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PAYMENTS BUREAUS IN BOSNIA AND HERZEGOVINA : OBSTACLES TO DEVELOPMENT AND A STRATEGY FOR ORDERLY TRANSFORMATION

This report was prepared by team under the supervision and direction of the
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FOREWORD

A number of recent studies by various donors have concluded that the Payments System in Bosnia and Herzegovina needs to be reformed in order to create a modern payments environment that will support a private sector, market oriented business environment. This study incorporates the evidence and findings of the earlier studies with regard to the payments system but broadens the focus to include all functions of the Payment Bureaus operating in Bosnia and Herzegovina. The payments system in BiH is under the control of the Payment Bureaus, which are vested with monopoly control of all non-cash transactions. Control over and information obtained from the payments system is used as a platform to control a number of governmental and non-governmental functions and services, including tax collection and allocation. A strategic plan to restructure the payments system therefore must consider alternatives to continue providing these other services during the transition to a modern payments environment. For that reason, this report focuses on all of the functions provided by the Payment Bureaus, not only on the payments system.

This study was prepared under the direction and supervision of Dr. Mike E. Sarhan, Director of USAID/BiH Economic Restructuring Office (ERO). The team performing the study was organized and led by Dr. David D. Whitehead, Resident Macroeconomic Advisor, Macroeconomic Technical Assistance Project. Other team members included: Dr. Bryan Roberts, a USAID resident macroeconomic advisor seconded to OHR with experience in the structure of the BiH economy and governance; Mr. Dan Berney, a USAID resident bank supervision advisor with expertise in bank organization, restructuring and supervision; Dr. James Lyon, a local business consultant and businessman; Dr. Mack Ott, a macroeconomist with the Barents Group; Dr. Neil Murphy, a payments system expert; Mr. Branko Greganovic, a financial expert from Slovenia with broad experience in the SDK; and Dr. David King, USAID Chief-of-Party for the Business Consulting component of the Business Development Program. The study has also benefited significantly from comments and suggestions on treasury, tax and banking issues by the resident advisors from the US Treasury, Mr. George Mullinax and Ms. Anne Schwartz. Finally, Roger Connelly of the SIGMA Group provided useful insights based on his work on the Macedonian payments system and its reform.

Thanks are also offered to the valuable comments received from the IMF, WB, OHR, CBBH, and CAFAO.

LIST OF ACRONYMS

ATMs	Automatic Teller Machines
BiH	*Bosna i Hercegovina*, Bosnia and Herzegovina
CAFAO	Customs and Fiscal Assistance Office (EC-funded)
CBBH	Central Bank of Bosnia-Herzegovina
DBRS	*Srpska razvojna banka*, Development Bank of Republika Srpska; controls the SPP.
DM	Deutsche Mark
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EU	European Union
FD	Financial Director
FIRB	Financial Infrastructure Reorganisation Board
FRY	Federal Republic of Yugoslavia
GDP	Gross Domestic Product
HB	*Herceg-Bosna*
HDZ	*Hrvatska demokratska zajednica* (Croatian Democratic Union) Croat political party
HVO	*Hrvatsko vijece odbrane* (Croatian Council of Defence), the Croatian Armed forces in Bosnia-Herzegovina
IAG	International Advisory Group
IMF	International Monetary Fund
IT	Information Technology
KM	Konvertible Marka (BiH currency)
LAN	Local Area Network
LOSB	Law on the Office of Social Bookkeeping
LSB	Law on Social Bookkeeping
MoF	Ministry of Finance of the Federation
NBBH	National Bank of Bosnia and Herzegovina
NBRS	National Bank of the Republika Srpska
NBY	National Bank of Yugoslavia
OHR	Office of the High Representative
PBs	the BiH Payment Bureaus: ZPP, ZAP and SPP.
POS	Point of Sale (systems)
PPP	Purchasing Power Parity
RS	*Republika Srpska*
RTGS	Real Time Gross Settlement
SDA	*Stranka za demokratsku akciju* (Party for Democratic Action), Bosniak Political party
SDK	*Sluzba drustvenog knjigovodstva* (Service of Social Book-keeping)
SDS	*Srpska demokratska stranka* (Serbian Democratic Party), Karadzic-dominated Serbian political party.

SFRY	Socialist Federal Republic of Yugoslavia
SPP	*Sluzba za platni promet*, Republika Srpska Payment Bureau.
SRS	*Srpska radikalna stranka* (Serbian Radical Party), Seselj-dominated Serbian political party
SWIFT	Society for World-wide Financial Transmission
TARGET	Transeuropean Automated Real Time Gross Settlement Express Transfers
TCL	Telecommunication Links
TTS	Telephone Transfer System
UNDP	United Nations Development Program
UNHCR	United Nations High Commission for Refugees
USTDA	United States Trade and Development Agency
USAID	United States Agency for International Development
USD	U.S. Dollar
UST	U.S. Treasury
WB	World Bank
YUD	Yugoslav Dinar
ZAP	*Zavod za Platni Promet*, payment bureau in Croat-dominated areas of the Federation
ZPP	*Zavod za Platni Promet*, payment bureau in Bosniak-dominated areas of the Federation

PAYMENT BUREAUS IN BOSNIA AND HERZEGOVINA:
OBSTACLES TO DEVELOPMENT AND A STRATEGY FOR ORDERLY TRANSFORMATION

EXECUTIVE SUMMARY

The system of Payment Bureaus (PBs) in Bosnia and Herzegovina (the ZPP, ZAP and SPP) represses the development of a modern market-oriented economy and impedes financial intermediation and private-sector business development. For the BiH economy to prosper, the PBs must be reformed. Descended from the Social Bookkeeping Service of the former Yugoslavia (SFRY), these bureaus were created in the mid-1950's to control and manage socially owned resources through monopoly control of the financial sector. This monopoly provides the PBs with the information necessary to control all business and financial transactions, to assure that the central plan was met. This was and still is a system of ultimate control over the allocation and distribution of productive resources and as such prevents the emergence of a free-market economy.

The term "Payment Bureaus" is misleading. These institutions perform numerous functions not directly related to providing payment services. These functions include: the collection and distribution of taxes; accounting, audit and treasury services for businesses and the government; services normally associated with commercial banks or the central bank; and gathering and processing statistical information for the Government. The PBs' monopoly over the payments system provides the means to gather information necessary to perform this wide array of public and private sector functions. The PBs collect and distribute money, and they charge high fees for their services. Yet, their revenues do not appear in government budgets. Their activities are not transparent and their corporate governance is questionable.

The PB system seriously represses the flow of funds in the Bosnian economy. This is a critical weakness, because the chronic absence of liquidity in the economy is seriously constraining its growth. The total active loan assets of the domestic banking system are estimated at less than DM 500 million. Routine receivables- and inventory-based working capital credit lines are not available. There are no cash management activities, no short-term deposit instruments, and no commercial paper. Yet the highly intrusive practices of the PB's, which create significant costs and uncertainties for those transferring money through the system, make them avoid the system whenever possible.This is reflected in the very high level of cash transactions relative to total economic activity, in the prevalence of non-monetized barter transactions, and in the sizeable amount of domestic transactions that are settled through external transfers at foreign banks.These activities directly deprive the system of loanable funds. In addition, the PB's themselves hold large idle balances (KM 400 million) at any time.Finally, the difficulties of dealing with the PB's, but the legal requirement to do so, are major deterrents to foreign investment in Bosnia. With an efficient, western-style payments system, all of these sources of funds would be in the system and normally available for banks' funding activities, financing a wide range of

credit needs, from banks' covering overnight shortages to long-term credit for businesses. A conservative estimate of the aggregate of these withheld financial resources is at least DM 1 billion – 3-4 times the total donor contribution to the Bosnian commercial sector in 1998.

The Payment Bureaus function as monobanks and are capable of extending or creating credit. Because they report directly to entity-level Governments, this capacity is dangerous and can result in the allocation of credit according to Government dictates, perhaps in some instances to benefit political parties. Although prohibited by law from doing so, evidence was found that the PBs do make loans. Creation of credit by the PBs is particularly disturbing, because this directly undermines the Currency Board mandate of the Dayton Agreement. The non-transparency and credit-creation capabilities of the PBs give those controlling these organizations a tremendous amount of potential power. Whether or not these capabilities are actually used is less important than the fact that the capacity and thus possibility of abuse exist.

This study describes the nature of the PBs and how they affect economic activities by evaluating both statistical data and evidence from surveys of BiH banks and businesses. It evaluates several important costs to the BiH economy that result from PB practices. Several of these costs are quantitatively estimated using available data, and the BiH payments system costs and efficiency are compared to those of more efficient and market oriented economies. A program for comprehensive reform is then proposed that will establish a competitive, efficient and transparent payments environment by the end of 2000.

It is not possible to accurately evaluate the effects of the PBs on the BiH economy simply by analyzing their legal frameworks. Many important impacts result from informal practices and procedures that can only be identified by talking directly with businesses and banks. A survey of businesses and commercial banks revealed that the payments system in BiH is associated with corruption and fraud. It negatively impacts businesses by charging excessively high transactions fees, and it creates high risk and uncertainties associated with payment delays and ineffective legal recourse for arbitrary decisions by the PBs. The PBs have the ability to approve or disapprove business transactions which effectively raises the costs of conducting normal business activity. In short, the current system makes possible bureaucratic intervention into all aspects of business life. The business community views the current payments system as a major barrier to economic development and a serious obstacle to attracting foreign investment.

On the banking side, the survey revealed that the development of commercial banking services is stymied by requirements that all commercial bank transactions go through the PBs. The fact that banks cannot provide normal commercial banking services eliminates the ability of banks to establish sound business and consumer relationships. The limited services provided by banks are insufficient to attract household or consumer deposits, which are the most important source of financial funds in normal economies. This severely

limits the degree of financial intermediation in the BiH economy, and without effective financial intermediation, economic growth is retarded.

According to this study, in 1997 the PBs cost the BiH economy KM 255-311 million in direct and indirect costs. This amounted to approximately 5 percent of GDP in 1997 or about 20 percent of the total budgets of the two entities in 1998. These estimates are conservative and do not include many costs that were identified but could not be quantified. The study also finds that the BiH payments system is more costly and yet dramatically less efficient than West European payments systems.

This study reveals an urgent need to reform and transform the Payment Bureaus in both entities, in both the non-payment and payment areas of their activity. With regard to the payments services provided by the PBs, this study agrees with previous studies' conclusions that reform and modernization of the payments system will be complicated. The functions performed by the PBs tend to be interrelated and must be separated. The PBs are also extremely powerful political institutions. Any reform and transformation of these institutions must be executed in an orderly and careful manner.

A detailed plan to reform all of the interrelated functions of the Payment Bureaus requires a complete functional audit of these institutions. A detailed financial audit, although of great interest, is not recommended, as it would be quite costly and yet add little to our understanding of the PBs. Demands for such a detailed financial audit at this time may also be counterproductive in that it may be viewed as a witch hunt, thereby increasing the resistance of policymakers to undertake reform of the system. A limited financial review to verify the holdings of the Payment Bureaus is recommended.

This report offers a strategic plan and timeline for immediate as well as gradual reforms that stresses the need for a coordinated and coherent approach to reforming all functions of the PBs. As an immediate first step, a proper system of corporate governance needs to be imposed on the PBs. This would allow the current system to be properly controlled prior to and during the restructuring process. It should be noted that the plan offered by USAID to transform the Payment Bureaus is consistent with the plans that have been prepared either by or for the IMF and World Bank. While USAID's plan is somewhat more aggressive than the other two, it also recommends a gradualist approach with carefully synchronized phases that reform all of the many PB functions. Experience suggests that all target dates slip, so an aggressive (but not unreasonable) timetable is more likely to result in timely reform.

It should be noted that all government bodies and businesses that the study team talked to, agreed on the need to reform PBs, but not on the depth of reform required. The greatest danger is that limited reform would accomplish only superficial reform, while allowing the maintenance of appropriate control over the economy by state organs. The suggested reform therefore is a comprehensive plan to produce a modern financial environment supportive of a free market economic system.

PART I

OVERVIEW OF FINDINGS, IMPLICATIONS AND RECOMMENDATIONS

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Findings, Implications and Recommendations

Focus on Payment Bureaus

Finding: The Payment Bureaus were established as institutions of control to support the achievement of a socialist economic system's goals under a central plan. In order to establish ultimate control over all business activity, the Payment Bureaus were given monopoly control over the means of making payments. The mandate of the Payment Bureaus was to control socially owned resources, not to facilitate the efficient processing of payments transactions, or to encourage the efficient flow of loanable funds through financial itremediation.

Implication: The label Payments Bureau is a misnomer. The Payment Bureaus in Bosnia and Herzegovina undertake many other functions unrelated to the payments system function. The Payment Bureaus are first and foremost institutions designed for control, and their activities penetrate every aspect of economic life. Control over the payments function provided this institution with the information necessary for ultimate control of all business activity. These institutions add no or little value in a free market system, and create major obstacles to the development of free markets, and the financial intermediation process, that supports free markets.

Recommendation: The Payment Bureaus must be dismantled and the functions they currently provide must be restructured to complement the move to a privatized free-market environment.

Finding: Although the Payment Bureaus currently fall under the control of the entity-level Governments, they provide Central Banking types of services and have the capacity to extend or create credit. The activities of the Payment Bureaus lack transparency, and the revenues that they generate do not show up in the Government budgets.

Implication: The ability of the Payment Bureaus to extend or create credit is in direct conflict with the concept of the Currency Board as prescribed by the Dayton Agreement in that it gives the entity-level governments the capacity to direct or create credit outside the control of the Central Bank.[1] Whether or not this capability is actually used is less

[1] The lack of appropriate external control and supervision of the PBs procedures, which affect credit extension, is even more troubling in light of a number of reports (also confirmed by the results of the survey carried out as part of this study) that the PBs make direct loans. Such loans could be extended either by drawing down existing accounts (in which case deposit money will expand but no injection of new money will occur) or simply through bookkeeping entries (in which case new money will be injected into the system i.e. money circulation). Since the PBs operate as monobanks (i.e., a single bank banking system) they are capable of injecting new money into the system in violation of the Currency Board rules. These injections are limited, however, by the demand for currency. A shortage of circulating currency would be one indication that this process is occurring. Whether or not money creation has occurred in this way is less important than the fact that it may occur and should be controlled.

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important than the fact that the capacity for abuse exists, and therefore should be controlled. As a Government institution, the activities of the Payment Bureaus should be transparent and open to public review. Mechanisms should be in place to assure that all public funds are properly used and not diverted to the benefit of private individuals or ethnic interests. To the extent that the Payment Bureaus can be used to divert public funds to inappropriate uses, elimination of this institution will strengthen public accountability.

Recommendation: Immediately establish appropriate corporate governance over the activities of the Payment Bureaus that will impose transparency and public accountability. Eliminate the capacity of the Payment Bureaus to extend or direct credit by moving appropriate payments system activities into the Central Bank and the commercial banking system. (It may be necessary to introduce measures to improve the operation of the payments system in the short term).

Finding: The Payment Bureaus control the functions shown in the following table, which lists each function, describes each function and recommends where this function should be placed in a free market environment.

Functions of the Payment Bureaus: Recommended Action and Potential Impact

Function	Description of Function	Recommended Action	Potential Impact
1. Payments System operation	Payment Bureaus have monopoly on all domestic payments.	Amend payment law to revoke monopoly status. Speed up plans for providing clearing mechanism through Central Bank. Allow commercial banks to provide payments services.	Positive-Banks could set up competitor while still able to use existing system. Fees should be reduced as a consequence. Providing payment service would increase the efficiency of financial intermediation through banks-by allowing banks to provide services to business and consumers-thereby attracting deposits Negative-no negative impact
2. Tax collection and distribution	Payment Bureaus currently collect all taxes.	Transfer function to Ministry of Finance, Cantons, etc. The tax collection function should be transferred to commercial banks. Tax administration and compliance has already been transferred to the Ministry of Finance	Positive-Reduce time and effort necessary to accomplish payments transactions because tax collection would no longer be implemented trough the payments system. This in turn could reduce underground economic activity and increase the size of the legal economy. Government revenues could be increased through greater incentives to participate in the legal economy. Tax collection efficiency may be improved. Negative-None if timed correctly.
3. Accounting Services	Payment Bureaus provide ex-ante accounting services for businesses and Government	Government and businesses should undertake these services for themselves.	Positive- Forces businesses to improve accounting ability, improves status of accounting profession, creates a private sector accounting service. Negative- none for businesses, but government will need alternative.
4. Cash Management	All businesses must deposit their cash with the Payment Bureaus every evening . All transaction greater than KM 100 must go through the Payment Bureaus.	Remove the requirement that all cash be sent to the Payment Bureaus and the requirement that all transaction above KM 100 must go through the Payment Bureaus.	Positive- Businesses can manage their own money, cash currently held at the Payment Bureaus will enter the financial intermediation system, and more cash is available for transaction purposes. Negative-Could reduce tax revenues short-term, because information on all transactions would be lost to government
5 Statistics Collection	PBs collect financial information on all businesses and provide analysis for Government purposes.	Transfer function to the Statistics Bureau.	Positive - places this function where it appropriately belongs. Negative – None
6. Lending Functions	Although not legally permitted, the Payment Bureaus provide credit under certain circumstances.	Provide proper corporate governance to control the Payment Bureaus' capacity to expand or create credit.	Positive- Would insure that Payment Bureaus funds are not misappropriated, and would close the gateway to breaches in the Currency Board rules regarding credit and money expansion. Negative- This could be politically sensitive. Those benefiting from credit will strongly oppose.

Focus on Payments System

Finding: The Payments Bureau activities penetrate every aspect of the economic lives of individuals and businesses through control of the payments system.

By law, every company in BiH must have accounts with a PB. Accounts for all three PBs are denoted by a three-part numerical code, which indicates the municipality, statistical code, and account holder. In addition to businesses and banks, governmental, cultural, civic, and other organizations have their own accounts, all with an accompanying three-digit statistical category. Tax collection is done through special numbered accounts. From these accounts, government funds are transferred to the accounts of government ministries and agencies, as well as to other organizations. Transfers from tax collection accounts to government accounts are free. On the basis of the three-digit statistical codes, the PBs compile economic and employment statistics and oversee all aspects of a company's finances. This system allows the Payment Bureaus to construct an ex-ante accounting of all revenues and expenses of all businesses in the country (at least, of those operating in the formal sector).

In addition, the Payment Bureaus place a remarkable set of regulations on commercial business activity. By law, businesses must observe the following regulations regarding financial and non-financial transactions:

1. All wholesale transactions must occur through a PB (wholesale transactions are defined as being greater than DM 99);
2. All barter-trade arrangements must be registered with a PB and treated as a wholesale transaction;
3. All retail operations are required to deposit 100% of revenues at a PB on a daily basis. They are not permitted to retain a portion of the cash to pay bills, make purchases, meet payroll, etc.;
4. All payrolls must go through a PB;
5. All taxes and customs duties must be paid through a PB;
6. All tax returns must be filed with a PB;
7. All deposits from a business to a bank must go through a PB;
8. A PB controls all funds deposited with and by a bank;
9. Each company is limited to KM/DM 1,000 petty cash withdrawal per day;
10. All petty cash expenditures must have matching receipts (petty cash expenditures are less than KM/DM 100).

As a result, the following economic activities are illegal:

1. All wholesale cash transactions;
2. Financial transactions through banks (with the exception of foreign payments);

3. Financial transactions between two legal entities (business to business, business to bank, etc.);
4. Withholding retail cash revenues from immediate deposit;
5. Meeting payroll through cash on hand;
6. Large petty cash withdrawals and expenditures;
7. Paying taxes in cash;
8. Depositing and withdrawing funds directly with a bank.

If a business operates according to law within the PB system, it has no need for a commercial bank account or standard commercial banking services, unless it is transferring funds out of the country or taking out a loan.

Implication: These policies and procedures undermine the development of the commercial banking sector and an effective system of financial intermediation by not allowing commercial banks the ability to offer services which could sustain customer relationships. Consumers and households have little reason to deposit funds in commercial banks, which in a normal market oriented system is the primary source from which funds are raised for intermediation purposes. The PBs thus break the savings-investment cycle and impair economic growth.

Recommendations: Commercial banks must be allowed to provide banking services, and the policies and procedures that act as barriers to this process must be removed. Appropriate laws need to be reviewed and if necessary changed.

Finding: Surveys of commercial banks and businesses revealed a number of qualitative costs associated with the current payments system. These costs include:

1. Reduced demand for non-cash payments and a lowered ratio of bank deposits to gross domestic product (GDP) (financial depth).
2. Favoring barter over monetary exchange.
3. Lessening specialization by firms and reducing the development of business such as subcontracting and outsourcing.
4. Encouraging imports at the expense of domestic producers - critical in a Currency Board environment.
5. Raising the necessary quantity of working capital for normal business activity.
6. Increasing payments system risk, especially fraud, increasing inefficiencies and payment delays, and creating legal barriers to problem resolution.
7. Reducing creditor information about potential borrowers and reducing the ability of banks to allocate credit efficiently.
8. Fundamentally undermining private property rights. Owners of financial resources in the Payment Bureaus have no legal recourse when the PBs confiscate their financial property. This reduces or eliminates the desire of foreign investors to invest in BiH.

Implication: This system fundamentally affects the allocation of resources and retards economic activity

Recommendation: This system must be changed.

Finding: The quantifiable costs of the BiH Payments System to the BiH economy are estimated at from KM 255 million to KM 311 million in 1997. This represents approximately 5 percent of GDP or over 20 percent of the combined budgets of the Federation and the RS for 1998. The study also finds that the BiH payments system is more costly and yet dramatically less efficient than West European payments systems.

Implication: A more efficient private sector payments environment could expand GDP, increase public revenues and result in less need for donor budgetary support for the Entity level Governments.

Recommendation: The donor community must demand an orderly transformation of the payments system.

CONCLUSIONS AND ACTION PLAN

The payments system needs to be transformed into an institution that will support a free market economic system, but this cannot be undertaken in a vacuum. The interrelationships among all of the functions provided by the Payment Bureaus need to be considered and their continuance assured. A strategic plan and suggested target dates for reform is presented in the following table. This plan is detailed in part II of this study. It should be noted, however, that the recommended plan and timeline should be fine-tuned after a complete functional audit of the Payment Bureaus is performed. The actual plan should also be flexible and allow for revisions as the reform process unfolds.

We finally note that the proposed reforms of the PBs may come at the social cost of a small increase in short-term unemployment. The PBs together employ approximately 2,500 people. Given the nature of the PB activities, many of their employees are likely to have skills that will be in demand as the commercial banking sector expands after PB reform and Bosnia's financial markets open up. Some PB employees will move to new jobs in the commercial banking sector, alternative clearinghouses, and other financial institutions with little need for retraining. There may be a need to establish training and placement programs for those who will experience difficulties in finding new positions. Early retirement programs should also be reviewed as viable alternatives for some workers that may lose their jobs.

The gains that will come from eliminating current PB practices will have an important positive impact on the level and growth of national income. This will in turn increase

public revenues, a part of which can be used to finance benefits for any former PB employees experiencing difficulties in the labor market. Worrying about inefficiencies in the process of reform is misplaced given the remarkable costs of current payments arrangements. Even if some social costs were incurred by the change, it would be far better to enter into a period of reform than to retain the abysmally wasteful status quo.

Action Plan and Timeline for Transformation of the Payment Bureaus in Bosnia and Herzegovina

Required Actions	**To be done Not later than:**
Reach agreement on the detailed transformation plan within the international community and with Entity and State governments	February 1999
Amend Federation Internal Payment Law to establish a new and improved managing board for the ZPP and good governance, transparency, and accountability	March 1999
Transfer of DM and Kuna domestically through ZAP and ZPP ended; all cash DM transferred to CBBH	April 1999: DM June 1999: Kuna
CBBH in cooperation with Entity Banking Agencies to develop and publish prudential standards for permitting banks to provide payment services	April 1999
Federation and Republic of Srpska to adopt a Payment Transactions Law and supporting legislation that governs payments rather than bureaus and establishes the rights and obligations of depositors, banks, and the CBBH; this Law will: -allow payment bureau account holders to transfer funds to a commercial bank of their choice; -provide legal provisions for checks and other payment instruments; -permit banks to establish correspondent accounts with each other and clear *on-us* transactions; -end requirement that all enterprises have accounts with the payment bureaus; -formulate laws on organizing clearinghouses	May 1999
Ending of the ZPP and SPP monopoly on payment processing	May 1999
RS Government will complete full separation of the SPP from the SDB and adopt amendments to appropriate laws to ensure proper operation and governance of the SPP (as above)	May 1999
PB management to cooperate fully with the international community in carrying out a functional audit of all of their activities, information flows, etc. and to provide relevant information and preliminary recommendations for the orderly transfer of functions to appropriate bodies	June 1999
CBBH develops payment order standards for interbank and other reserve account uses and for clearing customer payments through clearing houses or bilaterally	June 1999
All inter-entity settlement done in the CBBH	June 1999
Completion of financial verification of ZPP and SPP accounts by an internationally-reputed audit firm	June 1999
CBBH to develop rules and regulations governing banks' utilization of their reserve accounts at the CBBH to settle their net payments	June 1999
Begin process of building up Treasury functions at the Ministries of	June 1999

Finance	
Abolish overnight ceiling on cash holdings by businesses and the requirement that businesses deposit cash with the payment bureaus	August 1999
Adjust reporting requirements and other relevant instructions needed to enforce tax collection without reliance on payments bureau data; amend Tax Administration Law appropriately	August 1999
Establish new tax reporting systems in banks and businesses; enable the Ministries of Finance to collect taxes without need for payment bureau data	June 2000
Complete development of Treasury functions at the Ministries of Finance	June 2000
Banks meeting prudential standards for providing payment services and having established a new tax reporting system to open customer giro accounts and offer such services	(Once standards are met and reporting system put in place)
Develop alternate reporting mechanisms for state-owned enterprises, e.g. ex-post reporting	February 2000
Reassess PB's role as agents for storing and selling banknotes	December 200
Transfer statistical functions of the PBs to other institutions	December 2000
Organization of alternative clearinghouses	December 2000
PB clearinghouse assets (infrastructure and staff) that remain valuable to be sold off	December 2000

PART II

DETAILED REPORT
-- CONCLUSIONS AND RECOMMENDATIONS --

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Payment Bureaus in Bosnia and Herzegovina:
Obstacles to Development and a Strategy for Orderly Transformation

Section I. Introduction

The Payment Bureaus (PBs) operating today in Bosnia and Herzegovina (BiH) affect every aspect of the economic, business, and financial sectors, as well as the life of the average Bosnian citizen. The PBs are primarily agencies of state control rather than facilitators of private-sector decisions by entrepreneurs, innovators, and investors. While the current mixture of payments functions (i.e., payments system), revenue collection, public expenditure, data gathering, and bookkeeping is dysfunctional from the perspective of a market economy, it was appropriate from the perspective of a state-controlled socialist economy. The annual direct and indirect costs of the current payments system to the BiH economy in 1997 is estimated to be in the range of KM 255 to 311 million, or 5 percent of gross domestic product (GDP). The low end of this range, which is a very conservative estimate, is almost 20 percent of the combined 1998 budget for the Federation and the Republika Srpska (RS).

To the extent that the payments system is only one of many functions performed by the PBs, this report makes a clear distinction between the two. Historically, the PBs were given a monopoly over the payments system, which provided the PBs with the information necessary for controlling the nation's financial resources and for providing supporting services for other government functions, e.g., tax collection and financial auditing. The PBs operate under different names in BiH. In the Bosniak-majority region of the Federation, the PB is known as ZPP (Zavod za platni promet), in the Croat-majority region as ZAP (Zavod za platni promet), and in the RS as the SPP (Sluzba za platni promet).

Since the PBs are inappropriate to serve a free market economy, they are largely responsible for stifling the development of both a healthy and workable financial intermediation sector and business development and growth. Whether these Bureaus continue to function as they have in the recent past or are fundamentally reformed will play a key role in determining the degree to which the Bosnian economy enjoys sustained economic growth. The clear consensus among BiH business and financial operators, as well as the international community, is that the PBs as institutions must be abolished.

The two fundamental premises motivating this study are: (1) the current Payment Bureaus lack transparency and public accountability, and this fosters an environment conducive to corruption and political abuse, and (2) the current payments system, managed by the PBs, impedes the development of a market economy in BiH by imposing high costs on businesses and banks, by being too intrusive into and even abusive of the affairs of businesses and banks, and behaving in ways that violate the letter and spirit of the Central Bank Law.

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The objective of this study is to document the structure, functions and operations of the BiH Payment Bureaus, including the payments system activities they maintain. This documentation covers a wide range of topics, from what the institutions are allowed to do by law and what they actually do in practice, to the costs that these Bureaus impose on the economy. The study also compares the current payments system in BiH to payments system in market oriented economies and proposes a reform program to replace the current Payment Bureaus with modern institutions providing governmental and private sector services. Major reforms and transformation of the Bureaus, especially the payments system, are the keystones to stimulate substantial financial and economic growth in BiH in a transparent market oriented environment.

