**Bosnia and Herzegovina** **DRAFT**

**Federation of Bosnia and Herzegovina**

**Federal Ministry of Finance**

# 2004 BUDGET FRAMEWORK PAPER

## (MEDIUM-TERM EXPENDITURE FRAMEWORK 2004-06)

**July 2003**

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## Abbreviations

| | | |
|---|---|---|
| BFP | - | Budget Framework Paper |
| BiH | - | Bosnia and Herzegovina |
| CEE | - | Central and Eastern Europe |
| DFID | - | United Kingdome Department for International Development |
| FBiH | - | Federation of Bosnia and Herzegovina |
| EC | - | European Commission |
| EU | - | European Union |
| FTA | - | Free Trade Area |
| GDP | - | Gross Domestic Product |
| IDPs | - | Internally Displaced Persons |
| ITA | - | Indirect Tax Authority |
| MoF | - | Ministry of Finance |
| MTEF | - | Medium-Term Expenditure Framework |
| NGO | - | Non-Governmental Organisation |
| NATO | - | North Atlantic Treaty Organisation |
| PFP | - | Partnership for Peace (NATO) |
| PRP | - | Priority Reconstruction Programme |
| PRSP | - | Poverty Reduction Strategy Paper |
| SME | - | Small and Medium-Scale Enterprise |
| VAT | - | Value Added Tax |

# Conclusions and Recommendations

***The 2004-06 MTEF emphasises fiscal sustainability.***

Underlying the 2004-06 MTEF is the objective of achieving greater fiscal sustainability by reducing the present very high levels of public expenditures which are also a constraint on economic growth and the development of the private sector. Improvements in public service delivery will be achieved primarily through the more effective and efficient use of existing resources.

***The MTEF proposals are based on relatively conservative macro-economic assumptions***

For BiH as a whole real economic growth is projected to increase to 6.0% annually in 2006. More conservative assumptions have been taken as a basis for fiscal planning under the 2004-06 MTEF based on real economic growth of 4.0% to 4.5%, annual inflation of 1.5% to 2.0% and a stable international exchange rate. These assumptions remain dependent on the implementation of strong programme of economic reform measures backed up by improved tax compliance.

***Implementation of FTAs will impact on revenue growth***

During the first quarter of 2003 revenues performed strongly increasing by 12% compared with the same period in 2002 due to the one-time impact of tax policy measures taken during 2002. With the Free Trade Agreements (FTAs) with neighbouring countries starting to have a significant impact on customs receipts, revenues for 2003 as a whole are expected to show more modest growth of 2.9% compared with the previous year.

Establishment of a unified customs administration under the Indirect Taxation Authority (ITA) will facilitate further improvements in the efficiency and effectiveness of tax administration. Legislation and associated arrangements will be finalised to enable the introduction of VAT by 2006.

Revenues are projected to increase by 4.5% annually between 2002 and 2006. The fall in customs receipts will be offset by increased sales tax receipts as collection of sales tax for all excisable goods is moved to the point of import or manufacture and strong growth. Non-tax revenues are also expected to show significant increase due to better capture and recording of own revenues under the new Treasury procedures. As a share of GDP revenues will fall from 50.0% of GDP in 2002 to 47.4% in 2006.

***While levels of external financing will continue to fall***

Receipts of external financing have fallen sharply since 2000 following the conclusion of the Priority Reconstruction Programme (PRP). With a number of donors expected to withdraw from BiH external assistance will decline further. The MTEF projections assume budgetary support financing will fall from KM 149 million in 2002 to KM 102 million in 2006, with project assistance falling from KM 245 million to KM 149 million over the same period. Outside of the MTEF donors are expected to continue to provide significant levels of technical assistance grants to support the implementation of economic and institutional reform measures.

***Allowing only modest expenditure growth***

General government expenditure is expected to increase by around 3.2% annually from KM 4,205 million in 2002 to KM 4,614 in 2006. In real terms annual expenditure growth will be below 2%. As a share of GDP expenditure will fall from 55.4% in 2002 to 47.7% in 2006. Discretionary spending from the State Budget fall in 2004 as further functions are transferred to the State and will show minimal growth thereafter. Canton and municipal expenditures are projected to grow faster reflecting the emphasis under the BiH Development Strategy on improving public service delivery.

***External debt servicing will remain at sustainable levels, while progress is made towards resolving the problem of accumulated domestic debt.***

Following agreements with external creditors external debt servicing expenditures have been at sustainable levels of around 2.0% of GDP and are expected to remain so during 2004-06. Current domestic borrowing will be limited to that necessary to offset cash flow fluctuations while the restraints on canton and municipal borrowing will be maintained.

A strategy will be finalised for managing the high level of accumulated domestic debt, covering expenditure arrears, war-related claims and frozen foreign currency deposits. These liabilities will be handled outside of the MTEF in order not jeopardise essential public spending on public infrastructure and services.

***The public service wagebill will be frozen at current levels***

Expenditure on the public service wagebill is exceptionally high by international standards both as a share of GDP (16.8%) and of general government expenditure (30.7%). The high level of wagebill expenditures is related to the relatively high costs of employment in terms of pay, allowances and contributions. In recent years increasing wagebill allocations have crowded out expenditures on operations and maintenance with detrimental impact on the efficiency and quality of public services.

Wagebill restraint will therefore be a central element of public expenditure policy during 2004-06 requiring:

- a freeze in nominal terms on total wagebill allocations;
- stricter controls over the size of the public service and identification of areas where significant staff reductions can be achieved;
- ensuring that public service salaries are set with regard to conditions in the wider labour market; and
- meeting the cost of pay reform by savings arising from staff reductions.

***But allocations for operations and maintenance will be increased***

By contrast, expenditure on operations maintenance allocations fell in nominal terms between 1999 and 2002 and is significantly lower than for other countries in the region both as a share of GDP and of general government expenditure. This has resulted in public service operations becoming less adequately resourced and in growing backlog of routine maintenance. During 2004-06 budgetary spending on operations and maintenance will increased significantly. The MTEF projections consequently assume annual growth of 10% in allocations.

***As will domestic allocations for public investment***

Public investment fell from the very high levels of over 20% of GDP under the PRP to 6.4% of GDP in 2002. Externally financed public investment will decline further during 2004-06, and domestic resource allocation will have to be increased if overall levels of public investment are to be maintained close to regional averages. The MTEF projections therefore provide for domestic allocations to increase by 20% annually. Nevertheless total public investment is projected to fall to 4.5% of GDP by 2006.

Procedures for managing both externally and domestically financed public investment are currently fragmented and inadequate. To ensure proper accountability externally financed projects must be brought fully within the annual Budget. At the same time a comprehensive inventory of domestically financed public investment projects will be undertaken and more rigorous procedures introduced for project identification, selection and appraisal. More transparent procedures will also be adopted for channelling external resources to finance projects at the sub-Entity level.

***While subsidies to the Social Funds will be phased out***

In recent years the level of subsidy to the pensions and health insurance funds have been substantially reduced. In 2002 they accounted for less than 1.3% of social fund spending. The remaining subsidies will be phased out in 2004 with the determination of pension entitlements being directly linked to fund revenues.

***More effective and efficient public services will require better co-ordination with sub-Entity governments***

At the sub-Entity level public expenditure has been characterised by substantial year-on-year fluctuations and considerable differences in per capita spending levels on public services. To enable more effective use of resources at the sub-Entity level:

- revenue policy, assignment and administration reforms will be managed in a way that provides for greater predictability in sub-Entity revenues;
- resources will be assigned between the Federation and sub-Entity governments so as to reflect better their respective expenditure responsibilities;
- measures will be identified to ameliorate the considerable geographical variations in per capita spending and in the quality of public services;
- better co-ordination will be sought between Entity and sub-Entity governments in the prior assessment of the costs of government policies and legislation.

***There a significant requirements for restructuring of sectoral expenditure programmes.***

Expenditures on defence, public order and education in FBiH are substantial higher than in comparator countries. While spending on social protection is comparable with regional averages, a substantial share of resources are allocated to the very generous veterans' entitlement programmes, while allocations for poverty-related social assistance and social services are very low.

The BiH Development Strategy has highlighted the requirement for further reform of expenditure programmes linked to the overall reduction of public expenditure as a share of GDP. Reflecting these requirements the 2004-06 MTEF proposes that:

- Expenditure on general public services and law and order will be held at current nominal levels.
- Defence spending will fall significantly following further planned reductions in military personnel.
- Education spending will increase broadly in line with inflation over the three years.
- Health spending will be determined primarily by the projected growth in health insurance revenues. No further subsidies will be provided to the health insurance funds. The limited budgetary funding for public health programmes will be increased.
- Spending on veteran's benefits will be frozen at current levels, to enable resources to be allocated to strengthening poverty-related social assistance programmes, including child allowance.
- Some increase in spending on community services and housing will be required in response to the additional demands arising from rapid urbanisation as well as by the return of refugees and IDPs.
- In the economic services sector domestic allocations for transport infrastructure will have to be increased to offset the fall in donor financing.

The MTEF includes a more detailed analysis of the implications of policies under the BiH Development Strategy for public expenditure allocations (Attachment 2). This will be used in evaluating budgetary requests with spending agencies required to demonstrate progress with the implementation of agreed reform measures

# 2004 Budget Framework Paper

# The Medium-Term Expenditure Framework 2004-06

## A. Introduction

1. Linked to the preparation of the BiH Development Strategy, the Federation Ministry of Finance (MoF) took the decision in early 2002 to strengthen the annual medium-term expenditure framework (MTEF) exercise. The MTEF is intended to provide a more strategic basis for fiscal planning and public resource allocation with the aim of ensuring greater effectiveness and efficiency in the use of public resources. Preparation of the MTEF took place during March to July and forms the basis of the annual Budget Framework Paper (BFP). The 2004-06 MTEF is based on a more extensive analysis of budget operations and reflects the enhanced government policy framework that is provided by the BiH Development Strategy. In developing the MTEF and preparing the BFP, the Federation MoF has received extensive support from the World Bank and the United Kingdom Department for International Development (DFID).

2. As in previous years, the purpose of the BFP is to present strategic issues and recommendations to the Government in order to secure agreement on the resource projections and policy framework within which the annual budget should be prepared. The BFP is also intended to facilitate improved co-ordination between the Federation and Canton governments in the planning of public expenditure programmes. Recognising the complexity of public expenditure programmes in FBiH, the BFP provides an integrated and comprehensive analysis of budgetary operations covering not only the Federation and Canton budgets, but also the budgets of the Social Funds (health, pensions and employment), the other off-budget funds (primarily roads and water fees) and investment project expenditures financed by the international donor agencies.

3. The 2004 BFP sets out the basis for the development of the detailed expenditure proposals for the 2004 budget, within a broader medium-term fiscal perspective and linked to the wider policies and strategies contained in the BiH Development Strategy. The analysis covers the following areas: (i) macroeconomic assumptions and revenue projections; (ii) external financing; (iii) the expenditure framework for 2004-06; (iv) cross cutting budgetary issues; and (v) sectoral expenditure priorities and resource allocation guidelines. The more detailed analysis undertaken in each of the areas is contained in a second volume of annexes covering the technical analysis undertaken by the MTEF Working Group.

4. Underlying the proposals for the 2004-06 MTEF are the central objectives of achieving greater fiscal consolidation and reining in the present very high levels of public expenditure which is seen as constraint to sustained economic growth and the development of the private sector. Consequently, the growth in domestic revenues and expenditures will slow markedly, showing little real growth during 2004-06. Improvements in public service delivery will therefore have to be financed primarily from efficiency savings, emphasising the importance of better prioritisation with public expenditure programmes.

**Box 1: Preparation of the 2004-06 MTEF**

Preparation of the 2004-06 MTEF was initiated in March 2003 with the formation of the an inter-departmental Working Group in the MoF. The Working Group met regularly over a four month period, and oversaw the development of the MTEF analysis and proposals. Preparation of the MTEF was closely co-ordinated with that of the BiH Development Strategy which was used to help define the overall budget strategy and in the identification of sectoral resource allocation priorities. Considerable effort was also put into developing a consistent and comprehensive analysis of recent public expenditure trends by major economic item and by function. This has provided a much stronger basis, than in previous BFPs, for projecting forward public resource allocations.

In early July the MTEF analysis and proposals were presented at two workshops with the full FBiH PRSP Working Group and with canton finance ministers. This provided an opportunity for consultation with key stakeholders prior to finalisation of the MTEF proposals and preparation of the BFP.

## B. Macroeconomic Assumptions and Revenue Projections[1]

### Macroeconomic Assumptions

5. Since 1995, FBiH has recorded high levels of economic growth consistent with post-war recovery. Per capita GDP increased form KM 2,238 in 1997 to KM 3,217 in 2002, although it still remains at around half the level of 1990. Nevertheless in recent years economic growth has slowed as the period of post-war economic recovery has come to a close and as international donor activity has declined. The investment climate in FBiH has also been affected by political instability in the region, slower growth in the world economy as well as slower than anticipated progress with economic reform. As a result annual economic growth in real terms fell from 11% in 1998 to an estimated 4.5% in 2002.

