



VALUE CHAIN FOR SHOES PRODUCTION



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1. Introduction

CREDO Krajina is a project funded by Sweden and implemented by the Enterprise Development Agency Eda from Banja Luka in cooperation with the Association for Development NERDA from Tuzla.

The project's aims to improve competitiveness of small and medium enterprises in the Krajina area, in order to create and sustain jobs, reduce poverty and improve economic status of the area. The project shall support creation of more than 200 new jobs and keeping of 1000 jobs in companies / sectors covered by project interventions. Also, the project should facilitate vertical and horizontal coordination of policies directed towards small and medium enterprises in the project area.

Duration of the Project is 30 months and it consists of multiple phases and components. Priority economic sectors with significant potential for creating new jobs were selected through initial analysis and then representatives of companies from these sectors, through sectoral committees will define priority needs for advisory support and training. In addition, part of the advisory and financial support will be directed towards cities and municipalities that intend to significantly improve local business environment and to establish permanent and effective dialogue with the private sector.

We extend our gratitude to sector experts, members of Sector Boards, participants in workshops, survey, and interviews conducted within the project for their help in implementation of research. We would like to thank especially to Mr. Shawn Cunningham and Mr. Frank Waeltring from Mesopartner for methodological guidance and advisory support in preparation of value chain analysis.

2. Research Approach

The research consisted of a combination of quantitative and qualitative research. The process started with the development of a target population of firms. A baseline study was conducted to collect data on the sectors that could be used to both inform of the priorities but also for monitoring and evaluation purposes.

This was followed by a qualitative assessment of the targeted sectors. Qualitative assessment of the leather and shoe sector was done through series of interviews with the main stakeholders within the value chain. Interviews were organized with several companies and institutions in the chain, including supporting and policy institutions (the RS Chamber of Commerce, RS Ministry for Industry, Energy and Mining).

A team of experts visited firms and their supporting organizations to collect information on the many aspects related to doing business - competitive pressures on firms, demand conditions, factor conditions, rivalry, etc. Also, the workshop with the sectoral committee, consisting of directors and owners of leather/footwear production firms in the region, coupled with representatives from the RS Ministry of Industry, Mining and Energy and RS Chamber of Commerce, was held in order to get/test additional findings.

Finally, the report was prepared based on the baseline study, additional desk research and field research through interviews and workshop.

3. Overview of the Leather and Footwear Processing Chain

The footwear sector is an important part of the European manufacturing industry and it plays a crucial role in the economy and social well-being in numerous localized regions within the EU. The footwear market has had its annual sales of around 2.1 billion pairs and a value of around €49 billion in 2011, while the EU alone accounts for about 5% of global production. The industry is dominated by small and medium-sized enterprises (SMEs) and it is particularly exposed to international competition. This structure can be considered as both a strength and a weakness, as SMEs are generally more flexible, and yet, at the same time, more likely to lack investment capability.

At present, the footwear industry is also highly globalised. Competition from countries with low labour cost and less-regulated working conditions has forced the EU footwear production into serious restructuring strategies and re-location policies. The overall performance of footwear in the EU has been deeply affected by this unbalanced supply to the global market.

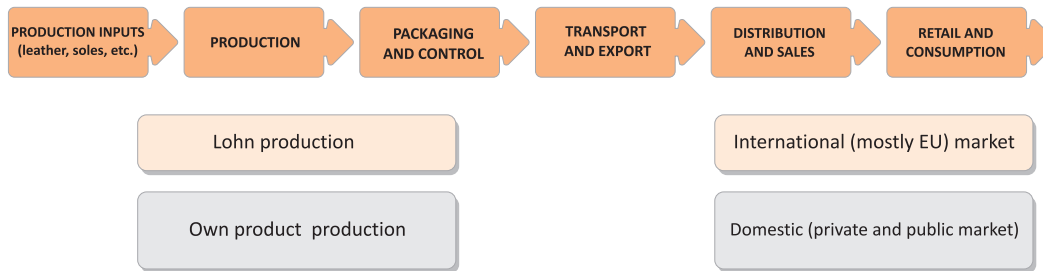
Today, the European footwear industry is a mature sector, where companies find it difficult to sustain a significant level of growth; it is strongly pulled by a highly unstable and rapidly changing demand, due to fashion-related and seasonal fluctuations. A profound restructuring of the distribution system is also taking place, giving more bargaining power to the distributors and putting pressure on prices. In general, the footwear sector has changed its structure over the years and nowadays it is organized within global value chains on one hand and within some local chains in different countries.

Focus of the VCA is related to footwear production in the Krajina area. This area is located in the North West of Bosnia and Herzegovina and it is made out of 35 municipalities. More specifically, the targeted sub-area for the footwear sector is covering 4-5 municipalities in which 90% of shoe production in the Krajina area is located. Also, the Krajina area is the area where the 95% of total footwear production in the Republic of Srpska was made.

The footwear production in the Krajina area is leaned on the previous tradition of shoes production under several socially owned companies (OOURs), which operated under the complex business enterprises (SOUR-s). SOURs were complex organizations made from several organizations (OOURs), usually

within one value chain. For example, SOUR Krajisnik was organization which gathered all leather and shoe production companies from municipalities Banja Luka, Kotor Varos, and Prnjavor. It should be noted that all the organizations within SOUR were financially and commercially independent, while SOUR has had some joint detached functions. Most of the owners/directors of the present footwear production companies were managers within these socially owned companies. Also, it should be mentioned that during socialism, export was made through export companies (agents), mostly based in other federal republics in former Yugoslavia (Slovenia for the Western Europe and Serbia for the Eastern Europe).

Generic Value Chain

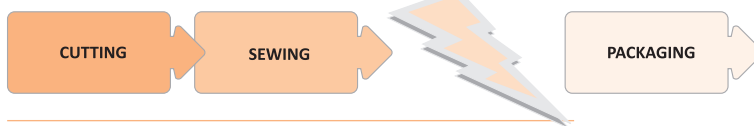


The dominant business model within the sector is seen in production on contractual basis for a known buyer who is also a supplier of raw materials. This low value added production is usually called *lohn* production¹. It can be said that local companies are involved within the global value chain with two differences – complete integral lohn production and partial lohn production. In partial lohn production, companies do not assemble the final products and they actually export only upper parts of shoes.

Integral Lohn Production



Partial Lohn Production



¹ The concept of lohn or lohn production focuses on processing raw materials into wholesale shoes production. A shoes manufacturer makes a contract which means that they will produce items at the request of a client at the exact technical parameters in exchange for a pre-established sum of money.

As much as 13,207,402 pairs of shoes were produced in 2012, which is more by 5.7% compared to the produced quantity of shoes in 2009. In addition to producing large quantities of shoes in 2012, it can be seen that companies have had a higher number of more complex operations in footwear production when compared to 2009. According to the RS Statistical Office, 5,087,823 pairs of shoes was the number of produced upper parts of shoes in 2012, which represented by a 2.5 % lower number (130.000 pairs) when compared to number of produced upper parts in 2009. As for the analysis of produced and sold quantities of shoes in 2012, it is important to point out that out of the total output of 13,207,402 pairs of shoes, 95% of pairs were produced in lohn business and 96% of pairs were sold. All lohn production is based on annual and multi-annual contracts between the local producers and well-known EU footwear producers/sellers.