The study contains five components:

1. Description and documentation of all the functions and activities of the PBs and assessment of their impact on four sectors: government, financial intermediaries, businesses, and consumers.
2. Documentation of the non-transparencies and resulting abuses of the PBs' payments system functions and the potential for misuse of public funds.
3. Examination of the costs and benefits of PB practices and activities for the BiH economy.
4. A survey of commercial banks and businesses to understand their interactions with the current payments system.
5. A recommended reform program for the Payment Bureaus and payments system and comparison with previous reform proposals.

Section II provides a history of the SDK (Sluzba drustvenog knjigovodstva—Service of Social Bookkeeping), the former Socialist Federal Republic of Yugoslavia (SFRY)'s Payment Bureau, which is the predecessor of the BiH systems. The structure and functions of the current Payment Bureaus is then described, followed by analysis of the payments system in BiH as operated by the Payment Bureaus. As a reference point for comparison, this section includes an outline of what a modern payments environment should look like. The BiH Payment Bureaus are then analyzed from two viewpoints: what they are responsible for doing by law, and what they actually do in practice. Insights on the actual operation of the PBs are gained from a survey of 30 businesses and 5 banks in both Entities. Detailed descriptions of the individual interviews with businesses, banks, and PB officials are contained in four annexes.[2]

The practices identified in the interview survey impose many important costs on the BiH economy. These costs are reviewed in sections III and IV, which also present quantitative

[2] Annex 1 contains descriptions of current ZPP procedures; Annex 2 contains interviews with BiH businesses; Annex 3 contains interviews with BiH banks; Annex 4 contains interviews with ZPP, ZAP and SPP officials.

estimates of the impact of the PBs on the BiH economy. Estimates are made of direct operating costs of the PBs; the excess labor firms are required to expend in dealing with the PBs, the degree of underdevelopment of the BiH financial sector, and the impact of this underdevelopment on economic growth. These quantitative costs are compared to the level of BiH national income and to the costs of payments systems of other countries, and it is shown that the BiH payments systems are more costly and dramatically less efficient than West European payments systems.

The final section presents a suggested program for reform and provides a timetable for specific actions.

Section II. Payment Bureaus

"The Office of social bookkeeping operates domestic payments systems to provide data on current financial developments and ex-ante control of legality of creation and utilization of socially owned capital." (Article 93 of the Law on the Office of Social Bookkeeping from 1983)

A. Historical Overview of the BiH Payment Bureaus

The structure and organization of the current BiH payments system is very different from its counterpart in market oriented economies, because it is a product of the BiH Payment Bureaus which was primarily responsible for managing socially owned resources in the implementation of a central plan. The Payments Bureau of the former Socialist Federal Republic of Yugoslavia (SFRY) was based on "social bookkeeping," a program introduced in SFRY in the early 1950s. Social bookkeeping was justified by the fact that SFRY had a "socially-owned" economy. Social bookkeeping was designed to maintain complete control over the creation and use of socially owned capital, collection of taxes and social security contributions, and decision-making in a presumably decentralized "self-management" system.[3]

Social bookkeeping developed after financial inspection functions were transferred from the Ministry of Finance to the National Bank of Yugoslavia (NBY) into the early 1950's. Until 1959, social-bookkeeping services were fully integrated in the NBY and were treated as one of its functions. During this period, formal law did not explicitly regulate social bookkeeping. The first law to regulate social bookkeeping, the Law on Social Bookkeeping (LSB), was adopted in 1959. The LSB established social bookkeeping as a public service, stipulated that it was performed by the NBY, and defined its functions to be maintaining records on and helping to control the creation and utilization of socially owned capital, maintaining records on economic developments, and controlling the payment of tax and social security payments by socially-owned companies.[4]

[3] Unlike the classic Soviet-type socialist economy, most firms in SFRY were nominally owned and controlled by their workers. Other socialist countries achieved comprehensive control of their economies through formal central planning, and payments and banking activity were conducted through institutions called "monobanks." Although SFRY seemed to rely on a different set of more decentralized institutions to perform banking and payments functions, this decentralized structure was in fact a facade. In practice, every transaction using socially owned capital was subject to the controls of a mono-banking system using a vast network of payments-system branches and using the services of social bookkeeping.

[4] The LBS reconfirmed the transfer of financial inspectors from Ministry of Finance by acknowledging that financial inspectors were employees of the social bookkeeping department of the NBY. Inspectors were headed by a general financial inspector appointed by the Cabinet. Oversight of the operations of the social bookkeeping function was the responsibility of the Governor of the NBY. The NBY reported about the social bookkeeping operations to the SFRY Parliament. The LBS also stipulated that the social bookkeeping department of the NBY was to be headed by a general manager appointed by the Cabinet. Its internal organization, fields of activities, and powers were defined in a separate constitution of the NBY. This constitution was drafted by the Cabinet and approved by the Parliament.

In 1961, a new law on credit and other banking services introduced giro accounts into banks. Until then, "banks" were actually non-autonomous territorial branches of the NBY. They kept accounts for all local clients, including socially owned companies. The 1961 law took socially owned company accounts away from banks and put them within the NBY. Banks were left with only the accounts of self-employed (e.g. craftsmen) and natural persons.

In 1962, amendments to the LBS re-organized the social bookkeeping system. Social bookkeeping was no longer conducted by a department of the NBY but by a separate agency under the umbrella of the NBY. More importantly, the amendments transferred operation of the domestic payments system to that agency and turned branches of the NBY into branches of the agency. This integrated the domestic payments system and social bookkeeping service into one agency called the Office of Social Bookkeeping (SDK).[5] The NBY and SDK were separated on 1 November 1962. The accounting and payment mechanism established at that point in time has survived fundamentally unchanged until today.

Further amendments to the LBS passed in March 1965 took the SDK completely out of the NBY structure and gave it the status of a separate legal entity. From 1965 to 1967, the general manager of the SDK was nominated by the Cabinet and appointed by Parliament, and the constitution of the SDK was proposed by the SDK and approved by Parliament. The SDK reported directly to Parliament, but the Cabinet maintained the right to define and control the rules and procedures governing social bookkeeping services. In 1967, a new law regulating SDK governance was adopted, the Law on the Office of Social Bookkeeping (LOSB), which further strengthened the SDK's independence.[6]

During 1971-74, changes to the Yugoslavian constitutional system strengthened the role of the republics, and changes were made in SDK law during 1972-77 to reflect this. The final changes to the LOBS in the SFRY era were made in 1983 and defined the SDK as a unified and independent organization. The SDK was to provide social bookkeeping and domestic payment services in its capacity as a shared public service of socially-owned companies and other users of socially owned capital, and an information-dissemination service of the social information system.

There are three key characteristics of the SDK that should be kept in mind when analyzing its descendants in BiH, the ZPP, ZAP, and SPP:

[5] The first article of the new law stipulated "A branch of the National bank is a primary organization unit of the social bookkeeping service which at the same time operates activities which according to the constitution of the National Bank and by their nature pertain to the National Bank." (Law on Amendments to the Law on Social Bookkeeping, Official Gazette of SFRY, no. 30, 25 July 1962)

[6] The right to propose a candidate for the general manager position was taken away from the Cabinet and assigned to Parliament, and the SDK was given exclusive rights to define its constitution

1. The SDK was designed to operate the domestic payments system as a mechanism to assure complete control of the creation and use of socially owned capital and to ensure the payment of taxes and social security contributions;

2. The payments system was accordingly designed and operated as a control system that fully resembled the institutions called "monobanks" in other socialist economies. The payments system operated by SDK was thus not built to provide payment services as traditionally understood in market economies;

3. Frequent changes to the legal basis of the SDK's operations since 1962 strengthened the independence of SDK but changed neither its goals and functions nor the way the payments mechanism was structured to support these goals and functions. The payments mechanism has thus remained fundamentally unchanged since November 1 1962, when the SDK took over operation of the domestic payments system from the NBY.

In 1991, SFRY began to dissolve, and in 1992; BiH declared independence. The subsequent civil war led to the creation of three separate payments systems in BiH: the ZPP that operates in the Bosniak-majority areas of the Federation, the ZAP that operates in the Croatian-majority areas of the Federation, and the SPP that operates in the Republika Srpska. Although the ZPP and ZAP are nominally unified as one payments system, in practice they operate as "parallel institutions" and are essentially independent organizations.

B. Current Structure and Function

What do the successor systems of the SDK do? We present a portrait of the BiH PBs as it exists in the laws of BiH. The legal portrait given in this section describes the PBs' legally mandated functions and their official governance system. This portrait contrasts sharply with the one presented in the following sections where the activities of the PBs are described from the perspective of their users.[7]

The ZPP and ZAP have changed little since their break away from the SDK, and the SPP remained integrated into the Yugoslav SDK. Their operating procedures and policies essentially parallel those of the SDK. A description of the policies and procedures of any

[7] The ZAP is the Payments Bureau that serves the Croatian-majority areas of the Federation. While theoretically a part of the Federation's ZPP system, it in practice operates completely independent of the ZPP and appears to be under HDZ control. Although it does not make loans as the ZPP and the SPP, its reliance on a foreign currency to denominate its transactions is troubling. The ZAP is supposed to follow the same rules and regulations that the ZPP does, as the two Bureaus are nominally unified.
The SPP remained connected to the Yugoslav SDK that combined forms an integrated payments system. The SPP is located inside the Development Bank of the Republic of Srpska (DBRS), which thus holds a monopoly over the payment system using mainly the Yugoslav Dinars but otherwise operates like the ZPP

of the three PBs therefore serves as an adequate description of all three. In the following discussion, the ZPP was chosen for this purpose. Interviews with each of the three PBs revealed that no major changes had occurred in their operating policies or procedures (see Annex 4: Interviews with the Payment Bureaus). The SPP has been moved into the Development Bank of the Republic of Srpska but operationally continues to function as it did prior to this change. The only significant change in the operations of the PBs that was identified involved not enforcing the rule that requires all payments in excess of DM 100 to go through the Payments Bureau. Otherwise, all three PBs look similar.

The ZPP, nominally a unified payments system for the entire Federation but in practice serving only the Bosniak areas of the Federation, is regulated by the Law on Internal Payments of 1995 and amendments to it of June 1998. This law "regulates internal payments flow..., sets organizations licensed for the payments and founds the ZPP of Bosnia and Herzegovina."[8] The 1995 Law defined the payment process as "accrual on an account, account to account transfers, collection from an account, downloads to an account and payment from an account" (Article 3) and defined a wide range of activities that were performed under Central Bank oversight and supervision (Article 7). The July 1998 amendments took supervision and oversight away from the Central Bank and made the ZPP directly responsible to the Ministry of Finance (MoF) of the Federation Government. The ZPP is authorized by law to conduct the following 12 activities:

(1) Maintain accounts of authorized organizations, legal entities and parts of legal entities, and shops and individuals, accounts for payments and allocation of public revenues, and accounts for accrual of payment turnover, and perform payments on those accounts;
(2) Collect, disburse and maintain records of government finances;
(3) Perform business operations of the cash payments system;
(4) Hold deposits and safeguard cash;
(5) Exchange and retain damaged and worn bills and coins;
(6) Perform treasury functions for banks and other payments system organizations;[9]
(7) Maintain and report on the account balances of licensed organizations;
(8) Accrue payment turnover of other bearers of the payments system;
(9) Provide records for credit and monetary policy and for overview of the economy;
(10) Perform control operations determined by special regulations or contracts;
(11) Submit daily copies of reports to the treasury of Federal Ministry of Finance about the balance and changes in the accounts of the Ministry;
(12) Regulate other payment flow activities determined by Law or contract.

[8] All references to the Law on Internal Payment are from the Official Gazette Federation of BIH, February 1995 and, as relevant, the Law on Changes and Amendments to the Law on Internal Payments System, Official Gazette, June 1998, and as further modified in a request to Parliament by the Minister of Finance on 3 July 1998.
[9] Treasury functions include management of cash and equivalent (short-term notes and securities) on both sides of the balance sheet, calculation and maintenance of monetary reserves, oversight of activities in the interbank market, and determining the amount of cash a commercial bank is allowed to keep on its premises.

These activities can be grouped into five basic ZPP functions:

- Payments system functions (involving activities 1,3,8,10,12);
- Government finance functions (involving activities 1,2,10,11,12);
- Central bank functions (involving activities 1,4,5,6,7,8,9,10,12);
- Private-sector banking functions (involving activities 1,3,4,5,6,7,8,9,10,12);
- Statistics and information functions (involving activities 1,7,9,11).

There are necessarily substantial overlaps (multiple assignments), because some of the activities are quite general financial record-keeping, transfer or control tasks, and many of these activities entail the transfer of funds or payments from one agent to another due to the nature of finance or double-entry accounting.

It is inappropriate to have payments system, Central Bank, private-sector banking, and possibly statistics and information functions under the control of the MoF of the Federation Government. Central Bank and private-sector banking functions in particular could and should be located in different institutions. Payments system functions should also be supervised elsewhere, in order to rationalize monetary policy, support the development of the financial sector, and spur the adoption of more efficient clearing procedures. The statistics and information function also arguably should be done in an autonomous agency not under the control of the MoF to facilitate independent review and oversight of government finance.

The first ZPP activity identified in the Law, maintenance of accounts and performing payments on those accounts, is a very broad activity that touches on each of the functions. For example, this activity includes the maintenance of accounts for "authorized organizations" that include both the central bank and commercial banks, maintenance of public revenue accounts that are part of the government finance process, and making payments on these accounts, which is the primary function of the payments system. Activity 12 is also a catchall category that should be included in all of the five functional groupings. The other activities overlap to a lesser extent.

The following is a brief discussion of the five functions along with the various activities assigned to each function:

Payments system functions (activities 1,3,8,10,12)

Payments system functions transfer funds from the payer's account to the payee's account. Thus, in addition to activities 1 and 12, we assign activities 3, 8, and 10 to this function. Activity 3 is cash management operations, which may occupy either the payments system or commercial banks, activity 8 is self-explanatory, and activity 10 is simply a catchall to cover financial transfer activities that will require financial control in their execution.

Government finances functions (activities 1,2,10,11,12)

This functional group encompasses activity 2 (the collection, disbursement and accounting for government financial flows), activity 10 (responsibility for financial control as directed by regulations), and activity 11 (the daily reporting process for the treasury of the Ministry of Finance and its accounts).

Central bank functions (activities 1,4,5,6,7,8,9,10,12)

The Central Bank of BiH (CBBH) should have assigned to it the responsibilities under activity 4 (holding deposits and safeguarding cash), activity 5 (exchanging damaged or worn-out currency), activity 6, 7, 8, and 9 insofar as they affect reserve management, clearing, and a potentially CBBH-mediated interbank market. Activity 10 also applies here.

Private sector bank functions (activities 1,3,4,5,6,7,8,9,10,12)

Activities that naturally would be within the purview of private-sector banks include activity 3 (performing business operations of the cash payments system) and activity 4 (holding deposits and safeguarding cash, which are the quintessential banking functions). In most countries, commercial banks assist the Central Bank in screening currency that should be removed (activity 5). Activities 6 through 10 are record keeping activities that commercial banks have to perform, but for which there may or may not be a commercial bank reporting function role.

Statistics and information functions (activities 1,7,9,11)

Statistical record-keeping and reporting activities will be shared by all five functions, but the Government's statistical agency will be the only one for which these activities are the primary function. Besides the omnibus activity 1, we include here the three record-keeping activities 7, 9, and 11. The foundation for financial oversight begins with an autonomous agency that has access to and oversight of records to be reviewed and audited.

It is extremely important to note that the ZPP is directed by law to report to the Federation MoF and not to the CBBH. Indeed, all governance relations between the CBBH and ZPP have been deleted by the amendments of July 1998. The ZPP is now an agency of the Federation Government and is directly controlled by the MoF. Article 29 of the 1995 Law stated that the ZPP was subjugated to the NBBH and that it was required to submit annual reports and operation plans to the NBBH, which became part of the NBBH's annual plan. The amended Law of 1998 now has the ZPP subjugated to the Federation MoF, to which it submits annual reports and business plans. The shift of ZPP supervision appears not only in the amended Article 29 but also in Articles 8, 46, 48, 51, 61, and 69. The rationale offered for these changes is that "only the Federation has

authority to proclaim regulations about finance and financial institutions of the Federation."[10]

Control of the ZPP has thus been shifted from the CBBH, whose central concern is control over monetary policy, to the Federation MoF, whose primary concern is revenue collection and distribution. Whereas the ZPP was formerly governed by a board drawn primarily from the NBBH, it is now overseen by a board comprised of finance ministers: the ZPP's director is the Minister of Finance of the Federation, and the board members are the Ministers of Finance of the 10 Cantons of the Federation. Since the ZPP is involved in the monetary process and has the potential to affect the quantity of money, there is a real potential for a conflict of interest between the Federation's focus on revenues and the CBBH's focus on monetary control.[11] This potential conflict of interest became reality in July 1998, the same month in which the Law was amended to transfer control to the Ministry of Finance.

During the summer of 1998, the process of liquidating the National Bank of Bosnia and Herzegovina (NBBH), the predecessor of the CBBH, began. The closure and eventual liquidation of NBBH are necessary both to assure the integrity of the CBBH Currency Board and to qualify for the second tranche of the IMF stand-by facility. On 16 July, the liquidator of the NBBH, ordered that its deposits be frozen, a standard step in any liquidation process. The Minister of Finance of the Federation declared that the freeze order was not in compliance with the Federal law on internal payments and ordered ZPP not to comply with it. Flouting of the freeze order would not have been possible under the Law on internal payments prior to the July amendments. The implications of the Minister's order are serious for the Central Bank, for the rule of law, and for the Constitution as mandated in the Dayton Peace Accord.

It is also very important to note that changes to Articles 36 and 37 by the July 1998 amendments deleted reporting responsibilities for ZPP in the event of bank overdrafts, and this creates the possibility of monetary expansion in violation of the currency board arrangement. Article 36 of the 1995 Law obliged the ZPP to inform the CBBH about an illiquid bank's situation, but the amended Article does not. Article 37 of the 1995 Law charged ZPP to compel a bank to replenish its reserve account if it was insufficient to meet reserve requirements, and to do so for the bank if it did not comply, but this article was deleted in the amended Law.

[10] Law on Changes and Amendments to the Law on Internal Payments System, Official Gazette FBIH, June 1998, Explanation, and Constitutional Basis. The reason for passing the law, the following was offered: "Establishing unique, direct, and immediate internal payments system on the areas of Federation of BiH is one of the main postulates for the operation of the economic and financial system, and especially for the system of insuring and making payments to public revenues and filling out and accomplishing the accruals on each level."

[11] That this potential has been at least occasionally actual is alleged in some of the interviews with banks and business respondents in our surveys; see below in II.B and II.C.

C. Other Payment Bureaus Practices and Procedures

The formal practices and procedures of the BiH PBs are described in detail in Annex 1. Understanding these practices and procedures is important for analyzing the functioning of the PBs in the area of payments systems and their impact on the economy. This section presents a brief summary of the key aspects of these practices and procedures.

By law, every company in BiH must have accounts with a PB. Accounts for all three PBs are denoted by a three-part numerical code, which indicates the municipality, statistical code, and account holder. The vast majority of businesses and organizations utilize the 601 statistical code, while banks use the 620 code. In addition to businesses and banks, governmental, cultural, civic, and other organizations have their own accounts, all with an accompanying three digit statistical category. Tax collection is done through special 840, 842, and 845 accounts. From these accounts, government funds are transferred to the accounts of government ministries and agencies (typically with the code 637), as well as to other organizations. The PBs charges no fees on these transfers. On the basis of the three digit statistical codes, the PBs compile economic and employment statistics and oversee all areas of a company's finances. It is suspected, but not yet definitively proven, that some funds could be transferred to the accounts of the political parties or used for other than official purposes. The PB accounts are denominated in different currencies in different areas. The ZPP denominates accounts in KM and DM, the ZAP in KM, DM and Croatian Kuna, and the SPP in KM and Yugoslav Dinars.

In the Federation, the ZPP also places a remarkable set of regulations on commercial business activity. By law, businesses must observe the following regulations regarding financial and non-financial transactions:

1. All wholesale transactions must occur through the ZPP (wholesale transactions are defined as being greater than DM 99);
2. All barter-trade arrangements must be registered with the ZPP and treated as a wholesale transaction;
3. All retail operations are required to deposit 100% of revenues at the ZPP on a daily basis. They are not permitted to retain a portion of the cash to pay bills, make purchases, meet payroll, etc.;
4. All payrolls must go through the ZPP;
5. All taxes and customs must be paid through the ZPP;
6. All tax returns must be filed with the ZPP;
7. All deposits from a business to a bank must go through the ZPP;
8. All funds deposited with and by a bank are controlled by the ZPP;
9. Each company is limited to DM 1,000 petty cash withdrawal per day;
10. All petty cash expenditures must have matching receipts (petty cash expenditures are less than DM 100).

As a result, the following economic activities are illegal:

1. All wholesale cash transactions;
2. Financial transactions through banks (with the exception of foreign payments);
3. Financial transactions between two legal entities (business to business, business to bank, etc.);
4. Withholding cash retail revenues from immediate deposit;
5. Meeting payroll through cash on hand;
6. Large petty cash withdrawals and expenditures;
7. Paying taxes in cash;
8. Depositing funds directly with a bank.

If a business operates according to law within the ZPP system, it has no need for a commercial bank account or standard commercial banking services, unless it is transferring funds out of the country or taking out a loan. This effectively undermines the development of the commercial banking sector and an effective system of financial intermediation. Currently, the PBs require each business to have a contract with a commercial bank, which allow the PB to allocate KM deposit by a firm to a particular bank. This requirement by the PBs is simply for their accounting purposes. Thus, while businesses must have accounts with banks, their deposits are completely controlled by the PBs.

The PB system seriously represses the flow of funds in the Bosnian economy. This is a critical weakness, because the chronic absence of liquidity in the economy is seriously constraining its growth. The total active loan assets of the domestic banking system are estimated at less than DM 500 million. Routine receivables- and inventory-based working capital credit lines are not available.There are no cash management activities, no short-term deposit instruments, and no commercial paper. Yet the highly intrusive practices of the PB's, which create significant costs and uncertainties for those transferring money through the system, make them avoid the system whenever possible. This is reflected in the very high level of cash transactions relative to total economic activity, in the prevalence of non-monetized barter transactions, and in the sizeable amount of domestic transactions that are settled through external transfers at foreign banks.These activities directly deprive the system of loanable funds. In addition, the PB's themselves hold, a large idle balances (KM 400 million) at any time.Finally, the difficulties of dealing with the PB's, but the legal requirement to do so, are major deterrents to foreign investment in Bosnia. With an efficient, western-style payments system, all of these sources of funds would be in the system and normally available for banks' funding activities, financing a wide range of credit needs, from banks' covering overnight shortages to long-term credit for businesses.A conservative estimate of the aggregate of these withheld sources is at least DM 1 billion – 3-4 times the total donor contribution to the Bosnian commercial sector in 1998.

Section III. Payments Systems

In order to evaluate the impact of the BiH Payment Bureaus on the economy it is necessary to focus on the payments system and how it operates. There are two ways in which this can be done. First, the formal laws that govern payments system activities can be reviewed, and the tasks that these organizations are legally charged with performing can be identified. Second, the users of the services that these systems provide can be queried as to what these systems really do. Both the *de jure* and functioning of the BiH payments systems were evaluated in the previous section as part of the evaluation of the Payment Bureaus. The *de facto* functions of the BIH payments systems as described by users of this system is presented in this section, following a brief description of what a payments system does in a market oriented economy, which is intended as a frame of reference or as a base line against which to measure the efficiency or inefficiencies of the BIH payments system.

A. Payments Systems in Market Economies: A Base Line

Payment Bureau operations undermine the ability of commercial banks to develop customer relations by providing payment services. This impacts the commercial banks relationship with both businesses and consumers. More importantly the lack of being able to provide payment services undermines the ability of the banks to attract deposits which are the basis for financial intermediation.

In a market economy, the means of production are privately owned, and individual owners make decisions on their use. The payments system facilitates the execution of these decentralized decisions. In contrast, in a centrally planned economy with social ownership of the means of production, the payments system is a means of control to ensure the execution of the plan. The payments system is integrated with record keeping and taxation, which is not the case in market economies but which is logical in centrally planned economy.

The process of clearing and settlement of payments is an integral part of any financial system, no matter how it is designed. In a market economy, payment systems support the development of markets for goods and services, efficient financial management by business firms, households, and the public sector, and the development of the financial system. The financial system in turn contributes to economic well being by allocating scarce resources efficiently. Such efficiency is best achieved when decision-makers have good incentives and are guided by prices, and there is substantial competition.

In any economy, payments can be made in several ways. *Barter transactions*, in which goods are exchanged for goods, are both primitive and inefficient, because it is difficult to match together two people who have goods that match the other's needs. *Cash transactions* are the simplest of all true financial transactions. A payer gives cash to a

payee in exchange for goods or services, with delivery of both usually being simultaneous. There are no other parties involved in the transaction, no delays between the sending and receiving of payment, and no need to determine the credit standing of either party. The vast number of transactions in any economy are cash transactions. Even in developed economies, where there are many alternatives, roughly 80% of all transactions are conducted with cash. However, in value terms cash transactions account for only a very small proportion of total payments made, because the average size of each cash transaction is quite small.

In order to conduct cash transactions, the parties must be in close physical proximity and must have physical possession of the cash and the good or service rendered while in close proximity. There is also usually little or no evidence of the transaction being made, making it difficult to track it for purposes of accounting or control, and there are risks involved in carrying the cash. For these reasons, most nations have moved to payment arrangements that involve more complex relationships among a number of parties and more efficient transfer of large amounts of funds in which delivery and payment may not be simultaneous and the parties may not know each other. Whenever there is not delivery versus payment, there is an element of credit judgment in the transaction: either the payer must trust the payee to deliver goods or services, and/or the payee must trust the payer to deliver payment. Also, since the physical movement of currency is usually impractical, the payer must make some other arrangement through an acceptable third party to transfer payment.

More advanced types of payment transactions involve risks not present for cash transactions. *Counterparty risk* occurs when the payee receives a document indicating that the payer has funds, but upon presentation of the document, there are not sufficient funds available. If the transaction involves third parties such as banks, it is also possible that the bank itself does not have sufficient funds to meet all such claims, even though the individual payers may have sufficient funds. Since this usually occurs at the end of a time period (usually a day) when banks net out and settle all their claims on each other, this is known as *settlement risk*.

Non-cash payments transactions come in two general types: debit and credit transfers. A *debit transfer* occurs if a document is sent by a payer to a payee authorizing a third party (usually a bank) to transfer funds to the payee or his agent (usually another bank), the payee deposits the document with his bank, and the bank of the payee then presents the document to the bank of the payer to transfer the funds. In a debit transfer, there is always a possibility of Counterparty risk. Debit transfers also create "float," which is the amount of funds outstanding (money or credit created by mismatches between debits and credits) during the period in which they are not yet collected by the payee. A *credit transfer* occurs when a payer notifies his bank to remit funds to the bank of the payee. There is no Counterparty risk in this case, as the bank of the payee will determine whether

there are sufficient funds to honor the request. Also, there is no incentive for the payee or his bank to expend real resources to expedite payment.[12]

Both debit and credit transfers may involve settlement risk, depending upon how the banks deal with each other in transferring the funds. If both the payer and the payee use the same bank, so that the transfer is an *on-us* transaction, settlement risk is not present. If the payer and payee deal with different banks, there are two basic options to handle the transfer. First, the two banks may deal with each other directly. The banks could choose to engage in *gross settlement* and process each transaction separately as it arrives. This is quite complicated and requires a great deal of liquidity. Alternatively, the two banks could engage in *net settlement* and add up all the claims that they have on each other at the end of a designated time period; as many claims would cancel each other, only a much smaller net amount would need to be transferred. A problem occurs if the bank that needs to send an amount to the other bank in order to settle cannot meet the obligation.

It is usually even more efficient to have a number of banks combine into a *multilateral settlement* system. When many banks are involved, there is usually some type of clearinghouse arrangement in which all banks deal with a central institution, the clearinghouse, and all claims on netted out on a multilateral basis. This requires even fewer resources, but settlement risk is still present and even less transparent since the net obligator and recipient may not have dealt with each other. The complex transactions involved in multilateral settlement may have to be unwound if one bank fails to clear its obligations, and there exists the possibility of *systemic failure*. In order to avoid such problems, especially for large value payments, many countries rely on the alternative *Real Time Gross Settlement* (RTGS) system that settles payments in real time on a gross basis.[13]

Payments systems in market economies do entail costs. The direct costs of payments systems in developed market economies are estimated to be less than 2.7% of GDP. These costs include the operating costs associated with processing payments and the costs associated with risk management.[14] There are some basic findings on how payments system costs can be lowered. First, credit transfer systems have lower costs than debit transfer systems. Second, electronic transfer systems have lower costs than paper-based systems. Third, the pricing of payment services should directly reflect costs.

