Accession of Bosnia and Herzegovina to the European Union: Impact on Public Finances, Budget and Legislation

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Abstract— **The main objective of this paper is to define the impact and the consequences of the processes of European Integration on public finances, management of the budget and legal standardization in Bosnia and Herzegovina and to give, accordingly to conducted research, the answer to a dilemma whether joining the EU will bring more advantages or disadvantages to Bosnia and Herzegovina and both of the it`s Entities.**

A special analysis is given on the impact of the accession process on budgetary revenues, the costs of reform, and the institutional adjustment. The net financial effect of the pre-accession process and of joining the EU on the budgetary deficit and public debt of Bosnia and Herzegovina has also been analysed.

Index Terms*— *Association process; Budget; European integration; Legislation; Public finances

I. Introduction

THE benefits of EU integration are numerous whether political, economic or financial. On the other side, the entry into the EU is closely related to the costs, such as the cost of standardization, transition costs and indirect costs, like the cost of the common agricultural policy. Being a member of the European Union brings plenty of challenges, especially for less developed countries.

While the benefits related to the progress in each sector (legislation, stability, security, opening new markets) are numerous, challenges for the new members are different and mainly associated with the increased competition in the EU and efforts that should be made to reach European Union standards. The costs of adopting the norms and standards of the European Union, the costs of transition and reduced freedom in decision-making are the main disadvantages appearing in the less developed countries.

At the start of membership, the changes that must occur in less developed countries can create a variety of problems such as migration, unemployment, reduced autonomy and reduced competitiveness. On the other hand, due to the structural funds, the new members have the opportunity to achieve great progress in infrastructure and business environment.

Along the way from potential to actual candidate country, further adjustments of the system of the budget and the budgetary processes in Bosnia and Herzegovina are necessary for the sake of providing a better capacity to absorb resources from the pre-accession programme, IPA, and after membership, from the Cohesion and Structural funds of the EU. On this road Bosnia and Herzegovina should adjust the process of budgetary management and the structure of the budget.

II. MARKET ECONOMY IN BOSNIA AND HERZEGOVINA

In the conclusions of the European Council in Copenhagen in June 1993, it was stated that membership of the Union requires the existence of a functional market economy and the ability to deal with competitive pressure and market forces inside the Union. Therefore, before making analysis, a short overview of the existence of functioning market economy in Bosnia and Herzegovina is required.

In 2011, the economic recovery was present, with real GDP growth accelerating slightly to 1.3%, as compared to 0.7% a year earlier. Domestic demand revived, supported by a relatively stable inflow of remittances and slightly accelerating credit growth. The indicators available for 2012 suggest that the economic recovery stalled, negatively affected by the worsened external environment. Industrial production fell by 6.5% in the first seven months of the year, while exports of goods dropped by 4.3%. Per capita income, measured in purchasing power standards (PPS), decreased to 29% of the EU average in 2011 from 30% in 2010. Overall, economic recovery gained some momentum in 2011, but this positive trend was reversed in 2012.

The current account deficit was financed mainly by external borrowing and, by smaller percent, by foreign direct investment (FDI). Bosnia and Herzegovina's external public debt increased by 5.9% to 26.1% of GDP in 2011, while external private debt reached 33.1% of GDP. In the first half

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of 2012, the external public debt rose further by 5.1% year on year.

The largest creditor remains the World Bank group. A large part of the debt is contracted on concessional terms with the average interest rate of all debt being at only 1.6%. Average annual inflation reached 3.7% in 2012, compared to 2.1% in 2011. The highest increases were registered in transport and food prices, reflecting international price developments.

The monetary policy of the Central Bank continued to be conducted under a currency board arrangement, with the euro as the reserve currency, enjoying a high level of confidence and credibility. The consolidated budget deficit reached 1.3% of GDP in 2011, compared with 2.5% in 2010.

The transparency, sustainability and reliability of public finances in Bosnia and Herzegovina were seriously undermined by the long delay in adoption of the State-level budget and of the Global Frameworks for Fiscal Policies for 2012-2014 and 2013-2015. The State-level budget for 2012 was approved in May.

General government debt, both domestic and foreign, increased by 6% and stood at 39.5% of GDP at the end of 2011. External debt accounted for 26.1% of GDP and domestic debt for 13.3%.

The weakened budget planning and lack of fiscal coordination severely threaten the transparency, reliability and sustainability of public finances and are a serious impediment to short- and medium-term economic planning. Some limited improvements have been made to the business environment but significant administrative barriers remain for private-sector development.

