. Dunning and Lundan (2008a) have also suggested that in this global and dynamic economy, firm-specific and location-specific institutions are becoming more important in reducing the transaction costs of cross-border value added and exchange activities. According to Verbeke and Yuan (2010) Dunning's typology does not give enough attention to unique characteristics of firms and geographic sources of ownership advantages and their transferability.

Table 2. Incorporating Institutional Assets into the Eclectic Paradigm

INSTITUTIONS	OWNERSHIP	LOCATION	INTERNALIZATION
	Corporate governance	Social Capital	Organizational/relational
FORMAL	<ul style="list-style-type: none"> - External legislation/regulations - Discipline of economic markets - Corporate goals, internal command systems and - Incentive structures 	<ul style="list-style-type: none"> - Laws/regulations - Discipline of political markets - Rules-based incentives/standards - Cross-border investment agreements 	<ul style="list-style-type: none"> - Contracts (e.g. inter-firm)
INFORMAL	<ul style="list-style-type: none"> - Codes/norms/conventions - Country/corporate cultures - Moral ecology/mindsets (particularly of decision takers) - Pressures from competitors and special interest groups 	<ul style="list-style-type: none"> - Inherited social customs, traditions - Foreign organizations as institution reshapers - Motivating institutions (e.g. re innovation, entrepreneurship), competitiveness - Attitudes toward change and uncertainty 	<ul style="list-style-type: none"> - Covenants, codes, trust-based relations (both inter and intra firm). - Institution-building through networks/clusters of firms - Extent/form of institutional/cultural distance
ENFORCEMENT/EMPOWERMENT MECHANISMS			
FORMAL	<ul style="list-style-type: none"> - Sanctions/penalties (both external & internal to firms) - Stakeholder action (consumers, investors, labour unions, civil society) 	<ul style="list-style-type: none"> - Sanctions, penalties, policies - Quality of public organizations (e.g. re protection of property rights; rule setting, legal system) - Collective learning (in shaping and implementing institutions) 	<ul style="list-style-type: none"> - Penalties for breaking contracts - Strikes, lock-outs, high labour turnover - Education/training

(table continues)

(continued)

INSTITUTIONS	OWNERSHIP	LOCATION	INTERNALIZATION
	Corporate governance	Social Capital	Organizational/relational
INFORMAL	<ul style="list-style-type: none"> - Moral suasion - Loss, or gain, of status/recognition - Retaliatory options - Build up/decline of relational assets (e.g. trust, reciprocity, etc) - Blackballing 	<ul style="list-style-type: none"> - Belief systems - Tradition (e.g. pride/shame) - Demonstrations, active participation in policy making organizations (Bottomup influence) - Societal guidance/moral suasion (Top-down influence on institutions, organizations and individuals) - Social safety nets 	<ul style="list-style-type: none"> - No repeat transactions - Guilt, shame - External economies arising from networks/alliances, e.g. learning benefits - Blackballing
INSTITUTIONAL DYSFUNCTION	<ul style="list-style-type: none"> - Dishonest accounting practices, fraud and other corporate malfeasance - Lack of transparency - Inadequate institutional framework 	<ul style="list-style-type: none"> - Crime, corruption, flaws in justice system, breakdown in communities/personal relationsInability - Inability to cope with technological or institutional change 	<ul style="list-style-type: none"> - Lack of good intra or inter-corporate relations. Failure of alliances, codes, lack of transparency/ honesty etc.

Source: Dunning, J.H., *Towards a New Paradigm of Development: Implications for the Determinants of International Business Activity*, 2006, p.215.

1.3 Regulatory Reforms

Regulatory reform refers to the change of usage of a regulation and change in the manner of its creation. The reform is part of an ideological shift towards neoliberal values initiated by an economic shock during the 1970s. The 1970s economic crisis lead to a change in orientation of the country's long-term goals from a socialist towards a so-called competition state, so that an increase in the efficiency and effectiveness of public administration was necessary if such a state was to be created. Regulatory reform emerges exactly under the influence of an understanding of a state's primary goals, being one of the most important parts of the public sector reform. Today, it has become a global trend and is a process that exists in almost all OECD member countries. Initial goal of regulatory reform was achieving maximum competitiveness at the global market through simplifying the regulatory system in business sector (Petek, 2009).

Regulatory reform takes a wide variety of forms but there is no generally accepted definition. According to OECD Report on Regulatory Reform (OECD, 1997) regulatory reform can be defined as a means to increase performance, and enhance cost-effectiveness of government and other regulations. Reform can mean the overall change of a reform, or its specific parts, unlike Deregulation-which implies the overall or partial elimination of regulation. Majone (1996) also found that regulatory reform begins with a deregulation phase, i.e. with a process of removing certain regulations and simplifying the regulatory system with the goal of decreasing costs, risks and barriers imposed on the business sector and the market transactions. Reregulation is the second phase of regulatory reform, characterised by the application of the newly formed standards and procedures. This also happens due to the danger of excessive deregulations. The term 'regulatory reform' has in the last 15 years referred to the processes of combining deregulation and reregulation, and the same trends can be perceived at the EU level as well. According to Herzberg (2008), the main goal of business regulatory reforms is to reduce the burden of regulatory compliance for businesses i.e. obstacles to doing business and the other compliance costs. The benefits which may accrue from this reform include increased investment, productivity or employment as well as reduced corruption.

Also OECD (2006) suggests that regulatory reform can reduce business burdens and increase the transparency of regulatory regimes what in turn support entrepreneurship, market entry, economic growth and attracts foreign and domestic investors.

Herzberg (2008) made a distinction between a few types of regulatory reforms:

- Regulatory reforms and simplification that are implemented at level of country or local level. Reform entities could be countries, regions, governments, municipalities or towns.
- Regulatory reform implemented at sectoral level is classified as project of improving investment climate on industry level. These projects aim to improve policy framework of laws, regulations, administrative processes and fiscal arrangement for specific industries. The main goal of these projects is to increase exports and growth of important industries and to encourage investors to use investment opportunities of the country.
- Regulatory reforms that focus on certain transactions like tax administration and cross-border trade organization.

Based on the abovementioned definitions, we can conclude that the main goal of regulatory reform is improving the quality of regulation and decreasing administrative barriers for doing business, which would lead to better investment climate of the country and a higher FDI inflow into the country. So by 'regulatory reform' we refer to measures for improvement of regulatory framework with objective of improving the business environment in which

company operate and invest. We can say it is strategy that includes deregulation, reregulation, simplification and building institutions.

However, according to OECD (2006) there is no specific regulatory reform model that is universally applicable. Designing and implementation of overall regulatory reform is a hard task that involves activities on fields of legislations, institutions and organisation and affects number of economic sectors through time. Political commitment and coordination plays important role in regulatory reform. The best way to achieve good quality regulation in developing countries is through long-term regulatory reform strategy that involves design of institutional framework, introduction of tools for regulatory assessment and mechanisms for transparency, all of which need to be implemented and eventually bring results. So effective regulatory reform strategy should include few integrated elements:

- Overall and long-term strategy with main goal to improve the quality of the regulatory environment, with clear evidence that the objectives have been achieved;
- Introduction and implementation of Regulatory Impact Analysis (RIA) if it is not yet introduced;
- Design of institutional framework according to good practice;
- Instruments that ensure transparency (public private consultation, access to information on regulatory requirements, etc.).

In this master thesis we will research four key areas of regulatory reform: Administrative barriers, Regulatory framework, Regulatory Impact Analysis and Institutional framework.

Regulatory reform is not simple process. Jacobs (2007) finds that regulatory reform is very complex task for governments because regulatory systems are usually decentralized among many institutions and they are not transparent. Regulatory reform is especially important in developing countries where numerous obstacles create unhealthy environment for doing business. These obstacles have their own deep roots in political, systemic and administrative areas. The OECD was the initiator of the international activity regarding the administrative simplification and regulatory reform process since 1990. OECD (2005b) gave recommendations and guidelines for implementation of regulatory reform as shown in Table 3.

Table 3. Guidelines on the Quality and Performance of Regulations

1) Adopt regulatory reform programme that involves clear objectives and frameworks for implementation at highest political level;
2) Ensure that regulations meet objectives through assessment impacts and review of regulations;

(table continues)

(continued)

3) Ensure principles of transparency and non-discriminatory in regulatory processes and ensure implementation of regulations through regulatory institutions;
4) If necessary, competition policy should be reviewed and the effectiveness and enforcement of policy should be strengthen;
5) Stimulate competition through designing high quality regulations and eliminate them if there is clear evidence that they do not serve in public interest;
6) Strengthen economic efficiency, competitiveness and enhance market openness through elimination of regulatory barriers to investments and trade
7) Identify important linkages with other policy objectives and develop policies to achieve those objectives in ways that support reform.

Source: OECD, *Guiding Principles for Regulatory Quality and Performance*, 2005, p.3.

Assessing the outcomes of regulatory reform programmes is complex task (Kirkpatrick et al., 2004). There are three challenges to regulatory reform:

- The first challenge is based on the time of the eventual reform. Changes in behavior of the reform program can lead to changes in business behavior, which would impact the overall reform outcome.
- The second challenge refers to the scale of the reform. The question is: How much of a reform would be tolerated, and which policies need to be looked upon.
- The third challenge has to do with the complexity issue. The cause/effect relationship needs to be taken into account and how the reform would impact the overall outcome and on what levels.

Kim, Kim, and Yanh (2008) found that regulatory reform is becoming more important in developing countries as these countries beginning to realize importance of regulatory framework since inefficient regulatory regime effect allocation of resources, foreign investment as well as raise the possibility of corruption. According to OECD (2010) one of the most important determinants of FDI in South East Europe (hereinafter: SEE) is quality of the regulatory environment, even more important than macroeconomic stability, GDP or cost of labour. Thus, these countries have realized importance of regulatory reform in economic growth.

Haidar (2012) investigated the relation between business regulatory reforms and economic growth in 172 countries using Doing Business database in period 2006 - 2010. The results show significant and positive relationship between business regulatory reforms and economic

growth where business regulation reform is associated with a 0.15 per cent increase in income per capita growth. Popescu (2009) investigated effects of regulatory reform on business environment within the New Member States of EU. The results show that reduction of administrative burden on the business, elimination of heavy bureaucracy and redirecting these amounts to innovative activities would make savings to the government and increase labour productivity. Also Popescu found that economic growth that is result of improvement of business environment is influenced by public policies such as barriers to entry, fiscal policy, taxes, infrastructure, as exogenous factors.

SEE countries are beginning to understand the importance of regulatory reform and high-quality regulations. According to Penev (2009b) legal and regulatory reform in Western Balkan countries is a precondition for the transformation of their legal system into a market oriented one, fully harmonized with the *acquis communautaire*. Creation of a favourable, market oriented legal and regulatory environment requires: a) modern, good quality, market oriented laws, b) institutional framework essential for implementation. Penev (2009a) found that the main goal of cooperation among SEE countries since 2001 was improvement of regulatory environment in the countries. OECD Investment Compact for SEE supported this cooperation. These countries created platform for regulatory reform agenda by signing several declarations. SEE countries continued cooperation in the area of regulatory reform through the South East Europe Investment Committee (SEEIC). SEEIC was established in 2007 and was under auspices of the OECD Investment Compact for SEE. The main task of SEEIC was to initiate and support the reform and implementation of the policies that promote investments in SEE region. Currently, SEEIC (2013) has three main objectives:

- Establishment within SEE countries, South East Europe 2020 Strategy based on five growth pillars: integrated, smart, sustainable and inclusive growth underpinned by governance for growth;
- Increase of competitiveness and enhancing regional value chains;
- Increase of investment promotion of the SEE region as an attractive investment destination.

SEE countries have recognized importance of regional cooperation and support in the area of regulatory reform. Parliaments of B&H, Montenegro, Serbia and Albania signed a Regional declaration with the focus on improvement of regulatory quality and the implementation of laws on the regional level.

1.3.1 Administrative Barriers

Administrative procedures exist in all countries. The reason why governments have administrative procedures is to protect the environment, ensure security, and protection of

health. These procedures reduce market failures, adding to the global public utility (Morisset & Neso, 2002).

There are many forms of administrative formalities but there is no common definition. Administrative formalities are also known as administrative barriers and administrative procedures (Jacobs & Coolidge, 2006). According to Morisset and Neso (2002) administrative barriers are procedural, regulatory or technological factors that obstruct or restrict the entry of new companies into an industry or market. Globerman and Shapiro (2006) define administrative barriers to business as the effort in time and money required by businesses or investors to supply the government with mandatory information and acquire the same from governments.

According to FIAS (2002) the removal of unnecessary administrative barriers could produce following benefits to country:

- An abundance of administrative procedures by a certain government can lead a company to abandon that country as its choice as an international market.
- Another advantage of removing these procedures is the fact that it would raise competitiveness and increase the overall dialogue between the government and the investor.
- By eliminating these procedures, the government of the country helps that nation towards its membership to the EU, because it headlines economic reform and the attraction of both foreign and domestic investors.

Administrative barriers affect country's investment climate and investor's decision where to invest. Morisset and Neso (2002) found that a country with administrative procedures that are not consistent, efficient and transparent, and are excessively time-consuming and costly to accomplish when establishing and operating a business, will lead to loss of potential investors and cancelling their investments.

1.3.2 Regulatory Framework

The main role of regulatory reform is improvement of regulatory quality and that is why the term “regulation” needs to be defined before all. According to OECD (1997) regulation can be defined as the requirements the government sets towards business and the citizens. Regulations include all laws and rules adopted and issued by government or regulatory bodies which have regulatory powers.

Both the OECD and the EU have turned regulatory quality as the basis of regulatory reform. The current definitions of regulatory quality are not difficult to understand. European Commission (2001) argues in its official publications that high-quality regulation is efficient,

effective, coherent, and simple (easy to understand) regulation. Low quality regulation affect investment in two ways, first low quality of regulation raises costs and this affects rate of return on investment and second, higher costs are barriers to investments. Low quality of regulations and poor enforcement of rules lead to business risks and this discourage investors to make investments. By low quality regulation we refer to regulations with low compliance, that causes excessive social costs, that are redundant and overlapping. There are a number of studies that support the view that the quality of regulations affects inflow of investments and the economic growth of country. Jalilian, Kirkpatrick, and Parker (2007) and Radaelli (2004b) have shown that regulatory quality affect on economic growth and competitiveness of country. Bussea and Groizard (2006) investigated relations between government regulations, FDI and economic growth. They found that country must have good quality regulations and supporting institutions to benefit from FDI inflows. Kirkpatrick, Parker, and Zhang (2006) examined impact of effective regulatory framework of country on regulatory credibility to the private sector and thereby encourage private investment. They used econometric model to estimate determinants of FDI in infrastructure in developing countries for period 1990 - 2002. Two variables are used: first quality of the regulatory environment for the infrastructure sector and second did they establish independent regulators in the telecommunications and electric power industries. The results show that both variables are significant and positively related to the private investment in infrastructure. Djankov, McLiesh, and Ramalho (2006) found that economies with better regulations grow faster. The research was conducted in 135 countries and the results indicated that improvement of business regulations implies a 2.3% point increase in annual growth. Sun (2002) claims that a government needs to look at its regulatory framework, and see that it has regulations that enhance business. Some of these reforms are seen in the form of commercial laws and institutions that enforce those laws. These frameworks also act as a confidence of the government, which in turn attracts investors. However, governments need to be careful because regulatory reforms can be abused by politicians which would only damage the attractiveness of that country to foreign and domestic investors. Penev and Marušić (2009) found that the quality of regulations and the elimination of administrative barriers on business can be perfectly exemplified and create more favourable business image in the Western Balkans.

The regulatory reform approved by government should set up the principles that will guide government in process of reviewing and making regulation. According to Mandelkern (2001) there are six principles of good quality regulation:

- Necessity - This principle demands that government assess whether it is necessary or not, adopting new regulation.
- Proportionality - This principle demands that any regulation must establish a balance between the benefits that it provides and the constraints it imposes.

- Subsidiarity - This principle ensures that all decisions taken by government are as close as possible to the citizen.
- Transparency - This principle requires improvement of regulatory quality by taking into consideration views of not only public administration bodies but also views of all parties who are involved into drafting of legislation.
- Accountability - Regulations adopted by authorities should be applicable.
- Accessibility - Regulation should be consistent, comprehensible and accessible to whom it is addressed, and this crucial for proper implementation.
- Simplicity - To make effective use of the rights granted to citizens, regulations should be simple to use and understand and detailed as much as necessary.