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[12] In the case of a debit transfer, flow of information goes from payer to payee while the transfer of funds is initiated by the payee with instructions to the bank of the payer; in the case of a credit transfer, funds and information flows go in the same direction. It is also true that the number of steps required to process a debit transfer are much higher than for a credit transfer, and real resources are expended at every step in the process.

[13] RTGS systems are usually managed by a country's Central Bank and settle through the reserve accounts of commercial banks held by the Central Bank. One problem with RTGS systems is that during the day, customers of a commercial bank may be receiving and sending funds in amounts that cause the bank's reserve account held at the Central Bank to have a negative balance. This situation is known as a daylight overdraft. To avoid such problems, the Central Bank and commercial banks work out systems of risk management to discourage these overdrafts.

[14] Banks, customers, clearinghouses, and central banks have to spend real resources to deal with Counterparty and settlement risk. For example, in an RTGS system, the extension of daylight overdraft credit is undesirable, and avoidance of overdraft credit requires oversight and monitoring.

Finally, those who benefit from a payment service should bear the cost, and this is a problem for debit transfer systems.[15]

B. Comparison with BiH Payments System

The Payment Bureaus system in BiH does not support the development of a viable banking sector. In BiH, the ratio of bank deposits to GDP is approximately 10%. In many emerging economies, the ratio is much higher, in the general range of 50%. Therefore, the banking system in BiH could realistically be more than four times its present size. That would imply improved liquidity, greater resource availability, and improved resource allocation. However, any financial system intermediates between suppliers of funds and users of funds. In most economies, the largest net domestic supplier of funds is the household sector. However, in BiH, there is little reason for households to become customers of banks supplying them funds-since there is little available for households in the way of services. There are no payment services for individuals, no credit services, and no wide array of deposits and investment products available. There are no card systems (credit or debit), no automatic teller machines (ATMs) or point of sale (POS) systems.

It has been shown that households consider the financial institutions that supply their payment services to be their primary financial service provider. Hence, that is the first step in developing and marketing financial services to households. Most other services are then tied to the payments account. Existing payment arrangements in BiH impede the development of such a set of products and services. Moreover, the lack of a viable, competitive payments system is a substantial impediment to the attraction of foreign capital to the BiH banking system.

In short, the existing payments system impedes business development by not allowing banks to specialize in information assessment and credit judgment, resulting in a dearth of liquidity and a misallocation of resources. Current payment arrangement do not allow the household to efficiently manage its payments, and financial sector repression limits the availability of households to have access to credit, savings, and investment products that allow them to achieve their goals. Finally, the current system gives little incentive for households to conduct business through the financial system, repressing the development of financial intermediation.

While the development of sophisticated money and capital markets (with the exemption of an effective interbank market) is beyond the scope of this project, it should be noted that such markets are held together by an efficient payments system. This is the reason that the TARGET (Transeuropean Automated Real Time Gross Settlement Express Transfers) system is such an important segment to the movement to European Monetary Union. Hence, the further development of such markets in BiH, and their links to the EU, require a more efficient modern payments system.

[15] Because the payer benefits from float while the payee and his bank incur costs to minimize the float.

C. User Perspectives of the BiH Payments System

What do the BiH PBs actually do as a payments system? To complement the previous review of formal law and PB practices and procedures, the USAID study team conducted a survey that involved interviewing 30 businesses and 6 banks in both the Federation and the RS. These interviews, presented in details in Annexes 2 and 3, describe the experiences of business managers and bankers in their dealings with the PBs. Survey respondents represent a wide cross-section of the BiH economy. They include Bosniaks, Croats, and Serbs from both Entities engaged in the manufacturing, construction, mining, hospitality, telecommunications, apparel, banking, and information sectors of the economy. Many of the survey respondents were apprehensive about discussing the PBs openly, and most asked for anonymity. Several businessmen refused to discuss the matter at all, indicating they could suffer repercussions if someone found out. In addition, several PB workers were surveyed on an informal basis to get their thoughts on the inner workings of the system, and they too asked for anonymity.

It would not be surprising to find some differences between the *de jure* and *de facto* descriptions of the PBs. The interviews strongly suggest, however, that there are very substantive discrepancies between what the law prescribes and what the clients experience. Many respondents suggested that PBs might be involved in serious violations of law and abuses of power. It is believed that these practices are detrimental to the development of business activity and the private sector in BiH.

1. Survey of Commercial Banks

The BiH payments systems have major impacts on the functioning and development of the commercial banking sector. This section summarizes these impacts, and discusses the potentials and capabilities of the banks to immediately replace some of the payment functions of the PBs. The descriptions provided here are based on and supported by over two years of international community experience working with banks and bank regulators, and the interviews conducted with banks in the Federation and RS. The nature of the relationship between the banks and the PB varies by area, which will be described as appropriate throughout the discussion.

(1) Intermediation of DM Deposits

A large volume of deposits, estimated at DM 400 million, is sitting in the vaults of the ZPP and ZAP and is not being "openly" intermediated. This money represents the cash holdings of all businesses, which is required to be held at the ZPP at no interest. This money is "on account" at the ZPP or ZAP, and companies may use it to make payments between each other, but it is not available to banks to be loaned to the commercial and household sectors. At the average current interest rate in the Federation, about 24% per annum, this results in over DM 86 million opportunity cost (i.e., lost interest income to the

Federation economy per year) for not utilizing this amount.[16] By any measure, this is a highly wasteful use of resources in a country with few internal sources of investment funds. However, there is the probability that ZPP is using these funds to generate, but not report on, additional cash flows through illegal lending and investment activities. It should be noted that these activities were hinted at in the surveys but are not recorded on the ZPPs books. The total amount of deposits recorded on banks' active balance sheets in the Federation is approximately KM 600 million. Allowing banks to intermediate DM 400 million funds held at the PBs would result in an immediate increase in total Federation deposits of well over 50%. In the RS, the amount held by SPP is smaller, estimated at DM 50 million. However, this money can be intermediated through the Development Bank of the Republika Srpska (DBRS).

(2) Asset and Liability Management

Banks have difficulty predicting the deposit levels on their balance sheets under the current system. They also have difficulty predicting customer behavior. This is because a bank's customers can access their funds through either the bank or the PB. Theoretically, banks find out their deposit balances the following day, but in practice, this can take up to a week (see section on business survey). However, information on customer balances and behavior is a major source of information for decisions on credit allocation in a market based banking system. The result of this is that banks cannot appropriately make asset/liability management or credit allocation decisions.

(3) Increased Cost and Complexity of Payment Transactions

All internal payments must be made through the PBs. In the case of payments ordered through the banks, this means that the fee to the customer consists of the PB's fee(s) plus the bank's fee. For example, if a customer in the Federation wants to move his money from his bank account for external payments to his bank account for internal payments (both accounts being held in the same bank), he orders the bank to make the transaction, the bank files a payment order with the PB, a fee of 0.3% is charged, of which 0.1% goes to the PB and 0.2% to the bank, and the following day, the bank is informed that internal payment account has been credited. In this example, the customer has to pay 0.3% and lose the use of his money for one day just to move money between two of his own accounts at the same bank.[17]

[16] We ignore here the lost creation of money and economic activity through the multiplier effect, which results from denying these funds to the commercial banking sector.

[17] We note that it there is evidence that the ZPP and ZAP charge a fee twice for the same transaction ("hit both sides of a transaction") In this case, the total ZPP/ZAP fee would be 0.2%. If any telephone or wire service is involved, the ZPP/ZAP charges additional fees that could conceivably put the total charge at 0.4%.

(4) Forcing Participation by Companies in the Domestic Banking System

Companies have no choice regarding whether or not to participate in the domestic banking system. To be a legally registered enterprise, a company must open a KM account at the PB, and this account must be linked to a domestic bank. Options such as keeping money in a safer foreign bank and paying local companies from that bank are not legal. This is done informally, however, between many local companies. Most of these "informal" transactions are cleared in Frankfurt, Germany.

(5) Increasing Cost and Complexity of Cash Management

PB rules require limits on the amount of cash that banks may keep on hand that result in daily transfers of cash to and from the PBs by almost all banks. These transactions are time consuming and expensive. Each transfer of cash to a PB in the Federation is charged 0.1%, and each withdrawal from a Federation PB is also charged 0.1%. In addition, when this procedure is done for a bank customer, banks tack on an additional charge averaging 0.2% (but sometimes much higher). This results in an average cost to the customer for withdrawing cash of 0.3%.

(6) Picking Winners in the Banking System

The PBs give preferential treatment to certain banks through a variety of ways. Two banks interviewed by the international community in early 1997 stated that they had access to loans from the PBs. They stated that this was not well known to their competitors and that they would not like it to be known. The Federation law on internal payments clearly states that the ZPP may not make loans.

Another example of preferential treatment is the transfer of deposit accounts from the former National Bank to the banking system. These accounts were transferred to a small group of local banks popularly believed to have ties to the majority political party without the agreement of the account holders. The account holders were given 30 days during which they could select another bank or withdraw their deposits.

Payment Capabilities of the Current Banking System

It is commonly alleged that the role of the PBs in clearing payments is necessary because BiH banks do not have the capacity or ability to take over this function. This statement is largely exaggerated. Based on the interviews conducted for this study and the experience of the international community in working with the BiH banking sector, several types of payment transactions could be immediately conducted by almost all banks, including "*on us*" transactions between accounts held within the same bank, transactions between bank customers through correspondent bank accounts, and all payments to or from individuals or institutions abroad. Most of the banks surveyed also claimed they could generate reports that replicate the data-gathering function of the PBs. These reports could be forwarded to the Tax Administration area of the Ministry of Finance for tax purposes.

It should also be noted that there are approximately five banks in the country that could rather rapidly perform almost all payment transactions ordered by their customers. One of these (Hrvatska Banka Mostar) will within six months have on-line, real-time linkage between all of its branches (which cover the bulk of the Federation). Another of these banks (Market Banka Sarajevo) estimates that it could perform over 75% of its payments operations today without involving the PBs.

2. Survey of Businesses

The following summarizes the results of the business survey. This is presented by describing the official PB position on a series of questions and contrasting this with survey respondents' answer to the same questions. Annexes 2 and 3 present each interview in detail.

(1) What is the payments bureau?

Official position: According to PB officials, it is a benevolent organization whose sole concern is executing payment transactions in as rapid and efficient a manner as possible. They provide cash management for businesses and government and collect economic and financial statistics.

Actual businesses experience: The vast majority of businessmen viewed the PBs as an agency of the central (Entity) government, whose sole purpose was to exercise maximum control over the economy, with the payment settlement aspect as only one portion of its functions. It is seen by one businessman as *"a state within a state that no one can effectively sue."* Most private businessmen view it as an all-powerful government organ working hand in glove with the tax collection agencies. State-sector businessmen view it as the means the state uses to maintain auditing and financial control over the state sector of the economy. Bankers view the monopoly on payments as an impediment to the development of a viable commercial banking system.

The overall impression is of an inefficient, overly bureaucratic agency empowered to control all aspects of economic life, including a company's cash flows. One foreign investor stated that *"it is Kafka come to life."* Most respondents saw no difference between the PBs and the tax authorities. Respondents indicate that it is not uncommon for a PB account controller to question a company's use of funds, and occasionally to deny the company access to its own funds if the controller disapproves of the purpose.

(2) What are the Payment Bureaus' fee structures?

Official position: The fee structure is widely known and well publicized.

Actual business experience: None of the respondents knew the level of PB fees. None had ever seen a PB fee schedule. Several called their accountants, who, after hasty calculations, *returned* with varying answers: 0.15%, 0.20%, 0.30%, and 0.70%. One respondent claimed that PB fees amount to 1.1% of his gross revenues. On the basis of survey responses, it appears that different companies pay different fees according to their size, connections, and the municipality where they are located. The PB charges the payer a fee for each transaction, in addition to special charges for handling cash deposits and disbursements.

One former ZPP employee claimed that the branch where he worked charged a higher rate than was permitted by law, but because no one knew the rate structure or how ZPP billed, they could get away with it. One business respondent claims to pay over DM 2,000 monthly for ZPP services, and another claims to pay DM 1,000 monthly. One bank paid approximately DM 1 million in fees during 1997, while several others paid upwards of DM 500,000 each. Most businesses complained about the manner in which the PBs arbitrarily deduct fees from their account at the end of each month.

(3) How long does it take to have settle transactions?

Official position: All payment transactions are completed within 24 hours.

Actual business experience: The respondents indicated that transaction times varied dramatically. All agreed that intra-cantonal transfers typically take 24 hours. Inter-cantonal transfers appear to take from 24 to 72 hours. Transfers between ZAP and ZPP take anywhere from 72 hours to two weeks. Inter-entity transfers presented a problem for the survey, as most respondents do not participate in *legal* inter-entity trade and had no real experience in this type of transaction. The few who had conducted inter-entity transactions through the PBs thought it took approximately 20 days to complete.

(4) Do the Payment Bureaus make mistakes and errors?

Official position: They rarely happen, due to the rigorous system of payment processing. When they do occur, they are easy to detect, because the customer can notice them on his daily balance statement. In other words, it is up to the customer to catch the errors.

Actual business experience: Many respondents indicated that the PB had made errors in their payment transfers. There appears to be no mechanism for catching errors, and the account holders are expected to report errors if any occur. The PB does not have a standardized system for reporting and processing errors. In some instances they will deny

responsibility for the error and refuse to fix it. One foreign investor has been attempting to get DM 2,500 returned for over one year, without success. Another respondent reports a minimum of two errors per month, and that it takes him an average of two to three months to resolve each error. The lack of an error-detection mechanism forces companies to maintain redundant record-keeping systems.

(5) Are financial records confidential?

Official position: All account information is confidential. Every account holder has a post-office style lock box at his local PB branch, where his daily financial statements are filed for pick-up.

Actual business experience: Not one of the respondents thought that his records were confidential. Most PB branches have sufficient lock boxes for only a small fraction of their account holders. Box holders are required to pay an extra fee to use the box. It appears that the wait to get boxes is long and that account holders will bribe PB officials to get a box. Respondents indicated that their daily statements are often filed in the wrong boxes. For the vast majority of account holders—who have no access to lock boxes—their daily financial reports are often left unattended in a public area of the PB, where unauthorized persons may peruse them at leisure. The survey team witnessed this in several PB branches. Other individuals resort to inside connections to gain access to financial information. At least two respondents indicated they had received visits from organized criminal elements that demanded a percentage of their cash flows based on PB financial statements that they had seen. Several respondents felt that organized crime has informers in the PB who alert them to the companies with the largest cash flows. Several respondents admitted looking at their competitors' daily balance statements.

(6) How are liens placed on an account or accounts blocked?

Official position: Creditors may place a lien on a debtor's account using a PB instrument known as an "acceptance order." The PB may also place a lien on an account or block it on the basis of a court order or an order from the tax authority. The PB may not block an account without a court order or an acceptance order.

Actual business experience: Although the acceptance order is widely used as an instrument of collateral, our respondents indicated numerous instances of abuse and fraud. In most instances, the debtor company has a friend in the PB who prevents implementation of the acceptance order. The PB does not control the issuance of these documents, thereby permitting companies to commit fraud by issuing acceptance orders as collateral for goods for which they have no intent of paying. Neither does it prosecute instances of acceptance order fraud, as required by law.

In the instance of court orders, several respondents indicated that they had received court judgments in their favor but that the PB refused to honor them. The most notorious of these occurred when the private company INTRADE received a supreme court settlement

in its favor placing a lien on the accounts of the state-owned giant ENERGOINVEST in the amount of DM 735,000. In spite of a Supreme Court decision, the ZPP refused to implement the lien. The ZPP told us they had not followed the Supreme Court order because a lower court (a curious interpretation of legal precedence) had overturned it. In this well-documented case, most believe that the ruling political party intervened with the ZPP to overturn the court order.

In addition, the PBs will place a lien on an account on the basis of back taxes, court orders, and for newly implemented taxes. Numerous respondents reported going to the PB to find that their account had either been blocked or been dunned for a new tax. When the account is blocked, the company literally ceases to function, as it is prevented from using its funds. It may not meet payroll, pay bills or suppliers, or withdraw cash until the outstanding issue has been settled. One foreign investor in Bosnia stated that the PB blocked his company's account, and it took 20 days for the PB to reverse this order. During that time, the investor was unable to use his PB account and was forced to shut his business down, losing a multi-million DM client as a result.

Under the current currency board system, the PB can block the 601 business accounts of all of a bank's customers should that bank itself have its account blocked. This has already happened in the case of SAB bank, forcing hundreds of businesses to either shut down or operate in the black economy over a period of several months.

(7) Are the Payment Bureaus' payroll services useful?

Official Position: The PB helps business with payroll by enabling them to pay all the taxes and withdraw cash for payroll.

Actual business experience: Of all the businesses surveyed, only one state-owned firm expressed satisfaction with the PB's payroll function. Under this system the employer must fill out as many as nine PB forms per employee, and the PB prevents employers from paying workers their salaries until all taxes have been paid. One respondent has to fill out 80 pieces of paper to pay nine employees. The employer then must wait from 1 to 3 hours in the PB to actually withdraw the cash. Occasionally the PB will have insufficient cash to disburse for payrolls. This places a particularly heavy burden on small and medium businesses, where it may take one employee two entire days to fill out the necessary paperwork. Most respondents expressed a strong desire to complete payroll without the PB's interference, using daily cash flows or commercial banking services. One company's full-time accountant stated that the paperwork required for the payroll seems to grow every month, to the point that *"even I don't know our laws."* Several respondents indicated they illegally employed their workers to avoid the PB payroll system and the accompanying paperwork and taxes.

(8) Are the Payment Bureaus' paperwork and time demands reasonable?

Official position: These are no heavier than would be required in any other payments clearance system.

Actual businesses experience: One of the most common complaints was the amount of time required to fill out the payment transfer forms, the payroll forms, and wait at the PB. The typical small- to medium-sized business needs at least one full-time employee to deal with the PB-required paperwork and forms. One respondent complained that he pays the PB DM 2,000 a month in fees and yet still has to have his employee wait for an hour each day to make payment transfers and get an account balance. The wait to withdraw petty cash, deposit daily receipts, or complete payroll transactions requires on average one to two hours per function. For retailers this means loosing a minimum of one and a half to two hours a day waiting in the PB. One respondent stated that the only positive aspect of the PB was that it interrupted his otherwise busy schedule and allowed him to meet all his friends, who are also waiting in line. Another stated that his accountant must spend three hours per day at the PB, waiting in line and conducting business. A foreign investor from the EU indicated that the PB system required his company to keep nearly double the amount of records that would be required in his home country.

Respondents from Republika Srpska indicated their waits were somewhat shorter, primarily because most businesses in the RS work illegally, thus reducing the amount of traffic at the SPP.

(9) Is there fraud and/or corruption in the payments systems?

Official position: Senior officials in the ZPP maintain that in the last 18 years there have been only two cases of employee theft, and that in both instances they were caught by the end of the working day. They also maintain that their workers are so well trained that they can detect forged banknotes by touch and immediately recognize falsified documents at first glance. They maintain there is no fraud or corruption in the system.

Actual businesses experience: Nearly every respondent mentioned an instance of a competitor using friends in the PB to block an acceptance order, take out a loan, circumvent the cash withdrawal limits, gain access to confidential records, or gain special after-hours service. Several respondents openly admitted to being the beneficiaries of such favors. In one instance, a businessman withdrew DM 17,000 in one day for petty cash. In another, a businessman admitted to receiving a loan. Several admitted using their connections to block implementation of acceptance orders. One foreign investor related several instances of outright fraud by PB officials when they refused to honor acceptance orders against debtor accounts. Several respondents indicated that they had been audited by tax inspectors when someone at the PB became angry and called the tax authority. One foreign investor indicated that a representative from a local gang showed up to extort protection money armed with a copy of the tax statement the company had filed at the PB. In another instance of PB-related extortion, a shoot-out ensued, with the extortionist

being shot and killed. Another respondent admitted bribing a PB official to get an illegal loan.

(10) Are the Payment Bureaus' cash management services useful?

Official position: The PB makes a business' life easier by taking care of cash management, "safeguarding its foreign currency," and helping it maintain the required cash management paperwork.

Actual businesses experience: All respondents seemed to agree that the moment cash was in the ZPP, it was no longer theirs. One foreign investor summed up the general feeling when he stated that *"My money's not mine! The municipality can take the money from my account whenever it wants! They will drain your account quite happily. My cash has no security. They could wipe us out tomorrow if a corrupt bureaucrat decided to do so."* A major concern of most businessmen is that the government will impose yet another retroactive tax to cover its financial needs. These taxes are deducted from the account with no advance warning,. and with no opportunity for the company to challenge or dispute the amount taken.

Although the ZPP holds all cash, it does not pay interest on these deposits. Rather, it charges account-holders a fee for depositing cash. The actual system of cash deposits and withdrawals permits others waiting in line to see the amount of cash being withdrawn and deposited, thereby raising security concerns for companies. In spite of holding all the cash reserves, the ZPP has been known to run out of cash at the end of the month, when pensions and payrolls are distributed simultaneously.

Because of a company's inability to manage its own cash flows, many operate in the illegal cash economy. One company's financial director reported carrying DM 20,000 in cash around in a bag for several days, because she couldn't deposit it legally at the bank, and the company legally couldn't keep more than DM 1,000 in cash on the premises. One manufacturer, who employs approximately 45 workers and has a weekly turnover of approximately DM 150,000, deposits only 10 to 15% of his cash into the system. He stated that *"in any other country, what we are doing would be legal and normal. Here we are criminals because we work outside the system."* For him it is less expensive and taxing on his business to bribe the local municipal officials and tax inspectors.

PBs and The Underground Economy

Because of the restrictions and drawbacks inherent in the system, most of the respondents indicated that they engage in illegal activities. Some indicated a non-compliance rate as high as 95%, while others indicated a non-compliance rate of between 45% and 60%. A few indicated they are in 100% compliance with all laws. The underground/informal economy comprises at least 40-50% of total economic activity in the Federation (higher in the Croat-majority areas, and in the RS). On the basis of statements made by the survey

respondents, it is apparent that BiH payments system practices help to drive a very substantial portion of economic activity underground.

Section IV. Payments System Impact on the BiH Economy

The *de jure* and *de facto* responsibilities and actions of the PBs have been identified. How does the operation of the PBs impact the BiH economy? We answer this question in two ways. First, stylized facts that emerge from the interview surveys are used together with basic economic analysis to identify several negative impacts of PB practices on economic activity. Second, we use quantitative statistical data to estimate the levels of PB revenues, the excess labor required from businesses in order to deal with the PBs, the share of PB-related value-added in BiH national income, the degree to which BiH's financial sector is unusually underdeveloped, and the impact of this underdevelopment on economic growth. The results show that the BiH PBs have low productivity and yet are remarkably expensive, and that the low level of development of BiH's financial sector has a powerful negative impact on expected future economic growth.

A. Qualitative Costs of the BiH Payments System

In a normal private market economy, payments systems facilitate decentralized decision-making and risk bearing. Payments operations are conducted remarkably efficiently in modern market economies. Anywhere from $50 to more than $100 of payments may flow through an advanced market economy for every dollar of GDP produced, yet total payments system costs in advanced economies absorb under 3 percent of GDP.[18]

Monopoly franchises such as the BiH PBs generally deliver a smaller amount of poorer-quality services at higher cost than a competitive industry. In the case of the PBs, poorer-quality service is reflected in the inefficient processing of payments transactions which results in a needless expenditure of time and energy on the part of banks and businesses that have to deal with the PBs. The total costs of BiH payments services include the fees charged, excess labor spent on dealing with the PBs, and the prevention of the commercial banking sector from intermediating a large amount of financial resources (the DM deposits kept in PB vaults). These costs are high and have important negative consequences for the BiH economy. These consequences are examined and supported by available evidence.

1. Reducing Demand for Non-Cash Money Payments

All economic goods and services are sensitive to price. If the price of a good rises, less of it will be demanded, and more of other substitute goods will be consumed in its place. Due to the costs of processing (including the time and hassle involved in dealing with the PBs), the demand for non-cash forms of money such as bank deposits is lowered by PB practices because it is relatively quite expensive compared to alternatives like cash.

[18] The United States economy in 1994 had more than 100 dollars of payments flow per dollar of GDP, but this included a large financial market transactions component. The same ratio for another G7 economy, for example Germany, is more be likely to be in the range of 50:1 (pp.1574-76 in Hancock and Humphrey 1998).

Reduced demand for non-cash money leads to an unnaturally low ratio of total bank deposits to GDP, a measure known as "financial depth" which will be explored more thoroughly in the next section of the study. Financial depth in BiH in 1997 was 15%, which is very low by any standard (financial depth in central European transition economies is on average 40% and in advanced industrialized economies often exceeds 100%). Poor development of the financial sector reduces the level of GDP and its growth rate. Use of non-cash money also requires businesses and banks to expend excess labor in processing its use. We develop an estimate of excess labor expended in the next section and find that it is roughly 5% of total employment.

2. Favoring Barter Over Monetary Exchange

In addition to substituting into cash in response to the high costs of using non-cash money, businesses have also substituted into using barter trade. Holding cash is more risky in BiH than in most other economies because of the legal regulations that set stringent limits on the amount of cash that businesses are permitted to hold. Under normal conditions, barter is a much more costly way to conduct transactions relative to money-mediated exchange. Monetary exchange is convenient and entails far simpler contractual arrangements. In a barter arrangement, it is necessary to provide two delivery schedules (the product offered and the product to be obtained) instead of one. Quality standards must be weighed in terms of dissimilar goods or services rather than one being compared against money. It is also problematic to match buyers and sellers together, because each must have what the other wants.

It nonetheless appears that the disadvantages of using cash and non-cash money in BiH are such that barter accounts for a significant percentage of BiH trade. Many survey respondents related numerous instances where a high rate of illiquidity forced them to engage in barter trade. One respondent reported receiving coupons for electrical energy from the state-run power company, while others reported dealing in lumber, cooking oil, sugar, coffee, alcoholic beverages, and construction materials. In all instances the respondents report being forced to offer the barter goods at disadvantageous prices and terms of payment. In most cases, working capital is tied up in barter goods for months on end.

3. Lessening Specialization by Firms.

A firm will buy an input into production from other firms if it is cheaper to do so than to produce the input in its own shop. Firms also tend to subcontract out many services rather than produce them internally. The impetus to do so is that it often minimizes total costs if a firm sells a semi-finished product to another firm for further processing rather than attempt to do all production in one firm. This approach allows firms to focus on activities in which it has the greatest expertise and productivity. Taxes on the payment process will reduce the profitability of this inter-firm activity and cause firms to do more

production in-house. This bias against subcontracting and specialization is another instance of substituting barter (within-firm trade) for monetary exchange (inter-firm trade).

Several manufacturers in our survey reported producing inputs which they would be willing to purchase on the market were PB fees and taxes lower. One large manufacturer told us that he trained, equipped, and used his own employees for final installation of his products rather than engage subcontractors. His rationale for this is the cost savings generated by keeping the business activities in-house.

4. Raising the Necessary Quantity of Working Capital

Although the PB officials we interviewed frequently asserted that the clearing time for payments in the system, whether intra-city, inter-city or inter-entity, was one day, survey respondents complained that the length of processing time is excessive. If this is true, then the interest cost of doing business or, more generally, the amount of working capital required to bridge the gap between accounts-receivable inflows and accounts-payable outflows will be larger than would be the case if payment processing was more efficient. This increases the amount of working capital necessary to conduct a given level of business activity.

Every survey respondent interviewed complained of lack of control over his company's cash flows. All stated that the PB system made planning difficult if not impossible and sometimes doubled the amount of working capital required to conduct normal business operations. One respondent complained that his company was unable to expand due to restrictive financial controls by the ZPP.

The supply of working capital is also reduced by the fact that a large volume of deposits estimated at DM 400 million does not flow from the PBs to the commercial banking sector. This money is held "on account" at the PBs, and companies may use it to make payments between each other, but it is not available to banks for intermediation.

5. Increasing Payments System Risks, Especially Fraud

While the claim has been made that there is no settlement risk with the PBs, these systems impose other very important risks that negatively affect business activity. Payment delays and inability to take legal action against the PBs both create uncertainty and increase risk associated with working with the PBs. Nearly all survey respondents reported significant instances of fraud in the payments system. Businesses and banks alike have experienced instances where PB insiders collude with businesses or banks to defraud other users. The indiscriminate and uncontrolled use of acceptance orders and the use of falsely verified *fifth copy* documents are the most widely reported occurrences. The lack of confidentiality of financial records exacerbates this situation and creates an environment where fraud is rife.