There is some small portion of companies that tries to develop and produce domestic shoe models, however, this represents less than 5% of the entire companies' production in the Krajina area. These companies are mostly producing shoes for domestic market - private and public consumption.

Domestic Production



Surprising findings, reached during the research, can be defined as follows:

- The sector has 2 types of lohn producers – those who have integrated production and those who perform only one or few phases during production,
- Limited information about potential markets and buyers – long-lasting consequence of the previous times during socialism, where export was made through export companies (agents),
- There are some champions in the sector (e.g. company Sportek),
- Bargaining power of companies is limited due to the nature of the contract with partners,
- Educational system does not support current development and production trends within the sector.

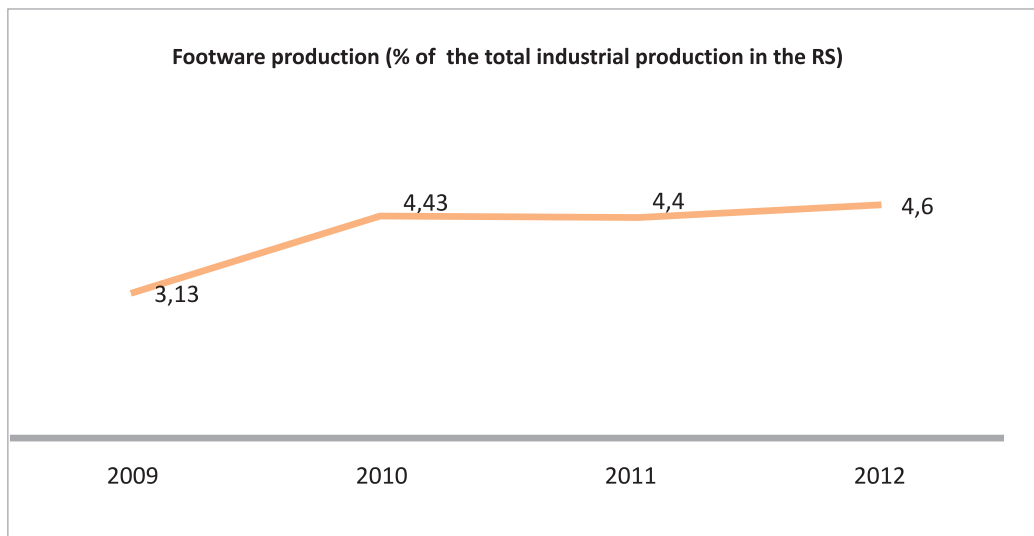
Leather and shoe production sector employs 4150 employees in 44 companies in the Krajina area. Total income of the sector in 2011 in all municipalities within the area was KM 85 millions. At the same time, the export was KM 68 millions (80% of total income)². The profit of the whole sector in the area was KM 6 million in 2011. Around 80% of total employments are women.

² Figures for total income and export are several times higher but not recorded due to the nature of the business model (import for export practice within the lohn production).

According to the APIF³, annual company reports for 2012 were submitted by 42 companies in the Republic of Srpska related to production of leather, leather products and footwear (out of 91 companies registered in the RS Statistical Office). As many as 34 companies are manufacturers of footwear included in the project CREDO Krajina. Analyzing the financial performance of the industry, it can be seen that over 95% of the total income was generated from the production of shoes, more than 98% of exports was achieved by manufacturers of shoes and more than 98% of employees in this industry are employed in the production of footwear. Based on these data in further analysis, we can ignore the participation of leather and leather products, and all data related to production can be seen as production of shoes.

The most relevant information related to policy makers at the entity level in the Republic of Srpska is seen in the fact that footwear production was 4,6% of the total industrial production in 2012. This trend is positive, which can be seen if we take in the account the period of 2009 - 2012.

Figure 01 - Participation of footwear production in the industry production in the Republic of Srpska