6. In this environment, the Government has continued to pursue a prudent macro-fiscal policy necessary to improve macroeconomic sustainability. Thus the consolidated budget deficit (excluding externally financed projects) fell from nearly 6% in 1997 to 3% in 2002. Better control of expenditure has taken place following the establishment of the Treasury system while the accumulation of further expenditure arrears has been halted. Expenditures from the Federation Budget are being reduced following the demobilisation of around 7,000 military personnel in 2002. Continuation of this strategy together with associated structural reforms is expected to result in continued strong economic growth and low inflation during 2004-06.

7. For BiH as a whole the draft BiH Development Strategy is projecting real economic growth as increasing to 6.0% annually. However, the 2004-06 MTEF has taken more modest growth assumptions consistent with the need for a cautious stance in projecting the Government's fiscal programme. Consequently the MTEF projections are based on real growth of 4.0%-4.5% during 2004-06 with annual inflation remaining at 1.5%-2.0%. On the fiscal account, the overall deficit (inclusive of externally financed projects) is projected to fall from 5.5% of GDP in 2002 to 1.3% in 2006. Fiscal discipline will be reinforced by continuation of the Government's policy of avoiding commercial external borrowing and further domestic borrowing.

**Chart 1: FBiH GDP 1999-2006 (Nominal)**

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8. The macroeconomic assumptions and fiscal projections for the 2004-06 MTEF remain dependent on the implementation of a strong programme of reform measures as well as on maintaining and improving tax compliance. The key policy issues that will need to be addressed over the medium-term include:

- tackling high levels of unemployment and poverty, requiring a more flexible labour market and better focusing of public expenditure towards poverty reduction;
- increasing private investment and domestic economic activity requiring more rapid progress in the privatisation of large-scale enterprises, in restructuring enterprises (including implementation of bankruptcy procedures), in reducing bureaucratic impediments to business and in the implementation of taxation reforms;
- reining in the very substantial grey economy, requiring renewed efforts to reduce tax evasion and ensuing that the revenue administrations operate efficiently and fairly - the establishment of a unified State Customs/Indirect Tax Authority (ITA) is expected to play a key role in achieving this; and
- further fiscal consolidation to offset the decline in external assistance requiring more efficient and effective use of limited public resources.

[1] A more detailed discussion of the MTEF macroeconomic assumptions and revenue projections is contained in Annex I.

**Recent Trends in Domestic Revenues**

9. Revenue receipts as a share of GDP were relatively stable between 1999 and 2002 at around 50% of GDP (Chart 2 and 3), although tax revenues have shown a slight downward trend from 28.5% of GDP in 1999 to 26.8% in 2002. The fall in sales tax revenues was particularly marked following the implementation of the decision to collect sales tax on excisable goods at the point of final sale, rather than at the point of import or manufacture. After the reversal of this decision for tobacco products in August 2002, there was a ten-fold increase in monthly sales tax receipts on tobacco products. Improvements in tax administration following implementation of the new law on tax administration have had a positive impact on revenue performance. Measures undertaken have included the establishment of units for the control of large taxpayers, enforced collection, and investigation.

| Chart 2: Domestic Revenues 1999-2002 | Chart 3: Composition of Budgetary Revenues 1999 |
|---|---|
| { EMBED Excel.Chart.8 \s } | { EMBED Excel.Chart.8 \s } |

10. In 2002 budgetary revenues accounted for almost 64% of total revenues. Since 1999 the share of total revenues accruing to the cantons has fallen from 42% to 29%, while that accruing to the Federation has increased from 25% to 29%. Municipalities receive only 6%-7% of total revenues. Social Fund revenues, primarily Health and Pensions Fund, grew by over 60% between 1999 and 2002 increasing as a share of total revenues from 25% to 33%.

11. Tax policy changes affecting sales tax and wage tax are the main reason for the significant decline in canton revenues which fell by 13% between 1999 and 2002. Additionally canton revenues have been subject to considerable year-on-year fluctuation. For example in Tuzla and Central Bosnia total revenue fell by 19% and 22% respectively between 2000 and 2001. A further feature of revenue assignment in FBiH is the considerable variations in the tax base between cantons. Thus while revenues in Sarajevo were KM 962 per capita in 2002, in Herceg-Bosnia canton they amounted to only KM 336.

12. During the first quarter of 2003, tax and social fund revenues grew by 12% compared with the same period in 2002. To a considerable extent this reflected the one-time effects of the measures taken during 2002 to strengthen revenue performance. However, the implementation of free trade agreements with BiH's main trading partners is expected to result in a significant fall in customs revenues over the year. Consequently, revenues over the course of 2003 are expected to show more modest growth with tax receipts rising by 2.9% and social fund revenues by 4.4% over the year.

**Revenue Policies and Projections 2004-06**

13. The MoF continues to face considerable difficulties in developing revenue forecasts. This is due both to the significant tax policy changes that are under consideration and the absence of sufficiently stable time-series data to provide a meaningful trend analysis. To avoid the risk of overestimating revenues and setting an unrealistic budget framework, relatively conservative assumptions have been used in projecting revenues for 2004-06. The projections were developed using a simple model that took into account recent trends in revenue receipts, the expected impact of recent and planned revenue policy measures (Box 2), and the GDP projections from the medium-term macroeconomic framework.

| Box 2: Revenue Impact of Assumptions in Revenue Policy and Administration | |
|---|---|
| **Revenue Source** | **Assumptions for MTEF Revenue Projections** |
| **Customs Duties** | ▪ New harmonised customs tariffs adopted and single customs administration implemented.<br>▪ The current downward trend in custom revenues, following implementation of the Free Trade Agreements (FTAs), will during 2004-06.<br>▪ Some increase in administrative efficiency and lower evasion through the establishment of a unified State level customs administration under the Indirect Tax Authority (ITA).. |
| **Excise Taxes** | ▪ Excise rates remain harmonised.<br>▪ Excise duties to stay the same.<br>▪ Limited increase in administrative efficiency. |
| **Sales Tax** | ▪ Change in collection point for all excisable products to the point of manufacturer or import during 2003. Increase in sales tax receipts of an additional 10%-15%.<br>▪ No change in average sales tax rate.<br>▪ Limited increase in administrative efficiency. |
| **VAT** | ▪ Effective implementation not before 2006. Single positive rate (similar to neighbouring countries, above existing average sales tax rate), with few or no exemptions. Rate and threshold level set to be revenue neutral. No additional impact on revenue receipts. |
| **Profit Tax** | ▪ Implementation of revised corporate income tax law during 2004. Limited impact on revenue receipts.<br>▪ Limited increase in administrative efficiency. |
| **Wage/Citizens Income Tax** | ▪ Any introduction of personal income tax during the 2004-06 period is assumed to have a revenue neutral impact. Introduction of pilot income tax in Brcko District from July 2003. Experience of this to be studied. Likely that the wider introduction of personal income tax will be delayed until after introduction of VAT (and thus after 2004-06 period).<br>▪ Limited increase in administrative efficiency. |
| **Other Taxes** | ▪ Trend growth in other tax revenues. |
| **Fees/Non-Tax Revenues** | ▪ Greater capture of own-source revenues (particularly at canton level). Increase in revenues of 5-10% annually. |
| **Social Fund Revenues** | ▪ GDP trend growth in all Funds |
| **Other Off-Budget Fund Revenues** | ▪ Reduction in tourism and other fees, with no noticeable decrease in receipts. |

14. The medium-term objective of harmonisation and greater integration with the EU will imply further major reforms of the fiscal system involving the establishment of a unified customs administration and the replacement of sales taxes by Value Added Tax (VAT). To this the ITA will be established at State level during the second half of 2003 with responsibility for administering the collection of customs duties, excise taxes and sales taxes. The ITA will also be the body responsible for collection of VAT to be introduced by 2006. For the purposes of the MTEF projections it has been assumed that the impact of VAT introduction will be revenue neutral.

15. These changes will allow the State Budget to be financed from revenues transferred directly from the ITA under a revenue sharing formula to be agreed with the Entity governments. They will also allow for the elimination of double taxation between the Entities and should result in a significant reduction in tax evasion. Greater transparency in the operation of the tax system will also significantly improve the environment for businesses and investors.

16. Total revenues are projected to increase by 4.5% annually from KM 3.8 billion in 2002 to KM 4.5 billion in 2006 (Table 1). Customs revenues are projected to fall by around 10% annually due to the implementation of the free trade agreements, although with the impact mitigated by improved collection of duties on goods originating from elsewhere. Sales taxes are expected to show strong growth following implementation of the decision to extend collection at the point of manufacture or import to other excisable commodities. Non-tax

revenues are similarly expected to show strong growth mainly due to the better "capture" of own revenues following the implementation of Treasury procedures.

**Table 1: Projected Domestic Revenues 2003-06**

| | 2002 Outturn | | 2003 Rev. Est. | | 2004 Projected | | 2005 Projected | | 2006 Projected | | Av Annual Growth Rate 2004 06 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | KM million | % of GDP | KM million | % of GDP | KM million | % of GDP | KM million | % of GDP | KM million | % of GDP | |
| **Tax Revenues** | **2,018.2** | **26.8%** | **2,077.0** | **26.3%** | **2,156.2** | **25.8%** | **2,249.9** | **25.4%** | **2,359.3** | **25.1%** | **4.6%** |
| Customs Duties | 516.2 | 6.9% | 485.6 | 6.1% | 446.5 | 5.3% | 401.2 | 4.5% | 360.4 | 3.8% | -10.2% |
| Excises | 450.7 | 6.0% | 461.8 | 5.8% | 495.2 | 5.9% | 543.7 | 6.1% | 597.8 | 6.3% | 9.9% |
| Sales Tax on Excisable Products | 199.9 | 2.7% | 220.4 | 2.8% | 256.0 | 3.1% | 291.6 | 3.3% | 325.7 | 3.5% | 12.8% |
| Sales Tax on Non-Excisable Products | 585.5 | 7.8% | 614.7 | 7.8% | 649.2 | 7.8% | 687.8 | 7.8% | 731.8 | 7.8% | 6.2% |
| Profit Tax | 40.2 | 0.5% | 58.9 | 0.7% | 62.2 | 0.7% | 65.9 | 0.7% | 70.1 | 0.7% | 6.2% |
| Wage Tax | 136.4 | 1.8% | 142.3 | 1.8% | 149.2 | 1.8% | 156.7 | 1.8% | 164.8 | 1.7% | 5.1% |
| Other Taxes | 89.4 | 1.2% | 93.3 | 1.2% | 97.9 | 1.2% | 103.0 | 1.2% | 108.6 | 1.2% | 5.3% |
| **Non-Tax Revenues** | **385.5** | **5.1%** | **375.6** | **4.8%** | **399.3** | **4.8%** | **426.7** | **4.8%** | **456.3** | **4.8%** | **6.9%** |
| Fees, fines and penalties | 149.0 | 2.0% | 130.0 | 1.6% | 140.4 | 1.7% | 151.5 | 1.7% | 163.6 | 1.7% | 8.0% |
| Receipts of Budget Beneficiaries | 73.9 | 1.0% | 75.0 | 0.9% | 80.0 | 1.0% | 87.4 | 1.0% | 95.8 | 1.0% | 9.4% |
| Other non-tax revenues | 162.6 | 2.2% | 170.6 | 2.2% | 179.0 | 2.1% | 187.8 | 2.1% | 197.0 | 2.1% | 4.9% |
| **Social Funds** | **1,256.1** | **16.7%** | **1,312.2** | **16.6%** | **1,375.8** | **16.5%** | **1,445.4** | **16.3%** | **1,520.0** | **16.1%** | **5.1%** |
| Health Insurance Fund | 495.1 | 6.6% | 507.9 | 6.4% | 532.5 | 6.4% | 559.5 | 6.3% | 588.4 | 6.2% | 5.1% |
| Pension Fund | 691.7 | 9.2% | 726.5 | 9.2% | 761.7 | 9.1% | 800.2 | 9.0% | 841.5 | 8.9% | 5.1% |
| Employment Fund | 69.3 | 0.9% | 77.8 | 1.0% | 81.6 | 1.0% | 85.7 | 1.0% | 90.1 | 1.0% | 5.1% |
| **Off-Budget Funds** | **102.9** | **1.4%** | **108.9** | **1.4%** | **114.9** | **1.4%** | **121.4** | **1.4%** | **128.3** | **1.4%** | **5.7%** |
| **Total General Government Revenues** | **3,762.6** | **50.0%** | **3,873.6** | **49.0%** | **4,046.2** | **48.5%** | **4,243.5** | **47.9%** | **4,463.9** | **47.4%** | **5.0%** |
| Memorandum Item: GDP (KM million) | 7,531 | | 7,907 | | 8,350 | | 8,851 | | 9,418 | | |

## C. External Financing

17. In recent years external assistance has provided an important source of financing for public expenditure, both in the form of budget support and through the funding of public investment under the Priority Reconstruction Programme (PRP). However, PRP expenditures have been undertaken off-budget and the Government has faced considerable difficulties in tracking expenditures on projects for which resources have been managed directly by the donor agencies. Nevertheless, available information shows that expenditures on the PRP have fallen sharply from KM 1,151 million in 1999 to KM 254 million in 2002, although the sharp fall in 2001 may to some extent reflect problems faced in recording these expenditures (Chart 4)[2]. Budget support assistance, both grant and credit, has shown significant inter-year variation reflecting both the fluctuations size of the "financing gap" and delays in the release of funds due to slow implementation of related reform measures. In 2002 external budgetary support financing amounted to KM 155 million.