6. Reducing Creditor Information about Potential Borrowers.

Since the PBs intercede in the payment process between borrower and lender, the lender has less incentives and is less able to gather the sort of information that makes it possible for banks to lend to "people they know" and to work with their clients in stressful times. This type of information is what makes a competitive bank better able to separate good credit risks from bad ones, to aid its clients in growing their businesses, and to maintain a healthy loan portfolio.

Survey respondents indicated that they have no reason to go to their bank (unless they are importing goods), because all financial transactions go through the PB, not their bank. One businessman had operated for almost ten years and amassed a company with a net worth of over DM 1 million without ever setting foot in a bank. The PBs' intrusion in the bank/business relationship means that banks have no information regarding their customers' cash flows or business activities, except in those instances where the customer imports or exports frequently. Respondents also indicated that the SPP in the Republika Srpska has intimidated and pressured bank customers to force them to transfer their accounts to the DBRS.

Note on Private Property Rights and the Payments Systems

One of the most important general costs of PB practices is the fundamental subversion of private property rights. The financial wealth of firms and households held with the PBs can be confiscated arbitrarily at any time, and so-called owners have no real legal recourse to challenging such actions. It is impossible to over-emphasize the negative impact of such a regime. Such subversion of property rights deters domestic investment and, perhaps more importantly for the near future, foreign investment in the BiH economy. According to IMF balance-of-payments statistics, total foreign investment in BiH during 1995-1997 was *zero*. There are of course other factors that deter foreign investment from coming to BiH, but the perversities of the payments systems are well known to foreign businessmen who have investigated the country as a potential investment site. Payments system practices deter in particular foreign banks from establishing operations in BiH. Until PB practices are fundamentally reformed so that there is a sound system of private property rights in BiH, significant levels of domestic and especially foreign investment cannot be expected in BiH.

B. Quantitative Estimates of the Impact of BiH Payments Systems on the Economy

1. PB Revenues, Costs, and Reported Net Income

The ZPP and ZAP have recently provided income statements for 1997 to the IMF. The ZPP statement reports monetary income of KM 40 million. The ZAP did not provide a

consolidated income statement but statements for individual sub-stations.[19] Consolidation of statements for the sub-stations gives a figure of KM 20 million in income. The study has also obtained the 1997 income statement for the SPP. Using the official YUD-DM exchange rate, SPP revenues are reported as KM 24 million. Total reported revenues for the PBs are KM 84 million.

It is possible to check officially reported revenues for the ZPP using data on the total number and value of transactions that it processed in 1997.[20] ZPP reports that the total number of transactions that they processed in 1997 was 23.5 million, and the total value of these transactions was KM 29.1 billion (giving a per-transaction value of KM 1,239). The following table shows the expected value of ZPP revenues for different levels of the average fee charged by ZPP on payments transactions:[21]

Average Fee	Expected Revenues (million KM)
0.1%	30.4
0.13%	39.1
0.15%	44.9
0.2%	59.5

Reported ZPP revenues are thus plausible if the average fee charged was roughly 0.13%. The official ZPP fee schedule is given in Annex 1 and is summarized as:

Type of Transfer	**Fee Charged[22]**
Wire/fax transfers	0.1%-0.25%
Cash deposits	0.1%-0.2%
Transfer payments under 30,000 KM	0.2%
Transfer payments between 30,000 and 60,000 KM	0.15%
Transfer payments over 30,000 KM	0.1%
Consumer transactions	0.5%
Bank cash deposits	0.3%

ZPP did not provide the study with data on transactions broken down by type and value.[23] A perusal of these fees, and some educated guesses on which types of transactions

[19] The sub-stations include Mostar (West), Livno, Vitez, Siroki Brijeg, Orasje, Jajce, and Caplina. It may be the case that there is a sub-station located in Tomislavgrad for which an income statement was not provided. The ZAP sub-stations provided statements separately for the first and second half of the year. For three sub-stations (Siroki Brijeg, Jajce, and Caplina), a statement was provided for only one half of the year. Data from the other sub-stations were used to estimate the missing revenue and cost elements for these three sub-stations.

[20] This data was provided to the study's team by the ZPP.

[21] Estimated revenues include estimated fee-based revenues, and non-fee income reported by the ZPP (equal to KM 1.2m).

[22] We do not summarize minimum and maximum limits on the amount paid per transaction, which are present in the case of cash deposits, consumer payments, wire and fax transfers, and bank cash deposits

[23] ZPP officials claimed that they do not have such information.

predominate in ZPP payments turnover, suggest that an average fee equal to 0.13% is not implausible. In particular, large-value transfer payments are charged 0.15% or 0.1%. Even though very few such payments were probably made in the Bosniak areas of the Federation in 1997, because the average value per transaction is so high for this group, they will have a very substantial weight in the value of transactions and thus substantial influence on the average fee charged.[24]

We thus find the reported income of ZPP to be quite plausible. Although transactions data for ZAP and SPP are not yet available, we assume that similar calculations for these bureaus would yield a similar result and thus accept the total value of reported revenues, KM 84 million, to be accurate.

Reported revenues, costs, and net income in 1997 (million KM) are summarized for the three bureaus in the following table:

	ZPP	**ZAP**	**SPP**
	KM mil	KM mil	KM mil
Total revenues	39.91	19.72	23.66
Fee-based revenues	38.63	19.32	22.44
Other revenues	1.28	0.40	1.22
Total costs	35.00	17.55	23.29
"Tangible" expenses	7.70		
Depreciation	2.49		
Salaries and reimbursements	8.47		
Expenses not depending on business results	1.92		
"Direct" expenses	14.43		
Materials, energy, salaries, and depreciation		10.21	
"Service" costs		3.78	
Financing expenses		0.02	
Fixed taxes		0.13	
Insurance damage compensation		0.00	
Calculated reserving		0.66	
"Direct" costs		2.76	
Material expenses			13.65
Income material, energy spare parts, small inventories			2.60
Services for material expenses			2.42
Included reserve material expenses			3.19
Amortization			1.67
Gross salaries/wages			3.67
Fees related to gross salaries			0.10

[24] This is true for the US payments system, for example, where large-value payments account for roughly 1% of total payments transactions but 90% of total transaction value.

A minimum estimate of the direct operating costs of running the PBs in 1997 is KM 31 million. These costs are in national income, or value-added, terms and include wages/salaries, depreciation, and net income. We use a national-income measure of costs so that they can be directly compared to the level of national income in BiH in 1997. This is a minimum estimate as it may be the case that some costs should properly be incorporated into net income.

2. Excessive Labor Costs of Dealing with the Payment Bureaus

Our survey of businesses provided 11 separate estimates of the labor time that a firm is forced to spend on dealing with the payments system above and beyond what normal bookkeeping activities would require. These estimates are summarized as:

Survey ID	Total employment (persons).	Excess labor spent on PB activities	% of total employment*
E332	90	2 employees	2.0%
N005	80	2 employees	2.5%
B465	45	0.5 employees	1.0%
B219	31	7 hours per day	2.8%
N006	11	4 hours per day	4.5%
J001	9	3 hours per day	4.7%
M503	9	1 employee	11.0%
N004	9	2 hours per day	2.8%
D493	8	15 hours per month	7.8%
C361	5	30 hours per month	3.1%
J007	5	5 hours per day	12.5%

* : calculated assuming 8 hours per employee per day, and 24 working days per month.

The data show that percentage excess labor falls with firm size. We are unable to take advantage of this extra information, because no data on the distribution of firms by employment size are available for the Federation or the RS. We use the simple arithmetic average of these estimates, which is 5.0% of total employment. Because a large fraction of employment is probably concentrated in small firms (20 employees or less) in the BiH economy, the simple average approach, which effectively averages together estimates of 6.7% for small firms and 2.1% for larger firms, is not likely to be significantly off the mark.

Other material expenses			0.00
Nonmaterial expenses			7.89
Fee expense			1.40
Non-business service costs			0.30
Expense accounts			0.49
Insurance premium			0.11
Other personnel costs			1.35
Taxes independent of business results			0.41
Fees (bank service fees)			1.29
Service fees			0.16
Reserves			0.76
Other non-material expenses			1.62
Financial expenses			0.95
Interest paid to other legal entities (corporations)			0.15
Other financing expenses			0.00
Neg. balance revaluation effects			0.80
Additional expenses (extraordinary)			0.80
Additional material expenses			0.17
Additional non-material expenses			0.63
Wages and salaries	8.47	4.39[a]	5.72
Depreciation	2.49	1.23[a]	1.67
Reported net income	4.91	2.17	0.38
Reported direct operating costs of PBs[b]	15.87	7.79	7.77

a : ZAP does not report separate data on wages/salaries and depreciation. Using shares of these costs in total costs for ZPP and SPP, wage/salaries for ZAP are assumed to be 25% of total costs, and depreciation to be 7% of total costs.

b : in national income (value-added) terms.

This table reveals that the three PBs have provided quite different income statements in terms of categorization of costs. The ZPP and ZAP report highly aggregated components of costs; the ZAP does not even report wages/salaries and depreciation separately. The SPP, on the other hand, provides detailed data on cost components. Without more information on what kinds of costs the various cost categories of each bureau cover, it is not clear how categories can be aggregated so as to achieve comparability across the PBs.

It should be noted that some cost items reported on the PBs' income statements might properly be treated as a component of net income. For example, ZPP reports the line item "direct" expenses, which were KM 14.4 million or about 41% of total costs in 1997. What kinds of costs this item includes has not been explained. It might include expenditures of funds that should be treated as allocation of net income (failure to explain these costs may suggest that these funds are used for inappropriate non-PB purposes). We thus refer to reported net income of the PBs to indicate that actual, properly accounted-for net income may be higher than what the PBs report.

In order to convert this into a monetary value of total labor expended on these activities in 1997, we first estimate total employment in 1997 and then multiply 5% of this by the average annual wage in 1997.[25] We do this calculation for each Entity separately. There are two estimates of total employment available: the official number, and a re-estimate calculated from data obtained in a World Bank labor market survey conducted in the spring of 1997. The following table summarizes the data and results:

	Labor force (people)		Excess labor employed		Average annual wage (KM)		Excess wage payments (mil.KM)	
	Fed.	RS	Fed.	RS	Fed.	RS	Fed.	RS
Official	350000	218921	17563	10986	4200	1140	73.8	12.5
WB survey	580000	362783[a]	29105	18205	4200	1140	122.2	20.8

a : estimated using survey results for Federation.

3. BiH Financial Depth in a Cross-Country Perspective

This study has shown that Payment Bureaus practices seriously handicap development of the BiH financial sector. PB practices prevent commercial banks from engaging in normal banking business, and the subversion of property rights brought about by the risks of arbitrary confiscation of funds lowers firms' and household's desires to hold their wealth in bank accounts. Although financial underdevelopment also results from poor banking practices and capabilities, and poor regulation of financial markets, it is also clear that if PB practices do not change, the financial sector will never have the opportunity to develop properly in BiH.

To what degree is the BiH financial sector under-developed? We answer this question by evaluating to what degree the level of *financial depth* was below what could be expected in BiH in 1997. Financial depth is the ratio of total bank deposits to GDP. Economists have traditionally looked at the financial depth measure to determine how well a country's financial sector is developed. Total bank deposits includes demand deposits, time deposits, bonds, and money market instruments. The higher a country's ratio value, the better developed its financial sector is, and the more willing people are to hold non-currency stores of wealth.

Financial depth empirically rises with the level of overall economic development. Wealthier countries have more sophisticated financial markets and (usually) more stable macroeconomies, and this promotes confidence in and increases the attractiveness of non-currency stores of wealth.[26] Financial depth should fall with the level of price inflation,

[25] It is difficult to know what wage should be used to calculate this labor cost. According to the survey results, some firms used clerical staff to deal with the Payment Bureaus whereas others used top-level management. We use the average wage for the whole economy, although there is reason to think that such labor is more expensive than this.
[26] The average degree of financial depth goes from below 20% for the world's poorest countries to over 100% for the richest countries.

because higher inflation indicates greater macroeconomic instability and might also mean a lower real return on deposits (if the deposit rate is controlled by the state and kept too low). Financial depth might also fall if a country is experiencing war or serious civil unrest, or has recently experienced such events. Finally, financial depth might be unusually low in transition economies because of unusually weak financial sectors. In countries of the former Yugoslavia, this is due to both PB practices and weak banking practices and regulation.

We used monetary, financial and national income data to evaluate financial depth for most countries of the world in 1995.[27] We then related the level of financial depth for 141 countries to several explanatory variables: GDP in purchasing-power-parity (PPP) terms, the consumer price inflation rate in 1995, and a set of dummy variables indicating whether a country experienced war or massive civil unrest in the early 1990's, whether a country was part of the former Soviet Union, whether a country was a non-Yugoslav central European transition economy, and whether a country was part of the former Yugoslavia.[28] Using statistical techniques, the individual impact of each of these factors on financial depth was quantitatively estimated..

The results of this analysis show that financial depth rises strongly with the level of income of a country and falls weakly with the level of price inflation.[29] The impact of war or massive civil unrest is negative but very small and insignificant. The impact of being in the former Soviet Union is negative and highly significant, and the impact of being a non-ex-Yugoslav central European economy is actually positive (but relatively insignificant). Most importantly for the purposes of this study, the impact of being an ex-Yugoslav country is negative and actually slightly greater than the impact of being an ex-Soviet

[27] For all countries except BiH, monetary and inflation data, and most nominal GDP data, are taken from the IMF's *International Financial Statistics* (November 1998). Per-capita GDP in purchasing-power-parity terms is taken from the UNDP's Human Development Report for 1998. For some transition economies, inflation and some nominal GDP data are taken from the journal *Economics of Transition*, **6**(1) (May 1998). 1997 values of the variables are included in the sample for BiH; monetary and inflation data are taken from the World Bank's *Economic Brief for Bosnia and Herzegovina* (July 17, 1998). A BiH inflation rate was calculated by aggregating the Federation and RS retail price inflation rates for 1997 (9 1% and 1.4% respectively) using Entity GDP weights.

[28] It is important to note that we use per-capita GDP converted into USD equivalents through the purchasing-power-parity (PPP) exchange rate rather than commercial exchange rates. It has been well established that commercial exchange rates do not reflect the true purchasing powers of currencies of poorer countries.

There is no available estimate of BiH GDP in purchasing-power-parity terms. We derive an estimate by converting 1997 per-capita GDP in DM terms into US dollar (USD) terms using the commercial DM/USD exchange rate and then applying a PPP-commercial exchange rate correction factor calculated from data on lower-middle-income developing countries (of which BiH is a member). This correction factor is on average equal to 3.7, which means that PPP per-capita income for BiH was $3,425 in 1997, a big increase on the commercial-exchange-rate figure of $921.

[29] The estimated regression is:

$$\text{Findep} = \underset{(6.7)}{0.199} + \underset{(12.2)}{0.00003}*\text{GDP} - \underset{(-1.1)}{0.027}*\text{Inflation} - \underset{(-0\ 3)}{0.021}*\text{War} - \underset{(-1.8)}{0.137}*\text{FSU} + \underset{(1.0)}{0.086}*\text{CenEur} - \underset{(-1.4)}{0.157}*\text{Ex-Yug}$$

Where findep is financial depth, FSU, CenEur, and Ex-Yug are dummy variables for ex-Soviet, non-Yugoslav central European and ex-Yugoslav countries respectively, and t-statistics are in parentheses. Number of observations is 141, and the adjusted R-squared statistic is 0.5742.

We also ran the regression substituting the real rate of interest on bank deposits for the inflation rate and found that it made no substantial difference to results.

country. Compared to their central European neighbors also going through transition, there is something different about the ex-Yugoslav countries, and this difference was not related to macroeconomic instability (as captured by the inflation rate) or war.

Using results of this analysis and actual values of the variables explaining the level of financial depth for BiH in 1997, the level of financial depth that could have been expected in BiH including the influence of the common ex-Yugoslav factors driving down financial depth was 13%, which is very close to the actual BiH value of 15%. However, if the common ex-Yugoslav factors had been absent, BiH financial depth would have been expected to be 29%. BiH financial depth was thus much less than it should have been due to the common factors that ex-Yugoslav countries jointly inherited. What are those common factors? One obvious factor is the descendants of the SDK, the contemporary PBs. Many negative impacts of the PBs have been identified in this study that depress financial activity and inhibit development of the banking system in BiH, and some of these impacts are likely to be relevant for other ex-Yugoslav economies as reform of their PBs has generally been difficult to achieve. It may also be true that the ex-Yugoslav countries all tend to have banks that engage in poor practices and are badly supervised and regulated. It is not clear, however, that the ex-Yugoslav countries are particularly worse off in this respect than the other central European transition economies.

4. Financial Depth and Economic Growth in a Cross-Country Perspective

It is also possible to evaluate the consequences of BiH's low level of financial depth for economic growth. Economists have established a strong relationship between the level of financial development and economic growth.[30] We analyze this relationship here by relating average annual real GDP growth during 1991-1995 for 99 countries to the level of financial depth and the inflation rate in 1995, and a dummy variable for the presence of war or massive civil strife in the early 1990's.[31] The squared level of financial depth is also included in the analysis, because the relationship between growth and financial depth is non-linear: economic growth increases with financial depth for countries at low levels of income, but decreases with financial depth for countries with high levels of income.[32] Financial depth impacts economic growth positively for developing countries, and inflation impacts economic growth negatively.[33]

The impact of BiH's low level of financial depth on growth is evaluated by using the estimated relationship to determine what BiH's growth would be with an expected value of financial depth of 29% and with an expected value of 13%, the difference between

[30] See King and Levine (1993), Levine (1997), and Levine and Zevros (1998).

[31] Switzerland and Hong Kong were dropped as excessively influential outlier observations.

[32] The fall-off at high-income levels is explained by the fact that the very richest countries tend to have slightly lower rates of growth than other countries, but financial depth continues to increase with GDP at high levels of income.

[33] The estimated regression is:

$$\text{GDP growth} = \underset{(-0.91)}{-0.010} + \underset{(2.5)}{0.103}*\text{Fin.dep.} - \underset{(-1.9)}{0.064}*\text{Fin.dep.}^2 - \underset{(-3.5)}{0.021}*\text{Inflation} - \underset{(-0.2)}{0.002}*\text{War}$$

where t-statistics are in parentheses. Number of observations is 99, and the adjusted R-squared statistic is 0.2480.

these two levels being accounted for by common ex-Yugoslav factors depressing financial depth. The resulting growth rates are 1.1% and –0.1% respectively. It is very important to note that such growth rates would be expected to hold for typical countries with these two levels of financial depth in the group of 99 countries examined here. BiH is not a typical country in that sense, because it is experiencing rapid growth due to the very unusual situation of recovering from war and massive aid inflows. These expected growth rates should thus be regarded as relevant to what might happen in BiH after this special growth period comes to an end, and BiH is on a more normal growth path.[34]

The difference between an average growth rate of 1.1% and –0.1% over the longer run is profound. For two countries that start at the same income level, if one grows at 1.1% and the other at –0.1%, then within 10 years the first economy is 13% bigger than the second, and over 50% bigger within 34 years. Seemingly small differences in average annual growth rates translate into large differences in the level of income within one or two generations. The benefits to economic growth of reforming the PBs and banking practices to promote better-functioning financial sectors are clear.

We estimate the monetary costs of lost growth to the BiH economy in 1997 at KM 51 million. This estimate is derived by noting that the difference between average growth rates for economies with 29% and 13% financial depth is 1.1%-(-0.1%), or 1.2%. The 1996 value of BiH was KM 4,189 million. Lost growth of 1.2% starting from a base of KM 4,189 million equals KM 51.0 million.

5. Total Costs of the BiH Payment Bureaus

The total costs of the BiH Payment Bureaus to the economy in 1997 that we have been able to quantitatively estimate were from KM 255 to 311 million, which reflects the sum of the estimated PB value-added (KM 32 million), excess labor costs incurred by businesses (KM 89-147 million), foregone interest income on non-intermediated funds (KM 86 million), and the monetary value of foregone economic growth (KM 51 million). This was from 4.4% to 5.4% of official BiH GDP in 1997 (KM 5,803 million). We stress again that this figure does not include various costs that this study has identified but which could not be quantitatively evaluated due to lack of appropriate statistical data.

The social costs associated with payments processing in the U.S. economy have been estimated at roughly 2.6% of GDP.[35] Because the U.S. payments system relies heavily on paper checks for non-cash transactions, the social costs of West European payments systems, which use electronic transfers to a much greater extent, are lower and probably less than 2% of GDP. Comparable social costs for the BiH payments system include both

[34] It should also be noted that the approach taken here does not control for some factors that play a role in determining the level of economic growth in addition to financial depth, inflation, and war. However, economists have shown that a strong relationship exists between these variables even when additional factors are controlled for, and we are confident that a growth differential similar to what has been identified here would emerge from a more sophisticated study.

[35] Humphrey, Pulley, and Vesala (1996), p.935.

the direct operating costs of the PBs and the excess labor spent by business on dealing with them. These costs were from 2% to 3% of BiH GDP in 1997. The costs of the BiH payments system thus exceed the costs of the typical West European system.

However, the productivity of the BiH payments system is substantially less than in Western Europe. West European economies process between 50 to 100 dollars of payments transactions for every dollar of GDP produced. A comparable ratio for the Federation's ZPP (Bosniak areas only) can be developed using the data on payments transactions value in 1997 provided to this study. The official 1997 value of total Federation GDP was KM 4,189 million. According to the United Nations High Commission for Refugees (UNHCR) data, Bosniaks comprised 76% of the Federation's population in 1997, and Croats 24%. If it is assumed that GDP per-capita was roughly the same in the Bosniak and Croat areas, then the 1997 value of Federation-Bosniak GDP was KM 3,188 million. The ratio of the value of total payments processed by the ZPP, KM 29,086 million, to Federation-Bosniak GDP in 1997 was thus 9.1. The other BiH PBs are very likely to have similar ratios, as they essentially use the same procedures and technologies.

The BiH payments system is therefore much less efficient than West European systems. Although it costs more in terms of GDP than West European systems, it processes from 5 to 10 times *less* payments value per unit of national income than those systems.

Section V. A Strategic Plan for Reform and Transformation of the BiH Payment Bureaus

"SDK is by and large an obsolete institution of our socio-political system" Marshal Tito
Note: Marshal Tito is gone but the SDK lives on

There is an urgent need to achieve reform of the PBs. The costs of these systems to the BiH economy have been documented in this study. It is anticipated that the donor funding that now props up the BiH economy will be sharply reduced starting in the year 2000. If the economy and living standards are to continue to improve after the end of massive donor assistance, the BiH economy will have to develop efficient institutions that facilitate growth and investment. The payments system is clearly one of the institutions that need to be modernized to support financial intermediation, a key to substantial economic growth It must also be noted that without reform of the PBs, it will be significantly more difficult to achieve reform in other areas, for example establishing healthy domestic capital markets.

The PBs are complex and complicated organization of state control. They are not simply or even primarily payments system agencies. The non-payment-system functions that the PBs carry out must be addressed in any reform program. Table V.1 summarizes the various functional aspects of the PBs, suggests needed reform steps for each, and briefly describes positive and negative consequences that could flow from reform.

Table V.1: Functional Aspects of the Payment Bureaus

Functional aspects	*Description of Function*	*Recommended Action*	*Potential impact of recommended action*
I. Payments system operations	Have monopoly on all domestic payments	Amend payment law to revoke monopoly status Speed up plans for a Clearing capability at CB	Positive- banks could set up competitor while still able to use existing system. Fees should be reduced Negative- none
II. Tax collection and distribution	All taxes are collected by PBs	Transfer function to MoF, cantons, etc.	Positive- Would change the focus from being a control mechanism to maximizing revenue collection. Could increase the legal economy Negative- could reduce tax revenue in the short term
III. Statistics collection	Collects financial info on all businesses	Transfer function to Statistics bureau	Positive- Puts this function where it belongs. Negative- may cause problem given that this function also analyzes tax statements for accuracy
IV. Treasury Services	Acts as treasury for Govt. bodies and businesses	Govt. and businesses perform for themselves	Positive- forces govt. and bus. To think about their uses of funds Negative- Some may not have capability in house
V. Cash Management	All businesses must deposit their cash with PBs	Remove the requirement that all cash be sent to PBs	Positive- Businesses can manage own money, problem of no change is solved, Cash currently held at PBs can be intermediated Negative- could reduce tax revenue short term
VI. Accounting Services	Needs to be detailed	Government and businesses should do for themselves	Positive- forces businesses to improve accounting abilities Negative- Some businesses may not have capability in house
VII. Interaction with Financial Police	Instigates audits and other actions by Financial Police	Set up, publicize, and enforce guidance for interaction between PB and Financial Police	Pos- forces greater transparency in PB actions
VIII. Lending Function	Provides credits in Certain circumstances	Investigate reasons and authorizations (probably in conjunction with audit)	Positive- would ensure that payment bureau funds are not being misappropriated Negative- Highly politically sensitive, parties will fight all the way

A particular concern is how to sequence reforms of the tax collection, statistical and payment functions in order to maximize the speed of reform but minimize negative shocks to fiscal revenues. Reform of the PBs must be neither too slow nor too fast. Given the current important role of the PBs in collecting tax revenues, a rapid move to alternative arrangements without suitable strengthening of the tax collection system may result in a significant negative shock to fiscal revenues. It will be essential to separate tax collection and Treasury functions and place them in more appropriate institutions. Assistance for and careful timing of this initiative will be crucial for reform success.

Reform should also not be unduly prolonged and delayed. It is already the case that a very large portion of the BiH economy is in the informal or "shadow" sector, in part due to PB practices. Any lowering of tax revenues that results from reforming the PBs will be offset to some degree by the greater willingness of businessmen and bankers to operate in the formal sector. It is also true that foreign payments, which account for a large portion of goods sold in BiH, are already paid through commercial banks, and many BiH banks are already performing (illegal) inter- and intra-bank transactions. If the PBs' monopoly on payments services were ended today, many activities could be immediately be undertaken by the private sector with little or n disruption.

Restructuring Plan and Comparison to Alternatives

Both the IMF and the World Bank (WB) have produced reform plans. Both plans recognize that PB reform steps must be carefully timed and that reform cannot be accomplished "overnight." This study proposes a reform program that builds on the work of these two efforts and is outlined in table V.2. The plan begins with the establishment of a new Governing Board for the Payment Bureaus to provide transparent corporate governance and control over the internal activities of the PBs. The immediate establishment of new corporate governance is necessary to insure that PBs undertake no activities which will breach the Currency Board rules or misuse funds for the benefit of ethnic interest or personal gain. This will be necessary during the interim period involving the restructuring of various functions of the PBs and privatizing the payments system. This new governing body should make the Payment Bureaus accountable and report their profits and losses through the Government's budget.

Table V.2: Action Plan and Timeline for Transformation of the Payment Bureaus in Bosnia and Herzegovina

Required Actions	**To be done Not later than:**
Reach agreement on the detailed transformation plan within the international community and with Entity and State governments	February 1999
Amend Federation Internal Payment Law to establish a new and improved managing board for the ZPP and good governance, transparency, and accountability	March 1999
Transfer of DM and Kuna domestically through ZAP and ZPP ended; all cash DM transferred to CBBH	April 1999: DM June 1999: Kuna
CBBH in cooperation with Entity Banking Agencies to develop and publish prudential standards for permitting banks to provide payment services	April 1999
Federation and Republic of Srpska to adopt a Payment Transactions Law and supporting legislation that governs payments rather than bureaus and establishes the rights and obligations of depositors, banks, and the CBBH; this Law will: -allow payment bureau account holders to transfer funds to a commercial bank of their choice; -provide legal provisions for checks and other payment instruments; -permit banks to establish correspondent accounts with each other and clear *on-us* transactions; -end requirement that all enterprises have accounts with the payment bureaus; -formulate laws on organizing clearinghouses	May 1999
Ending of the ZPP and SPP monopoly on payment processing	May 1999
RS Government will complete full separation of the SPP from the SDB and adopt amendments to appropriate laws to ensure proper operation and governance of the SPP (as above)	May 1999
PB management to cooperate fully with the international community in carrying out a functional audit of all of their activities, information flows, etc. and to provide relevant information and preliminary recommendations for the orderly transfer of functions to appropriate bodies	June 1999
CBBH develops payment order standards for interbank and other reserve account uses and for clearing customer payments through clearing houses or bilaterally	June 1999
All inter-entity settlement done in the CBBH	June 1999
Completion of financial verification of ZPP and SPP accounts by an internationally-reputed audit firm	June 1999
CBBH to develop rules and regulations governing banks' utilization of their reserve accounts at the CBBH to settle their net payments	June 1999

Begin process of building up Treasury functions at the Ministries of Finance	June 1999
Abolish overnight ceiling on cash holdings by businesses and the requirement that businesses deposit cash with the payment bureaus	August 1999
Adjust reporting requirements and other relevant instructions needed to enforce tax collection without reliance on payments bureau data; amend Tax Administration Law appropriately	August 1999
Establish new tax reporting systems in banks and businesses; enable the Ministries of Finance to collect taxes without need for payment bureau data	June 2000
Complete development of Treasury functions at the Ministries of Finance	June 2000
Banks meeting prudential standards for providing payment services and having established a new tax reporting system to open customer giro accounts and offer such services	(Once standards are met and reporting system put in place)
Develop alternate reporting mechanisms for state-owned enterprises, e.g. ex-post reporting	February 2000
Reassess PB's role as agents for storing and selling banknotes	December 200
Transfer statistical functions of the PBs to other institutions	December 2000
Organization of alternative clearinghouses	December 2000
PB clearinghouse assets (infrastructure and staff) that remain valuable to be sold off	December 2000

Another step is a functional audit of all the activities of the PBs and how these activities are currently organized. This functional audit will provide basic information necessary to design and implement a precise plan for dismantling the current non-payments functions and placing these functions within the proper public or private setting to support the Government or the development of private sector markets. A comprehensive financial audit of the PBs would be desirable but not cost effective. However, a limited financial verification focusing only on key elements on the balance sheet and income statement may be necessary to verify that records are accurate and that funds in the accounts are actually there and capable of being transferred to commercial banks. The fact that the PBs are capable of extending or creating credit in a nontransparent manner is sufficient justification to demand a restructuring of the PBs.