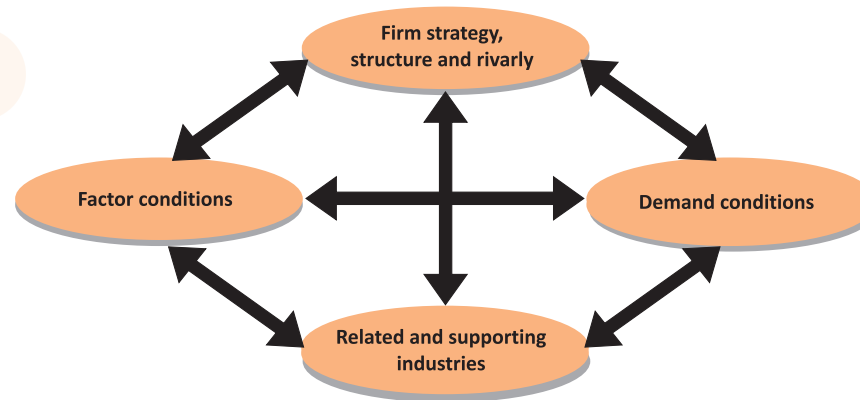


3 RS Agency for intermediary, IT and financial services (APIF)

4. Industry Competitiveness (Porters Diamond)

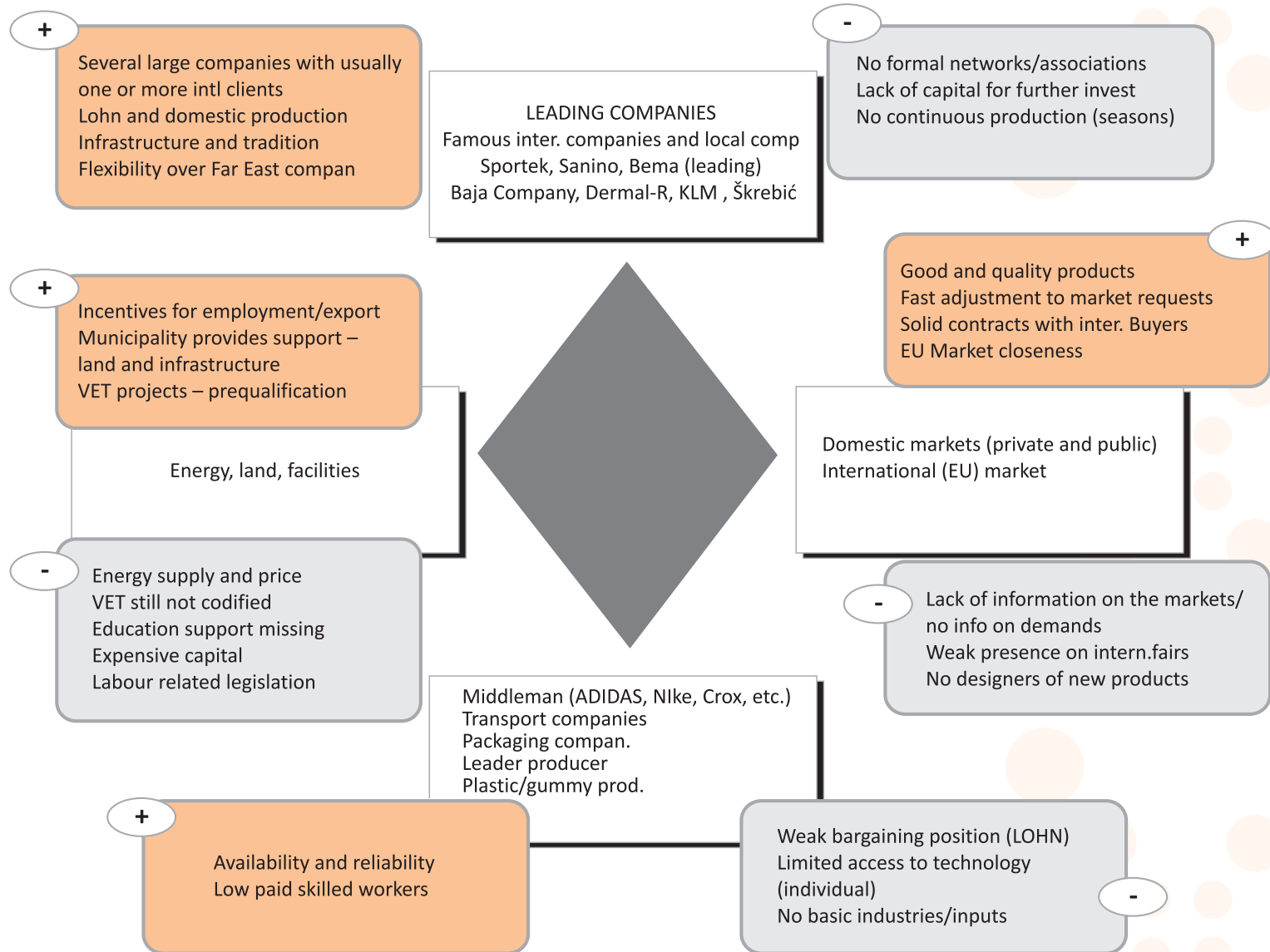
Michael Porter's "diamond" of competitiveness attempts to isolate the factors that influence the competitiveness of industries and nations (1998a:71) and is illustrated in Figure 02. The diamond is frequently used in country and industry-specific competitiveness assessments and benchmarks.

Figure 02: Porter's diamond of competitive advantage



The four broad attributes that shape the environment in which local firms compete, promote or impede the creation of competitive advantage are illustrated in Figure . This concept was applied in the analysis of the leather/footwear value chain in the project area.

Figure 03 – Porters' diamond related to footwear production in the Krajina area



4.1 Structure and Strategy of the Leading Firms

As previously noted, the footwear production industry is dominated by small and medium-sized enterprises (SMEs), and it is particularly exposed to international competition. This structure can be considered as both a strength and a weakness, as SMEs are generally more flexible, and yet, at the same time, more likely to lack investment capability.

However, leaders of the sector in the project area are 3 big companies, each with more than 1200 workers employing almost 85% of total employees within the sector. They have been mostly engaged in integrated production of shoes through lohn contracts with foreign suppliers who are at the same time the buyers of those products. These companies are also collaborating with smaller companies in the region by giving them some portion of contracted work and exchanging materials and equipment. The minor portion of the sector (2-3 companies) is producing their own product, mostly for local market.

Interesting trends related to the company size in the footwear sector

In the period of 2009 – 2012, the number of companies in the project area has stagnated while employment in the sector has considerably increased, particularly in 7 companies that employ more than 250 workers. Apparently, this trend affected the rise of 3 leading companies among these 7 with more than 1000 employees per company.

The performance of large companies in the last several years was prosperous, with constant growth in annual turnover, employability and profit. They are part of a global value chain, leaned on the trends in which the EU companies seek to reallocate their production to eastern countries due to reduction of costs. This trend of the main EU companies is caused by the flexibility of local producer, closeness, and timing in delivery of final and semi-final products.

Generally, there are no strong competition between companies in the sector in the project area. Usually, firms have 1-2 dominant EU partners, which they have cooperated with in the last several years. The competition is only seen when they compete on the internal market, mostly on public tenders for various local buyers (military, police and other institutional buyers). Also, it can be noted that the price of the workforce is relatively significant competitive pressure due to cheap, but rather less qualified, workforce in the Asia.

Cooperation is usually done on an ad-hoc basis and depends on individual initiatives of owners/directors. It is evident that the lack of trust is still very big obstacle for networking, however, this is a typical issue for Bosnia and Herzegovina. According to previous research, the social capital is at the rock bottom in the country, affecting the possibility to create more complex social arrangements between people in every day life, business, politics, etc.

The main priorities of companies in the footwear sector are to have stable contracts with foreign suppliers/buyers. They rather opt for stability than riskier strategies in producing their own products for (un)known buyers. In the last several years, they try to expand their operation within the value chain by investing into new phases of production (mostly assembling) in order to have more added values. Also, it is evident that producers will have to find new sources of production inputs, especially related to leather from (domestic) market due to requests from buyers. This gives new perspective to Lohn production, and roles of partners in it. Also, it enables local producers to have more value added, depending on their ability to find favorable production inputs. The firms, which produce their own products, are generally in this situation, however they lack stability, which comes with Lohn production. They have more of value added production, but very small production series due to smaller market niches.

When looking at the other priorities, it is seen that almost all firms from the shoes sector seek for new policies related to education of workers and experts/designers, maternity leave and other labor issues within the current work regulations, and access to more favorable finance.

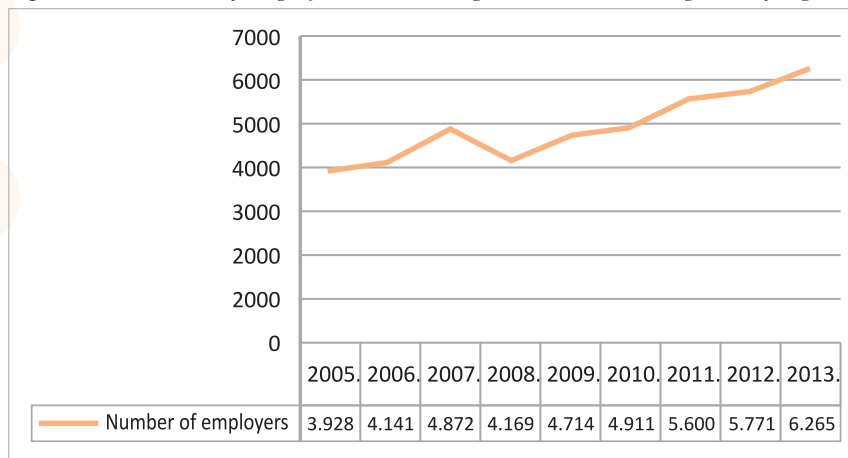
4.2 Factor Conditions

Shoe producers have a range of costs to manage with a particular focus on raw material and production costs (labor and machinery). Other important costs include regulatory compliance costs, logistics costs, general overheads (such as utilities) and marketing. Costs of production continue to be a challenge for companies and a large proportion of shoes producers have outsourced their production totally or partially to subcontractors.