According to APEC-EC (2008) good quality regulation is crucial for well-functioning economy and it facilitates achieving desired economic and social objectives. That is why governments need to find a balance between need for regulations and the cost that would regulation impose. The best way to maintain good quality of existing regulation and to control new regulation is by using regulatory reform policy. But there are many approaches to regulatory reform and it there is no single template for regulation-making that will be effective in all situations.

1.3.2.1 Regulation Impact Assessment (RIA)

Regulatory Impact Analysis (RIA) is a “process of analysis of regulation impact on business ambiance and represents a key tool of regulatory reform in creation of good quality regulation” (What is RIA, 2014). This tool obligates proponent of law to analyze impact assessment of the regulation and to explain what problem was solved with new regulation. RIA also requires that benefits of the application of new solution exceed the costs and that new regulation influence on market competition.

Once a new regulation is proposed, it is important to monitor and evaluate the methods of its implementation, as well as the achieved results. Consequently, it is necessary to identify both specific and measurable indicators for monitoring the act directly related to the objectives identified by state intervention, as well as to develop a methodology to measure the success of implementation of actions proposed. Monitoring the progress of the regulation and evaluating its results are both important stages of the RIA process. Monitoring and evaluation are part of the quality check process and provide valuable information to impact assessment analysts and policymakers on the success of the new regulation, in terms of the original objectives that were set for the measure. The results of monitoring and evaluation will provide useful lessons for improving the quality of subsequent RIA work. The RIA document should contain detailed proposals for the monitoring and evaluation of the new regulatory measure, including

an identification of the institutional responsibilities for carrying out and reporting on the monitoring and evaluation.

Stakeholder consultation is an integral part of the RIA process. Consultation is important as a source of evidence gathering and also as part of the processes of accountability. It is important to design a consultation plan, which identifies the key stakeholder groups and selects the most effective methods of conducting the consultation process. The results of the consultation and the responses of the stakeholders need to be summarized and included in the RIA document (MOFTER, 2012).

Term impact assessment consists of many techniques which are designed to measure impact of a policy decisions on national life, before those decisions are taken. Also it is assessment of alternative policies and the risks that these policies impose. Impact assessment could be used as guide to policy-makers in choosing right policies (Tokarski & Mayhew, 2000). Kirkpatrick and Parker (2007) gave similar definition of impact assessment. They defined it as a method of policy analysis with aim to help policy makers in the design, implementation and monitoring of improvements to the regulatory system. Impact assessment provides methodology framework for assessing the likely consequences of proposed regulation and consequences of implementation the existing regulations. Word "regulatory" was removed because obstacles for business were not always in form of laws or regulations but e.g. codes of practice, reporting requirements or funding guidance, and the impacts of these measures also needed to be assessed ("RIA", 2012).

RIA is a central part of the regulatory reform, which is why it is often equated with the entire regulatory reform. However, this is an exaggeration, since the reform itself covers far more elements than its central tool. In fact, RIA is a tool that can be used for different purposes, and the different goals of the regulatory reform demonstrate this. Therefore, economic literature distinguishes between a number of issues that RIA is trying to solve, such as the competitiveness issue, the issue of credibility of government bodies, the issue of public administration being too big and the need to "roll back the state", the issue of simplifying the regulatory system, the issue of creating a positive business environment, the need to achieve a "slim state", as well as the issue of increasing the legitimacy of the regulatory system (Radaelli, 2007). It is even more important to note that RIA also develops by expanding the reach of the regulatory reform. According to Welch and Waddington (2005), the benefits of RIA are:

- Increasing efficiency and quality of government interventions - RIA serves as an informational tool, between the government, and policy makers so that they implement policy that is better on business,
- RIA enhances competitiveness - Unnecessary regulatory burdens reduce the competitiveness of individual businesses directly, and indirectly reduce national competitiveness in the global economy,

- RIA also helps reduce corruption. Since the policy is clear, corruption is reduced, simply because of the reduction of the complexity of the policy itself.

RIA is a tool that assists government the way they regulate by increasing efficiency of regulations, removing barriers to business and by reducing corruption. These benefits are especially important for transition and developing countries, where are usually improvement of investment climate and reduction of corruption priorities. Kirkpatrick and Parker (2004) investigated application of RIA in low-income countries and found that RIA is already being applied in a number of these countries but it is still at an early stage of development. In contrast to these countries, developed countries like the USA, the United Kingdom, New Zealand, Canada and Australia introduced culture of RIA in their regulatory processes. According to Renda (2006) USA was the first country to adopt a model of RIA. The United Kingdom has been using RIA for many years as a key tool that helps improve regulation quality and reducing obstacles for doing business in country. RIA is important instrument and tool of modern regulation that are using many countries of OECD and EU.

Many countries have passed the legislation necessary for the adoption of substantial elements of regulatory policy, including RIA (see Table 4.). This is the best evidence of the importance that governments gave to regulatory reform. Legislating elements of regulatory policy ensures that policy is highly transparent (OECD, 2005a). In early 90s, according to Radaelli (2004b) only some OECD countries were using RIA but by 1996 more than half of OECD countries adopted this tool. By 2001, 14 out of 29 were using RIA and another 6 countries used RIA for some types of regulations.

Table 4. Legal Basis for Regulatory Impact Analysis (RIA) in OECD

Legal basis for RIA	Countries
Adopted RIA by law	The Czech Republic, Korea and Mexico
RIA required by presidential order	United States of America
RIA required by prime-ministerial decree or guidelines	Australia, Austria, France, Italy and the Netherlands
RIA is based on a cabinet directive, cabinet decision, government resolution or policy directive	Denmark, Finland, Japan, Hungary, New Zealand, Norway, Poland, Germany, Portugal, Sweden and the United Kingdom

Source: OECD, *Regulatory Impact Analysis in OECD Countries: Challenges for developing countries*, 2005, p.13.

According to OECD (2008a) what the RIA does is implement the rationale necessary for policy making. It eases the transition from one policy to the next, and adds a systematic approach to policy regulation.

According to experience of OECD countries, RIA is long-term process which should be improved over time and thus increases benefits of better regulation quality. However even though the benefits of the RIA are long term, its effectiveness could be seen even in the early stages.

1.3.3 Institutional Framework

There are many studies that evidence important function of effective regulatory institutions in countries' economic activity and growth. Some studies using statistical tools or tests like regressions on a cross section of countries, found positive influence of better regulatory governance on higher per capita incomes in the long run (Barro, 2000; Kaufmann, Kraay & Zoido-Lobaton, 2002). According to World Bank (2005) better quality of regulatory governance and institutions can stimulate economic growth of country by improving the investment climate. Other studies like Olson, Sarna, and Swamy (1998) found that countries with effective institutions and with good quality of governance have higher productivity growth. According to Kauffman et al. (2002) quality of regulation and governance is closely related to better economic outcomes. Literature shows that effectiveness of regulatory institutions is important indicator of countries' economic growth.

Implementation of regulatory reform requires institutional framework. Hence in this chapter we will focus on describing institutions that are usually established at the centre of government with main task to advocate and to lead regulatory reform. Countries around the world established various institutions that focus on facilitating, supporting and implementing regulatory reform. According to the Rodrigo (2010), the tasks of these institutions include:

- Drafting and amending rules and regulations
- Enforcing these rules
- Monitoring and reporting on regulatory processes.

Regulatory reform includes diverse institutions. According to Rodrigo (2010) these institutions can be oversight bodies and regulatory management bodies (within administrations or Parliaments). They also include independent regulators for sectoral economic activities and other contributors to regulatory quality like specialist for drafting laws and advisory bodies for regulatory reform. In this thesis we will focus on four types of regulatory institutions located in centre of government that could help government to successfully implement regulatory reform programs. These institutions are:

1. Regulatory oversight bodies;
2. High-level committees for regulatory reform;

3. Advisory and/or advocacy bodies;
4. Ad-hoc institutions.

Regulatory oversight bodies are the most common institutions for regulatory reform. Commonly called “Regulatory Reform Unit”, “Commission” or “Council”¹, these bodies work directly with the government. They are defined by their economic, legal, political and social conditions of the country. Based on research of Novion and Jacobzone (2011) these bodies should coordinate, train, supervise, support, and challenge. They promote and monitor regulatory reform. According to OECD (2011) regulatory oversight body is body responsible for promotion and monitoring regulatory reform and regulatory quality in the centre of government. The task of these bodies is also to advocate consistent application of regulatory policy across government.

High-level committees for regulatory reform have task to lead and to guide reform at the political level. These bodies provide guidance to decision makers by providing them with information on regulatory problems, priorities and relevant issues. Sometimes, they can even make decisions regarding policy. In some countries high-level committees are supported by oversight bodies that undertake research and provide background papers for consideration to committees, for example in Denmark² (Rodrigo, 2010). The main functions of high-level committees include:

- They provide support and establish a compromise between political and business representatives.
- They provide advice to governments and broader communities about regulatory decisions and their impacts.
- They find solutions and resolve differences between different areas of government.
- They provide opinions on proposed regulations and can even veto certain suggestions.

Advisory and/or advocacy bodies are in charged for advising government on regulatory reform policy and programs. Some OECD countries used advisory bodies to ensure that views of public and private stakeholders are taken into account. Reporting their findings to the government, these bodies act as powerful supporting institutions of regulatory reform process (OECD, 2011). Rodrigo (2010) made distinction between Public sector advocacy bodies and Private or public/private sector advisory bodies. **Public sector advocacy bodies** promote regulatory reform. Such bodies collect information about regulatory issues, inform

¹Serbia established in 2003 the **Council for Regulatory Reform of the Economic System**. The main task of this body is to improve business climate and support entrepreneurship, to improve quality of existing and proposed laws and regulations and other measures and initiatives that government considers and eventually approves. This council consists of high officials and private sector representatives (Rodrigo, 2010).

²Denmark has strengthened central co-ordination of regulatory reform through the **Regulation Committee**. This Committee was founded in 1998 and reports directly to the Prime Minister (OECD, 2010, p. 52).

stakeholders and citizens about the benefits of regulatory reforms, and provide their help in implementing such reforms. **Private or public/private sector advisory bodies** for regulatory reform can be drawn from the private sector, they can be mixture of public and private sector, or they can employ independent regulatory experts with academic backgrounds. Such bodies are imperative in consultation, data gathering and feedback.

Ad-hoc institutions for regulatory reform include task forces, working committees, etc. Labeled in different ways, these institutions are sometimes called committees or commissions, and sometimes task forces, sectors or initiatives. Over time, they came to stand behind sector specific or issue specific regulatory reform. According to Rodrigo (2010) these institutions typically have the following functions:

- Advising government and giving recommendations about concrete regulatory reform projects or issues,
- Initiation of coordination between bodies with regulatory powers like line ministries, regulatory agencies etc.,
- Identification and creation of capacities for regulatory reform inside the administration,
- Establishing better relations with private sector by promoting regulatory reform efforts, creating channels of communication and introducing consultation procedures with it,
- Launching specific parts of regulatory reform projects or specific activities,
- Participation in the designing, monitoring and implementation of regulatory reform projects.

In countries in development, regulatory reform institutions are vital in designing and implementing regulatory reform. The establishment of these units is specific for every country because of the existing institutional framework and the specific legal, political and administrative organization in the country that have to be taken into account.

2 PATTERN OF FOREIGN DIRECT INVESTMENTS IN B&H

Foreign companies' production and organizational learning (knowhow) introduced in the countries of Southeast Europe, and therein Bosnia and Herzegovina fosters reconstruction of developing economies thus making them more competitive. Additionally, having foreign investors enables an easier access to other markets and makes positive correlations between international risks and ranking of countries according to the number of their accomplished reforms and actual foreign investments that a country manages to achieve. Efficiency, rate and quality of investments in B&H are undoubtedly a prerequisite for a successful restructuring

and strengthening of export competitiveness and attainment of a long-term high sustainable growth rate.

The significance of foreign direct investments in developing countries increased proportionally to the rate by which these countries managed to achieve transformation and reform in the market economy and have achieved a certain level of financial stability and growth. Therefore, the main objective of investment movement in the countries of Central and Southeast Europe is concentration on economies with the best reform results. Requirements set for the foreign direct investments in most of the countries are becoming more alike regarding a more liberal approach that eventually makes good macroeconomic conditions and prosperous domestic economy the most significant factors that attract foreign capital investment.

Bosnia and Herzegovina, alongside the Southeast European countries, is becoming more aware of its own responsibility for creating environmental conditions that are more appealing to foreign investors. These include: a healthy and competitive domestic sector, legal and institutional frameworks that will prompt discrimination-free investment, liberal foreign exchange system, flexible labour market, and quality of public sector regulation. One of the key questions raised here, however, is how effectively foreign direct investments in B&H are utilized and what is their contribution to the economic development. The role of 'Greenfield' investments, as the main form of foreign direct investments, is crucial in this case. Namely, an investor is to build a new factory or an industrial plant in the domestic country as well as to employ local people, and more importantly an investor is to deliver a new product to the domestic market. It is suggested that out of all forms of direct investment, 'Greenfield' investments are the only ones that can improve the international competitiveness of the business entity.

The aim of further B&H European integration process is to help this country attract foreign investments. In addition, this process would facilitate market expansion for B&H producers. Complying with the European Union rules and regulations reduces risks by creating a business environment similar to those in the Western European countries. Bosnia and Herzegovina is to focus on the systematic advancement of all forms of economic and political cooperation not only with the countries of the EU and the world, but also with its neighbouring countries that are members of the CEFTA. The implications of the above stated conditions emphasize the need of Bosnia and Herzegovina to promptly remove all forms of limitations in the field of free capital flow and the exchange of goods and services and, therefore the limitations on the foreign direct investment flux. All structures in Bosnia and Herzegovina should pursue a common interest – to attract foreign direct investments so as to justify the confidence and existence of the private international capital in country.

B&H has made a few steps in improving the investment climate, but these steps only frustrated potential investors. In 2011, foreign investment totalled BAM 392 million, which is

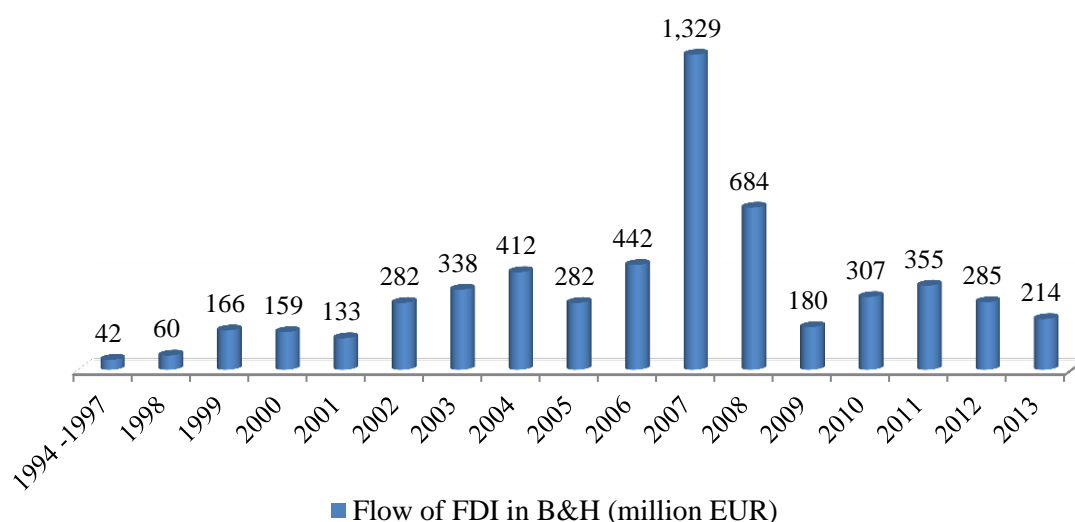
far away from its height of BAM 2.4 billion four years earlier. The banking sector can be seen as a kind of exception, due to the dominant position of Austrian banks in the local market. Still, the chief problems of Bosnian economy are high unemployment rate, slowdown of foreign direct investment, as well as the increased public sector spending. However, there are so many fields attractive to foreign investors, like the energy sector, infrastructure, agriculture, food production, and many others. On the other hand, there is also domestic skilled workforce that can be used. Tourism is also one of many sectors in B&H that foreign investors can use. There are so many different cultures, religions, traditions alongside architecture and historical sites with very impressive investment opportunities. Besides, if we take a look at the infrastructure and traffic roads, we can see that all traffic types require urgent renovation.