Transparency in the operation of existing PBs and review of existing legislation and drafting of new legislation relating to operation of payments systems are to be accomplished by the end of 1999. A new tax collection system is to be put in place during 1999 and 2000. Banks, however,. can begin clearing *on-us* and interbank payments as early as mid-1999 through alternative arrangements, for example through bilateral systems, reserve accounts at the Central Bank, or private clearinghouse(s). It is expected that by end-2000, the reform of BiH PBs will be complete. Activities properly carried out by other government agencies will be placed into new homes, and competition in the payments service sector will be introduced.

The plan proposed in this report is generally more ambitious than previous proposals. For example, while the recent World Bank report envisions organization of alternative clearinghouses by end-2001, and the IMF by end-2002, this proposed plan seeks to accomplish this by end-2000. As noted earlier, the private sector is capable of undertaking many activities currently run by the PBs very quickly and with little or no disruption. Bank officers questioned in the survey stated that they are already doing *on-us* transactions and could handle interbank clearing with selected partners within 3 months; they also said that the rest of the banks might take 6 months to catch on. They also claimed to be doing a limited amount of interbank domestic clearing with a few partner banks. A large portion of interbank clearing already takes place offshore, and there is a real danger that if reform is not undertaken soon, this will become the dominant clearing mechanism and turn domestic banks into affiliates of foreign commercial banks. The capacity of the BiH private sector to quickly and positively respond to elimination of the heavy hand of the PBs should not be underestimated.

An important step in the reform process is the ending of the legal monopoly on payment clearings by the PBs. Given private-sector capabilities, it is entirely plausible that alternative payment clearing mechanisms can be established relatively soon after the ending of this monopoly. Introducing competition into the payments arena would go a long way towards improving the quantity, quality, and price of payments services.

Introduction of new clearing mechanisms should be guided by several principles. First, any new mechanism should initially be aimed at involving only the most aggressive and potentially sound banks. The presence of large numbers of weak banks in the BiH financial sector should in no way preclude the establishing of a new clearing mechanism. Second, the system should be based upon credit transfers, which have lower costs and eliminate Counterparty risk. This requires some kind of clearinghouse arrangement among banks with Central Bank supervision. Moreover, any such system will require the eventual development of an interbank market to avoid settlement and systemic risks. Third, because the clearinghouse arrangement will likely be a net settlement system, it should be backed up by a large value transfer system to accommodate both interbank transfers to meet settlement obligations and an interbank funds market if borrowing is necessary. This is especially important with a currency board arrangement where Central Bank extension of credit to banks is not permitted. Fourth, pricing on a *per-item* basis is to be encouraged. Costs are related to numbers of transactions rather than the numbers written on the pieces of paper being processed. Hence, prices should reflect these costs. This also gives incentives for the users to migrate to the least cost payment media. Fifth, since it has been shown that electronic payments have the lowest costs, all systems and formats should be designed so that they can easily migrate to electronic form. Finally, since BiH trades with the European Union (EU), its currency will be tied to the European Monetary Union (the Euro will replace the D-Mark for the currency board peg). Thus, as the European Union is moving east (as close as the former Yugoslav Republic of Slovenia), all systems should be designed to be consistent with EU standards.

We finally note that the proposed reforms of the PBs may come at the social cost of higher unemployment. The PBs together employ approximately 2,500 people.[36] Given the nature of the PB activities, many of their employees are likely to have skills that will be in demand as the commercial banking sector expands after PB reform and the reform and opening of Bosnia's financial markets. Some PB employees should be able to transition to new jobs in the commercial banking sector, alternative clearinghouses, and other financial institutions with little need for retraining or job placement. There may be a need to establish training and placement programs for those who will experience difficulties in finding new positions. Early retirement programs should also be reviewed as viable alternatives for some workers that may lose their jobs. However, it must be noted that the gains that will come from eliminating current PB practices will have an important positive impact on the level and growth of national income, and this will increase public revenues, a part of which can be used to finance benefits for any former PB employees experiencing difficulties in the labor market. Worrying about inefficiencies in the process of reform is misplaced given the remarkable costs of current payments arrangements. Even if some social costs are incurred by change, it would be far better to enter into a period of reform than to retain the abysmally wasteful status quo.

[36] ZPP employed 1,091 people in October 1998. According to employment data from special-data sheets submitted for individual substations, ZAP employed roughly 430 people in 1997. SPP employed roughly 1,000 people in mid-1998

Implementation Plan and Initial Actions

GOVERNING BOARD OF THE PAYMENT BUREAUS

The various functions of the Payment Bureaus must be split apart and reorganized to support a free market economy. Implementing this effort mandates the establishment of two independent Boards (one for each entity), with sufficient powers to divest and reorganize the various functions now performed by the PBs. This requires the entities to immediately amend their internal payment and other appropriate laws to establish new and improved managing boards for the PBs.

This independent body or Governing Board must be given broad powers to govern the activities of the PBs while the functions are being separated and it should be given specific authority to undertake the process of dismantling and reorganizing these activities. The name of the Independent Board should be **The Financial Infrastructure Reorganization Board (FIRB).** This Governing Board should be given a specific mandate, defined powers and a timetable for completing its mandate. As all of the functions of the PBs will be either privatized or placed within an appropriate Government Ministry, the FIRB will have a limited life expectancy.

Need for an Independent Board: The first step in the implementation process is to take control of the three PBs. Currently the PBs are controlled by ethnic interests at the regional and entity level. While the payments system function of the PBs should be a unified statewide system, some of the other functions properly belong at the entity level. Since functions to be reorganized will be both state level and entity level, the Board overseeing the divestment of these activities will need to be organized along Entity lines but with an internal decision making body empowered to coordinate appropriate activities at the State level. The Central Bank of Bosnia and Herzegovina (a State level institution) is likely to play a major role, because it has a legislative mandate to manage the payment system environment, which is one of the major functional areas to be divested and reorganized.

Mandate: The FIRBs should be given a mandate to divest the various functions of the PBs and reorganize these functional activities into appropriate private and public sector institutions capable of supporting a free market private enterprise economic system. The Board should receive its mandate directly from the Entity level Governments. The Board must have full control of the PBs and must be clearly assigned decision-making authority.

Composition of and Support to the FIRB: Each of the FIRBs should be composed of not more than three members representing the following: the Prime Minister, the Banking Agency, and the Ministry of Finance. The FIRB will set policy and authorize divestitures of functions. An International Advisory Group (IAG) representing the following organizations: USAID (chair), IMF, World Bank, EU, OHR and US Treasury (UST) shall be established. The IAG will advise and assist the FIRBs and entity authorities with the

implementation of the agreed actions. The IAG will be advised by a group of prominent businessmen and bankers, and is supported by a Secretariat, provided by USAID, composed of a coordinator and technical and support staff. A donor/team leader will be identified/assigned to each functional area to be divested and reorganized. The IAG and Secretariat will provide a plan for the orderly dismantling of the PBs functions, which must be approved in whole and in part by the FIRBs. The technical assistance teams will be funded by the respective donor responsible for providing a systematic plan for divestment of each functional area. In order to ensure that each functional area activity (project) is consistent with the agreed strategy and that it takes into account any interrelationships with other areas, a preliminary terms of reference will be developed by the assigned team leader for each technical assistance area and reviewed by the IAG. The coordinator and functional area team leaders will report to and take directions from the IAG, consistent with the overall policy direction and authority of the FIRBs.

Timetable: The timetable for completing the work mandated of the FIRBs should reflect the eighteen months to two year horizon proposed in the "Payment Bureaus in Bosnia and Herzegovina: Obstacles to Development and Strategy for Orderly Reform."

Immediate Actions

The first action should be to commission a functional audit and limited financial verification of the three PBs. These two efforts will provide the information necessary to develop a systematic plan for an orderly reorganization of the functions of the PBs. With this information the systematic plan will then be produced by the Task Force coordinator with the help of the functional area directors to be assigned to divest functional areas of the PBs.

1. Functional Audit

The functional audit will document all functions performed by the PBs and the interrelationships among these functions. This is a necessary starting point for the development of a strategic plan to separate and reorganize these functions as either Government or private sector activities.

Scope and Level of Effort: The scope of the functional audit should be both broad and detailed, resulting in a document which not only specifies all functions performed by the PBs but all interrelationships among these functions. Conceptually, this document should take the form of an input-output analysis for each function performed by the PBs and a separate analysis of the input dependencies among functions. Thus, input in one functional area like a payment order, which creates an output measured in terms of financial transactions, is also a required input to a second functional area like tax collection. Therefore, information developed in the payments function would be a required input for a second function, tax collections. Either this input must be maintained or an alternative

input substituted in order to maintain tax collections. Conceptualizing each function and the interrelationships among functions in this way produces a precise picture of the interrelationships among functions. Such a process is necessary to assure that all functions may be performed as they are removed from the joint products produced by the PBs.

The level of effort involved in the functional audit would require the services of a team of seven professionals for one month and back up staff. The professionals would include a project management specialist, an organization design specialist, an information management specialist, a payment system specialist, a public finance specialist, an economist familiar with input output analysis and a professional writer. Backup staff would include two translators with typing skills, and two interpreters each hired for a period of six weeks. Two cars with drivers will also be needed as well as computers, printers etc.

2. Limited Financial Verification

The limited financial verification would review and verify the existence all financial accounts held by the PBs. This step is necessary to provide transparency as to what exactly is held by the PBs and to provide certainty as to the size and nature of accounts which will ultimately be placed under the control of privately owned financial institutions.

Scope and Level of Effort: The financial verification would be narrow focusing only on key elements on the balance sheet and income statement, and a few off-balance sheet items. The emphasis here should be on verification of what is on the books or controlled by the PBs. It is only necessary to verify that records are accurate in that funds on account in the PBs are actually there and capable of being transferred to another institution in the private or public sector. No attempt will be made to ascertain where missing funds may have been directed. The fact that they are no longer available is sufficient information for the purpose of relocating these accounts. The product produced would be a document specifying the key elements targeted for verification and the results of the verification effort.

The level of effort for the financial verification would involve two professional financial auditors for a period of three weeks and a sufficient number of lower level support workers to place at least one support worker at each Payments Bureau location simultaneously for a period of four days. The support workers could be local hires trained by the two professional auditors for this effort. Transportation to the Payments Bureau locations would be required for the lower level support staff. Office, staff and equipment would be necessary for the two professional auditors and at least one translator/ typist for a period of one month.

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ANNEX 1

Payment Bureaus Procedures And Practices

ZPP/ZAP/SPP PROCEDURES AND PRACTICES

I. Accounts

Deposit policies

No interest is paid on funds on deposit. In ZPP areas accounts are denominated in DM and KM. In ZAP areas the accounts are denominated in Croatian Kuna (KN) and DM. In Serbian areas they are denominated in Yugoslav Dinars (YUD), DM, and KM. A DM account must have a minimum of DM 300 on deposit.

Numbering protocol

Each PB account consists of a 5 digit prefix signifying the municipality branch office, followed by a three digit code signifying the company's statistical code, followed by a seven digit number for DM accounts, and a three to six digit number for KM accounts. The statistical codes are: 500-599 aggregate deposits with banks; 600-699 transaction accounts; 700-799 investment, holding, and fiduciary accounts; 800-899 tax accounts. The DM account number is the same as that of the KM account, with the number "2" added to the beginning of the account number. Government bodies have a hyphenated six-digit account for tax collection purposes. An example would be:

	Branch Designation		Statistical Code		Account Number
a) KM account	10194	-	601	-	123456
b) DM account	10194	-	601	-	2123456

Significant accounts

Business accounts (601): The 601 designation indicates a company engaged in manufacturing and trade. These account for the vast majority of PB accounts. All businesses have two 601 accounts: KM and DM. Academic, scientific, and news agency accounts (603): schools, some non-profit organizations, and newspapers utilize These accounts. It appears that radio and television come under this category. Bank accounts (620): In addition to the standard 601 account, a bank has several additional accounts on which it can receive deposits. The primary account is the 620 accounts. Government agencies (630): This includes government agencies off various types, and may or may not include ministries. Parastatal institutions (637): These include the PB and PTT accounts. This may also include government ministries. Small shops and small hospitality industry (678): These include small restaurants, cafes, bed and breakfast, small "Mom & Pop" type stores, etc. Government tax accounts (840-849): These accounts are used for collecting taxes and customs duties, communal infrastructure services (843), pensions and swage contributions (842), etc.

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II. Payment between two legal entities via the PB (business to business, business to individual, business to governmental agency, etc.)

Transfer procedure

The payer fills out a virman (a quadruplicate copy payment slip). This requires him to fill in his PB account number (a fourteen or fifteen digit number), the PB account number of the payee, the amount, and the purpose of payment. In addition, the payer is required to add internal PB numerical control designations, for which a widely sold hanDBRSook is available. Each virman must be signed by the company's authorized signatory, whose signature is on file at the PB. Each virman must also be stamped with the company stamp. If the payment is to be made in DM, the payer must take a red pen and draw two diagonal lines across the virman from the lower left-hand corner to the upper right-hand corner (in Croat-controlled areas, the lines run from upper left to lower right; in Serb areas, the lines run vertically down the left side of the virman). If the red lines are not present on a DM payment, the PB will refuse to accept the virman. There are no red pens available in the PB!

The payer takes the virman to the PB. The payer waits in line for his controller. Each firm has its own specific controller. The payer may not go to a different controller. Any given controller may have a long line of customers, who have to wait for up to 45 minutes to finish a transaction, while another controller may have no one in line. When payer reaches the head of the line, he presents the virman to his controller. The controller manually checks the amount on the virman against the balance in the payer's account.

Account information is contained on large stacks of computer printouts. If the payer's balance is sufficient, the controller manually records a debit on the computer printout. The controller then takes two of the copies, stamps them with a stamp, and returns two copies, both stamped. If the account balance is insufficient, the controller refuses to conduct a transaction.

Most firms and legal entities as proof of payment accept the fourth copy (known popularly yet illogically as the fifth copy – peti primerak). In theory the funds will be credited to the payee's account within one to two working days.

Fees

The PB charges a percentage for each debit and credit transaction. Fee schedules are unavailable to the customers. Rates seem to differ from branch to branch and from business to business. On the basis of available evidence, it appears that fees range from 0.10% to 0.70%. It is unknown how much is charged for cash withdrawals and cash deposits.

Problems

Settlement times: In practice, funds transferred between the Muslim dominated areas of the Federation arrive within one to two working days, except where distances are greater --between Bihac and Sarajevo for example. Transfers between the Muslim and Croat controlled portions of the Federation (ZPP to ZAP) require from 3 to 4 days (although one surveyed business stated that such transfers require from 15 to 45 days). **Note: the settlement procedure that was put in place since September 1998 at the CBBH has cut the required time significantly—to same day or in one day).** Although transfers between the Federation and Republika Srpska in theory require ten to fifteen days, businesses require export and import permission for this type of trade, thus driving most inter-entity business off the books.

Routing errors: The PB system frequently makes errors in routing funds. It appears that all transactions are carried out manually at the branch level, and are then sent to a central location for data entry at the end of each working day. This leads to multiple opportunities for human error. PB never checks for errors, and the customer is responsible for maintaining his own financial records and balance. When PB misroutes funds, it can take several months for the customer to detect the error. After this, several more months may pass before PB corrects the error. In some instances, PB will refuse to acknowledge an error has occurred.

Fraud: In instances where funds are transferred between PB branches, fraud will occasionally occur, when an account holder, in collusion with a PB employee, will stamp the fourth copy of the virman without debiting the payer's account. The payer then uses the false copy to obtain goods or services. The smaller PB branches present the greatest problem in this regard. Several respondents reported this problem, including banks.

Transaction time: Each transaction requires a trip to the PB, and a wait in line. It takes on average from four to five minutes to fill out each virman.

Paperwork: Preprinted virmans with a company's complete account information are unavailable. This leads to unnecessary loss of time through repetitively filling out account information. Respondents report this system requires them to double their bookkeeping.

Black economy: The above factors, combined with the PB's reporting of all transactions to the financial inspectors, causes many businesses to avoid the system altogether and engage in cash transactions (illegal) and route payments through private bank accounts outside the country. The current legal barriers against trade between the two entities force many firms to work around the PB system if they wish to engage in inter-entity trade.

III. Verifying a PB account balance

Balance statement

The PB does not issue a daily, weekly, or monthly statement of account balances. Rather, it issues a so-called statement only when there has been a change in the account balance, i.e., credit or debit. If an account is inactive, no balance statement will be forthcoming. Ironically, this report is called a "daily report" (dnevni izvod). Typically the KM and DM statements are issued on alternating days.

The account is credited

When an account is credited the daily report includes the second copy of the virman so that the credited party knows who paid.

The account holder debits his own account: PB will not include any information to inform the account holder of the payee's identity. The account holder is required to maintain this information separately. This requires the account holder to duplicate the entire PB record-keeping process.

PB unilaterally debits an account: This occurs when PB collects its fees or when a government agency collects taxes. A computer printout will accompany the dnevni izvod informing the account holder of the debit. At the end of the month PB encloses a short statement informing the account holder of how much money PB charged for its services.

Problems

Accessibility of account information: The daily report can be picked up at the local PB during restricted office hours–typically before 11:00 AM. The person collecting the report must know his company's entire 14 or 15 digit account number. The wait in line to collect a dnevni izvod can last up to 45 minutes. If a dnevni izvod is unavailable, controllers are not allowed to give account balance information. This system of alternating KM and DM statements also presents problems for the account holder, particularly around weekends or holidays.

Abuse: Although information is theoretically confidential, the daily reports are handled in a manner that leaves them open to public examination. In addition, many businessmen use their insider PB connections to view their competitors' account information, balance sheets, and cash flows. Respondents indicate that PB insiders show their cash flow statements and year-end balance sheets to criminals, who then visit the companies and extort money from them. PB employees also report suspicious account activities to the financial inspectors.

Duplication of records and effort: The system of daily reports requires each account holder to maintain his own parallel book-keeping system to catch PB errors and to maintain accurate records of all transactions.

IV. Withdrawing cash from a PB account

Cash Limits

The maximum amount permitted for daily cash withdrawal is DM/KM 1,000, typically in a mix of DM 800 and KM 200. If the account holder withdraws cash frequently, PB controllers will closely question subsequent withdrawals. If frequent cash withdrawals continue, the account holder receives a visit from the financial inspectors, who then perform a full audit. It appears that the PB informs the financial inspectors of frequent cash withdrawals.

Withdrawal procedure

- The account holder purchases a checkbook from PB. All checks are blank. They do not contain preprinted account information.

- The account holder fills out two checks in duplicate form: the first for DM 800 and the second for KM 200. Writing in his 14-digit KM account number and his 15-digit DM account number does this. Each check must be signed by an authorized signatory, whose signature is on file at the PB. Each check must also be stamped with the company stamp.

- The check for DM must have two red lines running diagonally from the lower left-hand corner to the upper right hand corner (in Croat-controlled areas the lines run from the upper left to lower right; in Serb areas the lines run vertically down the left side of the check). If the red lines are not present on a DM check, the PB will refuse to accept the check. There are no red pens available in the PB!

- Account holder waits in line for his controller.

- Controller verifies the account balance against the check amount. If the transaction is approved, the controller keeps one copy of each check, while giving the account holder back a stamped copy of each check. The account holder also retains a check stub for record-keeping purposes.

- The account holder waits in line at the KM likvidatura window.

- The teller stamps the KM check and places it on a pile of checks and cash deposit slips.

- The teller manually records each document in the pile on a piece of paper. When the teller has finished, he gives the pile of documents to the teller at the adjoining KM blagajna window.

- When the KM blagajna teller finishes the required paperwork he calls out the company's name and disburses cash. The account holder must present picture I.D., which is recorded, and sign for the cash. The amount withdrawn is open to public view.

- The account holder then repeats the same process at the DM likvidatura and blagajna windows with the DM check.

Problems

Time: The entire process has been known to take up to two hours.

Liquidity: Sometimes, especially at the end of the month, cash is unavailable in sufficient quantities to meet all account-holder needs.

Justification: By law, the account holder must have cash receipts to justify all the cash he has withdrawn. Businesses are prohibited from making cash expenditures in excess of DM 99. Therefore, the amount on any given receipt may not exceed DM 99.

Amount: The limit on cash withdrawals limits a business's ability to function in an efficient manner.

Confidentiality and security: Any cash withdrawal is witnessed by many PB customers, which to leads to problems with account confidentiality as well as the security of the person withdrawing cash.

Black economy: The above-mentioned problems force the typical business to conduct its cash business outside the PB system.

Abuse and fraud: Several respondents have reported circumventing the limits through their friends in the PB. The most common practice appears to be withdrawing large amounts of cash at once and then debiting the account over a period of days using the DM/KM 1,000 limit until the amount has been covered up. This typically does not show up as a negative balance.

V. Depositing cash to a PB account

Procedure

- The account holder fills out two cash deposit slips, one for the KM account and one for the DM account. He is required to fill in his 14 and 15 digit account numbers.

- The account holder waits in line at the KM likvidatura window. When he reaches the front of the line, he gives the teller his deposit slip. The teller stamps the slip, records it, and puts it on a pile. The pile is given to the KM blagajna teller.

- The blagajna teller calls out the company name, takes the cash, counts it, and verifies the deposit.

- The account holder then repeats the process with the DM deposit.

- For retailers, this process must be repeated every day, as the law requires them to deposit all revenues at the PB within 24 hours.

Problems

Time: Retailers and other companies engaged in cash operations are required by law to deposit 100% of their previous day's revenues at the PB. The wait to deposit can last up to an hour or longer, depending on the lines.

Confidentiality and security: Any cash deposit is witnessed by tens of PB customers, which to leads to problems with account confidentiality as well as the security of the person and company depositing cash.

Waiting: The entire process has been known to take up to two hours.

Black economy: The requirement to deposit 100% of all revenues in the PB drives 100% of all retail businesses to conduct a substantial portion of their cash transactions outside the PB system.

VI. Blocking a PB account

Blocking priorities

The order of priorities for blocking accounts is as follows: 1) taxes; 2) court orders; 3) workers' salaries and social contributions; 4) acceptance orders. Any of the three higher priorities take precedence over collecting private-sector debt.

Blocking order

A mechanism exists to place a lien on a PB account. Known as an akceptni nalog (acceptance order), a company will use it as security for bank loans, or goods received on deferred payment. In order for an akceptni nalog to be honored, it must be accompanied by a letter from the account holder (debtor), giving his permission to the PB to honor the akceptni nalog. In addition, a contract must be signed between the debtor and the creditor, clearly delineating the terms under which the creditor may use the akceptni nalog. Both the akceptni nalog, the accompanying letter of permission, and the contract must bear the signatures and stamps of the debtor issuing the akceptni nalog and the creditor.

Placing a lien

In the event that the creditor is unable to collect his receivables through normal means, he will take the akceptni nalog to the debtor's PB branch. After identifying which controller is responsible for the debtor's account, the creditor will wait in line. Upon reaching the front of the line, the creditor will present the akceptni nalog, letter of permission, and contract to the controller. If all documentation is in order, the controller will place a lien on the debtor's account in the amount specified on the akceptni nalog. When this amount has been transferred to the creditor's account, the lien is automatically removed.

Freezing an account

This occurs when a government agency, typically the financial police, freezes an account of a company which is under suspicion of illegal activities. It also appears that other agencies are capable of freezing a PB account. A freeze will occur on a client's account if the account of the client's commercial bank is frozen.

Problems

Fraud and abuse: This is one of the biggest complaints among survey respondents. Regulations require the PB to debit an account according to its priorities, which leave business debt in last place. Frequently, debtor companies are blocked for long periods of time and continue to function normally, while the blocking creditor company is unable to collect a single DM. A debtor will frequently use inside connections in the PB to block implementation of an akceptni nalog. This may take several forms:

> *The controller may refuse to accept the akceptni nalog, claiming there is a technical error in the manner in which it was filled out.*

Although accepting the akceptni nalog, the controller will not block the debtor's account and will allow the debtor to continue to use his account in the normal fashion.

The controller will accept the akceptni nalog and immediately notify the debtor, giving him time to transfer all funds out of his account before it is officially blocked.
The controller, acting on instructions from higher authorities in the PB, will refuse to block the account. The Energoinvest vs. Intrade case is an example of this.

Lack of PB control over issuance: Although the law forbids an account holder from issuing an acceptance order without sufficient funds in the account as security, this law is never or rarely enforced. Account holders are allowed to issue as many acceptance orders as they desire. Legal penalties either do not exist, or are not enforced. Many account holders issue acceptance orders for goods and services on terms of deferred payment then open another company with the intention of not paying their debts. In theory the PB is required to begin the liquidation of a company that is blocked for longer than 30 days and is unable to meet it obligations. It appears that this has never happened. In Croatia acceptance order fraud is now treated as check fraud and is vigorously and immediately prosecuted.

Criteria for blocking: When a bank's PB accounts are blocked, all companies with accounts at that bank also have their PB accounts blocked. In the instance of SAB bank this blockage lasted for some time and forced these businesses either to close or operate entirely in the black. The reasons and circumstances for blocking an account remain unclear. It also seems unclear as to who may exercise the blocking authority.

Black economy: The possibility that a government organization or a creditor may arbitrarily block an account causes many businesses to work outside of the PB system. There are numerous instances of businesses whose PB accounts have been frozen for over one year, during which time they have been unable to pay taxes, legally meet payroll obligations, and pay their suppliers. Yet these business continue to function in the black economy.

VII. Payroll through the PB

Paperwork

To complete a payroll transaction the PB requires nine (9) different documents per employee per municipality per pay cycle. If all employees live within the same municipality, only nine documents are required. If they live in different municipalities, nine pieces of paper must be utilized per municipality. These do not include the documents required by the tax authorities in the municipalities. The PB requires these documents simply to execute the transfers of funds required to pay taxes and social contributions, which amount to 87% of a workers total salary. This amount is not deducted from the workers' salaries, but is paid in addition to the salaries. It is calculated using the workers' wages as a base, i.e., a salary of DM 100 monthly would require the company to budget DM 187, plus DM 85 for the warm meal -- a total of DM 272.

Procedure

- Fill out one virman for the employer's contribution to the PIO (pensioners' and invalids' fund).
- Fill out one virman for the workers' contribution to the PIO.
- Fill out one virman for the employer's contribution to the unemployment insurance fund.
- Fill out one virman for the employees' contribution to the unemployment insurance fund.
- Fill out one virman for the tax on salaries.
- ***Fill out one KM check for the total amount of salaries***
- Fill out a second KM check for the "warm meal" (DM 85 per worker per month).
- ***Take the nine pieces of paper, with the municipal tax forms, to the PB***
- Wait in line at the controller's window. Give the controller all seven virmans and the two checks.
- The controller will process the virmans and the check as in a normal transfer payment and cash withdrawal transaction.
- After receiving the fourth copies of the virmans and the verified check copies, take the checks to the KM likvidatura window and follow the process for withdrawing cash (see IV/e above).

Problems

Occasionally the PB will run out of cash at the end of the month.
Small firms reported spending from one to two working days to fill out paperwork.
Larger firms have three and four man staffs working full time to complete payroll.
The amount of paperwork causes many firms to hire workers illegally to avoid the system.

VI. Transferring funds abroad from a PB account

Practice

This function may realistically be used only to pay the invoices or pro-forma invoices of foreign suppliers. Money may not be transferred to the foreign account of a private individual from a company account.