18. With the immediate post-war reconstruction period now over, the number of donors operating in BiH can be expected to fall sharply, while others can be expected to reduce their funding allocations. At the same time BiH is still a too early a stage in the EU accession process to quality for EC structural funds. Funding from the EC expected to be limited to budgetary support and technical assistance operations focused at the State level. Consequently, during 2004-06, there will be a further significant decline in external financing both for investment projects and budgetary support operations. Against this background, the MTEF projections (Chart 4) assume that:

- Budgetary support funding falls from KM 149 million in 2003 to KM 102 million in 2006 with the share of external debt servicing expenditures covered by budgetary support falling from 81% to 60%. To the extent that additional budget support financing might become available, this should be used to allow for further easing of the tax regime rather than to fuel additional public expenditure.
- Disbursements of external project assistance are projected to fall from KM 254 million in 2003 to KM 147 million in 2006. The major share of this financing will come from projects for which donor funding has already been committed. New donor financing commitments for public

[2] During preparation of the 2004-06 MTEF a detailed review of externally public investment was undertaken (see Annex IV). This revealed that the level of such financing that could be reasonably expected to fall within the fiscal framework was much lower than previously assumed.

investment are estimated at KM 110 per year, although only around 40% of these resources can be expected to be disbursed by 2006[3].

- Additionally, donor agencies are expected to continue to provide significant levels of technical assistance grants to support the implementation of the Government's economic reform programme. However, these resources, which are typically managed directly by the donor agencies, are not considered as part of the MTEF resource framework.

**Chart 4: Projected External Financing 2002-06**

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## D. Expenditure Framework for 2004-06

19. During 2004-06 public expenditures will be limited by domestic revenues and the availability of concessional external financing. As part of the strategy to establish fiscal sustainability, the Government will avoid recourse to commercial borrowing. Table 2 shows the summary fiscal framework for 2004-06, the full fiscal table is included at Attachment 1.

[3] Since funding commitments for public investment projects are typically disbursed over a 3-5 year period.

**Table 2: Comprehensive Expenditure Framework 2001-06**

| | 2001 Actual | 2002 Actual | 2003 Rev. Est. | 2004 Projected | 2005 Projected | 2006 Projected |
|---|---|---|---|---|---|---|
| | | | *Km million* | | | |
| **Total Revenue and Grants** | **3,446.8** | **3,760.3** | **3,898.4** | **4,074.2** | **4,271.5** | **4,491.9** |
| Total Revenues | 3,430.5 | 3,748.4 | 3,873.7 | 4,046.2 | 4,243.5 | 4,463.9 |
| *Tax Revenues* | *1,844.2* | *2,018.2* | *2,077.0* | *2,156.2* | *2,249.9* | *2,359.2* |
| *Non-Tax Revenues* | *338.8* | *385.5* | *375.6* | *399.3* | *426.7* | *456.3* |
| *Social Fund Revenues* | *1,138.2* | *1,241.9* | *1,312.2* | *1,375.8* | *1,445.4* | *1,520.0* |
| *Off-Budget Funds* | *109.3* | *102.9* | *108.9* | *114.9* | *121.4* | *128.3* |
| Budget Support Grants | 16.3 | 11.9 | 24.7 | 28.0 | 28.0 | 28.0 |
| **Total Expenditure** | **3,947.6** | **4,173.9** | **4,205.4** | **4,332.3** | **4,454.7** | **4,614.2** |
| Federation Budget[1] | 1,032.1 | 1,146.4 | 1,077.3 | 1,091.6 | 1,119.0 | 1,158.5 |
| *Financing of State Operations* | *50.2* | *51.7* | *78.0* | *147.2* | *149.8* | *152.6* |
| *Interest* | *75.4* | *98.1* | *73.4* | *78.0* | *70.2* | *72.5* |
| *Discretionary Spending* | *906.5* | *1,028.1* | *925.9* | *866.3* | *899.1* | *933.5* |
| *Net Lending* | *0.0* | *-31.4* | *0.0* | *0.0* | *0.0* | *0.0* |
| Canton and Municipal Expenditures | 1,340.7 | 1,425.6 | 1,432.9 | 1,483.9 | 1,578.5 | 1,662.4 |
| Externally Financed Projects | 359.7 | 253.9 | 254.4 | 266.5 | 191.5 | 147.0 |
| Social Fund Expenditures | 1,140.7 | 1,248.8 | 1,331.7 | 1,375.8 | 1,445.4 | 1,520.0 |
| Off-Budget Funds | 74.5 | 99.1 | 109.1 | 114.5 | 120.2 | 126.2 |
| **Budget Balance** | **-500.9** | **-413.6** | **-307.0** | **-258.1** | **-183.2** | **-122.3** |
| **Financing** | **500.9** | **413.6** | **307.0** | **258.1** | **183.2** | **122.3** |
| External Financing | 420.0 | 350.0 | 267.8 | 258.5 | 184.4 | 124.4 |
| *External Budget Support Credits* | *91.5* | *142.7* | *124.3* | *98.0* | *86.0* | *74.0* |
| *External Project Financing* | *359.7* | *253.9* | *254.4* | *266.5* | *191.5* | *147.0* |
| *Amortisation Payments* | *-31.2* | *-46.7* | *-110.9* | *-106.0* | *-93.2* | *-96.6* |
| Domestic Financing | 80.9 | 63.6 | 39.1 | -0.4 | -1.2 | -2.1 |
| | | | *% of GDP* | | | |
| **Total Revenue and Grants** | **47.7%** | **49.9%** | **49.3%** | **48.8%** | **48.3%** | **47.7%** |
| Total Revenues | 47.5% | 49.8% | 49.0% | 48.5% | 47.9% | 47.4% |
| Budget Support Grants | 0.2% | 0.2% | 0.3% | 0.3% | 0.3% | 0.3% |
| **Total Expenditure** | **54.6%** | **55.4%** | **53.2%** | **51.9%** | **50.3%** | **49.0%** |
| Federation Discretionary Expenditure | 12.5% | 13.7% | 11.7% | 10.4% | 10.2% | 9.9% |
| Canton and Municipal Expenditures | 18.6% | 18.9% | 18.1% | 17.8% | 17.8% | 17.7% |
| Externally Financed Projects | 5.0% | 3.4% | 3.2% | 3.2% | 2.2% | 1.6% |
| Social Fund Expenditures | 15.8% | 16.6% | 16.8% | 16.5% | 16.3% | 16.1% |
| Off-Budget Funds | 1.0% | 1.3% | 1.4% | 1.4% | 1.4% | 1.3% |
| **Budget Balance** | **-6.9%** | **-5.5%** | **-3.9%** | **-3.1%** | **-2.1%** | **-1.3%** |
| Social Fund Expenditures | 5.8% | 4.6% | 3.4% | 3.1% | 2.1% | 1.3% |
| Off-Budget Funds | 1.1% | 0.8% | 0.5% | 0.0% | 0.0% | 0.0% |
| Memorandum Item: GDP (KM million) | 7,224.0 | 7,531.0 | 7,907.0 | 8,350.0 | 8,851.0 | 9,418.0 |

Note:
[1] Excludes transfers: a) to social funds, cantons, municipalities; and (b) amortisation payments.
Source: Ministry of Finance

20. Total Government expenditure is expected to increase at around 3.2% per year from KM 4,205 million in 2003 to KM 4,614 million in 2006. By 2006 annual spending levels will have increased by 4.2% in real terms compared with 2003. The share of budgetary spending is expected remain at around 60% of total spending over the period. Other key points to note about the projections are:

- Discretionary spending from the Federation Budget (excluding transfers to cantons and social funds) is projected to decline from 40% of total budgetary expenditure in 2002 to 33% in 2006. This fall reflects both: (i) the increase in transfers to state operations as certain functions (e.g. in defence, and customs administration) are transferred to the State level; (ii) the fall in defence spending and the freezing of allocations for veteran's benefits programmes; and (iii) the emphasis being given under the BiH Development Strategy to improving public service delivery for which cantons have the major responsibility.
- Cantonal and municipal budgetary spending is projected to increase from 55% to 59% of total budgetary spending. Since the assignment of revenues to the municipal level is a canton responsibility – no separate projection has been developed for municipal spending.
- Spending on externally financed projects is projected to fall from 6% to 3% of total expenditure over the period.

**Box 3: Changes in the Presentation of the Expenditure Framework in the 2004 BFP**

Compared with previous BFPs, the presentation of the expenditure framework in the 2004 BFP has changed in a number of respects:

- The framework has been made more comprehensive with the inclusion of the category of "Off-Budget Funds" which principally include expenditures financed by the Roads Fund and water fees.
- Debt servicing expenditures have been divided between interest charges which are shown as an expenditure item and amortisation payments, which in common with international convention, are shown as a negative financing item.
- The expenditure figures are shown net of transfers to other levels of Government and to the Social Funds.
- The figure for net lending shown in 2002 covers Item 829111 "Return of Loans and Credits" in the 2002 Budget Execution Report.

## E. Cross-Cutting Budgetary Issues

21. For the 2004-06 MTEF, a more detailed analysis was undertaken of an number of cross-cutting issues that impact on resource availability and allocations across all sectors. Where appropriate this analysis made use of comparative data on public expenditures in the region (Box 4). This section summarises the findings from this analysis and concludes by setting out the resource allocation guidelines for expenditures by economic item.

**Box 4: Regional Comparators**

The MTEF analysis makes use of data on public expenditures from 9 countries in the Region (8 countries in the case of expenditure by function). Since data was only available for one year, the countries have been classified into three groups with data on average spending levels as a share of GDP and as a share of general government expenditure presented for each group. The country groups are:

- ◊ Albania, Bulgaria and Romania as representing countries in the Balkan region with relatively lower per capita GDP. In these countries general government expenditure (excluding interest) tended to be relatively lower averaging 33.5%.
- ◊ Poland, Czech Republic and Hungary, representing the countries due to accede to the EU in 2004. In these countries public expenditure (excluding interest payments) at 36.1% of GDP was close to the EU average of 35.7% of GDP.
- ◊ Croatia, Macedonia (for which no data was available for expenditure by function) and Slovenia representing other countries of the former Federal Republic of Yugoslavia where public expenditure (excluding interest payments) is significantly higher at 42.2% of GDP, although still considerably lower than in FBiH (53.6% of GDP).

In interpreting the data, it is important to take into account of spending levels both as a share of GDP and of total expenditure. Since public expenditure is higher in FBiH than in all comparator countries, it is to be expected that spending levels on particular economic items or functions will generally be higher. However, when expenditure as a share of total budgetary spending is also higher this can indicate that resources may not be allocated appropriately.

### Public Debt Management[4]

*External Debt*

22. For the purposes of MTEF projections of debt servicing expenditures have only been included for external debt. Following the substantial debt restructuring agreed with the Paris and London Clubs, external debt servicing expenditures have been at sustainable levels of around 2% of GDP, and are expected to remain at this level through 2006. In order to further strengthen fiscal sustainability all new external borrowing during 2004-06 will be obtained on concessional terms.

[4] See Annex 2 for a more detailed discussion of debt management issues.

*Domestic Borrowing*

23. Government policy has been to limit domestic borrowing to that necessary to offset cash flow fluctuations. However revenue shortfalls during 2001 and 2002 gave rise to a rapid increase in bank borrowing by cantons which necessitated the imposition of a complete ban on further bank borrowing by sub-Entity governments. Requirements to service existing bank debt have placed significant additional pressures on sub-Entity governments although the major share of this short-term debt has now been repaid. Future borrowing for cash-flow purposes will be limited to KM 20 million for the Federation Government, KM 10 million for the canton governments; and KM 8 million for the municipalities.

*Accumulated Domestic Debt*

24. Of much greater significance however is the substantial accumulated domestic debt which the government has been unable to service. This debt comprises:

- Expenditure Arrears. The accumulated arrears of budget beneficiaries and the social funds are estimated at around KM 1.4 billion with the majority of these liabilities relating to pensions and insurance funds contributions from the Ministry of Defence. The introduction of the Treasury system has facilitated in halting the build-up of further arrears.
- War-Related Claims. The registration of liabilities in respect of war-related claims for damages is under way, with claims of KM 150 million having so far been accepted by the courts. The Government recognises the need to limit the extent and total number of executable claims.
- Frozen Foreign Currency Deposits. These liabilities relate to pre-war foreign currency savings held by the population which were accepted under the Agreement of Succession of the Former SFRY that was concluded in 2001. While the extent of these liabilities is still to be determined, the principal is estimated at KM 1.5 billion.

25. During 2004-06, the Government's strategy for managing the stock of domestic debt will be to treat such liabilities outside of the budget framework in order not to jeopardise on-going spending programmes on public infrastructure and services. This will be done by: (i) completing the on-going work to register and quantify war-related claims and finalising with the State the legal and financial framework for resolving claims; (ii) placing one-off receipts from privatisation and succession monies into Escrow accounts; and (iii) seeking a partial write-down and securitisation of domestic claims on government.