Total trade (the sum of the volume of exports and imports of goods and services) increased further to 93.2% of GDP in 2011, as compared with 84.2% in 2010. The EU continues to be the country’s largest trading partner, with shares of 58% of total exports and 46.6% of total imports in 2012 (goods only). While the share of exports to the EU has increased somewhat, the share of imports from the EU has decreased slightly.

III. BENEFITS AND EXPENSES OF MEMBERSHIP IN THE EUROPEAN UNION

Political privileges caused by EU membership are primarily political safety and protection of national interests through the political institutions of the EU. By joining the EU, political and diplomatic rating, significantly increases, not only in Europe, but also worldwide. Also, EU members can express their views on political declarations in the EU during the process of creation, and thereby to participate in the creation of the EU law.

The positive economic effects for the Member States tend to come through more intense and liberalized trade, more efficient allocation of resources in the Union, the effect of the accumulation, reduction of interest rate and through much higher inflow of foreign investment. What encourages the development of these economic effects is the free flow of goods, labor and capital within the Union and immeasurably greater degree of political and legal framework that members own. A definite legal and political framework, achieved by accession to the EU, will attract foreign direct investment (FDI). The annual inflow of foreign direct investment in Central Europe is measurable in billions of dollars.

By becoming a member of the European Union, countries enter the the EU global market. Unique market is a market that guarantees the "free flow" of people, goods, services and capital. On practical level, this market enables EU citizens to live, work, study and run operations of the company in the entire area of the European Union, as well as to have at their disposal a wide range of goods and services at competitive prices.

Although political stability and economic framework are the main motivation for entering The European Union, financial aspects are also important, specially money transfers from the budget of the EU to it`s less developed regions (structural funds), as well as financial assistance to EU farmers, which is also financed from a common budget (Agricultural Fund). Both types of assistance are available to members of the EU that are considered to be underdeveloped and agricultural countries. Each region, which has a per capita gross national product less than 75% of the average of the EU has the right to the use these funds.

The most of the costs caused by EU membership:

- The costs of implementing all the norms and standards
- The problem of migration-increasing crime
- The possibility of competent people going in the other EU countries
- The possibility of relatively incompetent immigration coming from neighboring countries, looking for employment in an EU country
- The possibility of lowering wages in the EU
- The possibility of rising unemployment
- Costs of improving legislation
- Costs of compliance with the principles of economic
- Costs of printing banknotes and circulation with simultaneous withdrawal of the old currency
- Costs of complete modernization of industrial plants
- The possibility of loss of economic benefits, and leveling of cultural standards, religion and tradition
- Loss of market share of local companies
- Switching costs can be very high for poor countries with low economics and entrepreneurship
- Developed countries may suffer the consequences of adjusting of countries with weak economy

The lack of exit possibility from the Union

IV. IMPACT OF THE PROCESS OF EUROPEAN INTEGRATION ON PUBLIC FINANCES AND MANAGEMENT OF THE BUDGET IN BOSNIA AND HERZEGOVINA

The net financial effects include the adjustment of the structure of revenue from indirect taxes (VAT, excise and customs duty) in accordance with EU standards, costs for the strengthening of institutions, costs for joint financing of projects and costs of reforms and adjustments. These effects are very much dependent on the absorptive capacities of the pre-accession country.

Total effects of the pre-accession phase on the Bosnia and Herzegovina budget and the net financial effect (in % of GDP)

		2011	2012	2013	2014	2015	2016-2020	Total
1	*Adjustment of structure of revenue from indirect taxation*	0.12	-0.08	-0.31	-0.68	0.00	0.00	-0.96
2	*Institution building costs*	0.10	0.10	0.10	0.10	0.10	0.10	1.00
3	*Joint financing of projects costs*	0.34	0.34	0.34	0.40	0.45	0.50	4.37
4	*Reforms and adjustments costs*	0.30	0.30	0.30	0.30	0.30	0.30	3.00
5	*Total impact on the budget (1-2-3-4)*	-0.62	-0.82	-1.05	-1.48	-0.85	-0.90	-9.33
6	*Resources from EU funds*	0.80	0.80	0.80	0.90	1.00	1.00	9.30
7	*Net effect (5+6)*	0.18	-0.02	-0.25	-0.58	0.15	0.10	-0.03

Bosnia and Herzegovina receives **financial assistance** under the Instrument for Pre-accession Assistance (IPA) for supporting the strengthening of the rule of law, improving the capacity and efficiency of the public administration and supporting social and economic development. The IPA national allocation for 2012 is € 102.7 million. It includes the IPA 2012 national program (€ 84.8 million) which will cover projects in a variety of areas. Assuming that Bosnia and Herzegovina will become a full member of the EU in about 2020, it follows that Bosnia and Herzegovina will be able to use resources from the pre-accession funds in the new 2014-2020 perspective, and will have access to all five components of IPA funding.