Procedure

- Fill out a virman in the amount to be transferred, plus the bank's commission, and observe the regular procedures for payment (see II/a above).
- Take the following documents to the bank:

- the fourth copy of the virman.
- a signed and stamped duplicate copy of the 1450 form.
- an original or facsimile copy of the invoice to be paid.
- complete payment information for payee.

The bank will complete the transaction.

Repatriation of profits

Although the law permits the repatriation of profits by foreign investors, a tremendous amount of paperwork is required from various government ministries, which renders repatriation by legal means impractical. It appears that several foreign-owned firms have the Parent Company send fictitious invoices, which the Bosnian affiliate pays.

Problems

It appears the PB is an unnecessary step in the entire procedure of foreign payments, coming between businesses and banks.

Official Schedule of ZPP Payment Service Tariffs

(Published in the Sluzbeni List of the Republic of BiH, Br.11/1996)

Type of Service	Basis for Calculation	Fee
Fee for non-cash payments operation		
Receiving, control and processing of payments; producing summaries, specifications; services of keeping records, collection, calculation; distribution and directing revenues from aggregate temporary accounts, producing certain reports (B-2 and DBRS-2) and information on flow and balance of funds under public	-up to 3,000,000 BHD	0.2%
	-from 3,000,000 BHD to 6,000,000 BHD	0.15%
	-over 6,000,000 BHD	0.1%
For foreign currency payments operations.	-up to DM 30,000	0.2%
	-DM 30,000 to 60,000	0.15%
	-over DM 60,000	0.1%
Fee for cash payment operations		
Payments in cash for commercial bank accounts and for government budgets (620, 621, 623, and 630).	Individual payment	0.1%
Payments for other account holders	Individual payment	0.2%
Citizens' payments	Individual payment	0.5%
Payments of donations for BH Army by citizens	Individual payment	free
Data transfer from payment operation's order to other ZPP branches by phone, FAX or teleprinter		
For bank and government budget accounts (620, 621, 623, and 630)	(max. payment of DM 100; min. payment of DM 5)	0.1%
For other account holders	(max. payment of DM 250; min. payment of DM 5)	0.25%
Subsidies and cash surpluses from post		0.1%
Bank deposit operations		
Operations under NBBH functional account (508)	Debit transactions	0.15%
Operations under bank's functional accounts	Debit transactions	0.3%

ANNEX 2

PB Business-Client Interviews

PB QUESTIONAIRE INFORMATION

Company I.D. number: A302
Ownership: Private sole proprietorship
Type of business: Manufacturing, service
Location: Republika Srpska, and Federation

Company and management profile:
The manager owns companies in both RS and the Federation. The companies are approximately 2 kilometers apart.

RESPONDENTS' REACTIONS

His business in RS operates almost entirely outside the law. He uses the SDK only to pay the necessary bills and his taxes. Everything else is done in cash. It is easier and cheaper for him to bribe the tax inspectors than to deal with the SDK. He views the SDK as a state arm designed to take money from businessmen. He feels the state is corrupt, and therefore he should not have to support it. This causes him to skirt the SDK entirely. He dislikes the fact that the state has insight into his business activities. He claims to have received visits from criminal elements on the basis of his cash flows through the SDK. He feels the level of criminal activity in RS is far greater than in the Federation, and that these criminals are tied in to the local government. He also dislikes having the SDK take control of his money. He does not use the SDK system to transfer funds between his companies in the two entities. First of all, he doesn't place his excess cash into the SDK system. Secondly, there is too much paperwork required to do business between entities. Thirdly, it is easier for him to load cash into his bag and drive his car across the inter-entity boundary. His business in RS is service oriented, thereby generating lots of cash which is unreported. His business in the Federation purchases raw materials on the black market and sells most of his manufactured goods for cash to other companies engaged in cash businesses. He estimates that he conducts approximately 75% of his Federation business off the books. He states the Federation ZPP system is actually inferior to that of RS He says the RS system is more efficient and has shorter waits for money. He attributes the shorter waits to the smaller volumes handled by the Serbian system, which in turn is caused by higher incidences of black market activity. He also complained about the state of the banking system in RS, stating that it was primarily a scam for the state to get its hands on the foreign currency savings of the private citizens. In either case, he dislikes both ZPP systems and would prefer to use a private bank.

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PB QUESTIONAIRE INFORMATION

Company I.D. number: A440
Ownership: Private, sole proprietorship
Type of business: Manufacturing, barter-trade, wholesale and retail
Location: Federation, Zenica-Doboj Canton

Company and management profile:
The company is one of the larger manufacturers in Bosnia-Herzegovina.

RESPONSES:

Transaction settlement time:

- Within Bosniak-controlled areas: 1 to 2 days
- Between Bosniak and Croat-controlled areas: 18 to 45 day
- Between Federation and Republika Srpska: unknown

RESPONDENT'S REACTIONS

His complaints were many, and centered generally on the cronyism and corruption in the ZPP. He currently has numerous court decisions in his favor blocking the accounts of various companies and government agencies. In the instances where he has blocked companies, these companies are good friends with the local ZPP director, and the firms continue to function. In one instance a fully functioning company with 300 employees has been blocked for over one year and not a single DM has been collected. He has court decisions against several government agencies, none of which is being enforced. According to Bosnian law, if a company issues an acceptance order, it must have a corresponding amount of cash in its ZPP account on the day of issuance. If the company does not have funds, it is a criminal offense, and the ZPP is supposed to take action. To the best of his knowledge, the ZPP has never taken the legally required action against any company that has broken the law. In theory, if a certain period of time passes -- he thinks 30 days -- and the company has failed to meet its obligations, then the ZPP is supposed to begin a court-monitored liquidation of the company to meet the outstanding financial obligations. This has never occurred. His greatest frustration concerns the businessmen who open one company and get goods on terms of deferred payment using an acceptance order as guarantee. They then open another company, issue more acceptance orders, and fail to meet their financial obligations from the first or second company. Over time these businessmen will open an entire series of companies based entirely on unsecured acceptance orders. He mentioned Alemko Nuhanovic as an example of this. Another problem is the transaction time between ZAP and ZPP. It typically takes between 25 and 45 days for a transaction to occur. In one instance he had his customer push the Mostar ZAP and the transaction breezed through in 18 days. The problem is that the payment slip goes from the local branch ZAP to the Mostar main ZAP. From Mostar it travels to

Sarajevo main ZPP, then to the cantonal ZPP, and then to the local ZPP branch. He has friends in ZPP who enable him to get around the cash withdrawal limits. He does not feel his records are confidential and feels anyone can look at them. He didn't know how much the ZPP charged, and found out from his bookkeeper that it was 0.15% and 0.25%.

PB QUESTIONAIRE INFORMATION

Company I.D. number: B219
Ownership: Private, sole proprietorship
Type of business: Manufacture of construction materials, general contractor
Location: Federation, Sarajevo Canton

Company and management profile:
The director has been in the business for over 20 years. A Muslim, he conducts business with Republika Srpska and the Croat-controlled areas of the Federation.

RESPONSES:

Transaction settlement time:

- Within Bosniak-controlled areas: 1 to 2 days
- Between Bosniak- and Croat-controlled areas: 3 to 4 days
- Between Federation and Republika Srpska: unknown -- he does only cash business with them.

RESPONDENT'S REACTIONS

The director has friends in the local ZPP and has been able to circumvent the cash withdrawal requirements. Because of the low purchasing power in Bosnia, he is forced to operate with a very low margin. There have been instances on certain jobs where the ZPP collects a higher percentage of the margin than he does. He complained that the ZPP is a state within a state, and that no one can effectively sue it. He mentioned the Energoinvest vs. Intrade court case as an example. The amount of time spent completing ZPP paperwork is high: a minimum of three hours per day. He has one employee (in addition to a full-time book-keeper) who spends at least half of his working day carrying out ZPP related tasks. The requirement to pay workers is extremely burdensome. In order to pay one worker, the ZPP requires the completion of 9 different forms, not to mention the paperwork associated with the municipal tax authorities. Because of this he pays his workers illegally with cash. He complained that the financial records are literally on display where everyone can thumb through them. He has looked at other people's ZPP records to see if they had money in their account. In the one instance when he ran a negative balance, it was due to the ZPP debiting his account for fees, which he had insufficient funds to cover. Nonetheless, the ZPP deducted its fees and created a negative balance, which lasted for two days. He feels the ZPP is a worthless organization and should be replaced by a banking system. He is upset that the ZPP takes his money, doesn't give him interest, and charges him a fee for working with his money.

PB QUESTIONAIRE INFORMATION

Company I.D. number: B851
Ownership: Private, sole proprietorship
Type of business: Glazing firm, general contractor
Location: Federation, Sarajevo Canton

Company and management profile:
The director of the company has over 20 years experience as a glazier. He was very active in the large-scale go-go humanitarian re-glazing projects of 1996 and 1997, during which time he handled large amounts of cash.

RESPONSES:

Transaction settlement time:

- Within Bosniak-controlled areas: 1 to 2 days
- Between Bosniak and Croat-controlled areas: 3 to 4 days
- Between Federation and Republika Srpska: unknown

RESPONDENT'S REACTIONS

The director has numerous friends in the local ZPP (including a mistress) and has been able to circumvent the cash withdrawal requirements. Once he withdrew DM 17,000 in cash in the course of one day. The ZPP workers planned to cover it up by debiting his account over the course of 17 working days at DM 1,000 per day. Two days after the withdrawal a supplier blocked his account with an acceptance order for DM 42,000. Because the ZPP workers needed to cover the DM 17,000 disbursement they refused to honor the acceptance order until 15 working days had passed. After the cash withdrawal had been successfully covered up, they allowed him to transfer all remaining funds out of his account. Only then did the ZPP honor the acceptance order. His company's bookkeeper is also the financial inspector assigned to monitor his company, and she is a former ZPP employee. Because of the paperwork associated with paying workers, he only carries 2 of his 32 employees on the books. He is regularly able to access other people's financial statements and uses them to his advantage. He is certain that others have seen his information. Although he admitted to having received a loan from ZPP, he refused to disclose the amount or the terms of repayment. His only comment was that he had paid off someone. When asked how widespread this type of behavior is, he claimed that everybody has friends in the ZPP and that everybody uses it to their own advantage. He thinks he is charged 0.10% by the ZPP, but is not certain. Although he dislikes the ZPP system, he cannot imagine a different system to take its place.

PB QUESTIONAIRE INFORMATION

Company I.D. number: B465
Ownership: Private, sole proprietorship
Type of business: Manufacturing – garment industry
Location: Federation

Company and management profile:
The owner is a former manager in a state-owned company.

RESPONDENTS' REACTIONS

The owner's first response when asked about the ZPP was to throw his hands in the air, exclaim "arragh," and begin cursing. He used very colorful and unrepeatable language, in which he questioned their legitimacy, their mother's marital status, and made a few suggestions that they perform anatomically impossible acts on themselves. The owner views the ZPP as an organ that offers his business absolutely nothing, while taking everything from it through taxes, and by restricting his cash flow. For internal sales he operates as much as 90 % in the black economy, choosing to avoid the system entirely. Only for direct exports does he operate through the ZPP with 100% compliance, this due to the customs paperwork needed to track goods across the borders. He views the ZPP as slow, inefficient, cumbersome, and corrupt. He related two different instances when an acceptance order had not been honored because the other companies had friends in the ZPP. He also lamented that there is no adequate legal system to assist businesses in collecting their debts. He said the ZPP is a state within a state, and that it is above the law. He dislikes the time he has to wait. The fees are too high, and he has no idea what they are, or on what basis they are collected. He has had several tax audits over the past nine months, partly, he feels, because he has made enemies within the local ZPP branch by complaining to them about their service, as well as about the corruption when they wouldn't honor the acceptance order. When he asked the tax auditors (financial inspectors) why they were auditing him so frequently, they said it was because they had received information from the local ZPP that he may be cheating on his tax statements. He has a full-time bookkeeper on his staff, even though he has only 45 employees. In addition, he must have another employee devote half of his time to ZPP-related activities.

PB QUESTIONAIRE INFORMATION

Company I.D. number: C361
Ownership: Private, sole proprietorship
Type of business: Import-export, distribution, wholesaling grocery items and household products, barter-trade
Location: Federation, Sarajevo

Company and management profile:
The director is Muslim, but does business with Republika Srpska and has strong business ties with Croatia. The company is supplies grocery stores throughout the Federation. He indicated a willingness to go on record against the ZPP if asked to do so.

RESPONSES:

Transaction settlement time:

- Within Bosniak-controlled areas: 1 to 2 days
- Between Bosniak and Croat-controlled areas: 3 to 4 days
- Between Federation and Republika Srpska: up to 20 days

RESPONDENT'S REACTIONS

The director exhibited extreme displeasure with the ZPP, stating repeatedly and vociferously that the ZPP should be extinguished immediately. He wishes to see a western-style system where the banks handle all financial transactions. He repeatedly stated that a bank should do everything that the ZPP does, and that he wished to be able to chose his own bank. When asked to list the positive aspects of the ZPP he stated: "I don't see a single one." The ZPP frequently mis-routes funds, forcing him to undergo an agonizing process lasting up to several months before funds are recovered. ZPP never catches its own mistakes, but rather relies on the customer to do so, thereby forcing companies to maintain redundant record-keeping and financial accounting systems. Although he didn't know the fee level, his bookkeeper supplied us with the information that it is between 0.15 to 0.25%, depending on the type of transaction. Cash withdrawal time is from 30 to 90 minutes, depending on the level of activity. The ZPP typically makes at least two errors per month with his accounts, which takes him on average two months to straighten out. His bookkeeper estimates that the ZPP requires at least an extra 30 hours of work per month, with indirect costs totaling a minimum of DM 300 monthly.

PB QUESTIONAIRE INFORMATION

Company I.D. number: D281
Ownership: Private, sole proprietorship
Type of business: Manufacturing and processing
Location: Federation, Sarajevo

Company and management profile:
In contrast to most companies, all workers are legally employed and registered, all taxes are paid regularly, and the owner claims he does nothing illegally.

RESPONDENT'S REACTIONS

The owner initially refused to discuss the ZPP. After more than one hour and several drinks, he finally began discussing the topic, but remained reticent throughout the conversation. He claims that he pays approximately DM 2,000 per month to the ZPP in fees. He has no idea what the tariff structure is and has never received a price list for ZPP services. He has complained to the ZPP about this, but gotten nowhere. He would prefer using a private bank instead of the ZPP. He is pleased with the payment settlement times, which typically take twenty-four hours from the date of payment. However, he works only with the Muslim parts of the country and has no dealings with the Croats or Serbs. One significant problem is the amount of time required by the ZPP, particularly the long waits in line. He feels that if he is paying DM 2,000 monthly, he shouldn't have to wait in line for a controller who has to deal with 3,000 other firms at the same time. If each firm pays monthly fees of several hundred DM to the controller, than one controller can be responsible for collecting enormous revenues. He thinks more controllers should be hired. In addition to time spent waiting his company wastes time dealing with the bookkeeping demanded by ZPP records. Payroll is also a big problem, with lots of forms. He thinks the ZPP is a good source of revenues for the government, but has no idea where the money goes. He wouldn't mind paying the high tariffs if he knew they were going to the Pension/Invalid fund, or to some worthy cause, but he suspects the money is drained off by the state or the party. The abuse of acceptance orders is a wide-ranging problem. He feels two things cause it: abuse within the ZPP system; and a legal framework within Bosnia to deal with bankruptcy and liquidation. He feels legal system reform is needed, which will require the creation of a system of economic courts, which can handle bad debt, failure to pay, bankruptcy, etc. He would like to see the system changed so that he can use a bank whenever he wishes. His one positive comment was that the speed of payment settlement is good. When asked about involvement of organized crime he dismissed it, saying that he and his buddies were sufficiently tough to stand up to local thugs. He hinted that he knew of loans through the ZPP system, but refused to answer any questions about it.

PB QUESTIONAIRE INFORMATION

Company I.D. number: D493
Ownership: Private, sole proprietorship
Type of business: Computer and information systems, software engineering, installation and maintenance of networks
Location: Federation, Sarajevo

Company and management profile:
The company wholesales, installs and supports computer and information products. They write their own software and maintain a team of software and hardware engineers on staff. Customers include prominent state-owned companies and government ministries. The director showed us an RFP he had received from ZPP to establish computer networks based on UNIX and local area network (LAN) servers in the various ZPP branches under Bosniak control.

RESPONSES:

Transaction settlement time:

- Within Bosniak-controlled areas: 1 to 2 days
- Between Bosniak and Croat-controlled areas: unknown
- Between Federation and Republika Srpska: unknown

RESPONDENT'S REACTIONS

The director exhibited frustration with the entire ZPP system. He feels all the ZPP's functions should be handled by banks. He stated: "it's my money, let me worry about it." The director was not particularly articulate in his responses. He stated that the entire ZPP system frustrates him and that he dislikes it, plain and simple. He had no idea what the level of fees is, and called his book-keeper, who told him that it typically totaled as much as 1% of total revenue turnover monthly, to which the owner responded with profanity. He states that it takes him up to two hours to withdraw cash. He estimates the ZPP costs him a minimum of fifteen hours and DM 150 monthly. This does not include fees charged by the ZPP. He does not feel his financial information is confidential, as he can examine the records of other ZPP customers. He feels that his financial records have been misused by his competitors. His firm once had its account blocked, which caused him to shut down for three days until the blocking order was removed. He declined to go into great detail, stating simply that the ZPP was a tremendous frustration to his business aspirations and blocked his plans for expansion by controlling his working capital.

PB QUESTIONAIRE INFORMATION

Company I.D. number: E332
Ownership: State-run, shareholding company
Type of business: Resource extraction
Location: Federation

Company and management profile:
The owner is an old-fashioned socialist director, used to operating within a system of cronyism. The company's capacity ran down during the war, due to a lack of maintenance, and to equipment being requisitioned by the army. Chief problems remain a lack of sufficient working capital and a need to renew physical plant facilities.

RESPONDENTS' REACTIONS

The director is attempting to lower the book value of the company in anticipation of privatization. Local municipal officials, who also want a piece of the action, are aiding him in this. As a result, much of their work is done off the books, for cash, avoiding entirely the ZPP system. This enables the facility to continue operating and generate profits for the interested parties. He has no idea what the fees are, except that they are high. He was unable to get an adequate response from his bookkeeper concerning the fees. When asked why he avoids the ZPP, the director gave several reasons. First, he views the ZPP as a state organ for reporting and controlling the industry. He knows that he will be unable to privatize as desired if the ZPP -- i.e., the state -- sees the real operating figures of the company. Secondly, tax avoidance is an issue. High tax levels, retroactivity of taxes, and the ad hoc nature of tax implementation, as well as the frequency with which local municipal officials invent new taxes to cover operating deficits, causes him to report as little income as possible. Also, if he has positive cash flow the state will take a portion of his profits at the end of the year to finance other state-run enterprises that are not profitable, or to finance political parties. The local municipal officials who will be his new partners after privatization protect him from the inspectors. When he works off the books he is legally unable to deposit the cash, use it to pay workers, reinvest in the company, or use it to pay bills. Because the majority of work is done for cash, the company has had insufficient cash on the books to pay its workers and all its bills on time. It is unable to use the cash generated through black market activities for this purpose. The company is currently two months behind in paying its workers. In addition to the role of a controlling organ, the director had the typical complaints regarding high fees and slow service. He is particularly upset by his inability to collect money on the basis of acceptance orders. The inability to enforce any sort of judgement through the ZPP is also frustrating. He estimates that his company has two full-time employees to deal with the ZPP required paperwork. It takes him on average an entire day and a half to do paperwork for the 90 employees. Due to the illiquidity in the economy, he conducts anywhere from 15 to 20% of his business through barter trade.

PB QUESTIONAIRE INFORMATION

Company I.D. number: F111
Ownership: Private sole proprietorship
Type of business: Construction, hospitality
Location: Republika Srpska

Company and management profile:
The owner has been involved in both construction and the hospitality industry for almost 20 years.

RESPONDENTS' REACTIONS

The respondent has very strong connections to the SDS in Pale, and spent much of the war and post-war era smuggling between RS and the Federation. His construction company has been the recipient of numerous construction contracts from the SDS-dominated local government. These involved substantial kickbacks to local politicians. Most of these projects ended up being funded by cash, but through various budget accounts of the SPP. He described a complex process of money laundering which avoided the SPP almost entirely, enabling him to make kickbacks to the politicians. In the instances where state funds were used for construction, he conducted approximately 30% of the business on the books. In instances where private parties and international organizations fund the work, he works almost entirely in the black economy. He claims the payment settlement time through the SPP is relatively fast -- he can get money from Banja Luka to Pale in 24 hours. Nonetheless, because of the government's confiscatory tax policies and reporting requirements, as well as the SDK's powers, he avoids the system as much as possible. All inter-entity trade is done in the black economy. His friends in the local government protect him and allow him to operate with relative impunity. He has no real fear of being caught. He claims everyone in Pale is engaged in the same types of activities and everybody pays off the tax inspectors and police. He is unsure of what the fees are, but thinks they are around 0.30%, which he considers too high. He does not know if they charge him for debiting or crediting the account. He says the verified fifth copies are a problem, as SPP officials sometimes falsify them. He does no legal business with the Federation and has no idea of transaction times between the two payment systems. Cash withdrawal limits present no real problem, as he has friends working in the local branch that can help him out. He says that the SPP can give loans to account holders, but he was unclear as to whether this was the SPP or the DBRS.

PB QUESTIONAIRE INFORMATION

Company I.D. number: J001
Ownership: Private, sole proprietorship, 100% foreign owned
Type of business: Leasing and servicing of equipment.
Location: Federation, Sarajevo Canton

Company and management profile:
The company provides services to foreign and local partners.

RESPONSES:

Transaction settlement time:

- Within Bosniak-controlled areas: 1 to 2 days
- Between Bosniak and Croat-controlled areas: doesn't know
- Between Federation and Republika Srpska: doesn't know

RESPONDENT'S REACTIONS

The general manager (foreigner) estimates he wastes 20 minutes per day on ZPP-related paperwork. To meet payroll they are forced to fill out nine (9) separate forms per employee. Since they have 8 employees this amounts to almost eighty (80) pieces of paper. His accountant is forced to spend up to three hours per day at the ZPP. He estimates the ZPP forces him to double or triple the amount of bookkeeping and paperwork required. According to him the ZPP system is "Kafka come to life," with "endless corridors and iron grills." His greatest frustration is: "My money's not mine! The municipality can take the money from my account whenever it wants! They will drain your account quite happily. My cash has no security. They could wipe us out tomorrow, if a corrupt bureaucrat decided." for various taxes and to meet their budgetary needs. He views it as "another lump of bureaucracy." The firm's accountant complained that the ZPP seems to change the payroll forms almost on a monthly basis, and admitted that "even I don't know our laws." Due to the laws on cash transactions, all cash payments and deposits are treated as a retail transaction, subjected to a 5% or 10% tax. No matter the amount or type of transaction, the law treats the cash as proceeds from a retail transaction. The director sees the ZPP as a serious barrier to doing business in Bosnia-Herzegovina. His firm is forced to waste a minimum of 68 hours per month on the ZPP. He has never received a fee schedule and has no idea how much they charge, except that it is a lot. He sees no positive aspects to the ZPP system

PB QUESTIONAIRE INFORMATION

Company I.D. number: J002
Ownership: Private, limited liability partnership
Type of business: Services, consulting
Location: Federation, Sarajevo Canton

Company and management profile:
The company has a strong western presence in management, and is heavily involved with a significant western client.

RESPONSES:

Transaction settlement time:

- Within Bosniak-controlled areas: 1 to 2 days

RESPONDENT'S REACTIONS

The financial director (FD) and a manager met with us. Confidentiality of records is a major problem. ZPP insiders provided local criminals with the company's complete year-end report and cash flow statements. The criminals visited the company and demanded 10% of turnover. Cash is a big problem. The current ZPP system provides disincentives for depositing cash, and there are no alternatives in the private banking sector. As a result the FD has been known to carry large quantities of cash on his person. In one instance this amounted to DM 20,000. The FD says this is due to the high taxes on cash deposits, and the ZPP's restrictions on a company's ability to utilize its cash as it sees fit. The FD described the complete ZPP account numbering system. The FD also described numerous ways of circumventing the cash withdrawal limitations, using travel orders. The FD also described the process needed to transfer funds from a bank account to the ZPP system. This occurred in the context of funds transferred into the country from a foreign bank. The FD also described the manner in which these funds can be hidden from the tax and ZPP authorities and transferred out of the country. The FD stated it takes 2 days to fill out the necessary paperwork for payroll. The amount of paperwork depends on the municipalities where the workers reside: the more municipalities involved, the more paperwork involved. In a best-case scenario, payroll requires nine pieces of paper. In a worst-case scenario the company will have to complete nine pieces of paper per employee. The company once had a dispute with the ZPP, which lasted twenty days over a DM 40 amount, which the ZPP had debited from the company's account for its monthly fees. This caused the company's ZPP DM account to drop below the DM 300 minimum. Even though the company had more than sufficient funds in its KM account to cover the negative amount, the ZPP blocked both the company's ZPP accounts for twenty days until the dispute was settled. In this time the company was forced to shut down all its operations, including payroll and payment of invoices. The account blockages forced them to lose a major customer account.

PB QUESTIONAIRE INFORMATION

Company I.D. number: J007
Ownership: Private, limited liability partnership, 100% foreign owned
Type of business: Import and processing of construction materials, warehousing, and distribution. Counter-trade and barter agreements.
Location: Federation, Sarajevo

Company and management profile:
The company is involved in wholesaling, distributing, and processing in partnership with a major international corporation. To collect receivables, the company was forced into barter trade arrangements, which have included importing sugar and cooking oil, and exporting lumber. The company is active in both entities and in Croatia and Serbia as well. Management is non-Bosnian.

RESPONSES:

Transaction settlement time:

- Within Bosniak-controlled areas: 1 to 2 days
- Between Bosniak and Croat-controlled areas: 3 to 4 days
- Between Federation and Republika Srpska: 15 to 20 days

RESPONDENT'S REACTIONS

The director (a non-Bosnian) expressed extreme frustration with the ZPP. It forces his firm to engage in costly and time-consuming duplication of effort. One employee is assigned almost full-time to do nothing but manage ZPP transactions. This in addition to the regular bookkeeper. Director objects to arbitrariness of process, ability of most inspectors to immediately freeze or place a lien on a firm's account without cause, inefficiency of the entire system, and corruption in the system. Director feels the entire system should be immediately dismantled and replaced by a commercial banking system. On numerous occasions the director has blocked (placed a lien on) ZPP accounts of customers, only to have customers collude with ZPP officials to work around the lien, or to have ZPP officials refuse to honor the lien. The director knows of several instances when his customers and competitors viewed his financial records at the ZPP. The director has also been able to look at the ZPP financial records of some of his customers and competitors and use them to his advantage The director indicated that his firm works through offshore bank accounts to facilitate some financial transactions, and that it has also done inter-bank transfers in Bosnia itself, which are theoretically illegal. Bookkeeping requirements are double what he had in the west, and the bureaucratic paperwork is causing him to reconsider doing business in Bosnia. "You never know when some corrupt official will come in and shut you down because you didn't pay him that bribe. You never know when the government is going to need some money to cover its budget deficit. You never know when they will impose an arbitrary, retroactive tax. And

even if you did, they would simply take the money from your account. My money isn't safe and it isn't mine." He has begun hiring workers illegally and paying them in cash. The system prevents him from repatriating profits, so he simply makes dummy invoices for services from a foreign company and pays those through the bank.

PB QUESTIONAIRE INFORMATION

Company I.D. number: M005
Ownership: Group of six private businessmen
Type of business: Hospitality, manufacturing, service.
Location: Federation, Sarajevo Canton

Company and management profile:
Four of the businessmen involved are in the hospitality industry. The fifth individual has a manufacturing company employing 45 workers, in addition to a wholesale and retail business with weekly revenues estimated at DM 150,000. The sixth is the director of a state-owned service company. The discussion occurred over morning coffee in a local cafe.

RESPONDENTS' REACTIONS

The manufacturer estimates that only 10 to 15% of his business goes through the ZPP. The remainder is in the black economy. The hospitality industry owners typically conduct 8% to 10% of their business through the ZPP. The director of the state-run company conducts approximately 15 to 20% of his business through the ZPP; he is awaiting privatization, and he wants the company to have a low book value so that he can purchase it when privatization occurs. As a result, he operates primarily with cash. All expressed concern about the confidentiality of their ZPP financial records. In one instance a prominent Sarajevo gangster gained access to their financial records and cash flow statements. On the basis of these he sent a thug to visit three of the hospitality industry owners and demand protection money. In the ensuing struggle the thug was shot dead by one of the owners. The owner of the manufacturing company and the state-run service company also reported similar problems It appears the criminal element has strong ties to ZPP workers. The manufacturer has a weekly turnover of approximately DM 150,000, most of it in the black economy. He operates in the black to avoid depositing his cash in the ZPP. If he deposits his cash in the ZPP, financial inspectors and criminals will visit him, and he will be unable to have the business function in an efficient manner. The ZPP also creates major difficulties for operating the company's finances. The cash is no longer his to use as needed. If he operates outside the ZPP, his cash flow and payments function far more smoothly than using the ZPP His 45 workers are also unregistered, i.e., he pays them directly in cash and doesn't use the ZPP services. Because of this his workers are paid regularly and often in foreign currency. He avoids penalties from the authorities by bribery. The other businessmen essentially concurred and nodded their heads in agreement at his comments. Several expressed the idea that the ZPP criminalized their activities. One stated: "in any other country what we are doing would be legal and normal. Here we are criminals because we work outside the system." Most admitted to having friends at the ZPP, who allowed them to circumvent much of the system. Several admitted to having seen their competitors' financial statements.