B&H still faces many difficulties in opening its economy to foreign investment. This is still a country with complex legal and regulatory framework, with non-transparent business procedures, corruption, poor infrastructure, insufficient protection of property rights as well as weak judicial structures. There are also an evident and complex number of national laws. On the other hand, the number of scholarly articles on legal framework relevant to FDI is quite small. Without any considerable improvements on the business field, the government managed to place B&H at the very bottom of the business ladder.

2.1 FDI Inflows in Period 1994 - 2013

After war in B&H, FDI entered the stage through take-over investments what resulted in foreign trade deficit, unemployment, etc. B&H in 2007 recorded highest FDI inflow ever and this was three times more compared with inflow in 2006. This was significant improvement in investment climate of B&H. After 2007, B&H never reached this level of FDI inflow as we can see in Figure 1.

Figure 1. Foreign Direct Investments in Bosnia and Herzegovina (1994 - 2013)



Source: FIPA, *Investment opportunities in Bosnia and Herzegovina*, 2004, p.3.; FIPA, *FDI Position and Performance*, 2014.

According to FIPA (2014a) in the last 20 years 2007 was a record year when B&H attracted EUR 1.329 million due to the privatization of some large state-owned enterprises. In 2008 B&H attracted EUR 684 million what can be considered as satisfied but then in 2009 the global economic crisis affected the inflow of FDI. The gradual increase in inflows in the last years is encouraging, but they are still significantly lower than in the period before the global crisis.

Increase of FDI was recorded in 2010 and 2011. The inflow of FDI in 2010 increased 70.5% as compared to the 2009, with the recorded amount of EUR 307 million. The inflow of FDI in 2011 amounted to EUR 355 million and increased 15.7% as compared to 2010. Unfortunately, despite of positive estimation, inflow of FDI in 2012 amounted to EUR 285 million and decreased by 19.6% compared to the 2011.

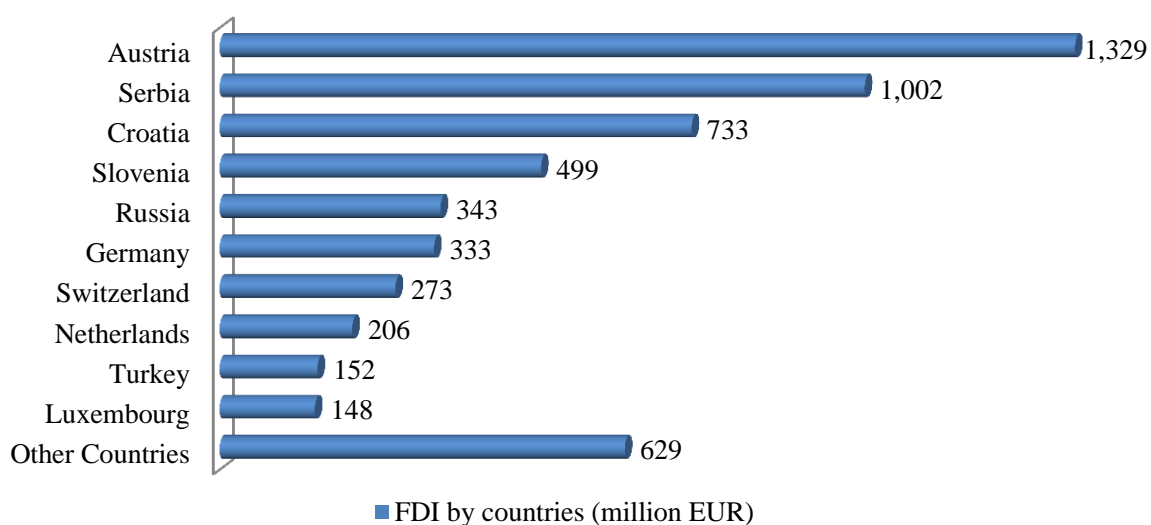
Global foreign direct investment inflow fell by 18% in 2012. In the countries of South Eastern Europe, the amount of FDI has almost halved, which is primarily a result of lower investment from the European Union countries, which are faced with the consequences of the economic crisis. UNCTAD estimated a positive trend of FDI flows in the next two years.

Unfortunately, despite promising expectations, foreign direct investment in 2012 and 2013 did not have a positive trend. The inflow of FDI in 2013 was BAM 418 million or EUR 214 million, which is 21.6% less than previous year. However, taking into account the ongoing projects, even with lower values of FDI in previous two years, we can be optimistic regarding future FDI growth (FIPA, 2014a).

2.2 FDI Inflows by Country

In the period from May 1994 to December 2013, 91 countries invested in B&H and more than 60% were European countries. According to FIPA (2014a) the investments were realized by companies from Austria 23.8%, Serbia 17.1%, Croatia 13.4%, Slovenia 9.3%, Russia 8.4%, Germany 5.5%, Switzerland 4.6%, Netherlands 3%, Turkey 2.7% and Luxembourg 2.5% and other countries 9.6% as we can see in Figure 2.

Figure 2. Investor Countries in B&H (May 1994 - December 2013)



Source: FIPA, *FDI Position and Performance*, 2014.

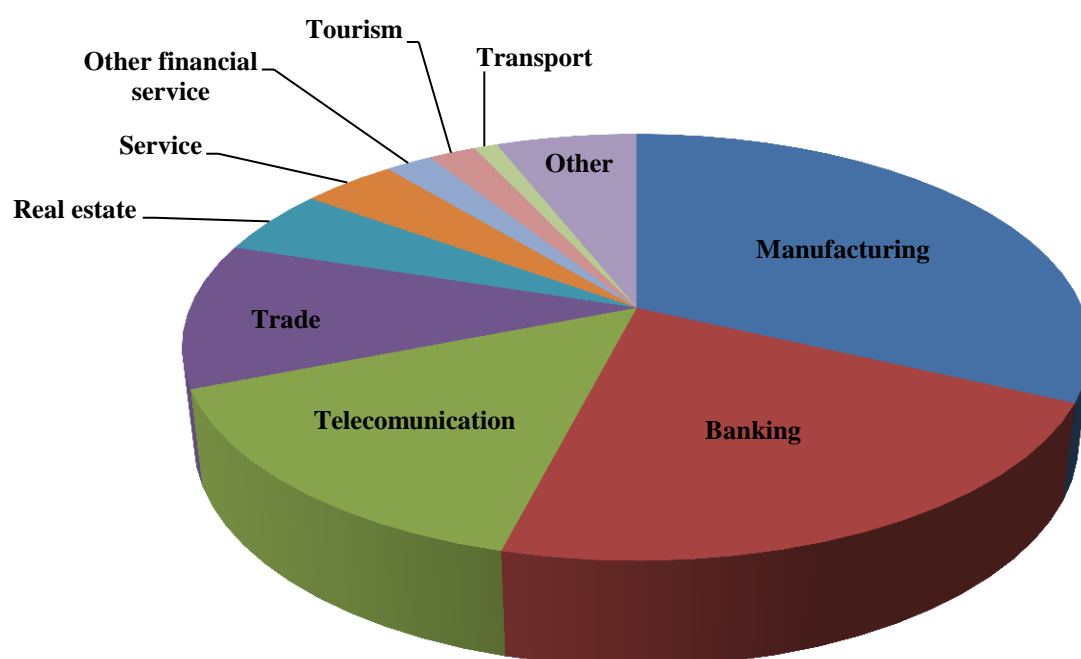
In terms of geographical distribution of investment inflows a significant change was recorded in 2011 and 2012, because the most investments were from Russia. Also in 2012, increased investment was recorded from Saudi Arabia and Kuwait. Russia, as the biggest investor country in 2012, invested EUR 78 million, followed by Austria with EUR 64 million and Croatia with EUR 60 million. At the same time, the decline of investments was recorded from some countries, which used to be the major investors in the previous years (FIPA, 2014a).

The biggest investor countries in the first nine months of 2013 were: Russia (EUR 97 million), Great Britain (EUR 69 million), Cyprus (EUR 20 million), Austria (EUR 15,5 million), Germany (EUR 9 million), Luxembourg (EUR 8,7 million), Slovenia (EUR 8,4 million), Serbia (EUR 8,4 million), the Netherlands (EUR 7,1 million) and Turkey (EUR 5,9 million).

2.3 FDI Inflows by Sectors

Manufacturing sector of B&H received the most amount of FDI in period May 1994 to December 2013. 32% of investment was in the production, 21% in banking sector, 15% in telecommunication sector, 11% in trade sector and the rest of investments were mostly in real estates, services etc. (see Figure 3). In the forthcoming period there are plans to privatize some state-owned companies and to make large investments in energy sector through construction of new and reconstruction of the existing facilities and plants.

Figure 3. Foreign Direct Investment Stocks in B&H by Industry (May 1994 - December 2013)



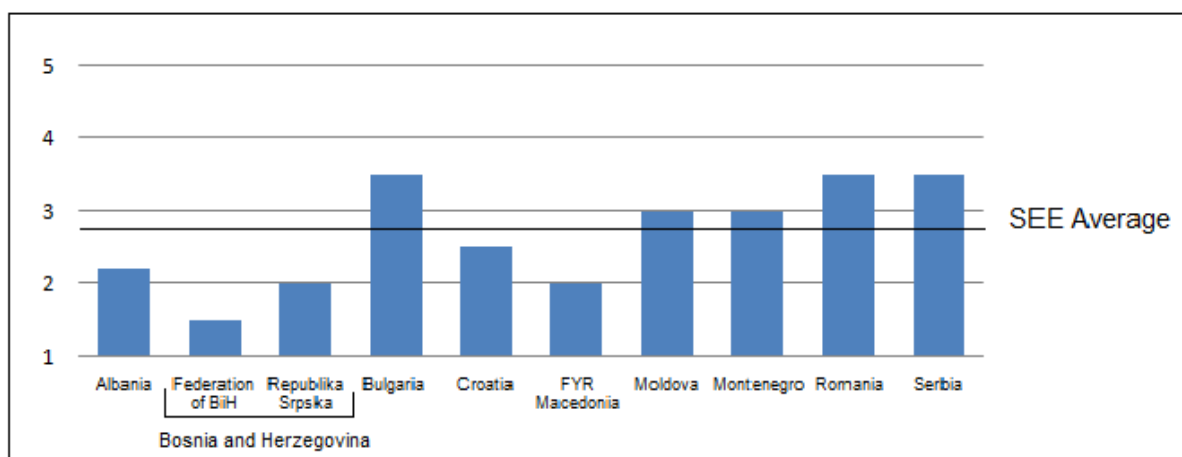
Source: FIPA, *FDI Position and Performance*, 2014.

3 REGULATORY REFORM IN BOSNIA AND HERZEGOVINA

Immediately after the war in B&H (1992–1995), the need for deregulation emerged from the fact that for the most part, the legislation was taken from and based on the law of the former Socialist Federal Republic of Yugoslavia (SFRY). A number of inherited laws from the former SFRY were obsolete and in collision with market economy legal standards. A number of areas had not been regulated at all, while some other areas had been overregulated. In order to create a market-friendly legal and regulatory environment, as a precondition for the development of the economy and society, intensive legislative reform was needed.

In B&H investment environment continues to be weak and reforms are very slow but businesses cannot wait years. According to OECD (2006) B&H has lowest level of regulatory reform compared to all SEE countries as shown in Figure 4.

Figure 4. Regulatory Reform in SEE* Countries



Note. * The evaluation of regulatory reform has been performed at the level of the Federation of Bosnia and Herzegovina and Republika Srpska due to the existence of different policy frameworks.

Source: OECD, *Investment Reform Index 2006: Progress in Policy Reforms to improve the Investment Climate in South East Europe*, 2006, p. 19.

Initial regulatory changes were made during the war, when the financial sector took the first steps to lay the foundations of the new financial system. The financial sector was the first sector deregulated in accordance with the standards of deregulation. In the period of 1996–1999, laws necessary for both B&H entities were accepted (the Law on Financial Transactions, the Law on Banks, the Law on Central Bank of BH and the Law on Foreign Currency Transactions), thus allowing for the adoption of international regulatory standards. According to these standards and laws, the BH banking system was fully deregulated since 1999. Since 2000, many activities were undertaken concerning removing administrative barriers and covered reforms in areas such as business registration, inspections, business licensing, customs and taxation administration (Penev, 2009).

Faster reform is urgently needed so as to stimulate investment and competitiveness. The importance of quality regulation is recognized and there are some projects that aimed to improve regulations in B&H. There are two major projects of regulatory reform in B&H: Bulldozer Initiative and Regulatory Guillotine.

Bulldozer Initiative was launched by the Office of the High Representative for B&H in 2002. Through a bottom-up approach, this initiative overcame the lack of political will and capacity at the government level. This delivered fast results-50 reforms in 150 days. It won the confidence of entrepreneurs. It also created investment climate reform by putting forth

concrete, quantifiable results. The private sector pushed forward reforms as a package, and was well received by the government. This created a constructive dialogue between the public and private sectors. The Bulldozer Initiative in B&H not only succeeded in bringing forth change, but also impacted positively the democratic mechanism for civic participation in government (Herzberg, 2004). This reform was successful because unlike others reforms this one passed as package and created positive relationships between the private and public sectors. Bulldozer Initiative did not only introduce reforms but also trained groups to advocate change and established sustainable democratic mechanisms for civic participation in government.

After the finalization of the Bulldozer initiative, a similar project was launched by the RS Government in 2006, the so called “**Regulatory Guillotine**”. The concept of Regulatory Guillotine was elaborated in Sweden in 1980, with the aim to revise a large number of regulations, eliminating those which do not correspond to the legal and market principles. Being one of the most important projects of regulatory reform in B&H, Regulatory Guillotine is a tool designed to remove unnecessary and inefficient regulations and formalities (permits and procedures) that were unfavourable and that increased the costs of doing business in RS and B&H. The overall goal of the project was to create a more favourable business environment. In order to continue activities regarding business ambiance improvement, the Government of RS started the establishment of procedures for the systematic assessment of regulatory impact - Regulatory Impact Analysis (RIA) on the business environment, for the purpose of a comprehensive economic system regulatory reform.

Republika Srpska was the first in the Balkans to implement a Regulatory Guillotine, and a guillotine of inspection procedures and control subjects. This Guillotine reduced business costs, administrative barriers, and corruption. More than 330 formalities (21%) and 2,473 inspection regulations (58%) were reviewed and eliminated as unnecessary for Republic Srpska and 23% of formalities were simplified. Prime Minister Milorad Dodik in September 2006 announced these results. Science than two registries for inspection-related measures have been set up. Republika Srpska was the first in the Balkans to implement a Regulatory Guillotine and the only to include not only formalities but also a guillotine of inspection procedures and control subjects. The Regulatory Guillotine led to reduction of business costs, removal of administrative barriers for business and reduction of potential sources of corruption (FIPA, 2010).

The government of FB&H and the International Finance Corporation (IFC) have started together the project of the regulatory reform in the FB&H. The project of the regulatory reform in FB&H is also called Regulatory Guillotine. In the period from 2009 to 2011, from the beginning of implementation of the Regulatory Reforms Project (Guillotine of Regulations) in the Federation of B&H (FB&H), 384 permits were identified, out of which 252 have been simplified, making the savings for the private sector in the amount of BAM 100 million. The greatest simplifications were achieved by shortening the duration of

processing procedures, and reducing the required documentation in some phases of business. The result has been achieved in creating an electronic registry of all the procedures, respectively permits that are issued at the FB&H level, which are now available at the website of FB&H Government. The goal of these efforts is to create the favourable atmosphere and environment for investors, both foreign, and domestic. Within the project of “Strengthening competitiveness at different levels of B&H”, FB&H Employment Service (FZZZ), together with the Team for generating investments of the International Finance Corporation (IFC) which is affiliated to the World Bank (WB), initiated activities to develop procedures for issuing work permits to foreigners, which will improve the overall process and make it more efficient, thus encouraging foreign investment.

The benefits of new procedures are reflected in the achievement of uniformity in handling the applications for work permits at the level of Federation of B&H (FB&H), shortening and achieving optimum deadlines in individual phases of the process for issuing work permits, and reduced volume of necessary documentation from 18 to 8 documents (FIPA, 2011).

However, regardless of the reforms implemented so far, the B&H business environment is still the most complicated in the region, according to the majority of indicators of business environment quality. In the latest World Bank Report on Doing Business, B&H was 126th out of 185 world countries according to an overall ease of doing business – below all Southeast European countries and among the worst-ranked countries in the transition region (World Bank, 2014b).