Shoe sector in the project area has a long time tradition. Also, most of the companies are owned by domestic and/or foreign investors who had large experience in shoe production. In general, most of businesses have their own buildings with solid basic infrastructure. They have solid, but rather old, equipment, while new technology and machines usually comes from suppliers of production inputs.

Current employees in the sector are generally well-skilled, but mature workers. In the last 20 years, educational programs for shoe makers were neglected due to the fact that this occupation is not attractive to students or their parents. Students rather opt for occupational education, such as mechanics, nurses or chefs although the local labor market has enormous unmet supply of these professions. Eventually, some of those students find their employment in shoes production companies, but a lot of resources was wasted due to adverse educational policies and weak link between education and labor market.

Figure 04 – Number of employees in the shoe production in the Republic of Srpska



The number of employees in the shoe sector in the RS was 6265 workers in 2013, which represents an increase of 8.6% (494 workers) when compared to 2012. However, in 2012/2013, only 283 secondary school students were enrolled in school programs that cover textile and leather/shoe sector. In 2013/2014, the number of enrolled students in the programs that cover textile and leather/shoes was almost twice lower – 144. It should be noted that the first higher education students in the last 20 years are expected to be enrolled in 2014/2015 on the Technology Faculty - Shoe Production and Design Programme.

Many companies cope with electricity and its stable supply – especially related to high costs for industrial facilities and unannounced interruption of supply that have negative impact on the process of production and machinery. However, no compensation for losses is possible due to current attitudes of decision makers.

Financial support to sector is seen through several governmental policies in the last few years. Firstly, the RS Government has provided subsidies in terms of reduction of labor costs through lower income taxes for employees. Also, the Government has provided annual support to export-oriented industries. The cost of capital at the local market is generally higher due to various risks. Hence, the companies tend to invest mostly their own resources/capital into expansion of production. It should be mentioned that return on capital in the sector is very slow.

Generally, entry to market in the shoe production sector is very easy. With minor investments into equipment, one or two highly qualified professional and to some extent qualified workers, the company can position itself within the certain phase of production. For the last several years, the prices for services related to partial production have remained the same and the producers try to decrease their own costs in order to increase their profitability.

4.3 Supporting and Related Industries

The shoe sector is a diverse which covers a wide variety of materials (textile, plastics, rubber and leather) and products from different types of men's, women's and children's shoes to more specialised products like snowboard boots and protective footwear. This diversity of end products corresponds to a multitude of industrial processes, enterprises and market structures. However, the shoe production in the project area is mostly based on production inputs such as leather, rubber and plastics.

Almost 100% of input materials are imported. The problem, which arises from year to year, is the lack of basic industries (leather and soles). The most important determinant for competitiveness and value adding in shoe production is the production of leather. However, it can be said that shoe producers do not have a choice related to import of leather due to the lack of these producers on the domestic market.

Generally, the shoe production leans against the following industries (value chains):

- Hide and Skin Collectors
- Tanneries
- Shoe Design & Model Makers
- Producers of Shoe Components

It is identified that Bosnia and Herzegovina has several companies, which deal with raw skin and their collection for export. These companies are exporting tens of millions EUR worth of raw skin to other countries, particularly to some EU countries like Austria, Italy and Slovenia. Raw leather is with other two products – honey and fish – on the positive list of materials from organic source that Bosnia and Herzegovina can export to the EU.

Top 10 importers of raw hides and skins (other than furskins) and leather (product code 41) from BiH

Rank	Country	Exported value in 2009	Exported value in 2010	Exported value in 2011	Exported value in 2012	Exported value in 2013
1	Austria	6036.73	18155.16	23620.17	28023.82	23083.66
2	Italy	7885.96	10746.39	12993.64	13395.7	18490.41
3	Slovenia	3423.13	5769.32	5393.32	3916.54	5867.09
4	Turkey	369.99	1837.51	3406	3055.79	3593.43
5	Germany	1941.73	2277.3	2369.27	4361.3	3150
6	Croatia	1114.27	1350.27	2051.93	2396.42	3047.61
7	Netherlands	152.01	0	0	157.07	1137.58
8	Belgium	0.72	0	0	807.1	1084.13
9	Hong Kong, China	1236.17	1259.14	2171.11	830.43	999.81
10	Serbia	501.21	818.59	1769.77	1642.97	661.77
	World	24310.39	45439.1	60945.47	62010.71	62563.25

Unit: Euro thousands

At the same time, companies from Bosnia and Herzegovina have imported 2,5 times higher amount in millions of EUR worth of leather for production of leather products, mostly shoes.

Top 10 exporters of raw hides and skins (other than furskins) and leather (product code 41) to BiH

Rank	Countries	Imported value in 2009	Imported value in 2010	Imported value in 2011	Imported value in 2012	Imported value in 2013
1	Italy	39175.26	45698.91	50855.98	51400.21	60401.01
2	France	2828.71	3943.11	5964.81	16275.76	12696.35
3	Austria	714.88	927.04	7832.23	8423.24	11441.32
4	Slovenia	5747.04	10577.71	8947.94	11509.35	10015.39
5	Serbia	3708.51	9703.38	9299.74	10910.64	7438.33
6	Germany	1484.26	9483.49	14245.04	12069.19	6400.12
7	Croatia	1809.8	4682.63	7874.59	7651.13	5904.74
8	Montenegro	1224.7	3538.7	4202.22	4421.95	5724.8
9	Hungary	1265.57	2268.26	2840.97	3106.33	4874.06
10	Slovakia	326.97	3011.55	6715.8	4460.83	4445.68
	World	69719.56	118540.94	150428.42	156957.83	157119.58

Unit: Euro thousands

When looking at the other supporting industries (soles, strings, rubbers, etc.) it is evident that most of products from those industries are imported through various wholesale agents or through contractual buyers/suppliers involved in the lohn business. Less than 10% of inputs can be found on the domestic markets. This is the consequence of previous economic and political system where former Yugoslavia was one common market and where all parts of former countries were specialized for certain industries and production. Even now, the most of import of soles, strings, rubbers, etc. comes from Serbia or Croatia.

The geographical concentration in the EU and current situation in the Krajina area

The complexity of the supply chain has resulted in a concentration of companies and formation of footwear producing districts in the EU, such as the Marche and Emilia Romagna in Italy, Elda and Elche in Spain and Norte in Portugal. This geographic concentration is one of the strengths of the footwear industry, driving the spread of knowledge and formation of networks of companies, both formal and informal. The similar situation, although very informal, is evident within companies in the Krajina area.