PB QUESTIONAIRE INFORMATION

Company I.D. number: M503
Ownership: Private sole proprietorship
Type of business: Wholesale, retail, dry goods
Location: Federation, Sarajevo Canton

Company and management profile:
The manager is young, energetic, and experienced in the field. The conversation centered primarily on his retail operations and the role the ZPP plays in this arena. His bookkeeper was also present.

RESPONDENTS' REACTIONS

Because the business operates with large volumes of cash, the ZPP plays a large role. He is required to deposit 100% of his daily cash receipts in the ZPP within twenty-four (24) hours. The deposit process is very long and painstaking. He must fill out two deposit slips, one for KM and the other for DM. He must list the number of bills and their denominations on the deposit slips. Upon arrival at the ZPP his employee must wait in line for the KM likvidatura window, where he turns in the deposit slip. He must then wait for the KM blagajna teller to call out his company's name. The combined waits can take up to an hour. He then turns the cash over to the KM blagajna teller, who counts the cash, and stamps the deposit slips. The KM cash is not available for use until the next day. He then must repeat the same process for the DM window. The respondent dislikes having to deal with the ZPP, or the requirement to deposit all his cash receipts. As is the case with all businessmen interviewed to date, he does not declare all his income. When asked to provide an estimate of the percentage of the economy operating in the black, he stated "a conservative estimate is of 40%" for the Muslim areas, with a much higher figure for the Croat and Serb areas. When asked about payroll, his bookkeeper exploded with anger and said the process was terrible and required a pile of paper "one meter deep." Asked about the fees, he responded that he had never received a price list and had no idea how much the ZPP charged. He only knew that in 1997 he paid the ZPP over DM 8,000 on a turnover of DM 2.5 million an average fee of 0.32%. The respondent would like to conduct his transactions with a bank instead of the ZPP. He said that at least then he could chose to work with whichever bank he wants. He claims that transfer times between Croat and Muslim controlled areas have recently improved, and that it now takes only two days for a transfer to occur between western Mostar and Sarajevo. He has just recently conducted his first transaction with RS two days ago. The money has not yet arrived from Banja Luka, and he will inform us how long the transfer times take. He has had many instances when the ZPP has refused to honor an acceptance order, and expressed anger that this abuse was allowed to continue. He wants to see a banking system handle the transactions where a bank would issue a guarantee of payment and the merchant would be able to rely on a bank guarantee.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N003
Ownership: Private, sole proprietorship
Type of business: Manufacturing, sales, export, import
Location: Federation

Company and management profile:
The owner has two significant experience outside Bosnia in the same field. He opened his business here during the Markovic-era reforms.

RESPONDENTS' REACTIONS

The owner manufactures and exports to EU countries. He has worked in an EU country for many. His first comment was that there is no logical reason for the existence of the ZPP. He wants to be able to do all his business through a bank, as he did in the EU. He feels completely helpless, as the ZPP has complete control over his money and cash flows. He is afraid to keep large sums in his ZPP account for more than 24 hours, for fear that the government will think up a new tax, or find some way to get its hands on his funds. He feels that every time someone deposits money to his ZPP account the government finds a way to take some portion of it for a hastily-invented tax. The high level of fees disturbs him, especially since he has no choice but to use the ZPP services. He repeatedly said that he wants the right to choose his own bank. In spite of this, he does have friends in the ZPP, and has used them to block the implementation of one acceptance order. He too has been on the receiving end of thwarted acceptance orders. For exports, everything is 100% on the books. However, he typically handles most of the payment transactions through foreign banks, so that he can avoid sending the money into the country and eventually bringing it into the ZPP system. In regard to the domestic market, he does as much as he can for cash. He thinks that if the law on depositing cash were rescinded, it would bring a lot of black economy activity into the legal economy. He would like to see a system similar to the EU, where business transactions are handled through banks.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N004
Ownership: Private, sole proprietorship
Type of business: Services industry
Location: Federation, Zenica-Doboj Canton

Company and management profile:
The owner is a young, energetic individual with entrepreneurial skills, lots of motivation, and a nose for business. He opened his first business during the Markovic-era reforms, but was wiped out by the war. Since the war he has gone from nothing to a business with monthly cash flows of over DM 60,000, with real estate holdings worth almost DM 1 million.

RESPONDENTS' REACTIONS

In the context of his various businesses, all of which are service oriented, he claims to report approximately 25% of his earnings to the ZPP. As is the case with all respondents to date, he pays all taxes through the ZPP. When asked what were the positive functions of the ZPP, he said: "I am so busy with work that I never get to see my friends. However, the long wait at the ZPP gives me the opportunity to meet them all regularly, as we are all forced to wait together approximately two hours per day." In other words, he views it as a social gathering point, and little else. He only has one employee legally registered. All the rest he pays off the books. The reasons for this are the problems and difficulties associated with the ZPP-required payroll paperwork. Simply to pay his single employee requires nine ZPP documents. The wait in line to withdraw payroll can take up to three hours. Regular cash withdrawals take almost the same amount of time as payroll. The respondent has his own lock box at the ZPP, but this does not contribute to confidentiality of records. The local ZPP branch has boxes available for only a small fraction of its customers. All the rest have their daily statements placed in yellow envelopes. The statements are often placed in the wrong envelopes or in the wrong boxes. He states that the ZPP is an unnecessary waste of time, and acts as a hindrance to his business. He would rather operate through a commercial bank. Because he does not import or export, he has never had to open a bank account. Under the new regulations, he is required to open an account with a commercial bank. He does not understand why, as all cash management functions are handled through the ZPP, and he has no use for a bank. He says that several people in his municipality have received loans from the ZPP, although he claims to have never received a loan. Those who received loans were typically individuals with political connections or friends in the ZPP.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N005
Ownership: State-run, shareholding
Type of business: Manufacturing and processing, construction
Location: Federation, Sarajevo Canton

Company and management profile:
The director speaks German and English, has lived abroad, and is an SDA party member. He has built a "poison pill" into his company to thwart any hostile privatization bids that would unseat him as director and not allow him a controlling interest in the company. The company exports to an EU country.

RESPONDENTS' REACTIONS

The director and his financial director were present for the survey. The director says he has three people employed full-time to deal with the company's finances and ZPP functions. He has 80 employees. The financial director stated that it takes several days to fill out all the payroll forms, and that the law on payroll processing seems to change almost monthly. The company has had several cases of acceptance order fraud, either where the ZPP refused to honor the acceptance order, or the issuer had no funds in his account. The director blames the ZPP for not pursuing this fraud more aggressively. He dislikes the additional expense the ZPP places on his overhead. He estimates that if he were working with a commercial bank instead of the ZPP he would need only one employee to manage the company's finances. As it is, the company has three employees, one of whom spends most of the day running back and forth to the ZPP and waiting in line. He estimates that without the ZPP, one employee could handle all the finances. This translates to an added overhead cost of almost DM 4,000 per month. In addition, he pays the ZPP between DM 1,500 and 2,000 in fees each month. He states the service is terrible and they frequently make mistakes routing payments. There is no error resolution process he is aware of, other than complaining loudly and frequently until they take notice. He dislikes the ZPP's control of his finances and cash flow. He claims his company operates in 100% compliance with the law. He also claims that prior to the fall 1998 elections, the ruling SDA party plundered the ZPP vacation fund accounts of his company to fund their election campaign. He says it is an open secret within the SDA that the ZPP funds party activities. When asked about state funds for state-owned companies, he stated that under the old Yugoslav system, the state would support state-owned companies that operated at a loss by channeling funds though the ZPP. Since the war he has heard of only a few rare instances where the government has supported a failing company. His company has been profitable and has received no funds from the state.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N006
Ownership: Privately owned, sole-proprietorship
Type of business: Manufacturing
Location: Federation, Gorazde

Company and management profile:
The owner is a small businessman operating a start-up company in an economically depressed area. He spent many years abroad.

RESPONDENTS' REACTIONS

The owner is frustrated with the entire system. As a small businessman with 10 employees he is faced with a mountain of paperwork. He is unable to understand all the regulations pertaining to the ZPP and various forms and procedures. The process is a nightmare for him. Because his firm is too small to have a full-time bookkeeper on staff, he has to spend almost half of his day involved in ZPP paperwork This takes away from time he could be using more productively for marketing and other activities. The bookkeeping system appears illogical to him. So too does the system and level of taxation. He feels that he would have more reason to work harder if the taxes were not so high. All his employees are legally registered, but he is considering legally firing them all and then rehiring them at higher salaries on the black market, simply so that he can avoid the ZPP paperwork. For a small business the ZPP is a monster, monopolizing his time and resources. His greatest frustration is that he cannot have a normal relationship with a commercial bank, as was the case in the EU country where he did business. He has no idea what his fees are, other than that they are "too high." He gets terrible service for the amount he pays the ZPP. He doesn't like the way the government arbitrarily confiscates new retroactive taxes from accounts whenever it needs money He dislikes that he is unable to control his own money. "The minute I put my money in the ZPP it is no longer mine. It becomes theirs, and they act like it is theirs. They won't even let me use it as I see fit." If the ZPP shut down tomorrow, he would use a commercial bank and never miss it. He also dislikes the cronyism and corruption he sees in the ZPP He knows of several people who have received special favors from the ZPP, including one friend who received a loan. He had no knowledge of the amount or the terms.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N007
Ownership: 100% foreign owned, sole-proprietorship
Type of business: Services
Location: Federation, Sarajevo

Company and management profile:
The general manager is a foreigner, as is the owner. The general manager has long experience in business and in this field in particular

RESPONDENTS' REACTIONS

The respondent is very angry at the ZPP and sees it as a serious impediment to doing business. In order to repatriate earnings they are forced to operate using false invoices from the parent company for services. He estimates that the ZPP requires a minimum of 2 to 3 hours of his company's time per day He has no idea what the ZPP charges him, except that it is quite a lot. It take them more than a full day to fill out all the ZPP payroll documents for their 25 full-time workers. Because of these problems, they hired 15 workers off the books, and will not hire any additional employees on the books. He could meet payroll far more efficiently if he did it himself. He sees the ZPP working very closely with the financial police, supplying them with information. When he was last audited the financial inspectors found errors in his bookkeeping, which cost him DM 22,000 in taxes and penalties. Even though the firm did nothing irregular, the system is not set up to handle the tax-free status of many international organizations, or to handle cash payments on the wholesale level He does much of his company's business outside Bosnia, and much of it using the Bosnian banking system for illegal, inter-bank payments. On the basis of his statements, it appears many foreign organizations in Bosnia completely skirt the ZPP system, preferring to work with the banks. The vast majority of payments he receives through the ZPP are less than DM 3,000. He views the ZPP as completely unnecessary and a hindrance to business. He sees no positive aspects of the ZPP. At the same time, he places little trust in the local banking system.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N008
Ownership: Partnership, privately owned
Type of business: Resource extraction
Location: Banja Luka, Republika Srpska

Company and management profile:
The respondent has many years experience in the state sector. There appears to be a little confusion on his part about the firm's ownership, as many of the company's resources belonged to a state-sector company that was "privatized" through a dubious process.

RESPONDENTS' REACTIONS

The respondent indicated that he works primarily for barter trade, as there is little money available in RS Even though they are supposed to register these barter trade deals with the SPP, they mainly skirt this requirement. The vast majority (80+) of their business is done with Serbia, from which they receive sugar, cooking oil, petroleum products, wheat, corn, processed food products, bricks, roofing tiles, pipe, electrical supplies, etc. Much of this traffic -- approximately 80% -- is done off the books. Most of his workers are paid off the books, and he pays them in a variety of manners, typically a portion in cash, and the remainder in goods. He even bribes the government inspectors using goods instead of money. Most SPP payments are made in Dinars, while the unofficial economy operates primarily in DM. He has no idea what fees he pays, although he knows they are high. He called his bookkeeper, who claimed it depended whether cash withdrawals or simple transfers were in question. The bookkeeper indicated that cash withdrawals and deposits were charged a higher fee, but even he didn't know how much. He doesn't like the relationship between the tax inspectors and the SPP, viewing them as one and the same. He says acceptance orders are worth nothing because no one has any cash flow through their account. Even when they are used, the issuer will typically use his contacts in the SPP to block their use. The requirements for payroll are a primary reason for paying the workers off the books, as is the difficulty of paying workers in barter through the SPP. The respondent views the SPP as a corrupt institution working to plunder the businessmen. He also says it works hand in glove with the criminal elements, who will visit companies based on their cash flow statements. He feels the situation has improved slightly since Dodik took office. He essentially maintains sufficient cash flow through his account to pay utility bills and a small amount of taxes. They have experienced few problems with receiving payment from Serbia since the Serbian SDK instituted its blockade of the SPP in early November 1998, primarily because he operates almost entirely for barter trade. He views the entire system in RS as rife with corruption, and says the only way to get by is to cheat

PB QUESTIONAIRE INFORMATION

Company I.D. number: N009
Ownership: Sole proprietorship, privately owned
Type of business: Wholesale, retail, import, export, construction
Location: Republika Srpska

Company and management profile:
The company engages in construction activities, wholesale of construction materials, and import/export activities, as well as retail activities.

RESPONDENTS' REACTIONS

The respondent is forced to run the retail outlet largely according to the law, due to its high visibility in the center of a major RS city. Approximately 25% of their employees are illegally working. The additional employees in their wholesale facilities are mostly illegally employed. In spite of this, it takes them approximately two days to fill out all the necessary paperwork. However, they have remained with their original bank. They were not certain what their fee levels were, so they called in their bookkeeper, who told them it was 0.28 for all transactions. The bookkeeper is uncertain what whether the fee is charged on the payer or the payee, or both. They pay approximately DM 1,100 worth of fees per month, but they only declare about 50% of their total retail sales revenues. The bookkeeper estimates that he spends at least three-quarters of his time dealing with SPP-related issues. The company has three full-time bookkeepers to help them track all the paperwork. They complained that there is no cash in the economy, so they conduct many barter trade transactions. Much of their business is with Serbia, primarily the export of raw materials along with the import of finished goods as barter. They would prefer to work through a bank, especially with regard to payroll. They dislike their inability to control their own money. The respondent stated that if he could use a commercial bank he would be able to earn interest income on his money.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N010
Ownership: joint venture foreign partnership, privately owned
Type of business: Wholesale of construction supplies, wholesale manufacturing and processing equipment, import
Location: Federation, Sarajevo Canton

Company and management profile:
A subsidiary of a European company, this firm primarily wholesales and distributes specialized products, as well as the equipment to process these products. Management is multi-national.

RESPONDENTS' REACTIONS

The general manager is a foreigner. He states that in all his years of business in the command economies of eastern Europe, he has never seen a system as insidious and inefficient as the ZPP. In his native country, even under the worst of communism, the system was never as restrictive as the ZPP system. With a work-force of six (6), he is forced to have a full-time employee to handle the paperwork associated with all the ZPP functions, including tax collection, payroll, and payments. His bookkeeper (a Bosnian) estimates that the ZPP takes up at least three hours of company time per day, perhaps more. The bookkeeper worked with one other western joint venture partnership prior to this one. He said that firm was nearly suffocated by the ZPP through restrictions on cash management. With the current company the situation is no better. The general manager stated that all his start-up working capital estimates had to be doubled, due to the ZPP's stranglehold on cash management Unfortunately he discovered this after opening up the business here. The bookkeeper stated that most fees are around 0.25% or higher. When he adds in all the various hidden fees and cash deposits it comes out to an average fee of approximately 0.53%. The bookkeeper stated that the planned expansion of their company has been put on temporary hold, due to their inability to accumulate working capital in as rapid a manner as they had planned. The slowness to working capital is caused in large part by the ZPP presence astride his finances. He wants to do his business with a bank of his choosing, and not the ZPP. He said: "let them compete with the banks on an equal basis. I will use whoever offers the best services at the best price." The company looses approximately 25% of its potential business due to legal barriers against cash in wholesale transactions They estimate that if they could do cash business legally they would literally double revenues overnight The bookkeeper had experience with acceptance order fraud in his old company, but not in the new one. He stated that many people use their friends in the ZPP to prevent an acceptance order from being honored.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N011
Ownership: Joint venture partnership, foreign-participation
Type of business: Manufacturing, construction
Location: Federation, Sarajevo Canton

Company and management profile:
The manager has many years' experience in a foreign country. Management also has foreign participation.

RESPONDENTS' REACTIONS

The manager and financial director met with us. The financial director indicated the ZPP charges fees of approximately 0.20% on most transactions. They rarely have a transaction large enough to qualify for the lower 0.15% fee. However, when you add up all the ZPP fees it is much higher, because they typically take almost 1.0% for inter-cantonal transfers. Both feel the fees are far to high, and that the service is bad. They have had bad experiences with acceptance order fraud and no longer accept acceptance orders as collateral, because of fraud within the ZPP. They do no business with RS and do a little business with the Croat areas. They have over 30 employees, and most are legally employed. However, they report all employee salaries at the minimum wage to lower the tax burden, and pay the employees a higher wage. Both complained about the ZPP, particularly the amount of time it takes to conduct transactions. Both related numerous horror stories of their experiences. The director stated a preference for using a commercial bank to handle his payments He stated that on several occasions he had tried to get a short term (15 day) bridge loan for working capital, but his bank had absolutely no idea about their company's operating finances and working capital needs. Even though they have had an account with the bank for two and a half years, the bank has absolutely no idea about their company's finances, business practices, cash flows, or ability to repay a loan. In order to get a loan they had to get the bank director to visit their plant and see their equipment and manufacturing capacity. The bank director expressed amazement: he thought the firm was just a little operation. In the EU country where he worked it was easier for his company to get a loan, because the bank was able to track their cash flows on a regular basis. He expressed concern over cronyism at the ZPP, which allows many people to circumvent the various limits on cash withdrawals. The financial director complained about the time needed to complete paperwork, stating it takes more than an entire day.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N012
Ownership: Private, sole proprietorship
Type of business: Construction, manufacturing
Location: Federation, Una-Sana Canton

Company and management profile:
A small businessman with a limited number of employees.

RESPONDENTS' REACTIONS

The respondent has a deep distrust of the ZPP system, and sees it as a governmental control mechanism. He runs most of his business off the books. None of his 16 workers are registered. He does this to avoid the high taxes and the time for paperwork. Even though most of his business is done for cash, the ZPP activities still cost him approximately one hour per day. In addition to this, it costs his secretary at least one hour per day, and he has an accountant who reviews the books on a monthly basis for the tax statements. He prefers to work outside the ZPP because he views it as a monopoly on his money. "The government just takes from me and gives me nothing in return. I fought during the war, as did my son. I have given everything for my country and the government still wants to take more." He sees the ZPP as a government representative for plundering the people. He uses the ZPP to cover the essential taxes, and to create a facade of legal operations. He has a reputation as one of the most honest businessmen in his canton. He says the people working in the ZPP are corrupt and take money for themselves. He related stories where people with connections had been able to get cash loans from the ZPP through their friends The director of the local bank is a friend, and he does cash business with the bank for importing materials. He also makes transfer payments (cash) between his bank and several suppliers and customers. He doesn't know what fees the ZPP charges, except that they are too high. Much of his business takes place with the Sarajevo canton. For ZPP transfers between these two cantons the ZPP charges a much higher than usual fee. He says it averages between 0.75% and 1.1% of the total amount transferred.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N013
Ownership: Sole proprietorship, privately owned.
Type of business: Manufacturing, construction, and agriculture.
Location: Federation, Republika Srpska

Company and management profile:
The owner is a private entrepreneur who has firms in both entities and has been active in the post-war reconstruction effort. In addition, he is involved in agricultural production. He has approximately 15 employees in the Federation and another 25 in the RS.

RESPONDENTS' REACTIONS

The respondent maintained good relations among all ethnic groups during the war and is able to do business in both entities He, as do most businessmen, continues to refer to the ZPP/SPP by the old name of SDK. The nature of his business involves large cash turnovers, and very little goes through the ZPP or SPP. He views both SPP and ZPP as a group of thieves. He says that all they do is take your money and give it to the government. "Once they get hold of my money I never see it again." He says the SPP charges higher fees than the ZPP, but it doesn't make much difference, because they both have excessive fee structures. He doesn't know exactly how much they charge, because he has never seen a price list. The service at both ZPP and SPP are terrible, although the SPP does seem to be somewhat more efficient. Even though the verified fifth copy is a good indication that payment has occurred, he did have one instance when he received a falsified fifth copy. He claims this was done in compliance with an SPP official who was on the take. He claims the worst cases of abuse occur in the outlying SPP and ZPP branches, both in the Federation and RS alike. He would like to be able to work with a bank instead of with the ZPP/SPP system. He says the system causes him to do more business with Yugoslavia. Because the Yugoslav SDK and the RS SPP form one unitary payments system, it is easier for him to import goods from Serbia, because he doesn't have to go through the extra step of transferring money to a bank from the ZPP. Also, import controls are looser and he can import goods into RS cheaper than into the Federation, often without paying customs duties He does minimal business through both the SPP and ZPP, typically enough to cover their tax and payroll obligations. He says the ZPP does nothing but prevent him from carrying out business. He does not feel his financial records are confidential, and admits to having seen competitors' financial statements on several occasions. He feels the ZPP/SPP bookkeeping places a heavy burden on his company. In each entity he has one bookkeeper working almost full time to maintain the company's books and balance sheets, do payroll, go to the ZPP/SPP, etc. He doesn't know how much it costs his company, but it is too much. He has had bad experiences with acceptance orders in both RS and the Federation. He declares them to be worthless, because most people have friends in the ZPP/SPP who will block the implementation of these orders.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N014
Ownership: Sole proprietorship, privately owned.
Type of business: Construction.
Location: Federation

Company and management profile:
The owner is a small businessman who has been involved in the post-war construction boom, and has undertaken numerous internationally funded projects for various aid organizations.

RESPONDENTS' REACTIONS

The respondent has had his ZPP account blocked since March of 1997. In spite of this he has continued to function semi-normally. At first his controller delayed implementation of the acceptance order for several weeks, and then, after the creditor complained, his controller was finally forced to honor the acceptance order. In spite of this, his firm has continued to operate quite openly. He is able to do this by using his brother's ZPP account. Also, most of his business is done with humanitarian aid organizations, and they pay cash. Because of this, he is able to skirt the ZPP. He feels the ZPP is a nuisance, and that he can do much better without it. He has engaged in barter trade deals, none of which he registered with the ZPP. He would prefer to do everything through his bank. He dislikes having to wait in line at the ZPP or to have to deal with the rudeness and inefficiency of the workers. He feels the ZPP cooperates very closely with municipal inspectors as well as tax inspectors. He has no idea how much the ZPP charges, but thinks it is close to 0 50%. He wasn't sure of this and called his bookkeeper to find out. The bookkeeper didn't know either and said she would call back when she calculated the amount, but never did. The respondent dislikes all aspects of the ZPP and said that he and all other businessmen would be better off without it.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N015
Ownership: Sole proprietorship, privately owned.
Type of business: Manufacturing, construction.
Location: Federation.

Company and management profile:
The owner employs 23 workers. He started from nothing in late 1996 and began manufacturing and construction work.

RESPONDENTS' REACTIONS

The owner hasn't been in the ZPP for almost 11 months. The last time he went was when a supplier blocked his account for DM 12,000. Because he works primarily for cash, his account has always maintained the minimum balance. When his account was blocked he ignored it entirely, and continued to work for cash. What few transactions he was forced to make through the ZPP he did via the account of his brother-in-law's firm. He sees no particular use for the ZPP. Before his account was blocked his secretary was forced to spend about one and a half-hours per day at the ZPP. He estimates that the daily ZPP paperwork also took between one and two hours. Most of his employees are unregistered, and he pays them cash. He says the ZPP provides no services that a bank can't do better. As far as he is concerned, the only thing the ZPP does is force him to operate underground. If the ZPP didn't exist his business could continue to function as if nothing had happened. He claims most companies feel the same. Much of his business is barter trade. This is primarily due to a lack of cash in the economy. "No one has cash, everyone has goods, and everybody wants my goods. So I sell them for other goods." He rarely, if ever, registered his barter trade business with the ZPP. His ZPP fees were always too high, and he disliked the way the municipality would make up new retroactive taxes and take the money from his account without his knowing it. The most well known of these was the sign tax. He sees no difference between the ZPP and the tax authorities, and says they operate as if they are the same organ.

PB QUESTIONAIRE INFORMATION

Company I.D. number: N016
Ownership: Sole proprietorship, privately owned, foreign ownership.
Type of business: Building supplies manufacturing and distribution
Location: Federation.

Company and management profile:
Foreign-owned, it represents one of the largest building material suppliers in Europe.

RESPONDENTS' REACTIONS

The financial manager met with us. He claims that they would prefer using a commercial bank to the ZPP, but they have no choice in the matter. The typical fees are around 0.20%, but there are all sorts of little charges that raise the actual rate to around 0.30. Most transfers are relatively small, around DM 5,000. The only transfers above DM 30,000 are those that go through the banks for foreign payments. He estimates they loose approximately one and a half-hours per day to ZPP paperwork. He dislikes doing payroll through the ZPP and claims it to be very inefficient, causing them to loose approximately 13.5 working hours. The company has 23 employees, and he says this is far too much time to spend on payroll. He referred to a mountain of paperwork for payroll. Because they are an almost exclusive supplier for BiH, they have a near monopoly position in the local economy, and are able to have higher profit margins than most other building supply distributors. He says that if not for the high profit margin, they would leave BiH. The paperwork is nearly doubled by ZPP requirements, and their accounting procedures and standards are not compatible with western standards and practices. The company refuses to accept acceptance orders, as there is too much fraud related to their use. This includes fraud by ZPP officials. His company would far prefer to use a commercial bank. They are effectively unable to repatriate profits, so they use fictitious invoices for services from the parent company.

ANNEX 3

SPP/ZPP Bank-Client Interviews

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BANK INTERVIEW--Payment Bureau Questionnaire Information

Company:	**Banja Luka Bank**
Ownership:	**Majority state owned**
Type of Business:	**Commercial Bank with branches in all major towns in the RS**
Location:	**Headquarters in Banja Luka**

Bank and management profile: Banja Luka Bank is a commercial bank operating in all major cities in the RS. Before the war it was part of the Privredna Banking system. Current activities are largely centered around fee-generating activities such as payment with abroad and foreign exchange.

Interview Responses: *Fees charged by SPP:* 46% of every transaction. Didn't have total fees paid for 1997 available but claimed it was over KM 100,000.
Received price list form SPP: Published in official gazette, but additional charges sometimes appear.
Time lost to SPP: Over three full time staff, but some would be needed even if SPP were abolished.
Costs of ZPP to Business: Over KM 100,000, lost fee opportunities, and loss of Information over customers activities.
Frequency of audits: At least annual
Taxes collected by SPP: All for bank, some for customers.
Services offered by SPP: Accounting for customer accounts, fairly reliable internal payments
Positive aspects: Fairly reliable payments, but would prefer to be allowed to provide this service itself. Otherwise, no positive aspects.
Which services are essential: Limited payment functions, otherwise none.
Transaction settlement time: Within RS 1 to 2 days. Between entities- varies, but can be very long

Respondent's Reactions: The Director was very unhappy with SPP's monopoly position, and particularly with its relatively new role as a direct competitor to commercial banks in all aspects of banking services. He stated that the fees were exorbitant (.46%), and that they were charged on both sides of a transaction. After both payer and payee have paid their fees, he stated that the average transaction cost for using the SPP was approximately 1%. His second major complaint was that the SPP used its monopoly powers and informational advantage to "steal" his customers. He claimed that some of his customers had been pressured to move their accounts to the SPP. This pressure took the form slowing down payments, and threatening to cut off access to cash through the cash management function.

When asked which functions of the SPP he could not perform in-house, he initially stated that there were none After some questioning, he admitted that there were a limited amount of internal payments for which he would probably still use the SPP if that were an

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option. He stressed, however, that over 80% of payments could be handled by the bank immediately, and that his bank would like to offer payment services to smaller banks on a correspondent bank basis. He agreed that one aspect of the current payments system that would be hard for banks to replicate would be the faith in stamped payment orders that businesses have. Banks do not have the type of trust in their ability to deliver payment that the SPP does. However, he claimed that the vast majority of his customer base had dealt with the bank for many years, and would be willing to rely on his bank for internal payments, as they already do for external payments. payments through Frankfurt.