3.1 Administrative barriers in B&H

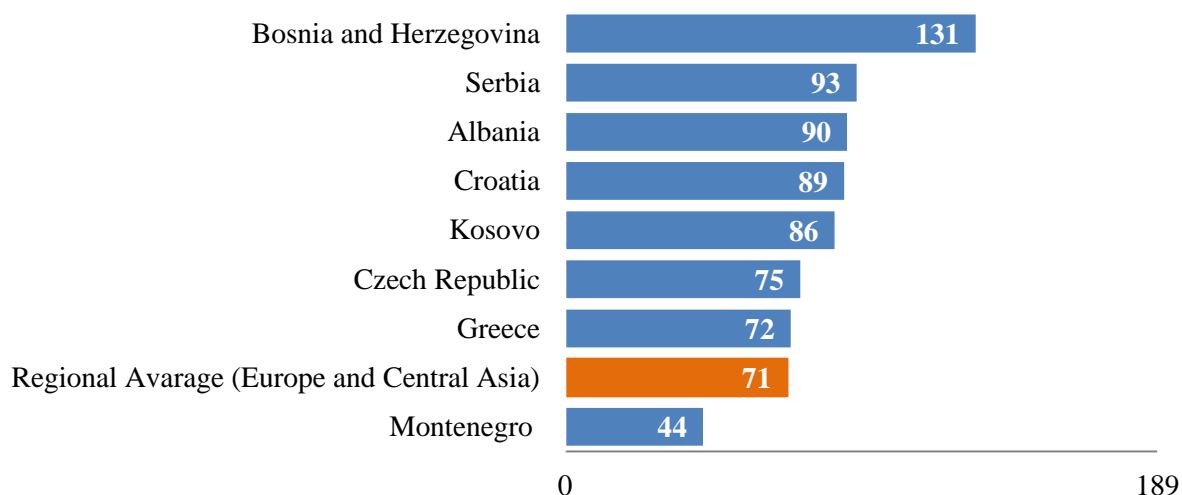
B&H is closely related to countries in South East Europe and EU. As a result of this, in the last few years its economy was deeply affected by global crisis. The impact of the crisis further exacerbated its investment climate so country continues to lag behind other countries of the region. Bosnia and Herzegovina regularly comes last in the regional comparisons of investment climate and competitiveness indicators, be it World Bank’s Doing Business report, Corruption Perception Index, Index of Economic Freedom, Global Competitiveness Index or Worldwide Governance Indicators. The existing generally recognized methodologies of evaluating individual countries worldwide are relevant indicators of how individual countries are attractive to investors. In following text we will presented B&H's rankings according to these indicators:

- World Bank, Doing Business 2013

World Bank’s Doing Business report assesses regulations that affect firms in 189 countries and ranks the countries in 10 areas of business regulation. Doing Business report is gathering and analysing various data to compare business regulation environments between countries and thus encourages these countries to improve their investment climate. B&H was ranked

131 (out of 189 countries) in 2014 World Bank Doing Business report and this was almost unchanged from its ranking of 130 in 2013. According to this report, B&H has the lowest rank compared to countries in the region in terms of ease of doing business, far below Serbia with ranking of 93, Albania with ranking of 90 or Croatia that ranks 89th (Figure 5).

Figure 5. How B&H and Comparator Economies Rank on the Ease of Doing Business

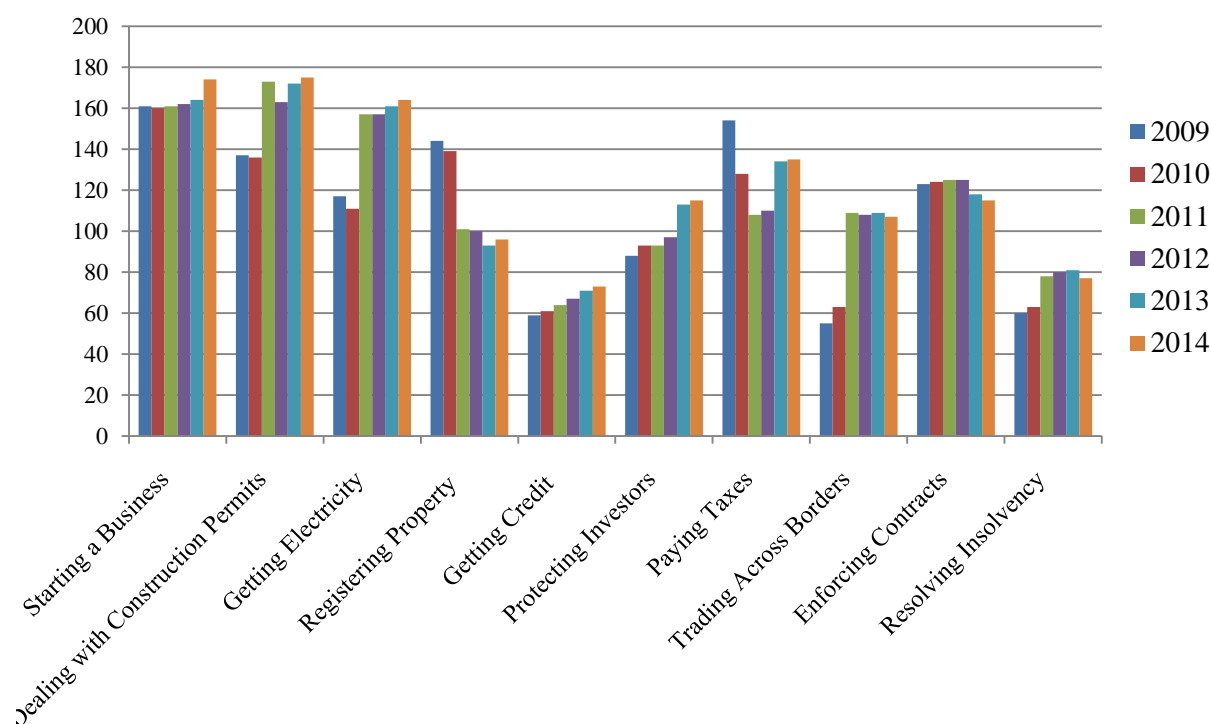


Source: World Bank, *Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises*, 2014, p.3.

Compared DB ranking last six years we can see very slow improvement and even deterioration in some categories (Figure 6). Compared to 2012 three areas out of ten are improved in 2013 and in 2014 there was very little improvement in ease of doing business (Figure 6). But compared to 2005 B&H improved by 8.4 percent and it is ranked 49 out of the top 50 overall most improved economies. According to DB report 2013 and 2014 (World Bank, 2013; World Bank, 2014b), B&H made reforms in four categories:

- Registering Property - B&H computerized the commercial registry what cut registration time by eight days and made easier to transfer property between companies.
- Paying Taxes - B&H introduced electronic filing and payment systems and thus eased the administrative burden of filing and paying social security contributions.
- Getting Credit - Bosnia and Herzegovina made access to credit information more difficult by stopping the private credit bureau's collection of credit information on individuals.
- Paying Taxes - Bosnia and Herzegovina introduced a penalty for failure to employ the required minimum number of people in special categories—though it also temporarily abolished the forestry tax.

Figure 6. Doing Business Rankings 2009 - 2014 in Bosnia and Herzegovina



Source: World Bank, *Business Reform Simulators*, 2014.

B&H's worst performance was in following categories: starting a business and dealing with construction permits.

1. Starting a Business – requires approximately 11 procedures, takes 37 days, costs 14.9% of income per capita and requires paid-in minimum capital of 29.1% of income per capita, which is well above the average for the region. B&H stands at 174 in the ranking of 189 economies on the ease of starting a business and has the worst ranking compared to neighbouring countries. This is a far more unfavourable position than that of all the countries in the region, some of which have made new strides in the past year. For instance, the self-declared country of Kosovo has created a One Stop Shop registration system and abolished certain post-company-registration procedures. Croatia has introduced a new form of business entity without minimum capital requirements, while Romania and Moldavia have simplified the pre-registration and registration formalities. For a number of years, Macedonia has been among the leading countries in the world when it comes to its quick registration system, and was ranked as 7th in the world in the latest report. According to eKapija-Poslovni portal (2014) B&H started with reform of business registration as a project within the field of the eGovernment reform, which is one of the six reform areas, implemented in B&H by the Coordinator's Office for Public Administration Reform. In this process, together with the Coordinator's Office, representatives from the competent institutions from the state level also participate, i.e. the representatives from the Federation, Republika Srpska and Brčko District,

respectively. These are primarily representatives of the General Secretariat of Government, or their specific organizational units: IT sectors dealing in e-administration, ministries of transport and communication, the Institute of Public Administration of FB&H and Information Society Agencies of RS. The objectives of the reform of business registration are establishing a One Stop Shop, shortening the time of registration and enabling cheaper registration process for business entities. The Road Map of Business Registration Reform has accurately predicted activities to reach these goals:

The first activity is the identification, mobilization and involvement of all stakeholders. A lot of actors are involved in the process of business registration and at different levels, as this area is regulated differently. There are basic legal acts, but there are also a number of bylaws. Upon identification of interested parties, workshops, consultations, conferences, etc. will be provided. It is also important to involve the private sector in these activities through discussions and processes of creating possible solutions.

The second activity is the analysis of business processes to the legislative, institutional, organizational and technical side. Along with this analysis, solutions will be sought for their simplification and proposals will be made for each component. It is envisaged to develop a conceptual design of the overall system for interoperability and exchange of business information between institutions of the One-Stop-Shop register for FB&H, the RS and Brčko District B&H.

The next activity is the Road Map of Business Registration Reform for specific detailed activities, timeframes, and responsible providers of activities, which will be adopted by governments at every level and whose implementation would reach the ultimate goal of establishing a One Stop Shop for business registration.

To achieve the goals of the Roadmap it is necessary first to implement a series of steps, which are different on certain levels; somewhere it is needed to amend more legislation, somewhere to propose solutions for online registration, and somewhere to computerize registers and to link entities participating in the process of business registration. The Road Map of Business Registration Reform practically represents steps that need to be taken by governments, at all four levels, in order to achieve that businesses can in one place, in a short period of time and as cheaply as possible, register their activities. The project relates to the registration of economic entities and tradesmen.

Republika Srpska has already completed one phase of the business registration reform, the phase of amendments to legislation, while in the Federation the process is ongoing through the adoption of amendments to the Law on Enterprises. In the RS the implementation of the second phase is starting, which is the creation of software that will provide connectivity among institutions that participate in this process. They have also determined that the APIF will be the body that will serve as the One Stop Shop.

Government of the Federation determined in the Work Programme for 2012/2014 the reduction of administrative barriers and costs in the area of starting a business as a strategic priority. The results of the project of the business registration reform should be fully implemented in the next two years (eKapija-Poslovni portal, 2014).

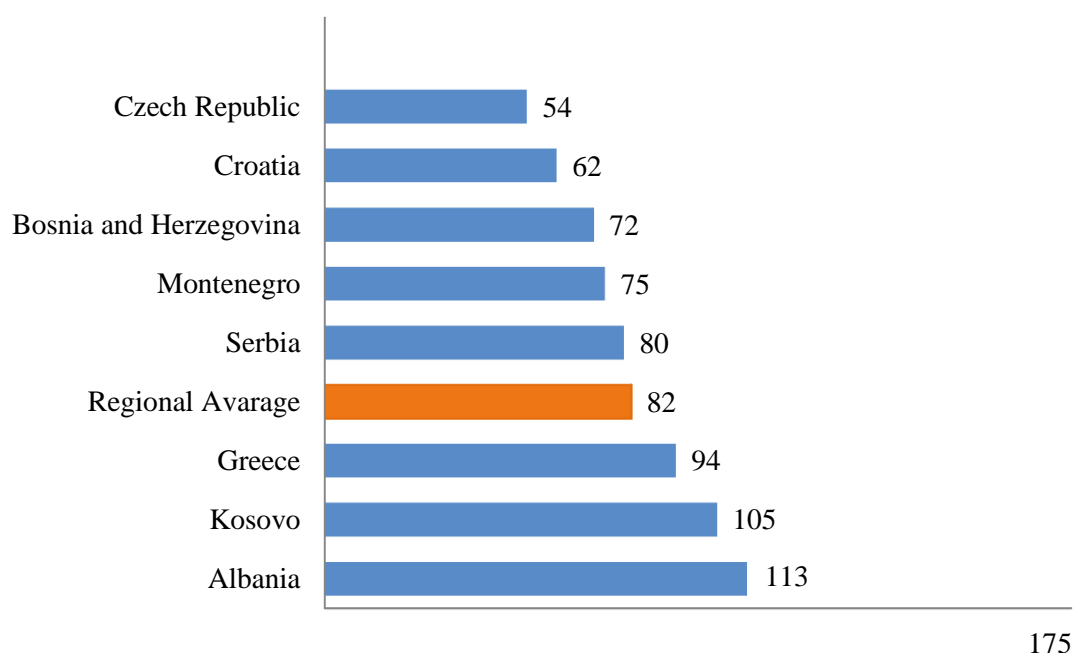
2. Construction Permits – getting construction permits requires 17 procedures, takes 179 days, costs 1.100,2 % of income per capita. B&H has made only a small step in this direction by shortening the time needed to obtain a permit by one day – i.e. from 180 to 179 days – while maintaining 17 procedures. The cost of obtaining a construction permit has, too, been symbolically reduced from 1.102,1 % to 1.100,2 % of the revenue measured per capita. By analysing the countries in the region, it is apparent that the most benefits have been implemented by Montenegro, which simplified the procedure and shortened the time needed to issue construction permits by introducing the One Stop Shop system. Kosovo, Slovenia and Macedonia follow Montenegro based on the number of reforms in this area.

This is also the worst position for B&H ever since the World Bank has started compiling this document which is important for investors' strategic decisions. The Report specifies that in the past year B&H has not implemented any reform related to reliefs for doing business, while the conditions for paying taxes have been simultaneously worsened. Namely, B&H is being criticised for additionally aggravating the tax-paying process for companies by introducing a fee for failing to employ the obligatory minimal number of people belonging to special categories, while still temporarily abolishing the forestry tax. Looking into the remaining nine areas analysed by the World Bank, one can notice that B&H is stagnating – a fact taken advantage of by Ukraine to move forward and for the first time since 2008 leave B&H at the bottom of the European countries list. Macedonia, coming at number 25 in the world, is the best-ranked country in the region, followed by Slovenia in the 33rd place, Montenegro in the 44th, and the self-declared country of Kosovo, which made a significant yearly progress by climbing for a total of 12 places at the global scale to reach number 86. Thus, according to the World Bank rating on business conditions, Kosovo has surpassed Croatia – coming in at number 89, Albania at the 90th place, and Serbia at the 93rd place in the world.

- **Corruption Perceptions Index**

Transparency International ranked B&H at 72 out of 177 countries in 2013. This CPI Index scores countries on how corrupt their public sectors are seen to be and B&H does not have the lowest ranking in the region and its rank is above regional average (Figure 7).

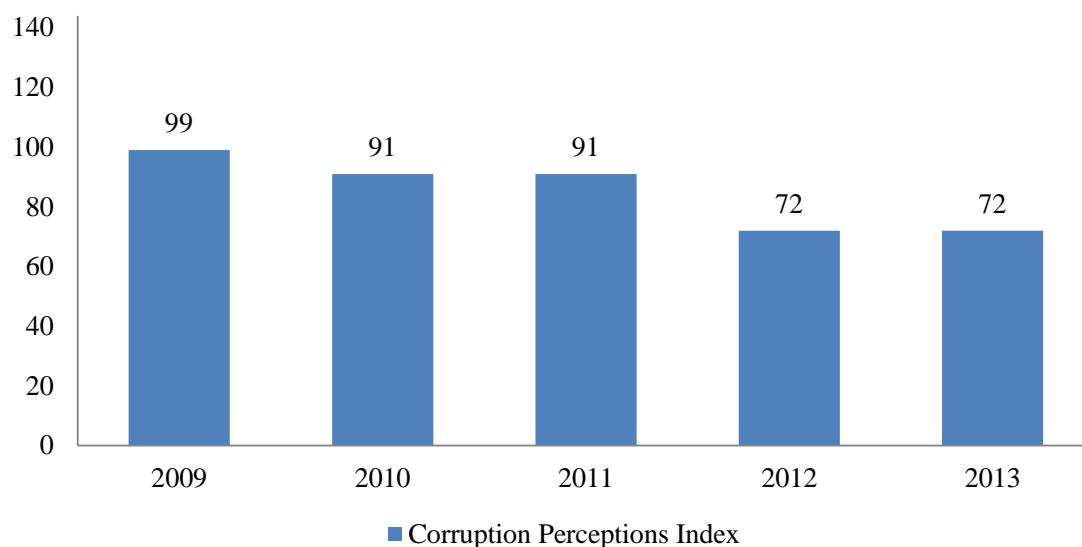
Figure 7. How B&H and Comparator Economies Rank on the Corruption Perceptions Index 2013



Source: Transparency International, *Corruption Perceptions Index 2013*, 2013, p.3.