**Wagebill and Operations and Maintenance Spending**[5]

26. In 2002 spending on wagebill[6] and operations and maintenance, excluding expenditures financed by the health insurance funds totalled KM 1,500 million (19.9% of GDP). Of this, wagebill expenditures amounted to KM 1,188 million (15.8% of GDP). By comparison with countries in the Region wagebill spending in FBiH is substantially higher as a share of GDP while operations and maintenance spending is lower (Chart 5). Between 1999 and 2002 the ratio of operations and maintenance to wagebill expenditures fell from 42.7% to 26.6% while operations and maintenance spending declined in real terms by almost 20%. By contrast, wagebill expenditures increased significantly in real terms despite rates of pay having remained unchanged over a number of years. This suggests that wage restraint has been undermined by the increased use of allowances to supplement pay packages. The high level of wagebill expenditures has significantly crowded out operations and maintenance spending with consequent adverse impacts on the efficiency of public services.

27. The high level of wagebill expenditures appears to be caused primarily by the relatively high costs of employment in the public service in terms of pay, allowances and contributions. Notwithstanding excessive staffing in certain areas, particularly law and order, overall public service employment appears to be comparable with other countries in the region, with employees in public administration, defence, education, health and social welfare[7] totalling 109,000 at the end of 2002 equivalent to 4.7 employees per 100 persons.

28. At the end 2002 employees paid from the Budget, which excludes health personnel paid from the Health Insurance Funds, totalled 79,546, of which 16,965 were military personnel. Almost 85% of non-military personnel are employed at the sub-entity level, of which 85% work at the canton level. There are substantial

[5] See Annex 3 for a more detailed discussion of spending on wagebill and operations and maintenance.

[6] Excluding severance pay for military personnel.

[7] Employment figures for these sectors are considered to provide a reasonable estimate of total public service employment.

variations in the level of public service employment across the different cantons, ranging from 1.7 per 100 persons in Tuzla Canton to 3.4 per 100 persons in Sarajevo Canton.

**Chart 5: Wagebill and Operations and Maintenance Spending**

{ EMBED Excel.Chart.8 \s } | { EMBED Excel.Chart.8 \s }

Notes:
1. FBiH Data refers to 2002.
2. Comparator country data refers to 1999, except for Croatia (2000) and Hungary (1998)
3. Excludes interest and amortisation payments.

29. With budgetary resources projected to grow more slowly, wagebill restraint will have to be a central policy under the 2004-06 MTEF. The key requirements will be:

- No increase in nominal terms in the public sector wagebill over the medium-term. This reflects the policy stance agreed for the BiH Development Strategy.
- Stricter controls over the size of the public service workforce and developing plans for "right-sizing" of public services that identify key areas where staffing reductions can be achieved.
- Ensuring that public service wage levels are set in relation to conditions in the wider labour market by introducing greater decompression in wage scales to better reflect demands for key skills.
- Covering the costs of pay reform by savings arising from reductions in the number of public service employees.
- Adopting target levels for spending on operations and maintenance to ensure that public service personnel are provided with adequate resources for the tasks for which they have been employed. The MTEF projections assume that spending on goods and services will increase by 10% annually.
- Implementation of civil service and public administration reform programmes to support the development of an affordable, efficient and well-managed public administration.

**Public Investment**[8]

30. Under the PRP public investment in FBiH had been at very high levels. By 2002, at 6.5% of GDP it had fallen to closer to regional averages (Chart 6). However, the decline in donor funding was also matched by a significant decline in domestic allocations from KM 482 million in 1999 to KM 241 million in 2002. With externally financed public investment projected to fall further during 2002-06, it will be necessary to increase domestically financed public investment in order to maintain overall levels of public investment at close to the regional average of around 5% of GDP. Securing such an increase will require much tighter control of other expenditure categories.

31. Reflecting these requirements the MTEF projections assume that domestic public investment allocations will increase by 20% annually although from a relatively low base. When externally financed projects are taken into account total public investment will fall from 5.5% of GDP in 2002 to 4.5% of GDP in 2006.

**Chart 6: Public Investment Expenditures**

{ EMBED Excel.Chart.8 \s }

Notes:
1. Comparator country data refers to 1999, except for Croatia (2000) and Hungary (1998)
2. Includes municipal expenditure. Excludes interest and amortisation payments.

32. A conclusion of the work done in preparing the 2004-06 MTEF is that there is an urgent requirement to strengthen the management of the public investment programme within a comprehensive and integrated budget framework. The recent establishment of an aid co-ordination unit within the MoF with responsibility for development a comprehensive public investment programme, covering both externally and domestically

[8] See Annex 4 for a more detailed review of issues relating to public investment and externally financed projects.

financed projects, provides an institutional framework within which these necessary improvements can be achieved. Other urgent issues that will have to be addressed during 2004-06 include:

- securing better and more timely information on external project commitments and resource flows;
- establishing a full-inventory of domestically financed projects and more rigorous procedures for the identification, appraisal and approval of these projects;
- inclusion of externally financed projects into the annual budget and budget execution report;
- developing more transparent procedures for channelling external resources for the financing of projects at the sub-Entity level; and
- ensuring that downstream recurrent costs are considered during project design and appraisal.

### Social Fund Expenditures

33. Table 3 shows projected expenditures for each of the four social funds. In recent years, the level of subsidy from the Budget to the social funds has been substantially reduced, accounting for less than 1.3% of total social fund spending in 2002. These subsides will be phased out from 2004 with pensions entitlements being directly linked to contributions.

**Table 3: Projection of Extra-Budgetary Fund Expenditures**

| | 2002 Actual | | 2003 Estimated | | 2004 Projected | | 2005 Projected | | 2006 Projected | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Km million | % of GDP | Km million | % of GDP | Km million | % of GDP | Km million | % of GDP | Km million | % of GDP |
| Health Insurance Fund | 487.5 | 6.5% | 517.4 | 6.5% | 532.5 | 6.4% | 559.5 | 6.3% | 588.4 | 6.2% |
| financed by: contributions | 495.1 | | 507.9 | | 532.5 | | 559.5 | | 588.4 | |
| reserves | -8.3 | | 5.0 | | 0.0 | | 0.0 | | 0.0 | |
| transfers from Federation Budget | 0.7 | | 4.5 | | 0.0 | | 0.0 | | 0.0 | |
| Pension Fund | 689.7 | 9.2% | 736.5 | 9.3% | 761.7 | 9.1% | 800.2 | 9.0% | 841.5 | 8.9% |
| financed by: contributions | 691.7 | | 726.5 | | 761.7 | | 800.2 | | 841.5 | |
| reserves | -17.0 | | 0.0 | | 0.0 | | 0.0 | | 0.0 | |
| transfers from Federation Budget | 15.0 | | 10.0 | | 0.0 | | 0.0 | | 0.0 | |
| Employment Fund | 71.6 | 1.0% | 77.8 | 1.0% | 81.6 | 1.0% | 85.7 | 1.0% | 90.1 | 1.0% |
| financed by: contributions | 65.1 | | 77.8 | | 81.6 | | 85.7 | | 90.1 | |
| reserves | 6.5 | | 0.0 | | 0.0 | | 0.0 | | 0.0 | |
| transfers from Federation Budget | 0.0 | | 0.0 | | 0.0 | | 0.0 | | 0.0 | |
| **Total** | **1,248.8** | **16.6%** | **1,331.7** | **16.8%** | **1,375.8** | **16.5%** | **1,445.4** | **16.3%** | **1,520.0** | **16.1%** |
| financed by: contributions | 1,251.9 | 16.6% | 1,312.2 | 16.6% | 1,375.8 | 16.5% | 1,445.4 | 16.3% | 1,520.0 | 16.1% |
| reserves | -18.8 | -0.3% | 5.0 | 0.1% | 0.0 | 0.0% | 0.0 | 0.0% | 0.0 | 0.0% |
| transfers from Federation Budget | 15.7 | 0.2% | 14.5 | 0.2% | 0.0 | 0.0% | 0.0 | 0.0% | 0.0 | 0.0% |
| Memorandum Item: GDP (KM million) | 7,531.0 | | 7,907.0 | | 8,350.0 | | 8,851.0 | | 9,418.0 | |

Source: Ministry of Finance

### Inter-Governmental Resource Allocation[9]

34. A feature of inter-governmental finance in FBiH is the very considerable differences in per capita revenues and expenditures between cantons. In 2002 per capita spending in Sarajevo Canton (excluding health insurance) in 2002 was 82% above the average for all cantons and 175% higher than that in Central Bosnia (Chart 7). At the same time revenues particularly at the sub-Entity level have in recent years been sensitive to changes in tax policy and administration making it difficult for canton governments to plan and manage public expenditure programmes. Thus total expenditure across all cantons fell by 10.2% in 2001 with that in Tuzla and Central Bosnia falling by over 20% compared with the previous year.

**Chart 7: Per Capita Expenditure by Canton**
**(excluding Canton Health Insurance and other off-budget funds)**

{ EMBED Excel.Chart.8 \s }

[9] See Annex 5 for a more detailed review of inter-governmental resource allocation issues.

35. The analysis undertaken for the MTEF highlighted a number of key issues that will have to be addressed in order to strengthen budget planning at the sub-Entity level and ensure a more appropriate balance in resource allocations between and among the different levels of Government. These include:

- Managing revenue policy, assignment and administration reforms in a way that provides for greater predictability in sub-Entity revenues.
- Ensuring that the division of resources between the Federation and sub-Entity levels of government reflects adequately the assignment of expenditure responsibilities.
- Mitigating the substantial variations in per capita revenues and expenditures by establishing mechanisms to ensure greater solidarity among sub-Entity governments. The MTEF projections assume that transfers to cantons and municipalities from the Federation Budget will increase from KM 9 million in 2003 to KM 40 million in 2006.
- Ensuring a more effective dialogue between sub-Entity governments and the Federation on issues relating to the reform of public service delivery and in the costing of government policies and legislation.
- Assessing the need for further adjustments in the assignment of responsibilities between the Federation and sub-Entity governments where this is necessary to achieve greater policy coherences and allow for greater effectiveness and efficiency in the use of resources.

**Projection of Budgetary Expenditures by Major Economic Category.**

36. Table 4 shows projected allocations by major economic category for budgetary expenditures during 2004-06 together with the underlying policy assumptions on which the allocations are based.