In the Krajina region there is only one tannery, which remained after the privatization after 1998. However, this factory is not working due to the decision of its new owners to keep it close. Interlocutors consider that this factory has obsolete technology without possibility to comply with the harsh EU standards related to environmental protection. It should be mentioned that Bosnia and Herzegovina has two more capacities for producing leather – tanneries in Bugojno and Visoko. While Bugojno copes with lack of operational capital, Visoko has specialized itself for production of leather car seats, mostly importing leather for South Amerika.

Specialized equipment is usually coming with production of new series and models under the contract between a foreign company/agent and local producer. Usually, the ordering party is delivering this machinery jointly with instructions and experts in order to put it into operation. It is seen that most of the companies within the sector do not have enough financial resources to buy these machines individually. Finally, it is evident that there is no proper support to the sector when looking at the design and new model making. In the previous systems, these functions were developed within huge industrial complex company organizations, which had also some training centers and institutes. Design is now completely imported with other “tangible” materials. It is seen that there is no point to develop these functions within just one shoe producer, no matter how big it is since interlocutors consider that one designer could serve the whole sector in the project area.

4.4 Demand Conditions

It is seen that the most demanding and sophisticated customers are the EU manufactures/dealers, who are using BiH companies for production of upper parts or entire shoes due to cheaper costs of the work force. For example, one of the leading EU companies, Gabor, has closed 7000 jobs in the EU – transferring most of the production to the East, including Bosnia and Herzegovina.

It is evident that the market demand has decreased globally in the last few years, but this has had no effect on the growth of shoe production in the project area. Most of lohn businesses in the project area are related to production of famous brands. While many domestic markets, including Bosnia and Herzegovina are dominated by low cost imports from Asia, the EU producers are discovering that they can find markets for (branded) luxury footwear in emerging economies. For example, Italian footwear companies have outsourced their production totally or partially to subcontractors, while continuing to carry out product design and marketing activities in-house. These stages are closely related, since designing a successful sample collection requires constant monitoring of the market (taste, demand trend, fashion, etc.) and keeping close relationships with the retailing system.

“Fast fashion” – Zara

Zara is the flagship chain store of Inditex Group. Since its launch at La Coruña in Spain during 1975, Zara has become Europe’s fastest-growing fashion retailer, with over 1,000 branches worldwide. Zara has experienced considerable success in the last few years and the key elements for its success are connected to a quick and constant offer of fashion products, at a reasonable price, carried out with a combination of vertical and territorial integration. Zara manufactures most of its footwear in factories concentrated in Spain, ***adopting a strategy of “quick response”, with delivery times of about 10 days.*** The example of fully integrated chains like Zara shows the way towards continuous creation and production of new designs in companies.

It is evident that the fashion and brand influenced consumer products present in the unique supply chain challenges for manufacturers, particularly given the increasing pace of change. Footwear manufacturers are beginning to develop processes for customization of footwear, to differentiate them from the competition and to meet increasing consumer demands for customized products. Thus, the BiH companies using their own advantages seen in the flexibility in production, closeness of the EU markets, quality of products, timing of delivery, etc. Far East and Asian companies cannot satisfy these requirements due to long times in delivery of these products overseas.

Some producers in the sector consider that there are some possibilities to improve the chain by improving organizational and industrial culture at the firm level, more specialists within the companies with proper education and connecting with basic industries in order to decrease the price of final product and have more satisfied customers. Also, they consider that the increase of producers' bargaining power through networking could lead to more revenues and profits.

Finally, there are several factors that could affect footwear industry and demand in it, regionally and globally⁴, by 2020:

- The size of recovery of EU economy as well as other world economies,
- Market developments in China and India, particularly related to the increase of life standards and change in patterns of consumption by their citizens,
- Fashion changes that bring uncertainty related to design of new products,
- Aging population and change in priorities for design due to requests for more comfortable and secure footwear,
- Increase of costs and time-lag in transport from Asia.

⁴ In-depth assessment of the situation of the European footwear sector and prospects for its future development, DG Enterprise & Industry European Commission Risk & Policy Analysts Limited, July 2012

5. Firm Level - Competitive Pressures within the Value Chain

Generally, companies from the sector are familiar with their competitions and their main strengths and weaknesses. The main competitive advantages of foreign competitors are seen in good knowledge of the market (EU companies) and cheaper production due to cheaper labor and raw materials (mostly Asian companies). Unfair competition is mostly characterized for import of goods from China and new entrants on the market that were founded by former employees of certain existing companies. The newcomers usually tend to have lower price of the work (eurocent per minute) for certain phases of production – cutting and sewing of upper parts of shoes. However, this is not so widespread due to the size and potential of these companies.

The competitive advantages of local companies are seen in high degree of professionalism in work, well trained workers, flexibility to changed conditions/demand to some extent, high quality of products and services. Most of companies have introduced international standards (ISO, CE mark, etc.) in order to satisfy high international requests to be part of globalised chain value. However, not all companies have the same path of development due to various strategies that they use.

Sportek – from lohn dependence to diversification

Sportek is the biggest footwear/shoe producer in the Krajina area, with almost 1500 workers in the municipality Kotor Varos. It is an Italian-owned company with a local management tightly leaned on the foreign-owned infrastructure abroad. The company has grown in the last 15 years, by changing its strategies and adapting to changing conditions. At the beginning in 1997, Sportek has been involved in a typical partial LOHN production. Through time, Sportek has introduced new production function and enabled itself to have complete production for companies like Nike, Crocs, Decathlon Group, etc. They see their previous success in constant investments in new technology, new products and their people. Currently, they are implementing the diversification strategy and developing new types of production – carbon bicycle frames and textile production.

All the companies use most of production inputs from abroad with no bargaining power related to suppliers of those components. This ties their hands in terms of possibility to decrease costs of raw materials. Interlocutors in our research have said that most of competitiveness in the shoe sector comes from possibility to influence the price of inputs and productivity in production.

As previously said, many companies from the sector have gradually introduced new production phases in order to increase their competitiveness and to be able to produce complete shoes. This trend is evident due to the fact most EU producers are reallocating their complete production to the Eastern Europe and Asia.

The production processes and their efficiency are depending on the qualified, but also predictable, work force. Since more than 80% of employees are woman, companies are faced with problems of great fluctuation of workers due to sick and maternity leaves of younger workers. At the same time, there are no proper governmental policies for compensating the companies for losses incurred due to national labor regulation.

Most of companies that are involved into lohn business have problem with seasonal influence and gaps in production due to the nature of the business. They perceive that these gaps could be filled with their own production but they do not have enough working capital for these activities. Also, they face with shortage of qualified specialized professionals – from design to mechanics.

6. Meso Level - Supporting Institutions

Bosnia and Herzegovina does neither have general nor sectoral industrial policies. Particularly, there are no specific policies that target the Krajina area due to the lack of institutional framework for the concept of regional policies in BiH. In this institutional setting, various institutions try to provide some assistance but mostly on a short term basis and with a limited horizon. Since there are no shoe producers in the Una-Sana Canton, we will focus only on the institutions and their support in the Republic of Srpska.