There were some improvements comparing 2011 and 2012. Positive developments are foundation of Anti-Corruption Agency and the State Aid law was adopted in 2012 to regulate misused budget finances in the country. But corruption challenges are lacking transparency and accountability due to a complex legal framework, lack of enforcement of the law and weak sanctions that do not outweigh corruption gains. Problems of current institutions responsible for implementation anti-corruption laws are: pressures from the executive, these institutions are under full control of the government, or do not have the capacity or authority to efficiently implement the laws. The Ombudsman and Audit Service recommendations are mostly ignored by the government and other sectors being evaluated. Statistics indicate that very few cases of corruption result in criminal convictions, and even fewer reach final verdicts. Bosnia and Herzegovina has no whistle blowing legislation in place. Their recommendations are: Political will is a crucial first step to reducing corruption; Anti-corruption institutions like the Anti-Corruption Agency (ACA) need the means to operate efficiently and independently; Judicial reforms are necessary to resolve its problematic structure and financing; The country's legal framework needs extensive amendments (Transparency International, 2012). In 2013 there were no improvements compared to 2012 so we can see stagnation as presented on Figure 8.

Figure 8. Corruption Perceptions Index of B&H (2009 - 2013)

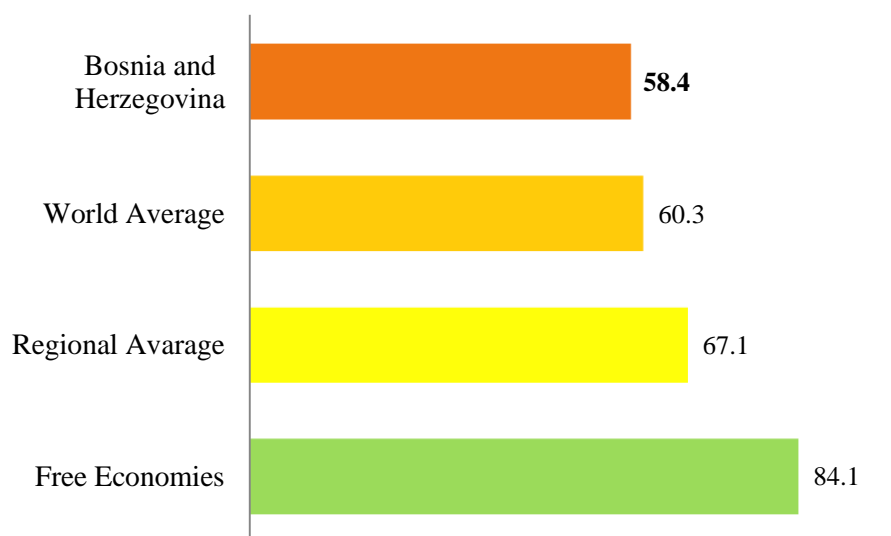


Source: Transparency International, *Corruption Perceptions Index*, 2014.

- **Index of Economic Freedom - Heritage Foundation**

In 2014 B&H had economic freedom score of 58.4 and this made the country 101st freest according to this ranking. Compared to 2013 there were improvements in some areas such as investment freedom, business freedom, and freedom from corruption and these improvements increased freedom score by 1.1 points. Compared to countries in Europe B&H is ranked 38th out of 43 countries and this score is below the global and regional averages (Figure 9). Bosnia and Herzegovina was first ranked 17 years ago (in 1998) and since then its ranking improved by 29 points which was the second best improvement of any country. Its scores increased in all 10 economic freedoms mostly because: eliminating economically repressive policies, implementation of reforms that enhance regulatory efficiency and market openness, and greater monetary stability. However, the economy in B&H is still considered “mostly unfree”. Deeper institutional reforms related to eradicating corruption and ensuring judicial independence are crucial in improving economic freedom and economic growth of the country (The Heritage Foundation and Dow Jones & Company, 2013).

Figure 9. Comparison Economic Freedom Scores of B&H with Regional and World Average in 2013

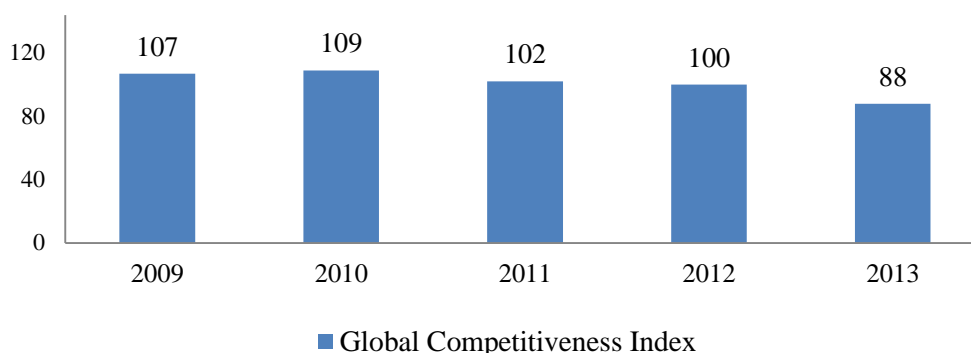


Source: The Heritage Foundation and Dow Jones & Company, *2013 Index of Economic Freedom*, 2013.

- **Global Competitiveness Index**

Global Competitiveness Index ranked B&H at 88 out of 144 countries. This Index comprises macro and micro aspects of competitiveness into a single index. B&H made great improvement on Competitiveness Index scale and from 100th place in 2012 came to 88th place in 2013 (Figure 10). This has been the most significant improvement on Competitiveness Index scale compared to other countries in the region. According to Global Competitiveness Index (GCI) the largest problems in B&H are: policy instability, access to financing, tax rates, government instability/coups, inefficient government bureaucracy, inflation, tax regulations, corruption, foreign currency regulations, etc. (World Economic Forum, 2012).

Figure 10. Global Competitiveness Index of B&H (2009 - 2013)

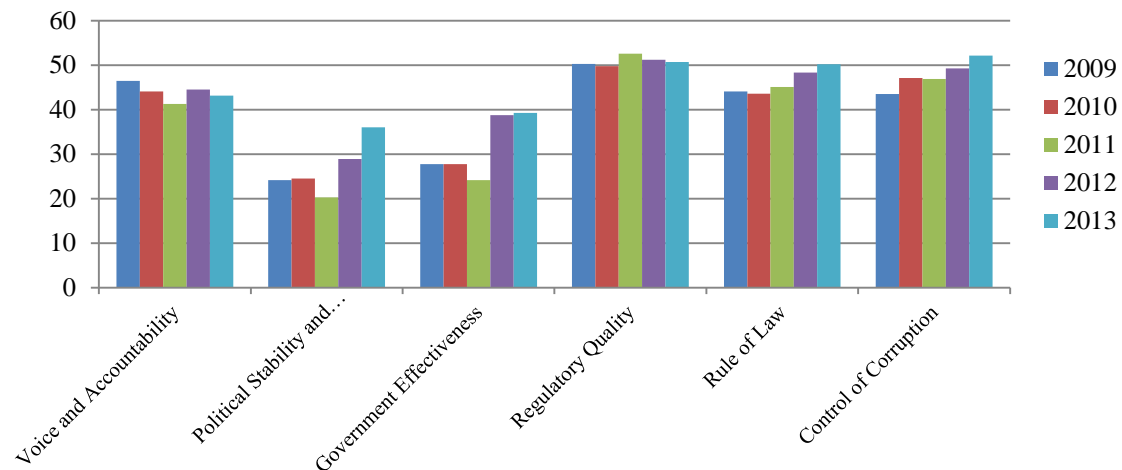


Source: World Economic Forum, *The Global Competitiveness Report 2010–2011: Full Data Edition*, 2010, p.15.; World Economic Forum, *The Global Competitiveness Report 2011–2012: Full Data Edition*, 2011, p.15.; World Economic Forum, *The Global Competitiveness Report 2012–2013: Full Data Edition*, 2012, p.15.

- Worldwide Governance Indicators

Last indicators we took are Worldwide Governance Indicators. These indicators aggregate six dimensions of governance based on 32 underlying data source and these dimensions are: Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption for over 200 countries and territories over the period 1996-2013 (Figure 11). During last five years B&H had some improvements in Rule of Law and Control of Corruption and especially in Political Stability and Government Effectiveness in 2012. But in 2013 compared to 2012 we can see deterioration of indicators Voice and Accountability and Regulatory Quality. Compared with neighbouring countries B&H is at the last place in all Worldwide Governance Indicators except in Control of Corruption and Rule of Law where Montenegro has lower rankings (World Bank, 2014c).

Figure 11. Worldwide Governance Indicators of B&H (2009 - 2013)



Source: World Bank, *Worldwide Governance Indicators: Country Data Report for Bosnia and Herzegovina, 1996-2013, 2014*.

Almost all the above mentioned research indicates that B&H is at the last place in comparison to the countries in the region. It can also be inferred that progress has been achieved in certain areas, but that it is very slow and insufficient for B&H to be competitive and keep up with the rest of the countries in the region and the EU. Most of the abovementioned research cites political instability, complicated registration procedures, bureaucracy and corruption as the biggest problems in the country.

3.2 Regulatory Framework in B&H

B&H wants to attract more FDI into the country. One prerequisite is to have modern FDI policy legislation in B&H, harmonized between state and entities so as to create a single economic space. To conform to best practice, the current B&H investment laws need to improve the clarity, certainty, stability and predictability which foreign investors expect in an investment law. A modern, well-structured investment law can be used also as an effective marketing tool for attracting foreign investment. This is particularly important when comparing the B&H investment laws to the investment laws of its neighbours. In addition, in reviewing and revising the B&H investment laws to ensure that the form and substance of the investment guarantees are in conformity with best practice, the B&H investment laws will need to meet the expectations of foreign investors, thereby improving their perception of the investment climate in B&H.

By looking at the history of legal regulation of foreign direct investment and its development in the territory of Bosnia and Herzegovina that has been followed by ideological and political oscillations on both the global and the regional plane, and bearing in mind that foreign direct

investments represent one of the key levers in creating a self-sustainable economic growth in B&H, we arrive at the conclusion that the legal regime in B&H requires a significant revision in order to comply with the best international practices and to create better environment for attracting foreign capital oriented towards manufacturing and provision of services. In this chapter we will focus our research on Law on Policy of FDI of B&H. Other laws that affect foreign investment in B&H and investment climate of B&H are shown in Appendix 1.

With the adoption of the reformist Law on Policy of FDI of B&H (LPFDI, “B&H Official Gazette”, number 17/98), B&H became involved in contemporary regulation and practice of foreign direct investment. The Law prescribes the meanings of the fundamental categories, the procedure of foreign direct investment, rights, privileges and duties of foreign investors, dispute settlement, and with the application of the Law, together with its implementing regulations, B&H rounded off its regulations in this field. In addition, since then, 39 bilateral agreements on promotion and protection of foreign investments have been concluded, which creates the preconditions for accelerating the process of FDI into B&H.

With the aim of providing support to foreign investors through reduction of limitations in 2003 the LPFDI was subject to first amendments, which resulted in publication of the Law on Amendments to the Law on Policy of FDI of B&H (“B&H Official Gazette“, number 13/03) which eliminated the obligation of the foreign investors to register their investments with the entity authorities. This has significantly facilitated the operations for foreign investors in B&H. With these measures, our legal system has accepted the liberal and open approach to foreign direct investments, with lesser limitations of pragmatic nature which are also familiar in comparative law.

State Law of FDI in B&H guarantees to foreign investors the same rights as B&H citizen or enterprise. Law on the Policy of Foreign Direct Investments of Bosnia and Herzegovina (Official Gazette of B&H, 17/98, 13/03 and 48/10) ensures:

- Foreign investors have national treatment in B&H what means that they have the same rights or obligations as residents of B&H.
- Foreign investors have right to open account in domestic or any convertible currency in any commercial bank in B&H.
- Foreign investors have right to employ any foreign nationals in accordance with labour and immigration laws in B&H.
- Foreign investors have right to transfer abroad money that is result of investment in B&H, freely without delay in any convertible currency.
- Foreign investors may own real estate in B&H and they have the same property rights regarding real estate as B&H legal entities.
- Foreign investors are protected against nationalization, expropriation, requisition or measures with similar effects except if these measures are taken in the public interest in

accordance with the applicable laws and regulations and against the payment of an appropriate compensation, i.e. compensation that is adequate, effective and prompt.

- All the rights and benefits mentioned above that are imposed by Law on the Policy of FDI of B&H cannot be terminated or overruled by subsequent laws and regulations. But if there is some subsequent regulation that is better for foreign investors, they have right to choose that regulation by which the investment will be regulated.

According to U.S. Department of State (2014) there are several incentives for FDI, including exemptions from payment of customs duties and customs fees. For direct tax purposes B&H is divided in three jurisdictions: the Federation, Republika Srpska and the Brčko District. In Federation income tax allows tax relief to foreign investor who invests BAM 20 million in period of five year. Domestic and foreign firms in Federation are exempted from paying profit tax if at least 30% of turnover at end of the year is from export. Corporate income tax in B&H allows offsetting of losses against profits over a period of five years. If an investor invests in fixed assets and pays taxes in Brčko District then investment is subject of tax relief. Republika Srpska does not have special investment incentives.

In order to attract foreign investments and improve business climate in the country Council of Ministers established Foreign Investors Supports Fund (FISP) in 2007 and FISP became operative as of February 2008 as a financial incentive for investors. FISP provides direct financial support to FDI and its budget depends on B&H's budget allocation.

Customs benefits - Exemption from paying customs duties is equipment of foreign investor that was imported as part of share capital (with the exception of passenger vehicles, slot and gambling machines). According to FIPA (2014b) in order to use this benefit foreign investor should submit a written request for exemption from paying import duties to the competent customs authority along with the following documents:

- Contract or other document about the investment on the basis of which the equipment was imported,
- Evidence about registration of the investment at the competent authority,
- Specification of equipment, certified by the investor, consisting with tariff number and mark (with quantity indication), single and total value,
- Statement of the investor that the equipment is maximum 10 years old,
- Confirmation of the competent institution that imported equipment is in accordance with environmental and employment protection standards.

Free trade zones in B&H have status of legal entity and its funders, according to Law on Free Trade Zones of B&H, could be one or more domestic and foreign legal entities or natural persons. Free zone is considered as economically justified if there is some evidence like feasibility study that will prove that the value of goods exported from a free zone will exceed at least 50% of the total value of manufactured goods leaving the free zone within the period

of 12 months. Free Trade Zones (FTZ) in B&H are established as parts of custom territory and there are four FTZ: Vogosca (Sarajevo), Visoko (Visoko), Hercegovina (Mostar), and Holc (Lukavac). FTZ may be created by foreign or domestic legal entity registered in B&H. Users of FTZs should pay only taxes related to wages and salaries and investors have right to invest capital in the FTZ and to transfer their profit and retransfer capital. Customs and tariffs are not paid on imports into FTZs. The import of equipment for manufacturing within FTZs may be discontinued, however, if the value of goods produced and exported abroad is less than 75 percent of the total value of goods produced in that zone.

Tax benefits - According to Law Corporate Income Tax in Federation B&H taxpayer who achieved 30% of its total revenue by export in the year for which the corporate income tax is being determined, is exempted from tax payment. The taxpayer who in the period of five consequent years invests into production in the value of minimum BAM 20 million, on the territory of the FB&H, is being exempted from the payment of corporate income tax for the period of five years beginning from the first investment year, in which minimum BAM 4 million must be invested. If the taxpayer, in the time period of five years, does not achieve the prescribed census for investment, he loses the right of tax exemption, and the unpaid corporate income tax is determined in accordance with the provisions of the Law on Corporate Income Tax augmented for penalty interest payable for untimely paid public revenues. The taxpayer who employs 50% of disabled persons or persons with special needs longer than one year more than is being exempted from the payment of corporate income tax for the year in which more than 50% disabled persons or persons with special needs were employed (International Business Publications, 2008).