## Table 4: Projection of Budgetary Expenditure By Economic Item

Km million/% of GDP

| | 2002 Actual | | | 2003 Estimated | | | 2004 Projected | | | 2005 Projected | | | 2006 Projected | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Federal | Canton + Municipal | Total | Federal | Canton + Municipal | Total | Federal | Canton + Municipal | Total | Federal | Canton + Municipal | Total | Federal | Canton + Municipal | Total | **Policy Assumptions** |
| **Gross Expenditure** | **1,175.9** | **1,425.6** | **2,601.6** | **1,100.8** | **1,432.9** | **2,533.7** | **1,106.6** | **1,483.9** | **2,590.5** | **1,149.0** | **1,578.5** | **2,727.5** | **1,198.5** | **1,662.4** | **2,860.9** | |
| | **15.6%** | **18.9%** | **34.5%** | **13.9%** | **18.1%** | **32.0%** | **13.3%** | **17.8%** | **31.0%** | **13.0%** | **17.8%** | **30.8%** | **12.7%** | **17.7%** | **30.4%** | |
| less Transfers to the State | 149.8 | | 149.8 | 151.4 | | 151.4 | 225.2 | | 225.2 | 219.9 | | 219.9 | 225.0 | | 225.0 | |
| *For State Operations* | *51.7* | | *51.7* | *78.0* | | *78.0* | *147.2* | | *147.2* | *149.8* | | *149.8* | *152.6* | | *152.6* | Increased in 2004 to reflect transfers of customs administration (KM28 million), Intelligence Services (KM 10 million) and Ministry of Defence and Army Joint Headquarters (KM 30 million) to State Level. |
| *Interest* | *98.1* | | *98.1* | *73.4* | | *73.4* | *78.0* | | *78.0* | *70.2* | | *70.2* | *72.5* | | *72.5* | |
| Inter-Budgetary Transfers | 29.5 | | 29.5 | 23.5 | | 23.5 | 15.0 | | 15.0 | 30.0 | | 30.0 | 40.0 | | 40.0 | |
| | 0.4% | 0.0% | 0.4% | 0.3% | 0.0% | 0.3% | 0.2% | 0.0% | 0.2% | 0.3% | 0.0% | 0.3% | 0.4% | 0.0% | 0.4% | |
| *To Cantons & Municipalities* | *13.8* | | *13.8* | *9.0* | | *9.0* | *15.0* | | *15.0* | *30.0* | | *30.0* | *40.0* | | *40.0* | Tranfers increased to provide increased funding to poorer cantons |
| *To Social Funds* | *15.7* | | *15.7* | *14.5* | | *14.5* | *0.0* | | *0.0* | *0.0* | | *0.0* | *0.0* | | *0.0* | Transfers to Social Funds phased out from 2004 |
| **Net Expenditure** | **996.7** | **1,425.6** | **2,422.3** | **925.9** | **1,432.9** | **2,358.8** | **866.3** | **1,483.9** | **2,350.2** | **899.1** | **1,578.5** | **2,477.6** | **933.5** | **1,662.4** | **2,595.9** | |
| | **13.2%** | **18.9%** | **32.2%** | **11.7%** | **18.1%** | **29.8%** | **10.4%** | **17.8%** | **28.1%** | **10.2%** | **17.8%** | **28.0%** | **9.9%** | **17.7%** | **27.6%** | |
| Wages and Contributions | 490.3 | 792.5 | 1,282.8 | 362.8 | 796.4 | 1,159.2 | 315.2 | 800.0 | 1,115.2 | 315.2 | 800.0 | 1,115.2 | 315.2 | 800.0 | 1,115.2 | Held constant in nominal terms. Federation allocations for 2004 adjusted to reflect transfer of functions to State. |
| | 6.5% | 10.5% | 17.0% | 4.6% | 10.1% | 14.7% | 3.8% | 9.6% | 13.4% | 3.6% | 9.0% | 12.6% | 3.3% | 8.5% | 11.8% | |
| Goods and Services | 78.1 | 234.0 | 312.1 | 103.7 | 191.3 | 295.0 | 91.5 | 210.5 | 301.9 | 100.6 | 231.5 | 332.1 | 110.7 | 254.7 | 365.4 | Increase by 10% annually. Federation allocation for 2004 adjusted to reflect transfer of functions to State. |
| | 1.0% | 3.1% | 4.1% | 1.3% | 2.4% | 3.7% | 1.1% | 2.5% | 3.6% | 1.1% | 2.6% | 3.8% | 1.2% | 2.7% | 3.9% | |
| Tranfers to Persons | 341.0 | 137.4 | 478.4 | 306.0 | 162.3 | 468.3 | 321.3 | 170.4 | 491.7 | 337.4 | 179.0 | 516.3 | 354.2 | 187.9 | 542.1 | Increased by 5% annually to support increased spending on poverty related social assistance programmes. |
| | 4.5% | 1.8% | 6.4% | 4.1% | 2.2% | 6.2% | 4.3% | 2.3% | 6.5% | 4.5% | 2.4% | 6.9% | 4.7% | 2.5% | 7.2% | |
| Other Expenditures & Net Lending | 51.2 | 141.4 | 192.6 | 112.5 | 163.4 | 275.9 | 89.3 | 159.7 | 249.0 | 87.0 | 196.1 | 283.2 | 82.7 | 213.6 | 296.3 | |
| | 0.7% | 1.9% | 2.6% | 1.4% | 2.1% | 3.5% | 1.1% | 1.9% | 3.0% | 1.0% | 2.2% | 3.2% | 0.9% | 2.3% | 3.1% | |
| Investment | 36.0 | 120.3 | 156.3 | 40.9 | 119.4 | 160.2 | 49.0 | 143.3 | 192.3 | 58.8 | 171.9 | 230.7 | 70.6 | 206.3 | 276.9 | Increased by 20% annually to partially offset fall in externally financed project expenditures. When externally financed projects are taken into account total public investment will fall from 5.5% of GDP in 2002 to 4.5% of GDP in 2006. |
| | 0.5% | 1.6% | 2.1% | 0.5% | 1.5% | 2.0% | 0.6% | 1.7% | 2.3% | 0.7% | 1.9% | 2.6% | 0.7% | 2.2% | 2.9% | |
| Memorandum Item: GDP (millions) | 7,531.0 | | | 7,907.0 | | | 8,350.0 | | | 8,851.0 | | | 9,418.0 | | | |

Source: Ministry of Finance

## F. Sectoral Expenditure Priorities and Resource Allocation Guidelines

### Recent Trends in Sectoral Spending Allocations

37. Table 5 shows recent trends in the allocation of resources by function (sector)[10]. The figures are inclusive of the Federation Budget, Cantonal Budgets, externally financed projects, social funds and off-budget funds. Municipal budgets have not been included since data on functional allocations is only available for 2002[11].

**Table 5: General Government Budget: Expenditures By Function 1999-2002**
(excluding Municipal Expenditures)

| | 1999 | | 2000 | | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|---|
| | Km million | % of GDP | Km million | % of GDP | Km million | % of GDP | Km million | % of GDP |
| **General Government Services** | **782.9** | **12.7%** | **783.8** | **11.7%** | **783.7** | **10.8%** | **900.9** | **12.0%** |
| General Public Services | 162.7 | 2.6% | 141.2 | 2.1% | 145.8 | 2.0% | 183.3 | 2.4% |
| Defence | 327.6 | 5.3% | 313.8 | 4.7% | 322.1 | 4.5% | 384.5 | 5.1% |
| Public Order and Safety | 292.6 | 4.8% | 328.8 | 4.9% | 315.8 | 4.4% | 333.1 | 4.4% |
| **Community and Social Services** | **2,433.8** | **39.6%** | **2,609.6** | **39.0%** | **2,317.0** | **32.1%** | **2,516.3** | **33.4%** |
| Education | 460.6 | 7.5% | 498.6 | 7.4% | 457.4 | 6.3% | 506.8 | 6.7% |
| Health | 523.1 | 8.5% | 476.1 | 7.1% | 457.0 | 6.3% | 516.4 | 6.9% |
| Social Protection | 1,199.2 | 19.5% | 1,479.4 | 22.1% | 1,283.4 | 17.8% | 1,408.2 | 18.7% |
| Housing and Community Amenities | 215.6 | 3.5% | 117.7 | 1.8% | 91.4 | 1.3% | 46.2 | 0.6% |
| Culture, Recreation and Religion | 35.4 | 0.6% | 37.8 | 0.6% | 27.9 | 0.4% | 38.7 | 0.5% |
| **Economic Services** | **938.4** | **15.3%** | **1,041.4** | **15.5%** | **351.4** | **4.9%** | **299.2** | **4.0%** |
| Energy and Fuel | 152.4 | 2.5% | 203.6 | 3.0% | 39.0 | 0.5% | 53.8 | 0.7% |
| Agriculture, Forestry & Fishing | 56.8 | 0.9% | 40.0 | 0.6% | 24.9 | 0.3% | 26.0 | 0.3% |
| Mining and Mineral Resources | 47.1 | 0.8% | 23.2 | 0.3% | 16.2 | 0.2% | 17.9 | 0.2% |
| Transport and Communications | 229.0 | 3.7% | 161.5 | 2.4% | 213.0 | 2.9% | 156.6 | 2.1% |
| Other economic Activities | 453.2 | 7.4% | 613.1 | 9.2% | 58.3 | 0.8% | 44.9 | 0.6% |
| **Other Expenditures** | **107.0** | **1.7%** | **23.3** | **0.3%** | **85.4** | **1.2%** | **34.4** | **0.5%** |
| **Total** | **4,262.1** | **69.4%** | **4,458.1** | **66.6%** | **3,537.5** | **49.0%** | **3,751.3** | **49.8%** |
| Memorandum Item: GDP (KM million) | 6,141.9 | | 6,698.7 | | 7,224.1 | | 7,531.0 | |

Note: Includes Federation Budget, Canton Budgets, Social Funds, Off-Budget Funds and Externally Financed Projects. Excludes interest and amortisation payments.

38. The figures highlight the predominance of spending in the social sectors, which in 2002 accounted for 67% of total expenditure and 33% of GDP. Total expenditures have fallen since 1999 as a result of the substantial decline in externally financed public investment. This has significantly influenced spending on economic services and on housing and community amenities.

39. Expenditure on General Government Services in FBiH, particularly defence and public order is substantially higher than averages for the region, both as a share of GDP and of total public expenditures (Chart 8). Similarly, expenditure on Community and Social Services is significantly greater both a share of GDP and also, with the exception of Croatia and Slovenia, as a share of total budgetary expenditure. Spending on education is particularly high compared with regional averages.

[10] There remain significant difficulties in deriving expenditure allocations by function in FBiH with inconsistencies applied in classifying expenditures across different governments and in factoring out inter-governmental transfers. Some caution must therefore be exercised in deriving conclusions from the analysis presented in this note.

[11] A detailed breakdown of expenditures by constituent budget is included at Annex VI.

| Chart 8: Expenditure by Function Regional Comparisons | |
|---|---|
| { EMBED Excel.Chart.8 \s } | { EMBED Excel.Chart.8 \s } |
| Notes:<br>1. FBiH Data refers to 2002.<br>2. Comparator country data refers to 1999, except for Croatia (2000) and Hungary (1998)<br>3. Excludes interest and amortisation payments. | |

**Implications for Resource Allocation Under the 2004-06 MTEF**

40. With public expenditure as a share of GDP, higher than all other countries in the region, it is clear that present patterns of public expenditure are unsustainable. The BiH Development Strategy has highlighted the scope for substantial reform of public expenditure programmes linked to the overall reduction of public expenditure as a share of GDP. Specifically it identifies requirements for restructuring of expenditures in the following areas:

- General Public Services: spending is significantly higher than in other countries, mainly due to the high level of municipal expenditure in this category. In 2002 municipalities accounted for almost half of all expenditures on general public services[12].
- Defence: spending as a share of GDP is over twice the average for the region. Expenditure is already set to fall significantly in 2003 following the demobilisation of 7,000 military personnel in 2002. There remains scope for further mutual reductions in defence establishments.
- Public Order and Safety: expenditure as a share of GDP is similarly over twice the average for the region with levels of employment remain substantially above pre-war levels. Further normalisation of society and rationalisation of the fragmented responsibilities for law and order should provide opportunities for reductions in personnel numbers over the medium-term.
- Education: spending levels are high, over twice average levels in the region and substantially higher than in other former Yugoslav republics. However, education outcomes are poor reflecting the fragmented education system and wide variations in funding per student. Financing of higher education provision has proved particularly problematical and proposals are now being developed to transfer this responsibility to the Federation level.
- Health: spending as a share of GDP is comparable with other former Yugoslav republics but is higher than elsewhere in the region. Nevertheless, the quality of health services is unsatisfactory and is reflected in the substantial private spending on health care, estimated at 5% of GDP. There remains substantial scope for improving the effectiveness and efficiency of public health spending through focusing resources on priority prevention and treatment programmes, tighter cost control, better procurement procedures and the further rationalisation of health-care facilities. It will also be necessary to address the severe geographical imbalances in the quality of public health services.
- Social Security and Welfare: spending is high as a share of GDP compared to regional averages, although less so as a share of total expenditure. However as a share of total sector spending (excluding municipal expenditures) it increased from 28% in 1999 to 36% in 2002. Pensions account for almost half of total sector allocations with spending on the very generous and extensive veterans' entitlements accounting for the major share of the remaining expenditure. Spending on poverty-related social assistance programmes is very low compared with regional norms and will need to be increased substantially if poverty reduction objectives are to be met.
- Economic Services: expenditure has fallen rapidly since 1999 as donor-funded projects under the PRP have been completed. Recorded spending is now at levels comparable with regional averages (although a substantial proportion of grant-funded expenditure is not yet recorded by the MoF). With donor funding of projects set to fall further over the medium-term, it will be necessary to ensure that investment in public infrastructure is not crowded out by spending demands in the social sectors.

[12] Although this may be somewhat overstated due to misclassification.

**Indicative Sectoral Resource Allocations and Guidelines**

41. Table 6 gives proposed resource allocations and guidelines for the 2004-06 MTEF consistent with identified reform requirements and priority expenditures identified in the draft BiH Development Strategy. Given the tight budgetary constraints during the 2004-06 period with sectoral resource allocations increasing by only 1.8% in real terms over the three years, the scope for major adjustments in spending allocations will be quite limited, particularly as the implementation of sector reform measures is itself likely to involve significant short-term costs that would need to be offset against any potential resources savings.

42. In all sectors there will be a need to assess priorities against these indicative allocations and determine the impact on the distribution of spending between the Federation and Canton budgets. In the case of canton expenditures, the eventual budget allocations will need to reflect the Canton Government's analysis of its own situation and priorities. However, a number of clear guidelines emerge from the indicative allocations in Table 6. These are:

- Expenditure on general public services and law and order should similarly be held at current (nominal) levels consistent with the implementation of efficiency measures.
- Spending on defence should fall significantly in nominal terms following the recent and planned reductions in military personnel.
- Education spending will be maintained at current nominal levels in 2004 and increased by 2.5% in 2005 and in 2006. Costs of restructuring the education system will therefore have to be met primarily from efficiency savings, for which there is considerable scope.
- Health spending will be determined by the growth in health insurance revenues. Some additional budgetary funding may be allocated to public health programmes.
- Budgetary spending on social security and welfare (KM 645 million in 2002) will be increased by 5% annually for transfers to persons and adjusted for inflation for other expenditures. This will allow additional resources to be allocated to poverty-related social assistance programmes including the introduction of child allowance. Spending on veterans' benefit programmes will not be allowed to increase above current nominal allocations. Subsidies to the pensions fund will be phased out from 2004.
- Increased real allocations for community amenities and housing will be required to meet the requirements for investment in urban infrastructure and housing arising from urban migration and the return of refugees and IDPs.
- In the economic services sectors, some increase in agriculture spending and domestically financed investment in transport infrastructure will be required to offset the anticipated decline in donor funding for these sectors.

**Sector Reform Matrix**

43. The attached matrix, which reflects the analysis and priorities identified in the BiH Development Strategy, provides a summary assessment of the key expenditure policy issues in the major sectors and their possible implications for resource allocations under the MTEF (Attachment 2).