The BiH Ministry of Foreign Trade and Economic Relations (MOFTER) is responsible for foreign trade and economic development, including the SME development. It should be noted that companies from the sector have said that they have not received proper support from this institution although they had several contacts and meetings with the Ministers and his associates. However, the MOFTER has recently brought temporary measure to decrease customs on soles for shoes that are imported by domestic produces.

The RS Ministry of Industry, Mining and Energy is responsible for industrial policies and improvement of competitiveness of companies in the Republic of Srpska. In 2013, the Ministry has spent KM 19.6 millions for supporting export oriented companies from various sectors. Several companies from the shoe sector have been awarded with the Ministry's grant. At the same time, some companies from the sector have used the support from the Ministry (4000 KM) to introduce quality standards at the firm level. Also, the Ministry has launched several subsidy schemes by providing KM 50 to every worker within the sector.

The RS Chamber of Commerce is an institution, which represents the main government partner representing the private sector in defining various governmental policies. The section for leather and shoes within the Chamber was very active in advocating and lobbying for various initiatives with more or less success. In general, initiatives to the state level Ministries and institutions related to change of certain customs regulation were not heard by decision-makers at the BiH level. At the same time, the entity level had had more understanding for these initiatives, including subsidies per workers or the financial support for companies' export.

Table - RS Government's supporting policies to the leather and footwear sector in the last 5 years

Policy	Year	Amount of money	Effect
Subsidy for textile, leather and shoes industry	2009 and 2010	KM 50 per worker (total amount 8,229,150 KM)	Maintaining the number of workers in the sector
Fiscal support related to lower base for social contribution	2011 onward	Base in the amount of 25% of total gross wage in the RS	Rise in employment Rise of export Rise of total revenue
Subsidy for export of firms in textile, leather and shoes industry	From 2006 onwards	KM 13,577,759	New FDI and domestic investments Rise of gross wage
Subsidy for employment in textile, leather and shoes industry	2011	KM 1,057,500	Employed 423 workers

The RS SME Agency is the institution founded in 2004 to support the establishment and development of small and medium-sized enterprises and entrepreneurship in the Republic of Srpska and generating a whole support system of small and medium enterprises. The main objectives of the Agency are to increase participation of the SMEs in the overall economy of the Republic of Srpska, changing the structure of the business through increasing the participation of productive activities and services in the total domestic product, increased technological development, competitiveness and open new markets for the SMEs, increasing the number of businesses and workers employed in these companies. Currently, the most important project for the shoe sector within the RS SME Agency is seen in the Swiss founded project "Prilika plus" which supported establishment of the Centre for education of workers in the footwear industry Sanino. Up to now, this centre has trained 65 workers, who later found their jobs in the company Sanino.

Another supporting institution is the Institute for Standardization of B&H. This institution proposes the strategy of standardization in B&H, prepares and publishes standards of Bosnia and Herzegovina, represents and acts on behalf of Bosnia and Herzegovina in international, European and other interstate organizations for standardization, and performs other tasks that originate from international agreements and memberships in the organizations. In the last several years, the institute has introduced several by-laws and guidebooks related to standards, which are in accordance to the EU market regulations. The weakest point in this area is the lack of proper conformity assessment infrastructure – accredited laboratories and certification bodies.

Generally, there is no cooperation between the sector and educational institution (high schools or faculties). The faculty for technology does not have programs that deal with the shoe productions nor design of these products. Although the shoe production generates constant growth and increase in employment in the project area, there are no high schools that educate shoe makers and other relevant shoe production educational profiles. The reason is seen in the lack of sound governmental policies that will link education and labor market needs. The education system seems to be autistic and not sensitive to impulses from the labor markets and various companies' needs. The first concrete activity between faculties and the sector is expected by the end of this year where the Faculty for Technology plans to introduce a new study program related to shoe production and design. Currently, the program is still not accredited and this will be done by the end of the year.

Municipalities are, in general, interested in the sector due to a high number of employed persons, but mostly without any concrete support to companies. The problems are seen in the lack of understanding and high taxes and fees that were introduced by the local level. Also, municipalities are not as active as they could be in providing stabile electricity supply. According to our conducted interviews, more than 60% of the companies have a problem with regular electricity supply, which interferes with the production processes.

Although companies within the shoe production sector fit almost perfectly into the “cluster story”, no formal partnerships or networks have been introduced up to now. The previous initiative to found the association of shoes and leather producers, led by German GTZ, has failed due to various reasons. However, it seems that networking and clustering is now something that is viable and that could present a good meso policy within the project area. This has been confirmed by many interlocutors during interviews since they see that the further development of the sector depends on their ability to create networks and/or clusters.

Trust and social capital as the missing building blocks for cooperation Robert Putnam, the most popular author on the social capital concept, once said: “Bonding without bridging results in Bosnia and Herzegovina,” (Salaj 2008). By this, he wanted to point out that the bridging of social capital is missing, while bonding social capital is, on the other hand, very strong.⁵ The lack of cooperation is the consequence of cultural factors, and the lack of trust between people. Recent findings (Salaj 2008) on social trust in Bosnia and Herzegovina that question the above (Putnam’s hypothesis on the existence of bonding social capital) reveal low levels of trust among people. Generalized trust levels reveal that only 16 percent of the population within the country believes that most people can be trusted. At the same time, 74 percent of those surveyed believe that in a relationship with other people, it is necessary to be careful.

Finally, it should be noted that there are neither proper analysis nor studies that could provide a clear view and good information background for sound decision-making in the future related to investment, research and development, technology improvement, etc. Good examples of organization of producers in the sector are seen in many parts of the world, but these experiences are not transferred into the local context.

⁵ The concept of social capital was popularized in Putnam’s “Making Democracy Work: Civic Traditions in Modern Italy” (1993). Social capital is used to explain that the quality of social relationship, how they influence the success of individuals and entire societies related to democracy, economic development, education achievement, health, etc. Bonding social capital keeps people together, who are similar in specific characteristics such as ethnicity, religion, social class, etc. Bridging social capital keeps together people who are not similar/don’t look alike.

7. Macro and Meta Level - Framework Conditions

The recent trends in the EU related to shoe production and footwear industry represent the major opportunity for further expansion of local producers due to the fact that the EU represents the main market for leather shoes or their parts from BiH. Almost 99% of export from BiH related to leather shoes goes to EU countries. One of the main challenges faced by the footwear industry is the increasing costs of production, which have led the EU firms to relocate and outsource their products and processes to developing countries as a cost-reducing strategy. Footwear manufacturers have a range of costs to manage with a particular focus on raw material and production costs (labor and machinery). Other important costs include regulatory compliance costs, logistics costs, general overheads (such as utilities) and marketing.

	Value in 2009	Value in 2010	Value in 2011	Value in 2012	Value in 2013
Export of leather shoes from BiH to EU	90,907.98	111,246.65	126,360.96	128,115.24	152,371.25
Total export of leather shoes from BiH	91,904.66	112,546.46	127,231.85	129,713.11	154,237.60
	98.92%	98.85%	99.32%	98.77%	98.79%

Unit: Euro (thousands)

Costs of production continue to be a challenge for companies and a large proportion of footwear manufacturers have outsourced their production, totally or partially, to subcontractors.