In Republika Srpska, amendments of the Law on Profit Tax RS introduced tax base reduction in the value of investment for investment in equipment intended for the company production activity and investments in plants and immovable property used for manufacturing and processing activities as well as tax base reduction in amount of paid personal income tax and mandatory constitution for the employer employing 30 workers during a calendar year (workers who were on the official evidence of Employment Office of RS). Also Republika Srpska established new incentives by Decree on Conditions and Implementation of the Investment and Employment Support Program (Official Gazette of RS No 70/12). These incentives (funding award) have goal to attract direct investments, increase employment, economic growth and transfer of knowledge and technologies. Funding award may be used by investors with existing investment projects in manufacturing sector that provide new employment in the territory of RS. Also these investors need to submit necessary documentation and the application to the Ministry of Finance of RS, after the announcement of a public call. Amount of award shall be proportional to the value of investment and number of the newly employed. According to Decree, minimum investment shall be BAM 2 million and at least 20 workers shall be employed in territory of:

- The developed and medium-developed local self-governance units in RS (development level is set in accordance with the RS Government decision), in the amount of BAM 3,500 and
- The underdeveloped and extremely underdeveloped local self-governance units in RS, in the amount of BAM 5,000.

Larger investment projects in amount over BAM 25 million which employ at least 100 new employees, regardless of the level of development of the local self-governance unit where the investment takes place, after submission of the application will receive the funds in the amount of 15% of the total value of investment. Conditions under which the funding will be realized are:

- Only beneficiary of the funding can use property acquired through direct investment,
- Investor cannot decrease number of employees for an undefined period during previous year, starting from the date of issue of public competition and during the period of implementation of the investment project,
- After finalisation of the investment project persons employed by this funding for undefined period will not decrease during at least three years (FIPA, 2014b).

When it comes to relations with the EU in this field, B&H does not have obligations to harmonize the legislation with the EU. The only obligation assumed under the Stabilization and Association Agreement with the EU is to allow EU companies to establish companies in B&H under the same terms which are provided to domestic ones. In addition, Article 91 of this Agreement foresees cooperation between B&H and the EU in terms of improving and protecting investment. Likewise, the Directorate for European Integration of B&H (DEI) has confirmed that there are no specific legal requirements of the EU in the field of foreign investments with which the Law on Policy of FDI of B&H should be harmonized.

The B&H investment laws will not themselves attract foreign investors to B&H. Serious foreign investors, before deciding to invest, will investigate the natural and human resources of B&H, its infrastructure and its local and regional markets before they turn their attention to the legal framework for foreign investment. While it is important to ensure that the B&H Investment Law and the investment laws of the Entities meet best practice standards, it is even more important to improve the investment climate in B&H in a broad range of areas so that the product which is marketed as B&H is as good or better than the products offered by B&H's neighbours and competitors. At the same time, it is indispensable to work on the harmonization of FDI policy and FDI with the best international practices in areas of interest for potential foreign investors, thus creating a safe legal environment for foreign investors in order to increase FDI inflow into B&H.

3.2.1 Regulatory Impact Assessment (RIA) in B&H

B&H is lagging behind in implementing regulatory impact assessment (RIA) compared to other SEE countries. B&H has introduced into the legislative system using RIA on draft legislation, although it is well known that RIA is effective instrument that increase efficiency and effectiveness of legislation and achieves it at minimum cost and with fewest negative consequences. RIA assesses the various options for reform of the Foreign Investment Law and by laws to promote foreign direct investment (FDI) and create a platform to support investors, to support strategic economic activities where FDI is restricted or prohibited, and to collect general information on FDI. It informs the Council of Ministers about the various options, and helps the working team develop a proposal for achieving these goals. In addition, RIA can include a proposal for better implementation of the existing administrative procedures; or, it can serve to simplify the process of registration for companies that have elements of foreign investment (IFC, 2010).

Moreover, Bosnia and Herzegovina has undertaken the obligation of harmonising the domestic legislation with the EU legislation on the date of signing the Stabilisation and Association Agreement (16 June 2008). In its early stages, the harmonization should focus on the basic elements of the EU *acquis communautaire* related to the internal market, as well as other trade-related areas, while in the later stages it should focus on the remaining parts of the EU *acquis* (Article 70 of the Stabilisation and Association Agreement). Having in mind that B&H will be facing a number of new regulations to be transposed, it is possible to assess the political, economic, social and ecological impact of adopting certain EU policies or specific regulations with the help of the Regulatory Impact Assessment. Several OECD publications (OECD, 1997 and OECD, 2008b) provide guide on using RIA. Ideally, RIA should be introduced into the legislative system of country, applied to all draft legislative proposals, and change the draft when necessary.

Institutional context of regulatory impact assessment in Bosnia and Herzegovina is inevitably complex because of constitutional arrangements which are set up for the country. In this section we will present institutions and procedures for RIA in B&H, separately for different levels of governance.

3.2.1.1 RIA on State Level

As far as legal basis for RIA is concerned, the bases for institutionalized impact assessment on the state level are the Unified Rules for Legislative Drafting in the Institutions of Bosnia and Herzegovina (adopted by the Parliament of B&H on 26 January 2005). Real RIA efforts on the state level so far have been project-like and not institutionalized. In summary, on the state level, requirements exist for regulatory impact assessment, but they are not yet implemented (except for assessment of impact on the budget). Regarding RIA in the context of European integration, Directorate for European Integration has a function for coordination

and so far has held several initiatives (training on RIA in 2005 for line institutions, four pilot full RIA studies in 2007, and conference on RIA in B&H Parliamentary Assembly in November 2007).

On the state level, in addition to DEI, there are several players with stakes for RIA. Ministry of Foreign Trade and Economic Relations so far produced three pilot full RIA studies, of which two through outsourcing, and one produced by the work of internal working group (on the impact of changes of the Law on Foreign Direct Investments). It has plans to institutionalize responsibility for better regulation policy and measurement of administrative burden in one of the departments of the Ministry (Department for Trade Relations and European Integration). Ministry of Justice of B&H is a stakeholder because it oversees how the Unified Rules for Legislative Drafting are implemented and is interested in promoting wider public consultations about draft decisions.

On the grounds of the Cooperation Agreement between the Ministry of Foreign Trade and Economic Relations of B&H and the International Finance Corporation (IFC), World Bank Group member, a pilot project of Regulatory Impact Assessment (RIA) was conducted in the period from 2007 through 2009 on the Law on Policy of FDI of B&H, which, after an activity which lasted for two and a half years, in June 2010 resulted in entering into force of the Law on Amendments to the Law on Policy of FDI of B&H ("B&H Official Gazette", number 48/10). This was followed by adoption, i.e. harmonization of the implementation regulation, resulting in preparation of the Instruction on the manner of submitting, maintaining records on, and publishing data on registered foreign direct investments in B&H ("B&H Official Gazette", number 86/10).

The basic aim of this RIA was to simplify the registration of foreign investment and remove administrative barriers. Three options were offered, where the assessment of the effects lead to the conclusion that the most acceptable option was to amend the Law in the sense of simplification of the procedure for registration of foreign investment and implementation of reforms, including preparation and publication of new instructions, i.e. by-laws.

By analysing the four perspectives – economic, social, environmental and public administration, the selected option was the only one which contributed to efficiency in the work of MOFTER, validity of data and records on FDI, and creation of a better business environment. This amendment eliminated the mandatory registration of companies with an element of foreign investment with MOFTER as a typical administrative barrier, and improved and simplified the procedure for registration of businesses for foreign investors thereby reducing the time and money required on their part. The competent municipal/primary court remains the only location at which foreign investors and/or local companies will perform registration.

Upon completed registration, the court is under the obligation to deliver to MOFTER the notification on registration in electronic form. The possibility for investment into military industry without a restriction of 49% share in equity with the prescribed terms was also opened. Moreover, an electronic data base on FDI was established which allowed the competent courts to deliver accurate and complete data on all registrations of businesses with a share of FDI in a timely manner (on monthly basis), and the data therein serves MOFTER to continue playing its role of the primary official source of information about FDI inflows into B&H. Many foreign investors or their representatives in B&H, following the introduced changes, have observed that this reform led to a substantial reduction of administrative barriers for the business community and welcomed the amendments made. As of entering into force of the aforementioned law, progress was noted in the field of military production in the sense that after the law had entered into force, there has been increased interest in investing in military industry in B&H (Example of “Pobjeda” Goražde –investor from Germany, as well as several other potential investors with whom negotiations are currently underway) (MOFTER, 2009).

Bearing in mind that this was a pilot project, and that the investment climate in B&H is less attractive than in other countries in the region and elsewhere, a new project in B&H between Council of Ministers and IFC has been initiated as a part of Partnership Strategy between the World Bank Group and B&H which is aimed at strengthening competitiveness and removal of regulatory and administrative barriers to doing business in B&H by implementing activities in the domain of regulatory reform, promotion of investment policy, development of agri-business and strengthening the orientation towards exports.

As a part of the new project, MOFTER, as partner for IFC, is extending the activities related to application of the Regulatory Impact Assessment (RIA) methodology on all regulations which regulate the field of foreign investment in order to simplify and improve the legal framework in accordance with the best international practice. Also, MOFTER analytical capacities for working with the FDI database will be strengthened so that the necessary reports can be created along the requirements of the institutions to which MOFTER submits the overviews of FDI inflows into B&H. This RIA (MOFTER, 2012) will focus on the following objectives to enable alignment of B&H FDI policy legislation with best practices:

Harmonization of existing FDI laws in B&H and creation of better business environment for investments: There is a conceptual contradiction and significant controversy between the entity laws on foreign investment and the state law on FDI policy. Article 19 of the Law on Policy of FDI of B&H envisages that as of its entering into force, the provisions of all regulations on foreign investment which are contrary or not in accordance with this Law will immediately cease to apply. In practice, we have the situation that FB&H has not harmonized its Law on Foreign Investment with the Law on Policy of FDI of B&H (e.g. Law on Foreign Investment of FB&H prescribes registration on the entity level that has been removed as early as in 2003; also the FB&H Law refers to the Ministry of Defence of

FB&H which has been abolished as the competent authority, etc.) which creates confusion among foreign investors. It is necessary to fully harmonize the Law on Foreign Investment of FB&H with the Law on Policy of FDI of B&H in terms of both substance and form. Republika Srpska has in substance harmonized the entity Law on Foreign Investment with the Law on Policy of FDI of B&H.

Investor protection: Investor protection refers to many aspects of FDI policy including investment in the sector of public information, guarantee against expropriation, stabilization clause, etc. The definition for “public information” which is stated in the law is all encompassing, but it is unclear whether it was meant that this definition includes e.g., printing operations, which simply produce content of the client and do not generate content themselves. For reasons illustrated in the following paragraph, which pertain to Article 4, paragraph (2), it could be more accurate to define the term “media business”, rather than “public information”.

By introducing an exact and precise definition of the term “public information“ i.e. “media business“ we create more attractive business environment for a foreign investor interested in this sector in the way that we ensure that the investor could clearly read from the definition which business it refers to, which activities are subject to restrictions and which are not, and how to get a prior approval, which procedure and from which authority in the case the investor intends to do activities that are subject to restrictions. This will create a clear and precise definition without a space for different interpretations which automatically creates security for investors.

Article 4 of the B&H Investment Law lists the sectors in which foreign investment is restricted, the so-called “negative list”. Under paragraph (a) of this Article, there is a limitation on foreign investment in the production and sale of arms, ammunition, explosives for military use, military equipment and “public information”. A foreign investor cannot make an investment in “enterprises” in these sectors in an amount of equity greater than 49% of the equity of any such enterprise. Secondly, it is implied that by owning not more than 49% of an enterprise, a foreign investor cannot control the enterprise which is not necessarily true. Investments can be structured so that the equity ownership does not reflect how the business is controlled. The definition set forth in paragraph (a) of this Article refers to the “production of [...] public information”. This wording is not accurate, and it might better be defined as an investment in a “media business”. The foreign investment is not in the “production” of public information; the foreign investment is in a “media business”. As there is a large problem in practice as well in terms of what is meant under the “public information” operations, since there is a new Classification of Activities in force under which there are different interpretations as to which activities represent public information, i.e. “media business“ (MOFTER, 2012).

With respect to paragraph (b) of this Article, it would be more clear if it stated that “any” investment in the restricted sectors must have the prior approval of the competent body of the

respective entity. However, for example, in the territory of the Federation of B&H no authority will issue the approval and all are holding themselves as not being competent which is one of the important issues and represents a real problem. It is therefore necessary to specifically list all the activities which require prior approval (in cooperation with courts and the Ministry of Justice) and determine which entity authorities are competent to issue the prior approval.

Article 16 provides foreign investors with one of the basic protections which all foreign investors expect to see in an investment law, a guarantee against expropriation substantially in accordance with best practice. To be in accordance with best practice, any act of expropriation must be in the public interest pursuant to applicable law, without any discrimination and against the payment of compensation calculated in accordance with the international standards; i.e. compensation which is adequate, effective and prompt.

Paragraph (c) of Article 16 requires details of the method of calculating compensation in accordance with international standards to be prescribed in regulations issued under Article 21 of the State Law. Some of the issues to be dealt with by these regulations include the reasons for which expropriation can take place, the requirement that expropriation be carried out by law, and the method of calculating compensation, including when, by whom, what factors should be taken into account in calculating compensation and what appeal process the foreign investor may use if the foreign investor disagrees with both the act of expropriation and the calculation of compensation by the government. Is there any reference to protecting private property in each of the Constitutions of B&H and the Entities? If so, the regulations should include a reference to the constitutional protection of private property. As foreign investors have the same expectations with respect to the guarantee against expropriation, it would be best practice to have the guarantee against expropriation more or less identical in the three investment laws.

Article 19 provides so-called “grandfather” protection to existing foreign investors. Article 19 states that although other laws and regulations applicable to foreign investment in Bosnia and Herzegovina which are inconsistent with the State Law shall be null and void, the rights and benefits granted to foreign investors under previous laws shall be protected. When giving “grandfather” protection to existing investors, there is a strong likelihood that there will be problems of implementation by the government agencies. It will not be easy for a government official to determine which law applies to the investment made by the foreign investor, especially where a foreign investor may have rights and benefits different from those granted under the B&H Investment Law. The second paragraph of Article 19 is one way of resolving the differences between the laws, as decided by the foreign investor. It allows existing foreign investors to write to the “competent body” of an entity within 120 days of the enactment of the State Law if they wish to be subject to the new law. Which body is the competent body of each Entity? The same body mentioned with respect to the approval of foreign investments made with respect to the “negative list” as discussed with reference to Article 4 above? This

should be made clear. The second paragraph requires the foreign investor to make a written request if the foreign investor decides to be subject to the new law.

- i. Who makes the request, the foreign investor or the local company in which the investment was made?
- ii. What if the competent body of the entity does not reply to the written request? How will the foreign investor (or the local company in which the investment is made) be able to show the government authorities that they are subject to the new law?
- iii. Is 120 days a sufficient period of time to give notice of an intention to be subject to the new law? What if the foreign investor is not aware of the change in the B&H Investment Law? How was this advertised to the general public, other than by the publication of the State Law?
- iv. Did any foreign investor or any local company with foreign investment write to the relevant competent bodies after the B&H Investment Law was enacted to request this protection? If not, then more publicity should be given to any changes made in the B&H Investment Law in the future.

Article 20 is another form of Article 19. The right and benefits granted under the B&H Investment Law cannot be terminated or eliminated by later legislation or regulations. This provides the same “grandfather” protection to foreign investors who invest under the B&H Investment Law as were granted to foreign investors who invested before the B&H Investment Law was enacted. Existing foreign investors under the B&H Investment Law shall have the same choice as provided under the second paragraph of Article 19. Why is stabilization needed for every change in the law? It is usual practice to provide stabilization to foreign investors who make long-term investments (such as under concessions or production-sharing agreements) in infrastructure and natural resources. The reason for this is that the investments that are large take a long time to construct and begin operations and that the foreign investors have to wait many years to obtain returns on these investments. When foreign investors on these projects originally agree to a financial package with the government, these foreign investors rely on the fact that the package will remain for the life of the investment.

For most investments, however, the foreign investor understands that the investment will be subject to the laws and regulations as they are in effect from “time to time”. Since most foreign investors do not negotiate special incentives as was done many years ago, the foreign investors who enter a country under the current legal regime do not need “grandfather” protection. Every country changes its laws from time to time, and as long as laws and regulations are not discriminatory in application, there is little reason for stabilizing the laws for all investors and providing “grandfather” protection. Article 20 states that the foreign investors shall have the choice to maintain their existing rights and benefits, or if they are more favourable, to accept the rights and benefits provided under the new law. This was done

in the second paragraph of Article 19. It is certain there will be some administration problems for government officials who have to administer more than one structure for foreign investors. For example, if there is a change in the rate of income taxation under this Article, the new rate of income taxation will not apply to the entity with foreign investment unless the local company with foreign investment agrees to accept the new rate of taxation.