## Table 6: Proposed Sectoral Resource Allocations/Guidelines 2004-06

| Sector/Function | 2002 | | | 2003 | | | 2004 | | | 2005 | | | 2006 | | | Assumptions |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | KM million | % of GDP | % of Total | KM million | % of GDP | % of Total | KM million | % of GDP | % of Total | KM million | % of GDP | % of Total | KM million | % of GDP | % of Total | |
| **General Government Services** | **1,113.0** | **14.8%** | **27.4%** | **972.1** | **12.4%** | **24.0%** | **940.3** | **11.3%** | **22.9%** | **928.5** | **10.6%** | **21.9%** | **917.4** | **9.8%** | **20.9%** | |
| General Public Services | 387.1 | 5.1% | 9.5% | 375.1 | 4.8% | 9.3% | 375.0 | 4.5% | 9.1% | 375.0 | 4.3% | 8.9% | 375.0 | 4.0% | 8.5% | Expenditure held at current levels consistent with implementation of efficiency measures. |
| Defence | 385.3 | 5.1% | 9.5% | 265.3 | 3.4% | 6.5% | 235.3 | 2.8% | 5.7% | 223.5 | 2.5% | 5.3% | 212.4 | 2.3% | 4.8% | Reduced by KM 30 million in 2003 with transfer of functions to State. Reductions of 5% per annum in nominal allocations in subsequent years consistent with downsizing of defence forces |
| Public Order & Safety | 340.6 | 4.5% | 8.4% | 331.8 | 4.2% | 8.2% | 330.0 | 4.0% | 8.0% | 330.0 | 3.8% | 7.8% | 330.0 | 3.5% | 7.5% | Expenditure held at current levels consistent with implementation of efficiency measures. |
| **Community and Social Services** | **2,592.5** | **34.4%** | **63.9%** | **2,658.7** | **33.9%** | **65.6%** | **2,739.0** | **33.1%** | **66.7%** | **2,859.6** | **32.6%** | **67.5%** | **2,997.0** | **32.1%** | **68.3%** | |
| Education | 511.4 | 6.8% | 12.6% | 486.2 | 6.2% | 12.0% | 490.0 | 5.9% | 11.9% | 502.3 | 5.7% | 11.9% | 523.6 | 5.6% | 11.9% | No increase in allocations in 2004. Thereafter increased by 2.5% p.a to offset restructuring costs. Funding of higher education is likely to be shifted to Federation Budget from 2005. |
| Health | 516.5 | 6.9% | 12.7% | 551.5 | 7.0% | 13.6% | 564.5 | 6.8% | 13.7% | 593.7 | 6.8% | 14.0% | 624.9 | 6.7% | 14.2% | Spending allocations driven by growth in health insurance revenues. Allocations to public health programmes financed from Federation and Canton Budgets increase by 5% annually in real terms. |
| Social Security and Welfare | 1,425.6 | 18.9% | 35.2% | 1,459.5 | 18.6% | 36.0% | 1,514.7 | 18.3% | 36.9% | 1,585.1 | 18.0% | 37.4% | 1,660.1 | 17.8% | 37.8% | Social fund spending matched to revenues. Budgetary spending: (i) transfers to persons increase by 5% p.a. to finance poverty-oriented social assistance (including child allowance); (ii) veterans benefits held at current nominal levels; (iii) other budgetary spending increases with inflation. |
| *of which budgetary expenditure* | *664.3* | | | *645.2* | | | *671.5* | | | *699.1* | | | *728.4* | | | |
| Housing and Community Amenities | 94.1 | 1.2% | 2.3% | 111.1 | 1.4% | 2.7% | 118.5 | 1.4% | 2.9% | 126.6 | 1.4% | 3.0% | 135.4 | 1.4% | 3.1% | Allocations increase by 5% annually in real terms to meet requirements for investment in urban infrastructure and housing arising from urban migration and returnees. |
| Culture, Recreation and Religion | 45.0 | 0.6% | 1.1% | 50.4 | 0.6% | 1.2% | 51.2 | 0.6% | 1.2% | 52.0 | 0.6% | 1.2% | 53.0 | 0.6% | 1.2% | Increased for inflation |
| **Economic Services** | **315.7** | **4.2%** | **7.8%** | **332.0** | **4.2%** | **8.2%** | **327.8** | **4.0%** | **8.0%** | **346.6** | **3.9%** | **8.2%** | **374.8** | **4.0%** | **8.5%** | |
| Fuel and Energy | 54.0 | 0.7% | 1.3% | 54.1 | 0.7% | 1.3% | | | | | | | | | | Some increase in agriculture sector spending and domestically financed investment, particularly in transport and energy infrastructure. Further increases in spending would depend on additional donor funding in response to the launching of the Development Strategy. |
| Agriculture, Forestry and Fishing | 26.4 | 0.4% | 0.7% | 28.7 | 0.4% | 0.7% | | | | | | | | | | |
| Mining and Mineral Resources | 21.0 | 0.3% | 0.5% | 23.2 | 0.3% | 0.6% | | | | | | | | | | |
| Transportation and Communication | 163.6 | 2.2% | 4.0% | 171.7 | 2.2% | 4.2% | | | | | | | | | | |
| Other Economic Affairs and Services | 50.7 | 0.7% | 1.3% | 54.2 | 0.7% | 1.3% | | | | | | | | | | |
| **Other Expenditures** | **34.4** | **0.5%** | **0.8%** | **91.1** | **1.2%** | **2.2%** | **100.0** | **1.2%** | **2.4%** | **100.0** | **1.1%** | **2.4%** | **100.0** | **1.1%** | **2.3%** | |
| **Total Expenditure** | **4,055.6** | **53.9%** | **100.0%** | **4,054.0** | **51.7%** | **100.0%** | **4,107.1** | **49.6%** | **100.0%** | **4,234.7** | **48.2%** | **100.0%** | **4,389.2** | **47.0%** | **100.0%** | |
| Memorandum Item: GDP (KM million) | 7,531.0 | | | 7,846.6 | | | 8,286.0 | | | 8,783.1 | | | 9,345.2 | | | |

# Attachment 1

## Consolidated Fiscal Table

| | KM million | | | | | |
|---|---|---|---|---|---|---|
| | **2001 Actual** | **2002 Actual** | **2003 Rev Est.** | **2004 Proj.** | **2005 Proj.** | **2006 Proj.** |
| **Total Reveue and Grants** | **3,446.8** | **3,760.3** | **3,898.4** | **4,074.2** | **4,271.5** | **4,491.9** |
| **Total Revenues** | **3,430.5** | **3,748.4** | **3,873.7** | **4,046.2** | **4,243.5** | **4,463.9** |
| **Tax Revenues** | **1,844.2** | **2,018.2** | **2,077.0** | **2,156.2** | **2,249.9** | **2,359.2** |
| Customs Duties | 474.3 | 516.2 | 485.6 | 446.5 | 401.2 | 360.4 |
| Excises | 431.5 | 450.7 | 461.8 | 495.2 | 543.7 | 597.8 |
| Sales Tax on Excisables | 157.5 | 199.9 | 220.4 | 256.0 | 291.6 | 325.7 |
| Sales Tax on Non-Excisables | 508.0 | 585.5 | 614.7 | 649.2 | 687.8 | 731.8 |
| Profit Tax | 68.9 | 40.2 | 58.9 | 62.2 | 65.9 | 70.1 |
| Wage Tax | 126.6 | 136.4 | 142.3 | 149.2 | 156.7 | 164.8 |
| Other Taxes | 77.4 | 89.4 | 93.3 | 97.9 | 103.0 | 108.6 |
| **Non-Tax Revenues** | **338.8** | **385.5** | **375.6** | **399.3** | **426.7** | **456.3** |
| Fees, Fines & Penalties | 118.2 | 149.0 | 130.0 | 140.4 | 151.5 | 163.6 |
| Receipts of Budget Beneficiaries | 50.4 | 73.9 | 75.0 | 80.0 | 87.4 | 95.8 |
| Other Non-Tax Revenues | 170.2 | 162.6 | 170.6 | 179.0 | 187.8 | 197.0 |
| **Social Fund Revenues (excluding transfers)** | **1,138.2** | **1,241.9** | **1,312.2** | **1,375.8** | **1,445.4** | **1,520.0** |
| Health Insurance Fund Contributions + Other | 416.8 | 495.1 | 507.9 | 532.5 | 559.5 | 588.4 |
| Pension Fund Contributions + Other | 658.3 | 691.7 | 726.5 | 761.7 | 800.2 | 841.5 |
| Employment Fund Contributions + Other | 55.1 | 55.1 | 77.8 | 81.6 | 85.7 | 90.1 |
| Other (education, science, culture, sports) | 8.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Off-Budget Funds** | **109.3** | **102.9** | **108.9** | **114.9** | **121.4** | **128.3** |
| **Grants** | **16.3** | **11.9** | **24.7** | **28.0** | **28.0** | **28.0** |
| External Budget Support Grants | 16.3 | 11.9 | 24.7 | 28.0 | 28.0 | 28.0 |
| **Total Expenditure** | **3,947.6** | **4,173.9** | **4,205.4** | **4,332.3** | **4,454.7** | **4,614.2** |
| **Federation Budget(1)** | **1,032.1** | **1,146.4** | **1,077.3** | **1,091.6** | **1,119.0** | **1,158.5** |
| Transfers to the State | 125.6 | 149.8 | 151.4 | 225.2 | 219.9 | 225.0 |
| *For State Operations(2)* | *50.2* | *51.7* | *78.0* | *147.2* | *149.8* | *152.6* |
| *Interest* | *75.4* | *98.1* | *73.4* | *78.0* | *70.2* | *72.5* |
| Discretionary Expenditure | 906.5 | 1,028.1 | 925.9 | 866.3 | 899.1 | 933.5 |
| Net Lending | | -31.4 | | | | |
| **Canton and Municipal Budgetary Expenditure** | **1,340.7** | **1,425.6** | **1,432.9** | **1,483.9** | **1,578.5** | **1,662.4** |
| Cantons | 1,053.4 | 1,121.3 | 1,114.7 | | | |
| Municipalities | 287.2 | 304.3 | 318.2 | | | |
| **Externally Financed Projects** | **359.7** | **253.9** | **254.4** | **266.5** | **191.5** | **147.0** |
| **Social Fund Expenditures** | **1,140.7** | **1,248.8** | **1,331.7** | **1,375.8** | **1,445.4** | **1,520.0** |
| Health Insurance Fund | 418.6 | 487.5 | 517.4 | 532.5 | 559.5 | 588.4 |
| Pension Fund | 698.0 | 689.7 | 736.5 | 761.7 | 800.2 | 841.5 |
| Employment Fund | 24.0 | 71.6 | 77.8 | 81.6 | 85.7 | 90.1 |
| Other (education, science, culture, sports) | | | | 0.0 | 0.0 | 0.0 |
| **Off-Budget Funds** | **74.5** | **99.1** | **109.1** | **114.5** | **120.2** | **126.2** |
| **Budget Balance** | **-500.9** | **-413.6** | **-307.0** | **-258.1** | **-183.2** | **-122.3** |
| **Financing** | **500.9** | **413.6** | **307.0** | **258.1** | **183.2** | **122.3** |
| **External Financing** | **420.0** | **350.0** | **267.8** | **258.5** | **184.4** | **124.4** |
| External Budget Support Credits | 91.5 | 142.7 | 124.3 | 98.0 | 86.0 | 74.0 |
| External Project Financing | 359.7 | 253.9 | 254.4 | 266.5 | 191.5 | 147.0 |
| Amortisation Payments (Transfer to State) | -31.2 | -46.7 | -110.9 | -106.0 | -93.2 | -96.6 |
| **Domestic Financing** | **80.9** | **63.6** | **39.1** | **-0.4** | **-1.2** | **-2.1** |
| Domestic Borrowing/From Reserves/Arrears | 84.6 | 23.5 | 79.1 | -0.4 | -1.2 | -2.1 |
| Use of Succession Funds (net) | -3.7 | 43.0 | -40.0 | | | |
| Other Borrowing (net) | | -2.9 | | | | |
| Memo Item: Projected Revenues: Federation | | | 1,068.9 | 1,070.9 | 1,082.8 | 1,105.6 |
| Projected Revenues: Cantons+ Municipalities | | | 1,383.7 | 1,484.6 | 1,593.8 | 1,709.9 |

Notes:

(1) Excludes transfers to social funds, cantons and munciipalities and amortisation payments.

(2) In 2004 this is increased to reflect transfer of customs administraiton (KM 28 million), Intelligence Service (KM 10 million) and Ministry of Defence and Army Joint Headquarters (KM 30 million).