From 2007 to 2010 the average rate of the joint financing of IPA projects at the level of general government is 13.78%, local government accounting for 12.2% and central government 1.58% of contracted amounts. On average 32.81% of the contracted amount of the budget of projects is financed from IPA resources, which means that the average ratio of joint financing of projects from the national exchequer and IPA resources is about 42%. Since allocated IPA resources as a proportion of GDP is about 0.18%, it can be assumed an increase in the expenditure of general government in the amount of 0.34% of GDP by 2013, and a gradual enlargement to 0.5% of GDP in the new financial perspective 2014-2020, because of the access gained to an additional three components of IPA funding. Since the contracting of projects takes on average about a year, it is expected for 2014 0.4% of GDP, in 2015 0.45% of GDP and in the following period, 2016-2020, 0.5% of GDP expenditure for the joint financing of projects.

The amount of the external indebtedness of Bosnia and Herzegovina includes the loans which Bosnia and Herzegovina is liable for. According to IMF data the share of foreign debt in GDP in 2009 came to 21.7%. About 43% of the foreign debt of Bosnia and Herzegovina is exposed to currency risk, which above all depends on the trends in the euro as against all other world currencies, because since 1997 in Bosnia and Herzegovina the exchange rate has been tied (first to the mark, and then to the euro).

Most of the "new" loans granted to Bosnia and Herzegovina are still characterized by credit arrangements with a grace period and periods of repayment and a relatively low rate of interest. This is the case with all the new loans from the World Bank and IFAD, the government of Belgium and the government of Japan. Contracts concluded with the EBRD and the EIB have the standard conditions that these institutions apply. It is important to note that the grace period for all loans on the basis of old debt has expired and they are in the repayment phase. The average interest rate for all the loans taken out that related to foreign debt came, as of December 31, 2009, to 1.53%, with the average interest rate on the basis of the old debt being 1.83% and on the basis of the new debt 1.32%.

IMF estimates how that the share of public debt in GDP grew by 3.7 percentage points and that about 25% of the total amount of the public debt is exposed to the currency risk. The expected scenario for public debt sustainability shows a gradual reduction of the share of public debt in GDP to 28.1%, which satisfies the criteria of the SGP. This is primarily because of the assumption of a constant growth in GDP and negative real interest rates on the public debt. In the optimistic scenario in which we keep all the projections the same as in the expected scenario, with a constant share of revenue and expenditure in GDP in the 2011-2015 period, the share of public debt in GDP will reduce to as little as 23.5% in 2015.

On the revenue side because of harmonization with EU standards, it is expected a reduction of revenue from indirect taxes in a total amount of as much as 2% of GDP in the 2008-2014 period. After 2014 revenues should ascend by about the same rate as GDP. The total impact on the budget of general government in the whole of the observed period is negative, tending to rise from 2011 to 2014, after which it will stabilize at 0.9% of GDP. The total net effect in of the observed period is approximately equal to zero, but any change might mean additional changes in the structure of revenue and expenditure.

The restrictions and conditions of adhering to the Stability and Growth Pact are prescribed for new member states, but in the accession phase it is also important that they be respected so that the country should not enter the EU with serious fiscal difficulties.

V. TO ENTER OR NOT IN THE EU – EXPERIENCES FROM BOSNIA AND OTHER COUNTIES

Among the candidates for accession to the European Union, there is a common perception that membership in the European Union is to accelerate economic growth. These are the data on GDP levels of members who have already joined EU (once called the European Economic Community). Ireland became a member in 1973, Greece in 1981, Spain in 1981, Portugal in 1986 and Greek part of Cyprus joined in 2004. All these countries were below 75% of the EU average in GDP, therefore adaptation to funds would enable them to be closer to the average. Did they succeed? Ireland, famous for its future growth as the Celtic Tiger, took the advantage of growth in the last decade of the 20th century. Spain has experienced the full growth after joining the EEC, and is often cited as a typical example of rapid economic growth that occurs under the influence of EU membership. Portugal started from a very low level, and its growth has been good until 2000, when it stopped. The cause of this is unknown, but, until then, Portugal and Spain had similar trend of GDP growth. Greece did not only fail to move closer to the EU average, but it is actually diverged for a while. Greece has had a relatively large military and social costs and was amassing huge debt during the socialist government, but this is not sufficient explanation. Greece was also funded by the EU. From all this it can be concluded that the GDP of each country is influenced differently by joining the EU. How membership helps economic growth can be seen from the fact that the EU has given billions to Ireland, Portugal and Greece, but different results were obtained. Ireland now has about 40% above the EU average in GDP, but in the case of Portugal and Greece, both are about 25% below the average, which is far from fantastic. EU membership is not necessary, nor a sufficient reason for the growth of GDP.