Dispute settlement: B&H has been a member of the International Centre for the Settlement of Investment Disputes (ICSID) since 1997. It accepts international arbitration to settle private investment disputes if the parties agree to this option in a contract. However, B&H's legal/judicial system does not normally provide quick resolution of commercial disputes. Non-judicial dispute resolution mechanisms are small in numbers. Investors complain that legal judgments are at times not transparent and that they are of questionable objectivity. Progress on this field was the establishment of Council of Competition in 2004, which in 2005 became member of the International Competition Network (ICN). This Council is independent public institution with mission to enforce anti-trust laws, to prevent monopolies and to enhance competition. Also the Council reviews and approves foreign investments in cases of mergers and acquisitions of local companies by foreign companies.

Article 17 (Settlement of Investment Disputes) provides one of the most important protections that foreign investors expect under an investment law, yet in the case of the State Law, there is almost no meat on the skeleton which provides this guarantee. The first statement in Article 17 is that foreign investment disputes shall be settled in the relevant courts of B&H. There are some issues that must be decided in the relevant courts of B&H, such as a dispute under a local employment contract. But a foreign investor will not accept using the relevant courts of B&H to resolve any disputes between the foreign investor and the co-investors, either the Government of B&H or of the Entities on one part, or private parties on another part. Foreign investors are concerned about due process and fairness in the courts of the country in which the investment is made. Accordingly, foreign investors favour international arbitration for the settlement of investment disputes, in accordance with the rules of one of the accepted international bodies for this purpose. Article 17 allows the parties to an investment to settle any investment dispute as they decide themselves, using domestic or international conciliation or arbitration procedures.

Investment security (protection or guarantees): The Law on FDI Policy in B&H in Chapter III –RIGHTS, INCENTIVES AND OBLIGATIONS OF FOREIGN INVESTORS, in Articles 8-16 defines rights, incentives and obligations of foreign investors; it is recommended that they are presented in more precise way to insure better protection.

Article 8 of B&H FDI Policy Law provides foreign investors with the guarantee of “national treatment” ensuring that foreign investors have the same rights and obligations as B&H residents, and that entity will not have a discriminatory treatment of foreign investors in any form.

Article 11 of the LPFDI referring to Guarantee of Remittance of Funds provides to foreign investors a guarantee that they can remit the proceeds from their investment in B&H, including dividends and other monies and their invested capital upon sale or liquidation of their investments. The ability to remit freely monies derived from the foreign investment is in accordance with best practice.

Paragraph (a) of Article 11 gives foreign investors the right to open both foreign currency and national currency accounts in any commercial bank in B&H. For purposes of transferring funds to B&H when making an investment, the foreign investor must open accounts in a commercial bank in B&H. Under paragraph (b) of this Article, with respect to all payments related to their investments, foreign investors may freely transfer any money they have in national currency into foreign currency.

Paragraph (c) gives foreign investors the right to transfer abroad in freely convertible currency the proceeds of their investments, including dividends, interest, other fees, as well as their capital upon sale or liquidation of their investments and any compensation received from the expropriation of their investments. To make this guarantee more clear to potential foreign investors and avoid different interpretations, it should be more explicitly stated as to what comprises the “proceeds” of a foreign investment, including dividends, interest, management and other fees, royalty payments, and IP fees. The “proceeds” that can be remitted should include any payments by expatriate staff to meet their international obligations, including mortgage payments, insurance premiums and school fees. The best practice is to guarantee that the foreign investor can remit freely and without delay all amounts received as compensation from any expropriation which is not clear from this paragraph of Article 11. Not only foreign investors rely on the guarantee, the guarantee should also include the right of the local company into which the foreign investment has been made to freely remit money to meet its foreign obligations, both to the foreign investor as specified above and for its operations.

Paragraph (d) of Article 11 states that all “transactions”, which is assumed to mean all remittances included in the guarantee set forth in Article 11, shall be carried out in accordance with the laws of B&H. This begs the question of whether there are any laws or regulations that would in any way interfere with the ability to complete any of the remittances mentioned above. Potential foreign investors complain of a lack of sufficient information on registration procedure which is also inconsistent at the relevant courts in B&H which from the very start of the investment process adversely affects the perception of the investment climate in B&H and safety of the investment.

3.2.1.2 Entity level

There has been not much known about either institutionalization or practice of RIA on the level of Federation of Bosnia and Herzegovina (FB&H). According to the current regulations at the state and FB&H entity levels of the government, there is no special administrative body

whose exclusive obligation would be to analyse the impact of amendments on legal regulations and accompanying by-laws in B&H. There have been discussions about creating a unit for RIA/regulatory policy within the Office of the Prime Minister of FB&H. International Financial Corporation/World Bank (IFC/WB) has been consulting the Government of FB&H on this issue, but it remains to be seen whether this materializes.

Activities of regulatory reform in Republika Srpska (RS) started in 2006 through the project of “regulatory guillotine”. In 2007, RS completed the first pilot RIA on Draft Law of Spas, and then they did RIA on Draft Law on Tourist Fees. In 2009-2010, the work is underway in accomplishing RIA on the draft Law on Labour. After the “regulatory guillotine“, a single business register of formalities and inspection related measures was created by the Ministry of Economic Relations and Regional Co-operation of Republika Srpska. Many of these activities were accomplished with support from IFC/WB.

Department for Analysis of RS Regulations Influence within the Ministry of Economic Relations and Regional Co-operation was established in March 2007. Since 2009, all proponents of legislation by the Government of RS are required to obtain opinion of this Department as regards the impact of new regulatory measures on business (for example as regards permits and approvals)

National Assembly of the RS adopted the Proposal RS Regulatory Reform Strategy until 2015. This Strategy aims to improve investment climate by removing administrative barriers. A key element of the Strategy is introduction of RIA that assesses effects of new regulations and regulatory changes and considers all options for resolution of specific problems.

IFC/WB is also working with municipalities in both entities on regulatory policy, specifically on assessment of concrete instances of proposed legislation, or implementation aspects of adopted legislation (for example, construction permits, licenses for businesses, taxes) with the view of informing legislative authorities (municipalities and/or cantons) of implement ability.

3.2.1.3 External Stakeholders of RIA in B&H

Much of the RIA effort and production in B&H so far has been either driven by external stakeholders or produced with their financial assistance. In fall 2010 the main 'external' players were EU technical assistance (TA) projects (namely, EU support to DEI, EUSIP, TA project on trade policy) as well UNDP project for Strategic Planning and Policy Development (SPPD) which has tabled proposals about institutionalization of RIAs on both entity and state levels. International Financial Corporation (IFC)/World Bank is also a stakeholder. It is promoting achievement of better regulatory environment for businesses and it is from this perspective that RIA installation is viewed by the IFC.

As we have seen, it is necessary for the Regulatory Impact Assessment to adhere to the regulation proposals with the goal of offering support to the decision-making process that is followed by a precise analysis with the available options and the possible impact arising from them. We can freely say that the Regulatory Impact Assessment (RIA) is a good tool that improves the quality of the regulations and the relevant legislation, as well as their impact on the business environment and social flows in general. The very practice of implementing RIA is relatively recent – the European Commission introduced the regulatory impact assessment (RIA) in 2003.

In addition to the most important goal of the regulatory impact assessment (RIA) – i.e. timely decision-making by the government based on quality laws and by-laws – a consistent implementation of the RIA will help fulfil another FB&H obligation undertaken by B&H signing the Stabilisation and Association Agreement, which refers to harmonising the domestic legislation with the EU *acquis*.

3.3 Institutional Framework in B&H

The efficiency in implementing all strategic elements for attracting foreign direct investment mainly depends on organizational efficiency of all the stakeholders. Therefore, besides the fact that each company has to focus its attention on the development of its adequate promotion strategy, the government and its institutions also play a significant role in promoting companies and the country as whole (Sinanagić, Čivić, & Kamarić, 2012). In this chapter we will be focused on the institutions whose activities are directly oriented to the promotion of business potential of certain companies, but of the county as whole as well.

Under the Dayton Accord, B&H is made of up two entities and Brčko District which operates under its own administration. The Federation consists out of 10 cantons, all with their own governments. What this means is that B&H has many tiers of legal and regulatory framework that are duplicative and contradictory. Employers are heavily burdened by the government - 69% of the wage level in the Federation and 52% in Republic of Srpska. Complicated labour laws are deterrents to foreign investors.

One of the major difficulties faced by investors who want to invest in B&H is the lack of a single economic space in B&H. Although the income tax is harmonized at the state level, requirements for business registration are not harmonized. At the level of the RS requirements for registration are harmonized but in Federation B&H each of the 10 cantons has different procedures for registration. Simplifying the registration is very important to improve the investment climate. However it is very slow considering that the Federation still does not have institution for the removal of administrative barriers and for RIA. Although the government has launched a project “Strengthening of Capacities of the Institution/s for Control of Regulations and Establishment of the System of Reduction of Administrative

Barriers” that should form the institutions at the state level and in Brčko District, which will take over the tasks of reduction of administrative barriers and regulatory impact assessments, this project is just at the beginning. Unlike FB&H, RS established Department for analysis of RS regulations influence within the Ministry for economic relations and regional cooperation.

Communication between government and stakeholders during drafting and adaptation of legislation remains weak and occurs in an ad hoc way. B&H should adopt a lobby or transparency law and thus increase communication with key stakeholders. Good parliamentary website is useful instrument for providing information about legislative procedures to public and thus increases regulatory transparency. Although B&H has established a functioning parliamentary website, all content is not available in English and does not contain information about adoption of laws.

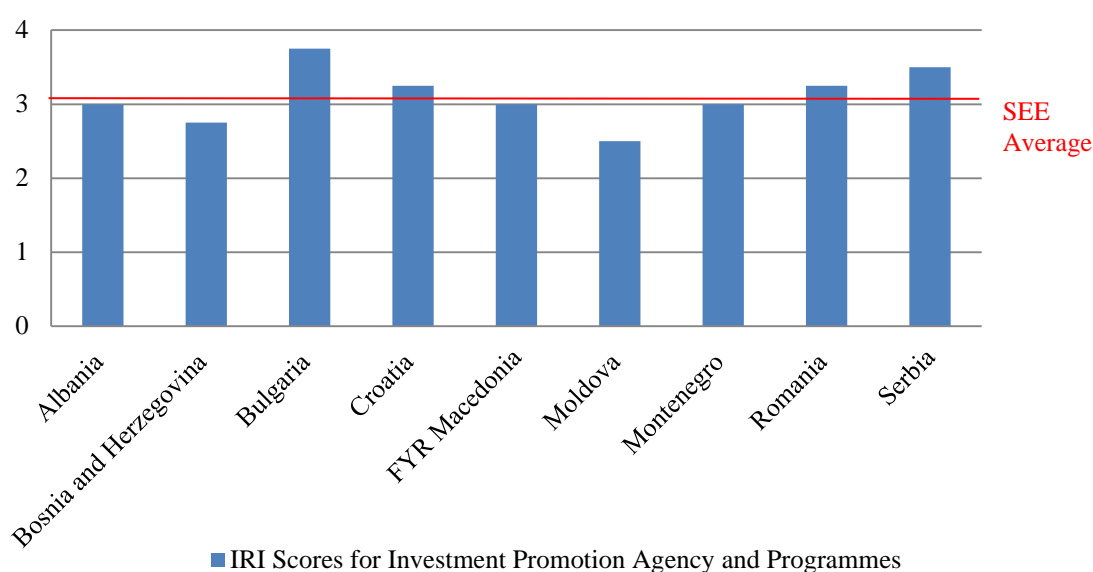
Considering the importance which FDI has for economic development of B&H, it is absolutely logical that individual companies, along with representatives of state institutions, are involved in attracting FDI. Institutions important for attraction FDI in B&H are: Foreign Investment Promotion Agency of Bosnia and Herzegovina, Foreign Trade Chamber of B&H (FTC), Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina and Foreign Investors Council (FIC).

Foreign Investment Promotion Agency of Bosnia and Herzegovina (FIPA) is a government agency that Council of Ministers of B&H established in 1999 to facilitate and support FDI. Mission of Agency is to attract FDI in B&H and to encourage existing investors to expand and develop their business in B&H. Other tasks of FIPA are to improve dialogue between public and private sectors, to improve investment climate and to promote positive image of the country (Misija FIPE, 2014).

Looking at the Agency's activities we can see that this is the institution that has an extremely important role both for attraction of foreign investors and for the development of a positive image of B&H. Regarding the amount of money invested in the improvement of the B&H image, we cannot be satisfied with results. The Audit Office of the Institutions of Bosnia and Herzegovina has, as part of a performance audit (Audit Office, 2013), analysed the efficiency of FIPA to promote and attract foreign investment to B&H. The goal of the audit was to assess whether FIPA has been performing its assigned tasks efficiently through the use of the public resources, i.e. whether it is doing the right things in the right way in order to efficiently promote B&H as a favourable country for investment. The results of the conducted analysis indicate that FIPA has not managed to impose itself as the main coordinator and implementer of the integral programs for promoting the possibilities for foreign investment. Regardless of the existence of a strategic document, B&H government does not have a clear commitment to promoting and attracting foreign investment, which significantly contributes to FIPA becoming a stagnating institution without any ability to improve its activities within the scope of its competence. The conditions created for an efficient presentation of investment

possibilities in B&H and for making successful connections between investors and investment seekers have not been utilised. According to foreign investors in B&H, FIPA's activities have so far not influenced their amount of investments in B&H. The key subjects expect FIPA to cooperate more intensively and to adopt a less bureaucratic approach, as well as to quickly grow into a modern agency that will be more successful in presenting the investment possibilities in B&H economy to potential investors. According to IRI (2006) scores for investment promotion agency and programmes B&H has almost the lowest ranking among neighbouring countries and below SEE average (Figure 12).

Figure 12. IRI Scores for Investment Promotion Agency and Programmes in B&H and Comparator Countries



Source: OECD, *Investment Reform Index 2006: Progress in Policy Reforms to improve the Investment Climate in South East Europe*, 2006.

In the opinion of the Audit Office of the Institutions of B&H (2013), all B&H institutions should be involved and contribute to improving the business environment in B&H, as well as promoting the possibilities for investment and attracting foreign investors in an appropriate manner. It is up to FIPA to identify and coordinate these institutions and to create a way of using their capacities. In order to this, FIPA needs support from the highest state level of government through a clear strategic commitment and setting measurable goals.

Foreign Trade Chamber of B&H (FTC) is very important institutional promoter of B&H. It was established in 2001 as an independent, nongovernmental, non-political and non-profit organization of economic entities associated in accordance with model of chambers of commerce in EU. There is extended network of Entity and regional Chambers of Commerce

in B&H with over 30.000 companies from all sectors. The above mentioned FIPA focuses its activity mostly to foreign investment and promotion of FDI in B&H, while the role of Foreign Trade Chamber in B&H is based on representation of the local companies' interests (Ovčina 2009). Even though they perform different activities, FIPA and Foreign Trade Chamber B&H should continuously maintain cooperation both between themselves and with other chambers of commerce in B&H. However, the current situation shows that the activities of the two mentioned institutions are not coordinated on satisfactory level, which is proven by insufficient volume of direct investments in B&H.

Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina (MOFTER, 2010) has departments for foreign investments - Foreign trade policy and customs tariff policy of B&H that is in charge of basic activities:

- providing legal aid by giving explanations, advices and other legal aid related to foreign investments;
- monitoring legality of acts in the field of foreign investments and protection of domestic production;
- development of drafts, proposals of laws and other regulations and amendments to these regulations concerning policy of foreign investments in B&H;
- development of analysis, reports, information and other materials and updating databases in the field of foreign investments and cooperation with FIPA;
- conduction of Regulatory Impact Analysis (RIA) during making new policies and laws.

Competences of MOFTER are complementary and affect mission and functions of FIPA, thus it is logical that these institutions cooperate, especially in enactments of laws and other regulations related to promotion of FDI.