**Consolidated Fiscal Table (continued)**

| | % of GDP | | | | | |
|---|---|---|---|---|---|---|
| | **2001 Actual** | **2002 Actual** | **2003 Rev Est.** | **2004 Proj.** | **2005 Proj.** | **2006 Proj.** |
| **Total Reveue and Grants** | **47.7%** | **49.9%** | **49.3%** | **48.8%** | **48.3%** | **47.7%** |
| **Total Revenues** | **47.5%** | **49.8%** | **49.0%** | **48.5%** | **47.9%** | **47.4%** |
| **Tax Revenues** | **25.5%** | **26.8%** | **26.3%** | **25.8%** | **25.4%** | **25.1%** |
| Customs Duties | 6.6% | 6.9% | 6.1% | 5.3% | 4.5% | 3.8% |
| Excises | 6.0% | 6.0% | 5.8% | 5.9% | 6.1% | 6.3% |
| Sales Tax on Excisables | 2.2% | 2.7% | 2.8% | 3.1% | 3.3% | 3.5% |
| Sales Tax on Non-Excisables | 7.0% | 7.8% | 7.8% | 7.8% | 7.8% | 7.8% |
| Profit Tax | 1.0% | 0.5% | 0.7% | 0.7% | 0.7% | 0.7% |
| Wage Tax | 1.8% | 1.8% | 1.8% | 1.8% | 1.8% | 1.8% |
| Other Taxes | 1.1% | 1.2% | 1.2% | 1.2% | 1.2% | 1.2% |
| **Non-Tax Revenues** | **4.7%** | **5.1%** | **4.8%** | **4.8%** | **4.8%** | **4.8%** |
| Fees, Fines & Penalties | 1.6% | 2.0% | 1.6% | 1.7% | 1.7% | 1.7% |
| Receipts of Budget Beneficiaries | 0.7% | 1.0% | 0.9% | 1.0% | 1.0% | 1.0% |
| Other Non-Tax Revenues | 2.4% | 2.2% | 2.2% | 2.1% | 2.1% | 2.1% |
| **Social Fund Revenues** | **15.8%** | **16.5%** | **16.6%** | **16.5%** | **16.3%** | **16.1%** |
| Health Insurance Fund Contributions | 5.8% | 6.6% | 6.4% | 6.4% | 6.3% | 6.2% |
| Pension Fund Contributions | 9.1% | 9.2% | 9.2% | 9.1% | 9.0% | 8.9% |
| Employment Fund Contributions | 0.8% | 0.7% | 1.0% | 1.0% | 1.0% | 1.0% |
| Other (education, science, culture, sports) | 0.1% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| **Off-Budget Funds** | **1.5%** | **1.4%** | **1.4%** | **1.4%** | **1.4%** | **1.4%** |
| **Grants** | **0.2%** | **0.2%** | **0.3%** | **0.3%** | **0.3%** | **0.3%** |
| External Budget Support Grants | 0.2% | 0.2% | 0.3% | 0.3% | 0.3% | 0.3% |
| **Total Expenditure** | **54.6%** | **55.4%** | **53.2%** | **51.9%** | **50.3%** | **49.0%** |
| **Federation Budget[1]** | **14.3%** | **15.2%** | **13.6%** | **13.3%** | **13.0%** | **12.7%** |
| Transfers to the State | 1.7% | 2.0% | 1.9% | 2.7% | 2.5% | 2.4% |
| *For State Operations* | *0.7%* | *0.7%* | *1.0%* | *1.8%* | *1.7%* | *1.6%* |
| *Interest* | *1.0%* | *1.3%* | *0.9%* | *0.9%* | *0.8%* | *0.8%* |
| Discretionary Expenditure | 12.5% | 13.7% | 11.7% | 10.6% | 10.5% | 10.3% |
| Net Lending | 0.0% | -0.4% | 0.0% | 0.0% | 0.0% | 0.0% |
| **Canton and Municipal Budgetary Expenditure** | **18.6%** | **18.9%** | **18.1%** | **17.6%** | **17.5%** | **17.2%** |
| Cantons | 14.6% | 14.9% | 14.1% | 0.0% | 0.0% | 0.0% |
| Municipalities | 4.0% | 4.0% | 4.0% | 0.0% | 0.0% | 0.0% |
| **Externally Financed Projects** | **5.0%** | **3.4%** | **3.2%** | **3.2%** | **2.2%** | **1.6%** |
| **Social Fund Expenditures** | **15.8%** | **16.6%** | **16.8%** | **16.5%** | **16.3%** | **16.1%** |
| Health Insurance Fund | 5.8% | 6.5% | 6.5% | 6.4% | 6.3% | 6.2% |
| Pension Fund | 9.7% | 9.2% | 9.3% | 9.1% | 9.0% | 8.9% |
| Employment Fund | 0.3% | 1.0% | 1.0% | 1.0% | 1.0% | 1.0% |
| Other (education, science, culture, sports) | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| **Off-Budget Funds** | **1.0%** | **1.3%** | **1.4%** | **1.4%** | **1.4%** | **1.3%** |
| **Budget Balance** | **-6.9%** | **-5.5%** | **-3.9%** | **-3.1%** | **-2.1%** | **-1.3%** |
| **Financing** | **6.9%** | **5.5%** | **3.9%** | **3.1%** | **2.1%** | **1.3%** |
| **External Financing** | **5.8%** | **4.6%** | **3.4%** | **3.1%** | **2.1%** | **1.3%** |
| External Budget Support Credits | 1.3% | 1.9% | 1.6% | 1.2% | 1.0% | 0.8% |
| External Project Financing | 5.0% | 3.4% | 3.2% | 3.2% | 2.2% | 1.6% |
| Amortisation Payments (Transfer to State) | -0.4% | -0.6% | -1.4% | -1.3% | -1.1% | -1.0% |
| **Domestic Financing (Net)** | **1.1%** | **0.8%** | **0.5%** | **0.0%** | **0.0%** | **0.0%** |
| ESCROW Account and Cantons (Net) | -0.1% | 0.6% | -0.5% | 0.0% | 0.0% | 0.0% |
| Other transactions | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Domestic Borrowing/From Reserves | 1.2% | 0.3% | 1.0% | 0.0% | 0.0% | 0.0% |
| Memorandum Item: GDP (KM million) | 7,224.1 | 7,531.0 | 7,907.0 | 8,349.8 | 8,850.8 | 9,417.2 |

# Attachment 2

## Sector Reform Priorities and Implications for MTEF Resource Allocations

| Function | Analysis of Existing Resource Allocations | Priority Reform Measures Identified | Implications for MTEF Resource Allocations |
|---|---|---|---|
| **A. General Government Servi ces** | | | |
| **A1. General Public Services** | ▪ Expenditure in 2002:<br>◊ KM 387 million<br>◊ 9.5% of total expenditure.<br>◊ 5.1% of GDP.<br>▪ Fragmented administrative structure results in very high costs of public administration and public services (including other sectors).<br>▪ Efficiency of public service relatively low, political appointments to senior positions, many staff lack appropriate training and skills, difficulties in recruiting and retaining key professional skills.<br>▪ Despite high levels of expenditure, the quality of public services are often unsatisfactory and associated with unnecessary bureaucracy.<br>▪ Incomplete and unreliable information makes planning of public administration reform difficult. | ▪ Goal of achieving through public administration reform a more policy responsive, merit-based, efficient and transparent public service.<br>▪ Establishment of basis for planning and managing reform of the public services:<br>◊ research into key areas of public service operation and development information systems,<br>◊ assessment of future size of public service with objective of progressively bringing it into line with European norms;<br>◊ development of civil service legislation covering Federation and Canton administrations and updating of regulations covering other public service cadres.<br>▪ Implementation of public finance reform measures including:<br>◊ deepening of treasury reforms;<br>◊ introduction of VAT with collection at State level;<br>◊ strengthened tax administration within Federation,<br>◊ formation of State Customs and VAT collection services.<br>▪ Reform and strengthening of public administration management across all public services covering:<br>◊ recruitment and appointment procedures;<br>◊ terms and conditions of service;<br>◊ job descriptions and staff appraisal,<br>◊ development and implementation of human resources and training plans for all major public services.<br>▪ Implementation of measures for downsizing of public administr-ation, focusing initially on those sectors where levels of staffing are excessive by international standards. | ▪ During 2004-06 no increase in total wagebill expenditure (across all sectors) in nominal terms will be permitted. Total wagebill spending projected to fall from 15.8% of GDP in 2002 to 12.3% of GDP in 2006.<br>▪ Cost of pay reform measures linked to implem-entation of reform civil service and other public services will have to be met from savings arising from reduction in the number of public service employees.<br>▪ MTEF projections assume target reduction of at least 5% annually in total number of public service personnel between 2002 and 2006. Costs of redundancy payments will have to be met from within annual wagebill ceiling.<br>▪ Downsizing of public service will result in increase demands on pension fund, employment fund and in certain cases social assistance expenditures.<br>▪ Establishment of State Customs and VAT collection services will result in transfer of functions and personnel to State Administration, but with some savings in costs through more efficient structures.<br>▪ Within Federation and Canton budgets additional resources will be required to support staff training and development activities. |

| Function | Analysis of Existing Resource Allocations | Priority Reform Measures Identified | Implications for MTEF Resource Allocations |
|---|---|---|---|
| **A2. Defence** | ▪ Expenditure in 2002:<br>◊ KM 385 million<br>◊ 9.5% of total expenditure.<br>◊ 5.1% of GDP.<br>▪ Spending on defence is around twice average in CEE countries.<br>▪ Spending excessively concentrated on personnel which accounts for around 80% of total defence spending.<br>▪ Programme of staff reductions initiated with the size of the army reduced by 7,000 in 2002. | ▪ BiH Defence Reform Commission established to develop basis for further reform of defence structures with eventual aim of joining NATO PFP programme. Commission due to report by October 2003.<br>▪ Further rationalisation and mutual reduction in size of the military planned. Armed forces to be cut by up to a further 7,000 personnel from 2004.<br>▪ Identification and disposal of unnecessary property/assets to reduce maintenance and administration expenses and finance redundancy programme. | ▪ Ministry of Defence and army joint headquarters functions expected to be transferred to State from 2004 involving estimated transfer of KM 30 million to State Budget.<br>▪ FBiH spending on defence projected to fall to 2.3% of GDP by 2006.<br>▪ Savings in staff costs and associated operations and maintenance costs.<br>▪ Short-term cost impact of redundancy measures to be felt in 2004. |
| **A3. Justice, Law and Order** | ▪ Expenditure in 2002:<br>◊ KM 341 million<br>◊ 8.4% of total expenditure.<br>◊ 4.5% of GDP.<br>▪ Spending on public order – around twice average for CEE countries and 4 times average for EU countries. Employment substantially above pre-war levels and still increasing with evidence that demobilised soldiers are finding employment in the law and order services.<br>▪ Recent measures to strengthen and establish an independent judiciary have resulted in substantial increase in spending on judiciary. | ▪ Development of plan for gradual reduction/rationalisation in public spending linked to measures to increase efficiency:<br>◊ immediate priority is to halt increase in staff numbers employed in law and order services;<br>◊ as situation further normalises, need to bring employment in law and order sector more into line with other CEE countries;<br>◊ identify and eliminate unnecessary property/assets to reduce maintenance and administration expenses.<br>▪ Further reforms are expected in the judiciary (what specific further measures are proposed). | ▪ Spending on justice, law and order projected to fall to 3.5% of GDP by 2006.<br>▪ Scope for saving in public order spending linked to size of staff reductions and costs of redundancy programmes.<br>▪ Streamlining of local court system will result in some cost savings. |
| **B. Community and Social Services** | | | |
| **B1. Education** | ▪ Expenditure in 2002:<br>◊ KM 511 million<br>◊ 12.6% of total expenditure.<br>◊ 6.8% of GDP.<br>▪ Living Standards Measurement Survey found that poverty was positively correlated to lack of education.<br>▪ Spending on education as share of GDP very high compared with other CEE countries. Fragmented education system results in high unit costs, inequitable provision, and poor outcomes. Unit costs in secondary and tertiary education are particularly high.<br>▪ Substantial geographical variations in spending levels per student contribute to significant variations in education outcomes.<br>▪ Outdated and inflexible systems which do not meet demands of a modern market economy:<br>◊ low enrolment rates, particularly in secondary education | ▪ Comprehensive review and restructuring of education system with objective of achieving greater efficiency and improved outcomes. Key requirements:<br>◊ reform education financing on basis of allocation of funding per student;<br>◊ greater independence to schools including in managing their own finances;<br>◊ Government to gradually take on responsibility for funding pre-school education;<br>◊ reduction in first year of primary education from age 7 to 6;<br>◊ reform of secondary education - increase in number of gymnasium schools;<br>◊ rationalisation of vocational training linking it better to labour market requirements;<br>◊ transfer of higher education from cantons to Federation government and consolidation of academic faculties within unitary universities; | ▪ High levels of spending and inefficiencies indicate that education spending should not be allowed to increase in real terms and that improvements should be sought through better use of existing resources. Spending on education projected to fall to 5.6% of GDP by 2006.<br>▪ Rationalise education system linked to measures to improve operational efficiency and ensure greater equity in education funding. Will require move away from input-based costing practices that entrench inefficiencies towards capitation-based funding mechanisms that can be linked to achievement of outputs and outcome targets.<br>▪ Transfer of higher education to Federation will result in reduction in Canton education spending of around KM 60-KM 70 million with corresponding increase in Federation spending. (Note: |