As for Bosnia and Herzegovina, according to the expected scenario, the net impact of joining the EU on the Bosnia and Herzegovina budget is a positive 0.41% of GDP. In the optimistic scenario this positive effect is as much as 2.1% of GDP, and in the pessimistic scenario it is negative, coming to -1.07% of GDP. In the expected scenario the sustainability of the public debt, the debt is expected to decrease gradually to 8.1% of GDP in 2015. This meets the SGP criteria. This is achieved primarily because of the assumption of a constant rise of GDP and negative real interest rates on the public debt. The optimistic scenario shows a reduction of the public debt as proportion of GDP to as little as 23.5% in 2015. A pessimistic scenario, including a combination of fiscal and macroeconomic shocks, shows an increase of the public debt in the observed mid-term period to 39% of GDP. But according to all the projections, the criteria of the Stability and Growth Pact are not put in threat.

On the other side, there are countries like Norway, Iceland and Switzerland, three developed countries which are not members of the EU, each for their own reasons. All three countries have extremely high level of development, and with exceedingly high socio gross product (Iceland and Norway have vast natural resources-fish and oil, while the Swizerland is banking world leader) and with law-regulated and sucessfully organised state institutions. These countries already have fully regulated political system, meeting European standards in various areas or, in the case of Norway, being far ahead in the field of ecology. Also, all three countries are members of the European Economic Community, which is one of the pillars of the EU, and thus have a contractual relationship with the EU and participate in the formation of economic policy of the European Union. Bosnia and Herzegovina is in a very different economic and development situation, which is more similar to the countries that want to enter or have recently joined the EU (Bulgaria, Croatia, Macedonia, Serbia, Albania, Hungary, Czech Republic). Bosnia and Herzegovina would, in contrast to these three developed countries, after joining the EU be one of the countries that would get more funds for their own economic development, but also for the development of their institutions. Bulgaria, for example, as a member of the underdeveloped countries, for the period 2007-2013 obtained from the EU total 7.362 billion euros, which is several times more than what Bosnia and Herzegovina gains in the same period as a non-member country.

When Bosnia and Herzegovina becomes a member of the EU, it will have the opportunity to use the resources of the European budget on various grounds, but, on the other hand, then it will be obligated to pay money to the EU budget and this is going to be an outflow of funds from the national budget. The relationship between the budget of Bosnia and Herzegovina and the EU budget is going to be bidirectional. This means that the country must provide sufficient amount of funds for co-financing. Practice shows that, before joining the EU, it is not a big problem. The reason is that the amount of funds, which is during this period received from the EU, is relatively small, so the amount of money needed for national co-financing is also relatively small. But, after joining the EU, there is access to a much larger quantity of funds, and that means more money is needed for national co-financing.

VI. CONCLUSION

Even though Bosnia and Herzegovina is a long way from being actual candidate country for membership in EU, it should go toward the idea, and, accordingly, make adjustments of the system of the budget and the budgetary process in order to provide a better capacity to absorb resources from the pre-accession program, IPA, and after membership, from the Cohesion and Structural funds of the EU. On the way to European Union, Bosnia and Herzegovina should define development strategies for three and more years, introduce strategic planning and adopt development strategies at all levels of government, draw up a pre-accession economic program (PEP) as candidate country, change the system of financial management, provide in the execution of the budget the ability to carry projects over from one year to the other, introduce a system of classifications of the budget that will enable monitoring and obtaining information about revenue, expenditure, assets and liabilities, and to bring in a system of budget classification according to sources of funding because of the new source of funding – EU assistance.

It is highly important that the process of joining the EU is not to be seen only through the debit/credit prism and that there should be no expectation of a positive or zero effect on the budget. This process is costly, and it cannot be expected that the expense is going to be totally financed from pre-accession assistance programs. However, this process does, in the long run, bring a candidate country greater benefits, which are reflected in the stability of the economy and fiscal system and higher rates of economic growth, and, therefore, Bosnia and Herzegovina should welcome and embrace the chance of becoming a part of the European Union.

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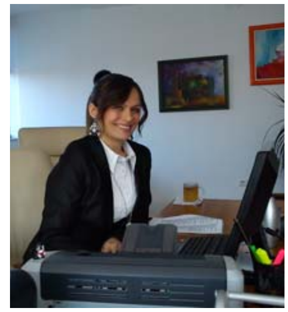

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