There is a specialized organization in B&H called the Agency for Privatization in Federation of B&H (FIPA, 2014b) which is in charge of many professional, advisory, educational and other business activities related to the process of privatization. Physical and legal entities, both foreign and local, have a vast number of possibilities for participating in the purchase of the state capital. According to FIPA (2014b) many state-owned companies are still in privatization process. Their estimation is that 30% of the large firms and 60% of small firms are now privatized or publicly traded. But still there are many large companies in telecommunication sector, energy sector etc. that could be privatized by potential foreign and local investors. One of the causes of low interest of investors according to Domazet, Čaušević, Mahmutović, Dedić, and Gotovuša (2008) is in the institutional weaknesses related to low capacity development agency for privatization and institutions that need that support.

A non-profit business association, which represents the interests of foreign companies, is the Foreign Investors Council (FIC, 2013). It was established in August 2006, intended to improve the investment and business environment in B&H, as well as the process of

communication and cooperation with the authorities in B&H. Its main duty is to identify the major obstacles that keep foreign investors out of B&H. FIC members are key foreign investors who invested in B&H. The reports made by FIC present first-hand experience of these investors and obstacles that they are facing before and after investing (Hodžić, 2013). One of the most important written documents of FIC B&H is the "White Book" that presents in one place concrete solutions to the legal and procedural obstacles that relevant institutions could forward to the legislative process, and thus contribute to the overall improvement of business environment in Bosnia and Herzegovina (FIC, 2013).

Sinanagić et al. (2012) investigated to which extent foreign investors are familiar with existing institutions in B&H whose goal should be attraction of FDI. Only 45% of the respondents are familiar with the existence of FIPA, while 55% of them are not familiar with this fact. They obtained discouraging figures for other institutions too. Only 36% of respondents are informed on the activities of MOFTER in attraction of FDI, and only 27% of them are familiar with the activities of FTC.

We can say with certainty that one of the reasons for a poor inflow of FDI in B&H is bad engagement of these institutions in efficient sharing of information on potentials of B&H with prospective investors. So, we can conclude that none of the missions to attract foreign capital are implemented adequately and efficiently. Therefore, if the goal of the B&H authorities is to attract a larger number of investors in coming period, they certainly have to work to introduce them to the above mentioned institutions and their activities.

The multitude of state, entity, cantonal and municipal administrations, together with the large quantity of laws and rules, creates a heavy, non-transparent system in this country. Thus, foreign investors are reluctant to provide assistance, or even to give some advice.

Business are subject to many entity and cantonal inspections including labour inspection, health inspection, environmental inspection, tourism inspection, water inspection, forestry inspection, veterinarian inspection, institution for the protection of cultural monuments, financial police etc. The problems that investors face are fees that are levied non-transparently during inspections, often changing regulations and rules and ineffective appeals against these fines (U.S. Department of State, 2014).

Corruption in institutions and complex business registration in B&H increase the costs of doing business in the country. Multitude levels of administrations in B&H create lack of transparency and thus opportunities to demand "service fees", what occurs regularly.

Labour costs are relatively low, and university enrolments are increasing in number. On the other hand, there are some sectors, like health care, which experienced a significant loss in the number of skilled employees, because there are no qualitative educations or training opportunities. People are hardly employed due to high tax rates on labour. Redundant

workforce is hardly dismissed due to current labour legislation provisions. Many workers are not even reported, because their employers tend to avoid paying taxes and benefits. As a result of all the things mentioned, the official unemployment rate at the end of 2012 was approximately 44 percent (U.S. Department of State, 2014).

CONCLUSION

The role of this thesis was to explain how to improve the investment climate in B&H through regulatory reform. Entities in B&H adopted some components of regulatory reform but there is no overall regulatory reform strategy at the state level. It is necessary to launch and implement overall regulatory reform at state level to improve its investment climate.

Since ‘regulatory reform’ is a broad term, we have focused on the following three main elements of the reform: administrative barriers, regulatory framework, and the RIA as the basic tool for improving the legislation, and the institutional framework. The best indicator of a country’s investment climate is FDI inflow. That is why Chapter 3 describes the current situation in B&H with FDI flows and points out the advantages and barriers for investing into B&H. Most of the attention during the research has been dedicated to the FDI-related regulatory framework, since it is one of the greatest obstacles for investing into B&H, and there are very few articles and researches dealing with this problem. Furthermore, improving the regulatory framework is relatively easy and inexpensive compared to other elements of the investment climate.

Legislation must be attractive for foreign investor in order to do business in the country. Therefore, it is first of all necessary to launch a state-level regulatory reform that would primarily encompass the elimination of administrative barriers for investors. The country remains one of the most challenging in which to start a business, and the administrative and regulatory burdens on existing businesses are very high. The reform of business registration (Establishing of a One Stop Shop) is a project that would reduce administrative barriers and costs in the area of starting a business. This project should be a strategic priority for B&H government.

The second element of the regulatory reform that is very important for improving the investment climate in B&H is the investment-related regulatory framework. The structure of B&H laws on investing does not deviate significantly from the standards of best practices. However, numerous provisions on foreign investment in B&H laws are incomplete, unclear, and insufficient and contrary to each other; hence, they are still not in accordance with best practices. To this aim, several measures can be taken such as:

- All kinds of registration formalities should be available on Internet. Also there should introduce central company register system and comprehensive and secure registry of all forms and formalities that B&H government requires.
- A functional parliamentary website should be introduced to inform the public about legislative procedures. This website exists but it is not available in English and does not contain any information about adaptation status of laws.
- Ex ante approvals should shift to ex post controls and monitoring of compliance after the firm starts its activities.
- Old regulations should be updated, and the redundant ones should be eliminated. The updating process must be done quickly, or otherwise it would slow down the economic growth. Guillotine is one of the best ways to do it.
- Transparency is vital in making a regulatory decision. Early and meaningful consultation is one of the most important assurances to businesses of a supportive legal environment. B&H should take into consideration three methods of public consultation: publication for comment; circulation of regulatory proposals for public comment; and business test panels and focus groups.
- In order to fight corruption, and to create a single economic space, the anti-corruption policies and legislations of both entities need to be harmonized. Particular attention needs to be paid on tax relevant policies, where tax evasion is extremely high. Also, raising public awareness is another step that needs to be taken in the battle against corruption. Citizens should be allowed to complain about corrupt officials, and they should inform the authorities if they witness corruption in government institutions.

RIA should be regarded as the basic tool for improving the legislation. B&H is lagging behind in implementing regulatory impact assessment (RIA) compared to other SEE countries. County still has not formalised by law use of RIA during drafting legislation. This tool is particularly important in the EU accession context because RIA facilitates adaptation of EU laws and regulations. Several OECD publications (OECD, 1997; OECD, 2008b) provide guide on using RIA. Ideally, it should be formally introduced into the legislative system, and applied to all legislative proposals. B&H should slowly, step by step, implement a program of RIA within the ministries and form body on state level that would be in charged for implementation of RIA. In addition to the already established Department for Analysis of RS Regulations Influence in Republika Srpska, similar body should be established in the FB&H.

In B&H, there were two RIAs conducted of the Law on Foreign Direct Investment – the first one in 2009 and the second in 2013. Two and a half years after the first RIA resulted in the Law on Amendments to the Law on the Policy of Foreign Direct Investment in B&H

(“Official Gazette of B&H”, no. 48/10) which entered into force in June 2010. This was followed by the adoption, that is, the harmonisation of the implementing law, which resulted in drafting the Instructions on Submitting, Record Keeping and Disclosing Information on FDI in B&H (“Official Gazette of B&H”, no. 86/10). The main goal of this RIA was to simplify the registration of foreign investment and to remove administrative barriers. Having in mind that this was a pilot project and that the investment climate in B&H is less attractive than in the other countries in the region, a new IFC project was initiated in B&H. Within this project, the Ministry of Foreign Trade and Economic Relations of B&H, as a client of IFC, has expanded its activities related to the application of the regulatory impact assessment (RIA) methodology to all the laws regulating the area of foreign investment in order to simplify and improve the legislative framework in accordance with best international practices. The main recommendations of this RIA are as follows:

- harmonise entity laws on foreign investment with the Law on the Policy of Foreign Direct Investment in B&H; thoroughly revise all the provisions within this area focusing on incompleteness and clarity, and in particular on contradictions and lack of harmonisation;
- crystallise the provisions with regard to investor protection – primarily related to defining the term ‘public information’ and the issue of competence of entity bodies for issuing a prior approval for investment into business from the so-called Negative list. Additionally, harmonize the issue of guarantee against expropriation, ensure the implementation of Article 19 – Protecting the “Current Conditions” and Article 20 – Stabilisation (e.g. Tax);
- reformulate Article 17 in accordance with best international practices, so that bilateral agreements on investments can also enable access to the rules of international arbitration for settling investment disputes;
- elaborate Article 11 of the state Law in order to make it even more precise.

In addition to regulatory framework, regulatory reform requires institutions that are fundamental to design and implement regulatory reform. In B&H it is necessary to improve the work of FIPA which is the most important institution for the improvement of the investment climate in country. FIPA can improve the country's image in the eyes of investors, improve communication between investors and the government, and thus attract more FDI in B&H. In area of investment promotion, FIPA should invest much more efforts in changing investors’ perceptions of B&H as the post-conflict state. The most important task on this field should be eliminating heavy bureaucracy through better coordination and relations among all levels of public offices. Also simplification of administrative procedures would facilitate foreign investing and improve B&H image in the world.

FIPA also needs to rise skills and qualifications of its employees or hire industrial specialist. This could improve quality of services that provide to investors and thus improve the country’s image. Also following the examples of the web pages of more advanced national

agencies for attracting foreign investment, FIPA should continuously analyse and improve the content and the appearance of its web page. In addition, FIPA should find the most appropriate way to make its activities and results more transparent and more easily accessible to competent institutions and other interested subjects.

Also, due to miscommunication between investors and government authorities, better channels for information flows need to be established. FIPA could further its role in establishing these channels. At last, the statistical capacity of government institutions needs to be enhanced in order to avoid duplication and make the essential coordination. All laws and secondary regulations should be made compatible with the *acquis communautaire* and coordinated between state and entity levels.

Over the last several years, the governments at the state and entity levels, with support from multilateral and bilateral partners, have taken a number of steps to improve investment climate but it is still far from conducive for enterprises to thrive in. Many reforms have been undertaken but more and deeper reforms are needed to make it business-friendly. The best indicator of poor investment climate is Doing Business Report where we have the worst ranking on ease of doing business in the region. This master thesis focuses only on a few areas of reform, partly because the governance structure in the country is simply not ready to handle and implement major changes because of the complex governance system and political situation. However, we suggested recommendations that can help B&H improve its investment climate, increase the inflow of investments, which in turn generate employment, raise living standards and economic growth.

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APPENDIX

Appendix: Legal framework for foreign investment in B&H

The legal framework for foreign investment on the level of **Bosnia and Herzegovina** is made up of:

- Law on Policy of Direct Foreign Investment (“B&H Official Gazette”, number 17/98, 13/03 and 48/10);
- Instruction on the manner of submitting, maintaining records on, and publishing data on registered foreign direct investments in Bosnia and Herzegovina (“B&H Official Gazette”, number 86/10);
- Instruction on the manner of determining reciprocity in the process of foreign direct investment (“B&H Official Gazette”, number 18/98) - reciprocity requirement is set only for real estate and applies for members in one of the countries successors to SFRY
- Decision on the manner and requirements for realization of the right to exemption from paying customs on equipment which is based on foreign investment (“B&H Official Gazette”, number 27/98)
- Rulebook on standards for compensation in case of expropriation (“B&H Official Gazette”, number 18/98) -this rulebook only applies if B&H has concluded a BIT with a particular country and if the provisions of the BIT do not foresees different solutions, as well as adoption of entity regulations;
- B&H Framework Law on Registration of Business Entities („Official Gazette of the B&H”, no. 42/04);
- Law on B&H Ministries and other B&H institutions (“Official Gazette” of B&H, no. 05/03);
- Law on Foreign Investment Promotion Agency („Official Gazette of the B&H”, no. 54/04);
- Law on Central Bank (“Official Gazette” of B&H no.1/97, 76/06, 9/05,14/03, 13/03, 8/03, 29/02);
- Law on Movement and Stay of Aliens and Asylum of B&H („Official Gazette of the B&H”, no. 36/08);
- Law on Protection of Personal Data („Official Gazette of the B&H” no.49/06);
- Regulation on the manner of keeping the records of personal data filing systems and the pertinent records form („Official Gazette of the B&H” no.52/09);
- Regulation on the manner of keeping and special measures of technical protection of personal data („Official Gazette of Bosnia and Herzegovina“ no.67/09);
- B&H Law on Personal Data Protection („Official Gazette of Bosnia and Herzegovina“ no.28/00, 45/06 and 102/09);
- Law on Statistics of Bosnia and Herzegovina („Official Gazette of the B&H” no. 26/04 and 42/04).

Federation of B&H

- Law on Foreign Investment of FB&H (“FB&H Official Gazette” no. 61/01 and 50/03);
- FB&H Law on Registration of Business Entities („FB&H Official Gazette”, no. 27/05, 68/05 and 43/09);
- Law on Classification of Activities („FB&H Official Gazette” no.70/07);
- Rulebook on Allocation of Tax Identification Number and Tax Registration at the Territory of Federation of Bosnia and Herzegovina („FB&H Official Gazette” no. 39/02, 1/03, 11/04 and 2/10).

Republika Srpska

- Law on Foreign Investment of RS („Official Gazette of the RS”, number 25/02 and 24/04 and 52/11);
- RS Law on Registration of Business Entities (“Official Gazette of the RS”, no. 42/05);
- Rulebook on Methodology for Allocation of Units in Accordance with Classification of Activities and on Methodology for Maintenance of Registry („Official Gazette of the RS”, no. 97/05).

Brčko Distrikt B&H

- Brčko District Law on Registration of Business Entities (“Official Gazette” of the Brčko District, no. 15/05).

Other relevant laws which may have direct or indirect impact on foreign investments are the following:

Law pertaining to investor protection

- Law on Ownership and Legal Relations and Rulebook on Standards for Compensation

Laws pertaining to company registration

- Law on Companies of RS („Official Gazette of the RS”, number 127/08, 58/09 and 100/11)
- Law on Companies of FB&H (“FB&H Official Gazette”, number 23/99, 45/00, 2/02, 6/02,29/03, 68/05, 91/07, 84/08, 88/08, 7/09 and 63/10)

Laws pertaining to taxes

- Law on Value Added Tax (“B&H Official Gazette”, number 09/05, 35/05 and 100/08)
- Instruction on value added tax refund for foreign nationals of B&H (“B&H Official Gazette”, number 01/07)
- Law on Corporate Profit Tax of FB&H (“FB&H Official Gazette”, number 97/07 and 39/09)
- Law on Corporate Profit Tax of RS („Official Gazette of the RS”, number 91/06 and 57/12)

Laws pertaining to free zones

- Law on Free Zones of B&H (“B&H Official Gazette”, number 99/09)
- Law on Free Zones of RS („Official Gazette of the RS”, number 65/03)
- Law on Free Zones of FB&H (“FB&H Official Gazette”, number 2/95, 37/04 and 43/04)

Laws pertaining to registration of business entities

- Framework Law on Registration of Business Entities in B&H (“B&H Official Gazette”, number 42/04)
- Law on Registration of Business Entities of FB&H (“FB&H Official Gazette”, number 27/05, 68/05 and 43/09)
- Law on Registration of Business Entities of RS („Official Gazette of the RS”, number 42/05 and 118/09)
- Decision on establishment and operations of representative offices of foreign entities in Bosnia and Herzegovina (“B&H Official Gazette”, number 15/03)

Laws pertaining to labour and employment

- Law on Labour of FB&H (“FB&H Official Gazette”, number 43/99, 32/00 and 29/03)
- Revised text of the Law on Labour of RS („Official Gazette of the RS”, number 55/07)
- Law on Movement and Stay of Foreign Nationals and Asylum of B&H (“B&H Official Gazette”, number 36/08)

Laws pertaining to customs

- Law on Customs Policy of B&H (“B&H Official Gazette”, number 57/04)
- Law on Amendments to the Law on Customs Policy of Bosnia and Herzegovina (“B&H Official Gazette”, number 51/06)
- Law on Amendments to the Law on Customs Policy of Bosnia and Herzegovina (“B&H Official Gazette”, number 93/08)
- Law on Amendments to the Law on Customs Policy of Bosnia and Herzegovina (“B&H Official Gazette”, number 54/10)
- Law on Amendments to the Law on Customs Policy of Bosnia and Herzegovina (“B&H Official Gazette”, number 76/11)