| Function | Analysis of Existing Resource Allocations | Priority Reform Measures Identified | Implications for MTEF Resource Allocations |
|---|---|---|---|
| | limiting future opportunities;<br>◊ curriculum ill-adapted to requirements of a market economy;<br>◊ inadequate arrangements for education and quality control;<br>◊ adult education particularly neglected;<br>◊ lack of reliable and comprehensive information on the operation of the education system. | ◊ quality to be improved through teacher training, improved career structures, curriculum reform and student testing.<br>▪ Implementation of reforms will require improvements in education sector planning and management and some further public investment.<br>▪ Research to be supported by tax exemptions. | this change is not reflected in the distribution of projected expenditures between the Federation as the arrangements and timing have still to be finalised)<br>▪ Encourage greater cost sharing/recovery, backed by more transparency cost-sharing arrangements.<br>▪ Reforms will involve significant staff reductions over medium-term. |
| **B2. Health** | ▪ Expenditure in 2002:<br>◊ KM 517 million<br>◊ 12.7% of total expenditure.<br>◊ 6.9% of GDP.<br>▪ Government health spending at 6.6% of GDP very high compared with other CEE countries. Health insurance contributions contribute significantly to tax burden.<br>▪ However, health revenues fall substantially short of financing requirements of legislated provision resulting in substantial private spending on health care – equivalent to 5% of GDP.<br>▪ Considerable inequalities in access to health care provision due to: (i) wide differences in per capita health insurance revenues among cantons; (ii) political and administrative barriers (particularly for returnees); (iii) high costs of health services; (iv) absence of guaranteed basic package of rights and services; (v) poor distribution of personnel, equipment and resources, and (vi) absence of operational control and monitoring of health care provision.<br>▪ Substantial overstaffing within health care system. Numbers of medical professionals under training substantially exceed demand. No properly organised system for continuing medical education and training.<br>▪ Clinical procedures outdated with an estimated that up to 30% of clinical procedures ineffective. Weak co-ordination among health care providers contributes to inefficiency. | ▪ Health reforms priorities to focus on:<br>◊ reducing regional differences in funding, access to and provision of quality health care;<br>◊ strengthening primary care through development of family medicine;<br>◊ introduction of standardised clinical procedures at secondary and tertiary levels.<br>▪ To be achieved through:<br>◊ creating state-wide body to co-ordinate health policy and agencies;<br>◊ updating and implementing Strategic Health Development Plan;<br>◊ reforming financing and management of health system to achieve equity and solidarity, requiring health information system.<br>◊ broadening of contributor base for health insurance;<br>◊ improvement of primary health care;<br>◊ rationalising hospital network and funding system to achieve greater efficiency in secondary and tertiary health services;<br>◊ revising and updating of health legislation;<br>◊ rationalising and reforming health and medical training system. | ▪ Spending projected to fall to 6.7% of GDP by 2006.<br>▪ Reform of health system to be financed through better use of existing resources. Priority requirements:<br>◊ increased investment and spending on primary health cares system (up to 40% of health expenditures);<br>◊ focusing resources on priority prevention and treatment programmes to improve health outcomes;<br>◊ savings in secondary and tertiary care though rationalisation of facilities and tighter costing of contracts with health providers;<br>◊ implementation of human resource development strategy to reduce excessive staffing levels, and rationalise training provision. |
| **B3. Social Welfare and Protection** | ▪ Expenditure in 2002:<br>◊ KM 1425 million<br>◊ 35.2% of total expenditure.<br>◊ 18.9% of GDP.<br>▪ Extensive welfare programmes have ensured that inequality is relatively low and poverty is not severe. However, social welfare programmes not well co-ordinated and targeted.<br>▪ Total public spending on social welfare and protection slightly higher than averages for CEE countries: | ▪ Development and implementation of a new unified legislation to provide for an affordable and sustainable level of veterans' benefits. Will lead to reduction in the number of beneficiaries in the lower categories, tighter eligibility and indexing of benefits to inflation.<br>▪ Reform of benefits for unemployment, social assistance, child and civilian victims of war to provide for consistency and an effective basic safety net: | ▪ Maintain social welfare and protection spending at around current share of expenditure. Spending projected to fall to 17.8% of GDP by 2006.<br>▪ Increase impact through better targeting:<br>◊ Pensions spending linked to contributions. No change in contribution rates have been assumed in the MTEF projections, although the scope for further reducing contribution rates will be |

| Function | Analysis of Existing Resource Allocations | Priority Reform Measures Identified | Implications for MTEF Resource Allocations |
|---|---|---|---|
| | ◊ Pensions expenditure accounts for around 50% of total sector spending. Recent reforms, including cash rationing of pensions, have improved financial sustainability of pension fund operations. Pensions now fully funded from contributions.<br>◊ Payment of veteran's benefits from Federation Budget account for a further 22% of sector spending (4% of GDP), with substantial canton and municipal expenditure also used to finance supplementary veterans' benefits. With total spending in excess of 5% of GDP, FBiH operates most generous veteran's programme in Europe.<br>◊ Employment programmes, financed from Employment Funds, represent 5% of sector spending. Question over efficiency and effectiveness of existing employment programmes funded by Employment Institutes which do not reflect best practice in the region. Lack of clarity in inter-governmental funding arrangements.<br>◊ Spending on poverty-oriented social and child protection programmes and on social services is the lowest in the region with no child benefits paid in recent years and minimal or intermittent social assistance payments from municipalities.<br>▪ Federal Law on Social Services has placed additional spending responsibilities on Cantons without corresponding adjustment in revenue assignment. Lack of clarity in assignment of responsibilities and resources for refugees and returnees. | ◊ civilian victims of war to have same rights as other handicapped persons;<br>◊ establishment of new database to reduce double claimants and improve access to benefits for displaced persons;<br>◊ local management of social assistance to be strengthened;<br>◊ community-based care and participation of NGOs in social services provision to be encouraged;<br>◊ development of operational manuals to promote uniform technical and service standards in social welfare system.<br>▪ Further strengthening of operation of pensions system involving:<br>◊ commitment to prompt payment of pensions and settlement of current arrears;<br>◊ better enforcement to ensure timely payment of contributions;<br>◊ establishment of co-operation between Entity pension systems;<br>◊ external auditing of pensions accounts.<br>▪ Rationalisation of veterans benefits programmes should reduce number of claimants.<br>▪ Development of employment services – SME start-up support, retraining and career advice schemes, tightening of unemployment reporting procedures to reduce abuse. | investigated.<br>◊ Spending on veterans' benefits to be held within current nominal allocations, pending agreement on implementation of reform measures.<br>◊ Allocations for social assistance and social services to be increased linked to reform of veterans' benefit programmes.<br>◊ Employment services to continue to be linked to Employment Fund revenues. Reforms to be introduced to ensure more effective use of these resources. |
| **B4. Housing and Community Affairs** | ▪ Expenditure in 2002:<br>◊ KM 94 million<br>◊ 2.3% of total expenditure.<br>◊ 1.2% of GDP.<br>▪ Accelerated pace of rural-urban migration has placed increasing strain on infrastructure in major urban centres.<br>▪ Around 50% of households connected to mains water supply. Deterioration in water supply infrastructure has led to severe problems in supply clean water for domestic use.<br>▪ Only seven towns had waste water purification plants, of which five still operational.<br>▪ Many water utilities operations not currently financially viable – leading to contingent demands on the Budget.<br>▪ Investment in recent years financed mainly from donor sources, such financing now falling sharply.<br>▪ Lack of well-coordinated and consistent mechanisms for channelling financing to municipalities for infrastructure investment.<br>▪ Weak financial management capacities in municipalities. | ▪ Establish integrated water management system supported by an efficient institutional structure and clear licensing rules.<br>▪ Major investment will be required in waster water treatment plants and sewerage systems – initial projects to be started in 2-3 urban areas.<br>▪ Major capital investment required in housing for displaced persons – estimated at KM 500 million for BiH as a whole.<br>▪ Strengthen management and viability of water utilities operations. | ▪ Expenditure projected to increase to 3.1% of GDP by 2006.<br>▪ Establish improved mechanisms for accessing private financing for housing sector – to avoid this placing further demands on Budget.<br>▪ Additional investment funding for water utilities and sewerage operations linked to implementation of management reforms to establish commercial viability.<br>▪ Investment financing for urban infrastructure linked to introduction of new financing mechanisms. |

| Function | Analysis of Existing Resource Allocations | Priority Reform Measures Identified | Implications for MTEF Resource Allocations |
|---|---|---|---|
| **C. Economic Services** | | | |
| **C1. Energy and Fuel** | ▪ Expenditure in 2002:<br>◊ KM 54 million<br>◊ 1.3% of total expenditure.<br>◊ 0.7% of GDP.<br>▪ Substantial support for reconstruction of the energy networks has been provided under the PRP – this funding is now diminishing rapidly.<br>▪ Energy prices low by international standards and do not cover all costs including environmental costs. | ▪ On-going restructuring of the sector to bring it into line with EU norms and standards, improve profitability, allow for privatisation and permit foreign direct investment. This will require:<br>◊ the development and implementation of adequate policy framework for the energy sector;<br>◊ strengthen institutional capacities, including establishment of regulatory bodies, for initiating market reforms and ensuring sound management or the energy sector;<br>◊ accelerating the restructuring of public energy companies to ensure transparency, accountability and the improvement of industrial, social and environmental performance;<br>◊ investment in improving the security and efficiency of energy networks and supplies.<br>▪ Reforms can be expected to result in increased energy prices. | ▪ To extent possible seek private capital investment in energy sector to reduce demands on limited public resources.<br>▪ Demands on budgetary funding will remain limited; priority areas include:<br>◊ limited temporary subsidies to smooth impact of and allow adjustment to higher energy costs.<br>◊ costs associated with establishment and operation of regulatory bodies.<br>◊ some further public investment in energy networks will be required pending privatisation. |
| **C2. Agriculture, Forestry and Fisheries** | ▪ Expenditure in 2002:<br>◊ KM 26 million<br>◊ 0.7% of total expenditure.<br>◊ 0.4% of GDP.<br>▪ Agriculture contributes around 7% of GDP. Substantial trade deficit in agricultural products.<br>▪ Agriculture is major employer, but suffers from outdated and disconnected structure and uncertainties over land ownership.<br>▪ Public expenditure on agriculture low by international standards.<br>▪ Some investment undertaken to improve legislative framework, strengthen technical support services and promote exports.<br>▪ Agricultural production subsidies and incentives are very limited and ad hoc. Their impact is uncertain.<br>▪ Extensive forests are major economic resource. However management has been inadequate and replanting neglected. | ▪ Improvement in agricultural education. Provision of incentives for scientific and applied research, promotion of co-operatives and agricultural associations. Strengthening of regulation – phyto-sanitary, agro-chemicals etc. Improvements to incentive structure and incentives for sector. Changes in foreign trade regime to match international protection levels.<br>▪ Strengthening of forestry inspectorates, establishment of forestry associations, privatisation of parastatal forestry enterprise. Development of forest inventory and monitoring system. | ▪ Limited scope for increasing financing in the sector – significant increases in agricultural subsidies would not be feasible nor conducive to economic efficiency.<br>▪ Some scope for further international assistance in developing agricultural support services.<br>▪ Investment in replanting of forests, forest roads, strengthening forest management, and promotion of new wood product activities ($20 million of international funding approved for BiH as a whole). |
| **C3. Industry and Manufacturing** | ▪ Industrial and manufacturing output is increasing, but sector still undergoing major structural reform with the decline of extractive and heavy industrial enterprises.<br>▪ Business environment continues to be adversely affected by excessive bureaucracy, corruption, and high level of taxation. | ▪ Continued support to businesses covering management, marketing, design and other areas. Government agencies will continue to seek foreign know-how and capital. Tax and customs concessions for investment. Creation of single economic space. Reductions in social contributions. Technical assistance to SMEs. Matching support for research and development. Incentives for establishing international company links. | ▪ Limited financing required for industrial promotion services.<br>▪ Tax breaks risk undermining fiscal stability and of limited impact compared to other measures to improve business environment. |

| Function | Analysis of Existing Resource Allocations | Priority Reform Measures Identified | Implications for MTEF Resource Allocations |
|---|---|---|---|
| **C4. Transport and Communications** | ▪ Expenditure in 2002:<br>◊ KM 164 million<br>◊ 4.0% of total expenditure.<br>◊ 2.2% of GDP.<br>▪ Substantial investment (over €250 million) made in reconstruction of roads and communication networks under PRP – funding now coming to an end.<br>▪ Road network requires further substantial investment in maintenance and upgrading.<br>▪ Only very limited rehabilitation of rail network has been undertaken to date.<br>▪ Fragmented responsibilities for transport network hinder effective development, maintenance and operation. | ▪ BiH Public Road Corporation to be established to co-ordinate investment in and maintenance of road network. Federation has responsibility for primary road network, Cantons for regional roads.<br>▪ Future investment in rail networks should be linked to master plan for establishment of economic viable rail system. Separation of rail infrastructure from operations in accordance with EU directives.<br>▪ Privatisation of telecommunications networks in medium-term. | ▪ Investment requirements estimated as follows (estimated at two-thirds of BiH total):<br>◊ road network – KM 470 million to 2006;<br>◊ rail network – KM 340 million to 2020;<br>◊ civil aviation infrastructure – KM 80 million to 2006;<br>◊ inland waterways – KM 19 million to 2006.<br>▪ Limited financing requires prioritisation of investments against technical and economic feasibility.<br>▪ Investment and maintenance of road networks to be financed from fuel levies and vehicle licences supplemented by international sources.<br>▪ External investment support to be sought for rail network (EIB and EBRD).<br>▪ BOT financing being sought for upgrading of international road corridors to reduce demands on public financing sources. |