In the last several years, international community has tried to unify local economic conditions and regulations within Bosnia and Herzegovina in order to set a “single economic space and common market” within the country. It can be said that this effort was successful with some minor differences that still exist when looking at regulations and conditions on the entity level.

The corporate tax rate in the Republic of Srpska is 10% which makes it one of the lowest rates in Europe, which is on average around 25-36%. Opting for such a low profit tax resulted in a moderate increase in the number of domestic and foreign companies, which registered their businesses in the Republika Srpska in years before the global economic crisis.

Value Added Tax (VAT) is currently set at 17%, while income tax is 8%.⁶ The average social contributions on gross salary are approximately 30.6%. In 2006, Bosnia and Herzegovina signed a regional free trade agreement, CEFTA, with the following countries: Albania, Croatia, Serbia, FYR Macedonia, Moldova, UNMIK /Kosovo, and Montenegro.

Domestic currency (convertible mark – KM) has a fixed exchange rate to euro. This enables international buyers to have longer-term contracts without fear for change of conditions due to appreciation/depreciation of local currency. However, many local producers consider that the exchange rate is not favorable and that a “strong convertible mark” has a negative effect on their export due to lower productivity in BiH. However, BiH has a currency board regime and there is no possibility to have a proper monetary policy that could interfere with the exchange rate.

There are also some negative impacts of framework conditions due to non-compliance to EU standards and rules. For example, a negative impact comes from the fact that BiH as a state has not accepted the EU regulations and directives in regard to technical conditions and characteristics that products must meet. Although the shoe producers in the project area have accepted strict EU standards, it should be mentioned that most of those standards come with international suppliers, which are “titulars” of these standards. A messy situation related to product norms and standardization is misused by various local importers to BiH affecting the price of products and the portion of market share at the local market. In general, the data from APIF and the RS Tax Revenue shows that the most of shoes sold on the local market come from the import since the 95% of produced shoes in the project area is sold abroad.

Interesting finding acquired through interviews with company’ owners in the sector is that foreign investors do not opt to buy local business through mergers and acquisition although their orders are sometimes the only contract that local companies have. In other cases, some FDIs have also local investors, as co-owner of the company. The complex business environment, bureaucracy and local business conditions are seen as the most important reason for this business practice due to the fact that internationals usually do not want to be involved in solving everyday problems with administration, regulation, licenses, etc. According to the Doing Business 2014 data, the country is ranked at the 130th place in the world. Here are some figures related to easiness of doing business in Bosnia and Herzegovina compared to the entire World.

⁶ Part of salary which will be tax-free is raised on 200 KM in 2014

Table – Ranking of Bosnia and Herzegovina related to Doing Business assessment by the WB

	Rang 2014.	Rang 2013.
Starting a Business	174	164
Dealing with Construction Permits	175	172
Getting Electricity	164	161
Registering Property	96	93
Getting Credit	73	71
Protecting Investors	115	113
Paying Taxes	135	134
Trading Across Borders	107	109
Enforcing Contracts	115	118
Resolving Insolvency	77	81

Source: World Bank

8. Summary of Main Findings

The footwear sector is an important part of the European manufacturing industry and it plays a crucial role in the economy and social well-being in numerous localized regions within the EU. At the same time, footwear industry in BiH represents a significant exporting industry that employs a considerable number of workers.

The dominant business model within the sector is seen in production on contractual basis for a pre-determined, who also acts as a supplier of the raw material (*lohn* production). There are some small portions of companies that try to develop and produce domestic shoe models, but this represents less than 10% of the entire production in the project area. However, these companies are rather small, usually less than 50 employees and they try to find their own niche on the shoe market. They usually produce shoes that can be used for individual and institutional customers. Institutional customers are seen in public firms and institutions, which buy a defined contingent of shoes through public procurement in order to assure compliance of employees with certain standards.

Leaders of the sector in the project area are 3 big companies, each with more than 1200 workers with almost 85% of total employees within the sector. The performance of large companies in the last several years was prosperous, with constant growth in annual turnover, employability and profit. They are part of a global value chain, leaned on the trends in which the EU companies seek to reallocate their production to Eastern countries for the purpose of reduction of costs. Their strategies are almost similar while the difference is seen in the level of finalization of products as well as the level of diversification of their production.

Cooperation is usually done on an ad-hoc basis and it depends on individual initiatives of owners/directors. The main priorities of companies in the shoe sector are to have stable contracts with foreign suppliers/buyers. Also, the firms from the shoe sector seek for new policies related to education, maternity leave, labor and access to more favorable finance.

Almost 100% of input materials are imported. The problem, which arises from year to year, is the lack of basic industries (leather and soles). The most important determinant for competitiveness and value adding in the shoe production is the production of leather. In the Krajina area there is only one tannery,

which remained after the privatization after 1998. However, this factory is not working due to the decision of its new owners to keep it closed. Interlocutors consider that this factory has obsolete technology without possibility to comply with the harsh EU standards related to environmental protection. Finally, it is evident that there are no proper support to the sector when looking at the design and new model making.

Companies from the sector are familiar with their competitions and their main strengths and weaknesses. The main competitive advantages of foreign competitors are seen in good knowledge of the market (EU companies) and cheaper production due to cheaper labor and raw materials (mostly Asian companies). Unfair competition is mostly characterized for import of goods from China and new entrants on the market that were founded by former employees of certain existing companies. In this institutional setting, various institutions try to provide some assistance but mostly on a short-term basis and with a limited horizon.

Generally, there is no cooperation between the sector and educational institutions (high schools or faculties).

Finally, it should be noted that there are neither proper analysis nor studies that could provide a clear view and good information background for sound decision-making in the future related to investment, research and development, technology improvement, etc.

9. Key Gaps Identified (EU Company/Sector as Benchmark)

There are several gaps at the firm level between domestic shoes producers and the EU competitors, as follows:

- The EU companies are more market driven, trying to find their niche for global competition. Local companies mostly seek for new lohn contracts under a close supervision from the EU partners,
- The EU companies are focused on customer, design and productivity increase, while local companies are mostly focused on production and quality of products,
- R&D component is very important for the EU companies, while local companies neglect this function,
- The EU companies have developed organizational culture within their organization,
- The EU companies have everyday information related to the market and demand for products,
- Institutional support related to formal and informal education is good in the EU.

Also, the following gaps are identified at the sector level:

- The EU companies have a huge internal market with the same regulatory framework, while local companies still cope with some basic standards,
- Access to capital to the EU companies is much easier in the EU than in the case of BiH companies,
- Sectoral industrial policy is driving the entire sector in the EU, while there are no strategic documents in the RS and Bosnia and Herzegovina,
- Clusters are common in various geographical areas in the EU, while this instrument is not used in BiH,
- Institutional support related to formal and informal education is good in the EU, while the education system in BiH is very problematic,
- Existence of sound analysis and studies related to the shoes sector in EU compared to the current state of affairs in the RS and BiH.