BANK INTERVIEW--Payment Bureau Questionnaire Information

Company:	**Crystal Bank**
Ownership:	**Majority state owned**
Type of Business:	**Commercial Bank with branches in all major towns in the RS**
Location:	**Headquarters in Banja Luka**

Bank and management profile: Crystal Bank is a commercial bank operating in all major cities in the RS. Before the war it was part of the Yugo Banking system. Current activities are largely centered around fee generating activities such as payment with abroad and FX exchange. It is one of the few banks in the RS which performs payments with abroad, and which has invested substantive amounts in an internal payment ability.

Interview Responses: *Fees charged by SPP:* 46% of every transaction. Didn't have total fees paid for 1997 available but claimed it was over KM 90,000. Claimed they would send information over later.
Received price list form SPP: Published in official gazette, but additional charges sometimes appear.
Time lost to SPP: Two full time staff.
Costs of ZPP to Business: Over KM 90,000, lost fee opportunities, and loss of Information over customers activities.
Frequency of audits: None in last year, but usually annual.
Taxes collected by SPP: All for bank, some for customers.
Services offered by SPP: Some internal payment, which it could not do itself
Positive aspects: Fairly reliable payments, but would prefer to be allowed to provide this service Itself. Otherwise, no positive aspects.
Which services are essential: Limited payment functions.
Transaction settlement time: Within RS 1 to 2 days, between entities- makes very few such payments, but the delay can be substantial

Respondent's Reactions: The director definitely wanted to provide payment services, but was less aggressive than some of his RS colleagues in his estimate of a timeframe by which he could give the same service as the SPP He believes it would be at least two years before he could fully duplicate all payment functions of the SPP. The director sits on the payments system reform steering committee formed by the Central Bank. He indicated some differences with members of the committee on the goal of the reforms. He believes that the ultimate goal must be to put all payment functions of the current SPP into the banking sector and to spin off other functions to the applicable bodies (MoF, tax administration etc.). He believes, however, that many members of the committee have a vested interest in seeing some version of SPP survive. As all bankers in the RS, the director was highly critical of the SPP's role as a commercial bank. He expressed his belief that SPP gave itself preferential treatment when processing payments orders of troubled creditors. Like most banks in the RS, Crystal bank also believes that SPP uses its

inside information and monopoly powers to pressure its customers to move their accounts to SPP.

BANK INTERVIEW--Payment Bureau Questionnaire Information

Company:	**Market Bank**
Ownership:	**Private**
Type of Business:	**Commercial Bank in Federation**
Location:	**Headquarters in Sarajevo**

Bank and management profile: Market bank is one of the premier private banks in the Federation. It has had the benefit of a substantial investment (approximately DM 5 million) from the European Bank for Reconstruction and Development (EBRD), and a twinning arrangement with Allied Irish Bank. Market bank is expanding its branch network in the Federation, and has plans to open offices in the RS. Market bank currently processes approximately 250 payments per day, 200 of which it claims it could do without any involvement from the ZPP.

Interview Responses: *Fees charged by SPP:* Bank states they are aware of the various fees charged, and they are consistent over time. Estimated at KM 800 for 1997
Received price list form SPP: Published in official gazette
Time lost to SPP: Two full time staff
Costs of ZPP to Business: Over KM 800,000, lost fee opportunities, and loss of Information over customers activities.
Frequency of audits: At least annual.
Taxes collected by SPP: All for bank, some for customers.
Services offered by SPP: Payments, accounting for customer deposits
Positive aspects: Fairly reliable payments, but would prefer to be allowed to provide this service Itself. Otherwise, no positive aspects.
Which services are essential: Limited payment functions, otherwise none.
Transaction settlement time: Within Sarajevo- 1 day, within Federation-2 to 3 days, sometimes longer if between Croat and Bosniak areas, between entities-not very often done but can take a long time

Respondent's Reactions: The director of Market Bank stated that over half of the payments initiated at the bank 150 out of 250 per day were payments with abroad. The bank with no involvement of ZPP currently does these. Of the 100 internal payments processed per day, he estimates that well over 50% could be done immediately without any ZPP involvement. These transactions consist mostly of transactions between two customers at his bank, and transactions between a customer at his bank and a customer of another bank with which he has a correspondent bank account.

The director is in favor of removing the ZPPs monopoly immediately. He does not see how a healthy banking system can be formed without this step being taken. While he does not believe the payment aspects of the ZPP can be eliminated immediately, he thinks they could be phased out over a year. He believes the scenario would include several strong banks setting up the capacity to handle payments cleared through their reserve accounts at

CBBH. Other banks in the system would probably use one of these banks as a correspondent.

BANK INTERVIEW--Payment Bureau Questionnaire Information

Company:	**Vakuvska**
Ownership:	**Majority Private**
Type of Business:	**Small commercial bank with limited branch network**
Location:	**Headquarters in Sarajevo**

Company and management profile: Vakuvska bank is a small commercial bank in Sarajevo formed during the war. It has a limited branch network and small balance sheet. It makes small business loans to both state and private companies. It also does a small amount of retail lending.

Interview Responses: *Fees charged by ZPP:* Average of .1% for cash deposit and withdrawal. Average of .25%for transfers.
Received price list form ZPP: Published in official gazette, but additional charges sometimes appear.
Time lost to ZPP: One full time staff.
Costs of ZPP to Business: Total for 97 will be sent but is estimated at DM 50,000, lost fee opportunities, and loss of Information over customers activities.
Frequency of audits: Annual.
Taxes collected by ZPP: All for bank, some for customers.
Services offered by ZPP: Payments, cash management
Positive aspects: Fairly reliable payments, but would prefer to be allowed to provide this service itself.
Which services are essential: Bank would be unable to process many of its payments on its own.
Transaction settlement time: Within Sarajevo 1 days, between entities- Haven't done Between ZPP/ZAP- do limited payments, but can take up to 5 days

Respondent's Reactions: The director supported lifting the ZPP monopoly on internal payments. He believes he could handle a large amount of payments without resorting to ZPP, but couldn't estimate the percentage In any case, he stated that it would be at least two years before his bank could handle all its own payments. Until this happened, he would use ZPP or a correspondent bank. This banker stated that with the exception of the payments, there were no functions of the ZPP that affected his bank that he could not perform in house.

Of particular concern to this banker, was the handling of the transfer of accounts from the NBBH to commercial banks He was upset that these accounts were transferred to Central Profit bank in Sarajevo without the customers being given the option of choosing their own bank. He believes that many customers would have chosen another institution such as his. The director had never heard of anyone getting a loan from ZPP and was surprised to hear of it.

BANK INTERVIEW--Payment Bureau Questionnaire Information

Company:	**Hrvatska Banka Mostar**
Ownership:	**Majority private owned**
	Type of Business: **Commercial Bank with branches in many parts of Federation**
Location:	**Headquarters in Mostar**

Company and management profile: Hrvatska Banka is the largest and fastest growing of the private banks in the Federation. It has focused on small business and retail business. It received a DM 5 million investment from the EBRD, and has a twinning partner (Allied Irish Bank). Hrvatska Bank also has one of the better-developed information technology (IT) capabilities in the BiH banking system. Management estimates that all branches and departments will be on line real time within six months. This seems realistic given a tour of their facilities, and interviews with their IT people.

Interview Responses: *Fees charged by ZAP:* 2% for payments, .1% for cash withdrawal. Approximately DM 1 million paid in 1997.
Received price list form ZAP: Published in official gazette, but additional charges sometimes appear.
Time lost to ZAP: Over three full time staff, but some would be needed even if ZAP were abolished.
Costs of ZAP to Business: Over KM 1 million, lost fee opportunities, and loss of Information over customers activities.
Frequency of audits: At least annual.
Taxes collected by ZAP: All for bank, some for customers.
Services offered by ZAP: None
Positive aspects: Fairly reliable payments, but would prefer to be allowed to provide this service itself. Otherwise, no positive aspects.
Which services are essential: Limited payment functions, otherwise none.
Transaction settlement time: Within municipalities 1 days, between ZAP/ZPP- several days, sometimes up to 10, between entities- varies, but can be very long

Respondent's Reactions: The interview was conducted over the phone, so some of the responses were difficult to interpret. However, the main thrust of the interview was that ZAP inhibits the banks ability to function as a market oriented commercial bank. Management believes that the bank is currently able to perform most payment functions, and will rapidly be able to perform all functions of ZAP which relate to them (within one year).

Management believe they are losing many fee opportunities based on not being able to offer domestic payment services They were more positive than most bankers, however, in believing that the monopoly would be ended in a relatively short period of time. They believe that the politicians have already decided that ZAP/ZPP reform is inevitable.

Bank Survey Questionnaire

General

- Do you have a schedule of how and when PB charges all fees to you?
- How often do these fees change, and what is the process?
- What is your monthly/annual PB bill?
- For KM, can legal persons have a PB account not connected to a bank?
- For DM, does your bank have access to any PB deposits?
- Have you ever had a disagreement with PB over fees, if so describe?
- Is there an appeal process for disagreements? If so, describe the process.
- Have you ever received a refund from PB?
- Which aspects of PB do you appreciate/not appreciate as a service to your company? (detail)
- Which services rendered by PB could you not replicate yourself? (Describe)
- Describe human resources expended in your dealings with PB.
- Describe the structure of your PB account/accounts Do you have ZPP/ZAP/SPP accounts? Does each branch have a sub account?

Payments System Operations

- Describe a basic domestic payment between companies ordered over your bank when:
  - Both companies have an account at your bank
  - One company has an account at your bank and the other at another bank
  - One company has account at your bank, but the other has only a PB account
- Describe a basic domestic payment between a legal person and a natural person using the same categories as in question one of this section.
- Does it matter in payments between companies which both have banks, whether those banks have correspondent bank accounts or not?

- Describe the steps a company must take to transfer money from PB/Bank accounts to accounts for external payments (foreign exchange account at bank).

- Describe a basic external payment between companies ordered over your bank. Is there any PB involvement?

- Tax collection and distribution:

  - Describe each type of tax PB collects from your bank and the method of collection (timeframes, amounts, etc.)
  - Describe each type of tax PB collects from your bank and the method of collection (timeframes, amounts, etc.).
  - Describe the impact on your deposit levels from collection of such taxes form your customers over their PB/bank accounts. When and by how much do they fluctuate?

Statistics Collection

- In addition to semi-annual submission of balance sheet and income statements, what other financial information do you provide to PB?

- What follow up in the form of requested corrections is done by PB?

- In determining the accuracy of these statements, how much is done by PB, and how much is done by the Financial Police?

- Do you receive any analysis of this information from PB?

Treasury services:

- Describe the various treasury services, which PB performs for you, if any. This should be tied to the cash management and accounting functions.

Cash Management

- Describe process for daily depositing of cash to PB

- How much cash may you keep on hand?

- How much cash may you legally withdraw per day/week etc.

- Are you aware of methods to circumvent these limits and do you use any of them?

Accounting services:

- Describe the accounting services, which PB performs for your bank in the following areas:
  - Keeping track of customer accounts
  - Keeping track of central bank reserve account
  - Specifying charts of accounts and format for financial information present
  - Other

Interaction with financial police:

- Describe your understanding of the interaction between PB and Financial police as regards your institution.
- Have you ever had a financial police audit? If so, was it instigated by PB
- Do you send PB reports to Financial Police also, or is that done between the institutions themselves?

Lending functions:

- Have you ever received a loan from PB? If so, what was the mechanism.
- Have you ever run a negative balance in your PB account?
- Have you ever had your PB account blocked? If so, describe the reason and its impact on your business.
- Do you know of others who have done one or two from this section? (knowledge from customer accounts perhaps)
- Other
- What additional functions not yet discussed does PB perform in relation to your bank (e.g. selling of forms).

ANNEX 4

Interviews with the Payment Bureaus

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Minutes of the Meeting with the SPP

Date:	**10 November 1998**
Institution:	**Development Bank, Banja Luka (former Serbian State Bank)**
Persons met:	**Rajko Travar, General Director**
	General Manager of payment operations
	Djordje Miku, General Manager of EDP
USAID:	**David Whitehead, USAID Macroeconomic Advisor**
	Danka Vukovic, David Whitehead's assistant
	Branko Greganovic, Advisor to Study

The bank was formed in 1997. Recently, it was renamed from Serbian State Bank to Development Bank of Republika Srpska (DBRS), and the seat of the bank was moved from Pale to Banja Luka.

The DBRS as established by Sluzba za platni promet (SPP, former SDK) and the Government. As the SPP is 100% owned by the state, the DBRS is under the complete control of the government. (Actually, it is very likely that SPP is still socially owned. Moreover, this probably was the reason why they decided to have the SPP as the owner of the DBRS. However, this assumption was not explicitly confirmed).

In establishing the DBRS, the SPP participated by providing real estate and equipment of SPP (90% of capital; the government provided a cash donation in order to start operations of the bank – 10% of capital). All employees of the SPP were employed by the DBRS at the same time, and the DBRS took over the responsibility of operating the domestic payments system, previously operated by the SPP

There are still around 1000 employees working in what used to be the SPP structure.
The DBRS did not take over most of the control functions of the SPP. They were transferred to (i) newly established financial police reporting to the Cabinet, and (ii) Tax Administration Office that was established on the basis of existing agency that used to be responsible for natural persons tax administration. The Tax Administration Office reports to the Ministry of Finance. The powers of the financial police and the Tax Administration Office are not unambiguously separated, which causes overlaps and tensions between the institutions. The customs administration is organized in a separate agency. (The domestic payments system herein is defined as execution of payments among resident persons notwithstanding the currency in which those payments are denominated).

The DBRS is organized into two separate departments (i) banking, and (ii) domestic payment operations. Payment operations were relieved of most of control functions.
The DBRS now has 66 branches throughout Republika Srpska that were inherited from the SPP. The payments mechanism is still fully based on the old SDK structure and has been developed from it. The legal persons (i e. companies) still do not have a choice:
they are allowed to have accounts opened only with the payments department of the DBRS.

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The domestic payments system (payments among residents) is operated by the payments department of the DBRS. The DBRS does not provide cross-border payments - these are performed solely by banks.

The DBRS operates payments in two currencies, the Yugoslav Dinar (YUD) and Konvertible Marka . All account holders have accounts in both currencies.
Direct transactions between a bank (620 class account) and its depositors (usually 601 class accounts) is still technically possible and represent a normal transaction in the course of every day operations. At the end of day, banks' giro accounts still get adjusted by the amount of net daily turnover on the giro accounts of account holders treated as their depositors.

The DBRS improved the intra-day control of a bank's coverage of interbank payments to reflect depositors' payments. It is now not possible to make a payment from a depositor of bank A to a depositor of bank B if bank A does not have enough intra-day cover on its giro account. The payments among depositors of the same bank are not controlled.
The DBRS also has a 620-class account with its payments system department as any other bank in the system. (This confirms that the payments system has not really changed. The only difference is that the organization operating domestic payments is now integrated into a commercial bank).

There are 17 banks operating in Republika Srbska. They have accounts abroad and operate cross-border payments. Only one of the banks is a SWIFT (society for worldwide inter-bank financial transmission) member at present

On the YUD side, the DBRS is fully integrated into the SPP's payment network of the Federal Republic of Yugoslavia (FRY) by means of direct bilateral telecommunication links with all other SPP branches in YUD currency area.

FRY has already introduced separate systems for settlement of small-value payments (multilateral net) and large-value payments (real time gross settlement). This is reflected in some changes of chart of accounts used to operate domestic payments system. However, the fundamental structure seems to have stayed untouched.

The National Bank of Republika Srpska (NBRS) was dismantled at the time of introduction of the Dayton Agreement's Central Bank of Bosnia and Herzegovina. The former National Bank took over the role and responsibilities of the Agency for Banking that supervises banks and issues bank licenses

The CBBH has a branch in Banja Luka that keeps the accounts of the banks as well. Every morning, banks move the necessary amount of funds from their CBBH accounts to their 620 class accounts operated by the DBRS

The DBRS is also in charge of YUD and KM currency (i e. coins and banknotes) management

The ex-SPP branches are connected with telecommunication links (TCL). All banks from Republika Srpska are also connected to that network via TCLs. On the other hand, companies are still not in position to establish TCLs with their ex-SPP branches.
The domestic payments system department of the DBRS is still performing some ex-ante controls at the point of submitting payment orders for payment. The most important is one by which the DBRS controls and ensures payment of taxes and social security contribution. In practice, the controller at the DBRS counter to whom the payment orders are submitted will not execute a payroll payment order unless payment orders for payment of taxes and social security contributions are presented at the same time. (This is the single most important ex-ante control of the formal SDK structure. The efficiency of the tax collection still fully depends exclusively on this control performed as a part of domestic payments operations). In addition, the DBRS' department still (i) executes payment orders issued by a court in course of collection of a creditor's claim, and (ii) is legally obliged to file a bankruptcy, if an account holder is not able to pay its payment orders for certain number of days. The head of payments system department noted that this affects the reputation of the whole commercial bank even if it has nothing to do with its commercial behavior.

Despite being connected to YUD domestic payments system network, banks from the RS do not have access to credit facilities of the National Bank of Yugoslavia (NBY). The only way they can get YUD from NBY is by selling foreign exchange.

The counterparties did not think that the regulation on the maximum amount of currency that can be kept in vaults is important. It looks like they do not implement that regulation in the RS.

On the YUD side, they still manage a queuing system set up to manage arrears accumulated in the system. On the KM side, they have never done that and do not intend to do it in future. The Yugoslav law on financial operations that stipulated the management of arrears was abolished in 1993.

At the time of introduction of KM, the YUD were not converted into KM. Counterparties noted that for that reason, it is rather difficult to get KM in Republika Srpska even if they would like to have it given instability in the YUD currency area.

The payment department of the DBRS does not keep any DM balances (i.e. giro accounts denominated in DM) No domestic payments are therefore settled in DM via the payment department of the DBRS.

As far as payments in DM with other two entities are concerned, the DBRS acts only as a clearing house, i.e keeping records and calculating net amounts which are settled weekly in cash. The DBRS also provides a service of providing cash to eligible parties as a part of its currency management role KM and YUD transactions are settled daily.
Natural persons are allowed to have accounts with payment department of DBRS. Despite that, most natural persons keep their accounts directly with banks.

Companies and private individuals seem to be allowed to open transactions accounts abroad. They can keep foreign exchange accounts with domestic banks as well.

Internal budget control is charged to a Budgetary Inspection within the Ministry of Finance. There is no external body charged with auditing public accounts (e.g. Court of Audit).

Basic statistical functions of the former SDK are still with the payment department of the DBRS.

Statistical and financial controls of creation and utilization of socially owned capital were abolished. There are no private bodies or companies auditing accounts of commercial entities.

Social ownership still exists. They are just about to set up a database supporting the ownership transformation process..The database is going to be kept and managed by the payment department of the DBRS. The ownership transformation process itself will be managed by newly established Agency for Privatization

The DBRS derives 80% of its revenues from operating the domestic payments system, where as 20% of the total come from its banking activities. By the end of this year, they plan to increase the share of banking revenues to around 40%. Companies' deposits are the major source of funds for banks

Relevant legislation: (i) Law on banking, 1996; (ii) Law on internal payments system, (iii) Law on foreign exchange operations.

Charts of accounts: (i) SPP as a company has been merged with a bank and now uses the chart of accounts prescribed for banks, (ii) banks use chart of accounts which is based on the old Yugoslav chart of accounts for banks and will be delivered to the USAID Macroeconomic Project office, (iii) domestic payments system is still accounted for on a chart of account prescribed by the SDK in 1990 with very little changes made since.

MINUTES OF THE MEETING WITH ZAP

Date:	**11 November 1998**
Institution:	**Zavod za platni promet (ZPP) in West Mostar**
Persons met:	**Anka Musa**
	Another lady from ZPP Mostar
USAID:	**Mack Ott, Barents Group**
	Branko Greganovic, Advisor to Study

Organization worked under the name SDK until 31 December 1993 and was then renamed to Zavod za platni promet (ZPP). (This organization is referred to as ZAP in the Croat-majority areas of the Federation).

Domestic payments system (payments among residents) is operated by the ZAP. The ZAP does not provide cross-border payments. Cross-border payments are performed solely by banks.

In 1993, some functions of control were transferred to the financial police and Tax Administration Office.

ZAP performs domestic payments (i.e. payments among residents) in three currencies: Croatian Kuna, DM, and KM. Each of them represents around 25%, 65% and 10% of payments operations respectively.

Deposits in DM are 100% covered with cash in ZAP vaults, whereas Kuna deposits have 55% cover in Kuna currency kept by ZAP

Unlike SPP in Banja Luka, Mostar ZAP is not linked to the Kuna payments system in Croatia operated by Croatian ZPP. Accordingly, banks as any other cross-border payment with other countries perform payments with Croatia.

Changes made to the ZAP after dissolution of ex-Yugoslavia followed the logic of former SDK. No fundamental changes were introduced to the payments structure and mechanism.

Direct transactions between a bank (620 class account) and its depositors (usually 601 class accounts) is still technically possible and represent a normal transaction in course of every day operations.

At the end of day, banks' giro accounts still get adjusted in the amount of the net daily turnover on the giro accounts of account holders treated as their depositors.
There are 12 banks operating in the area, the biggest one being the Hrvatska Banka.
The ZAP is also in charge of YUD and KM currency (i.e. coins and banknotes) management
The legal persons (i.e. companies) still do not have a choice· they are allowed to have accounts opened only with the ZAP Moreover, banks are not allowed to open

transaction accounts even for private citizens. This was decided after a short period of time when private citizens were allowed to open accounts with banks, but banks turned out not to be able to offer an efficient and fairly priced payment service. This arrangement under which only ZAP can open transaction accounts for either companies or private citizens was strengthened by the recent law regulating this area.

The ZAP cannot effect the transactions between accounts denominated in different currencies. All transactions of this type must go through banks.

Foreign exchange accounts can be opened only with domestic banks.

The financial police, who report to the Ministry of Finance, perform financial audit of both private and public accounts.

Tax control is carried out by the Tax Administration Office, which reports to the Ministry of Finance.

The ZPP is still performing some ex-ante controls at the point of submitting payment order for payment. The most important is one by which the ZPP controls and ensures payment of taxes and social security contribution. In practice, the controller at the ZPP counter to whom the payment orders are submitted will not execute a payroll payment order unless payment orders for payment of taxes and social security contributions are presented at the same time. (This is the single most important ex-ante control of the formal SDK structure. The efficiency of the tax collection therefore still fully depend exclusively on this control performed as a part of domestic payments operations.) In addition, the DBRS's department still (i) executes payment orders issued by a court in course of collection of a creditor's claim, (ii) controls compliance with regulation on maximum amount of cash in vaults.

The ZAP still manages the queuing system inherited from the former Yugoslavia to manage accumulated arrears. They do not perform any multilateral compensation and do not have any role in bankruptcy procedures.

Basic statistical functions of the former SDK are still with the ZAP.

Checks are not used, but credit cards are (Visa, Diners) Visa is cleared in Split, whereas the Diners Club card payments are cleared in one of the Diners' European regional centers.

The ZAP employs 370 people. The Government owns the ZAP, and the Cabinet appoints the management. (Actually, it is very likely that the ZPP is still socially owned. However, this assumption was not explicitly confirmed)

Banks have an option to connect to ZAP via TCL The network of ZAP branches is connected via bilateral TLCs.

Most bank funding comes from company deposits, borrowing abroad, and donors' on-lending operations.

Legislation: (i) the new Law on Banks, (ii) Law on Internal Payments System, the same one as in Bosniak entity, (iii) Law on FX operations (being approved by parliamentary procedure), and (iv) Law on Financial Operations from 1995.

Charts of accounts: (i) ZAP as a company still uses the old chart of accounts prescribed in 1977, (ii) banks use chart of accounts which will be delivered to the USAID Macroeconomic Project office, (iii) domestic payments system is still accounted for on a chart of account prescribed by the SDK in 1990 with very little changes made since.

MINUTES OF THE MEETING WITH ZPP

Date: **12 November 1998**
Institution: **Zavod za platni promet (ZPP), Sarajevo**
Persons met: **Ismet Jelic, Deputy General Manager for Payments System**
Another gentleman
USAID: **David Whitehead, USAID Macroeconomic Advisor**
Asja Rasavac, David Whitehead's assistant
Branko Greganovic, Advisor to Study

According to counterparties, the SDK in Sarajevo took a similar route as its counterpart in Slovenia. Control functions were transferred to other institutions, and a remaining part called Zavod za platni promet (ZPP) was charged with operating the domestic payments system. New control institutions, however, use information from ZPP to perform their functions.

Domestic payments system (payments among residents) is thus operated by the ZPP. The ZPP does not provide cross-border payments. Cross-border payments are performed solely by banks.

Companies can have foreign exchange accounts with banks to make payments abroad but are not allowed to keep balances on them for unlimited period of time. (It was not ascertained what was the maximum time a company can keep its foreign exchange funds with a bank). Counterparties were not sure whether companies can keep foreign exchange accounts abroad, but thought this was unlikely because it would make control impossible.

ZPP is owned by the state. (It is very likely that the ZPP is still socially owned. However, this assumption was not explicitly confirmed).

There are 56-57 banks operating in the Federation.

Direct transactions between a bank (620 class account) and its depositors (usually 601 class accounts) is still technically possible and represent a normal transaction in course of every day operations.

At the end of day, banks' giro accounts still get adjusted in the amount of the net daily turnover on the 'giro accounts of account holders treated as their depositors.
ZPP perform domestic payments (i e payments among residents) mainly in two currencies: DM, and KM. In addition, in some branches like (eastern) Mostar and Travnik, they also keep Croatian Kuna accounts

Payments in KM are controlled by the Central Bank of Bosnia and Herzegovina, whereas the payments in DM are currently not controlled by any organization.

The DM and Kuna accounts were established by (i) deposits of DM and Kuna currency and (ii) transfers of deposit money to accounts with ZPP

Branches of ZPP in different entities are not linked directly by bilateral accounts but indirectly through bilateral accounts the central branches of the three entities keep with each other.

Inter-entity payments are settled once a week, but lately they have seen some improvement in that area. Domestic payments are settled with significant and inconsistent lags due to the technological problems. To remedy this, the ZPP hired a Slovenian firm Hermes Softlab to set up telecommunication links among ZPP branches and modernize the payment mechanism.

Contrary to the situation in Banja Luka, the weekly settlement of claims between Bosniak and Croat entity takes place in deposit money form. Cash is exchanged only if the need arises within the limits of funds the entities keep with each other.

The legal persons (i.e. companies) still do not have a choice: they are allowed to have accounts opened only with the ZPP because otherwise it would be impossible to provide required controls. Natural persons are not allowed to have an account with ZPP, they can open it with a bank.

The ZPP is still performing some ex-ante controls at the point of submitting payment order for payment. The most important is one by which the ZPP controls and ensures payment of taxes and social security contribution. In practice, the controller at the ZPP counter to whom the payment orders are submitted will not execute a payroll payment order unless payment orders for payment of taxes and social security contributions are presented at the same time. (This is the single most important ex-ante control of the formal SDK structure. The efficiency of the tax collection therefore still depends exclusively on this control performed as a part of domestic payments operations). In addition, the DBRS's department still (i) executes payment orders issued by a court in course of collection of a creditor's claim, (ii) controls compliance with regulation on maximum amount of cash in vaults.

Setting financial accounting standards was moved to Agency for accounting and audit. The agency defines also charts of accounts to be used by different type of commercial and government entities.

It is not clear who took over the private and public accounts audit function. ZPP is not doing it, and for the time being there are no private auditing firms present neither does the Court of Accounts exist which would audit government related accounts.

Companies still report their balance sheets and income statements to the ZPP twice a year. However, it appears that this information is not being used, as the analysis department of the former SDK was dismantled some time ago

As in Banka Luka and Mostar, there are financial police and Tax Administration Offices in Sarajevo as well. They both report to the Ministry of Finance. The powers of financial police and Tax Administration Office, however, are not unambiguously separated which causes overlaps and tensions between the institutions.

The ZPP still manages the queuing system inherited from former Yugoslavia to manage accumulated arrears. They do not perform any multilateral compensation and do not have any role in bankruptcy procedure.

The ZPP is also in charge of KM currency (i e. coins and banknotes) management.

The ZPP employs just over 1,000 people.

Legislation: (i) Law on Banks, (ii) Law on Internal Payments System, (iii) Law on FX Operations, (iv) Law on Financial Operations.

Charts of accounts: (i) domestic payments system is still accounted for on a chart of account prescribed by the SDK in 1990 with very little changes made since, (ii) other relevant entities (banks) and ZPP as a company use charts of accounts defined by the Agency for accounting and audit. (It was not clarified which chart of account is used by the ZPP as a company and which one banks use)