Gaps can be found also at the macro/meta level:

- More flexible legislation related to workers/employees,
- Stable business environment and lack of corruption,

10. Main Recommendations and Next Actions

There are several recommendations that were identified in close collaboration with sectoral board members:

In the short run, it is necessary to:

- Prepare studies related to shoes production,
- Improvement of technological aspect of production and standards (education, ecology, quality systems),
- Enable cheaper sources of finance,
- Acquire additional contracts and markets,
- Launch new products (improving the design).

In the long run, it is necessary to:

- Organise a cluster from all interested stakeholders in the sector,
- Prepare strategy for development of shoes production,
- Provide support for development of the base industry – leather production,
- Enable favourable business climate through lower taxes and fees, improvement of electricity supply, registration of property, enforcing contract, protecting the investor, etc.
- Provide constant formal and informal education to employees in the sector,
- Move focus from loan to production of own products by initiating new investments into technology, equipment and people,
- Provide new, more favourable sources of funding from public and private sources (e.g. EBRD equity finding, Investment Development Bank, WBIF, etc.).

10.1 Recommendations Aimed at Industry

Shoes production' companies in the project area need to invest constantly into technology, people and new products. Also, they need to organise themselves in the cluster in order to prepare a joint strategy for the sector. It is evident that the production of shoes in the project area has a lot of potential that could be utilised in the future.

On the basis of the previous analysis, at least three strategies could be identified:

- Introduction of new phases of production in order to have integral lohn production – This strategy is typical for those companies like Company Skrebic, which did not have technology and equipment to produce final products from production inputs received from a foreign partner. This strategy brings more value added to the company and relatively increases its bargaining power due to possible alternatives in the own production.
- Make it bigger or more specialised – Local shoe producers of own products like Vodex or KLM are faced with challenges in the lack of capacity in production in order to meet demand from the EU and other markets. Alternatively, they need more investments into customisation of their current products in order to find their own niche.
- Utilisation of local resources and production inputs with/without diversification of production into new complementary sectors – leaders of the sector are faced with the need to stretch the current value chain and find alternatives to current production inputs, on one hand, while increasing their own capacities to have their own products, on the other hand. Sportek's current strategy shows that the complementary approach can be seen in diversification of production to other sector, such as textile industry.

10.2 Recommendations Aimed at Meso Organisations

The BiH Government should remove all impediments related to foreign trade and exports from BiH to the EU. It is necessary to equalise conditions in accordance to the EU internal rules in order to have the same regulations that are not discriminatory for local producers. Hence, the taxes and customs on production inputs needs to be revised in order to have common custom and tax policies like the business companies in the EU.

The government needs to be focused more on local producers and their voices in order to enable proper conditions for future work. Primarily, BiH government needs to align all their institutions such as the Foreign Trade Chamber, the Foreign Investment Promotion Agencies, Institute for Standardisation, Directorate for Economic Planning and such in order to support future policies related to the sector. The most important thing is to know the interest of local producers during negotiation related to the EU accession process.

The RS Government should recognise the sector and support establishment of clusters, providing them with a strategic framework and financial assistance. They should carefully analyse the effect of previous supporting programs and bring decision on their continuation in case of positive effects on the sector. Special role of the government is seen in the case of education. Government needs to be more active in defining and implementation of various secondary and higher educational programs in line with needs of the leather industry. VET programs also need to be in line with these policies.

Local communities should put more focus on the shoe production and its potential in the overall development at a local level, especially in fighting against unemployment of female population. They need to revise their tax policies and be more sensitive to industrial production. Also, they have to be more involved in making more favourable business environment and local conditions for production. Especially, they have to revise their spatial plans and have a closer communication with electricity distribution companies in order to have more stable electric supply to local industry.

The RS SME Agency should support innovations and R&D in local companies. They need to strive to increase the portion of investments related to the research and development in accordance with the EU standards. Also, they have to launch the supporting programs and give subsidies for innovation in production of local companies.

10.3 Policy Recommendations

When looking at the shoe production in the project area, it is seen that new policies are needed in order to push further development and competitiveness of local firms. Here are some of them:

- Foreign trade policy and customs related to footwear industry (state level),
- Fiscal policy related to property tax for production facilities (municipality),
- Fiscal policy related to income tax for employment of new workers (RS level),
- Provision of support for cluster formation (entity/municipalities),
- New education policy related to footwear production (entity/municipality),
- Re-industrialisation and support to development of industry (state/entity).

However, the most important preconditions are seen in the changing paradigm related to industry, where everybody needs to know about industrial development importance in the overall country development.

10.4 Opportunities for Collaboration

It is evident that collaboration and cooperation between shoes producers is necessary for their further development. The CREDO Krajina project and its sectoral board could initiate foundation of an association that can be a basis for other forms of networking. The concept of the project and its realisation leads toward more tight relations between the lead companies in the project area. Also, it is evident that companies within the leather and shoe sector are members of the RS Chamber of Commerce and that this institution is active in advocating and promoting activities related to the sector. A window of opportunity in collaboration between the domestic and international footwear companies is seen also in cooperation between the Chambers of Commerce from various countries. Additionally, they could be more active in utilising value chains in the various sectors in order to create more dynamic and competitive industries, especially in Europe. However, complex administrative system where various competences at a local, cantonal, entity and state level are not clear enough makes Bosnia and Herzegovina very difficult for collaboration of various institutions, especially if politics is interfered. Collaboration between various subjects and institutions within one administrative level, entity in the RS and mostly cantons in the Federation of BiH is viable, but other forms have usually not been so productive due to their complexity. For example, it is evident that cooperation between the MOFTER and the RS Industry for Industry, Mining and Energy is not functional due to constant struggle over competences related to various aspects of industrial policy. At the same time, this affects cooperation of all other institutions and agencies between these two administrative levels.

11. How to Measure whether Competitiveness is Increasing?

The measure of competitiveness is always tricky due to many other factors that could affect whether somebody is competitive and how this competitiveness change through time. For example, the rise of profit in local companies can be a measure of competitiveness under the condition that sector is still mostly leaned on international markets, that markets do not have monopoly or oligopoly structure and that it is stable through certain period of time and not affected by seasons or other things like depreciation of local currency. Also, the competitiveness can be measured by the value added in a company that changes through time. Other indicators show that competitiveness depends on the number of players (established companies and newcomers) in the local market. The most common way in transitional countries to increase competitiveness of local firms is to “import” competitiveness with introduction of new players in the market through the FDIs. Finally, competitiveness is increased through various government programs, especially related to education and R&D.

Thus, we plan to measure the increase of competitiveness through:

- Increase of profit in local companies,
- Increase of value added compared import/export in lohn jobs (import for export jobs),
- Number of firms in the sector in domestic market – more firms more competitive,
- Size of the FDIs in the sector (import of competitiveness),
- Number of introduced educational programs within the new government education policy,
- Growth of a number of (new) qualified workers within VET programme,
- Average age of production facilities and equipments.

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