Report No. 24297-BIH

Bosnia and Herzegovina
From Aid Dependency to Fiscal Self-Reliance
A Public Expenditure and Institutional Review

October 2002

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

CURRENCY AND EQUIVALENT UNITS

Currency Unit =Konvertible Marka

US$ 1=KM 1.97
Euro 1=KM 1.95

FISCAL YEAR

January 1 to December 31

ACRONYMS AND ABBREVIATIONS

AG	Auditor General
BI	Budget Institutions
BIH	Bosnia and Herzegovina
CBA	Currency Board Arrangement
CEE	Central and Eastern Europe
CEIT	Community Information and Epidemiological Technologies
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Report
CSW	Centers for Social Work
DPA	Dayton Peace Agreement
DR	Debt-to-GDP-Ratio
EBF	Extra Budgetary Funds
FDI	Foreign Direct Investment
FHIF	Federation Heath Insurance Fund
FIAS	Foreign Investment Advisory Services
GDP	Gross Domestic Product
GFS	Government Finance Statistics
MoF	Ministry of Finance
MoH	Ministry of Health
MoHSW	Ministry of Health and Social Welfare
MTEF	Medium Term Expenditure Framework
NPV	Net Present Value
O&M	Operations and Maintenance
OHR	Office of the High Representative
PEIR	Public Expenditure and Institutional Review
PEM	Public Expenditure Management
PHIF	Public Health Insurance Fund
RS	Republika Srpska
SFRY	Socialist Republic of Yugoslavia
SOTAC	Social Technical Assistance Project
SWCP	Social Welfare and Child Protection
TGL	Treasury General Ledger
W&S	Wages and Salaries

Vice President:	Johannes Linn (ECAVP)
Country Director:	Christiaan J. Poortman (ECC04)
Sector Director:	Cheryl Gray (ECSPE)
Sector Manager:	Kyle Peters (ECSPE)
Task Team Leader:	Sebnem Akkaya (ECSPE)

ACKNOWLEDGEMENTS

This Public Expenditure and Institutional Review (PEIR) is based on the findings of several missions that visited Bosnia and Herzegovina throughout 2002. The PEIR was undertaken jointly with Bosnia and Herzegovina's Country Financial Accountability Assessment (CFAA) and Country Procurement Assessment Report (CPAR), and it integrates findings of all three studies concerning public expenditure policy and institutional frameworks.

The PEIR was prepared by Sebnem Akkaya (team leader) with the support of a team of World Bank staff and consultants as well as various ministries and agencies of Bosnia and Herzegovina. The World Bank staff and consultants who contributed to the report include: Marcelo Bisogno (consolidation of fiscal accounts and expenditure diagnostic), Peter Darvas (education sector), Alma Kanani (budget management), Shaun O. Moss (CPAR, public procurement), Joao Oliveria (intergovernmental fiscal relations), Philip O'Keefe and Kendra Gregson (veterans' programs and social welfare), Robert Palacios (pensions), Rossana Polastri (macro/fiscal sustainability analysis), Verdon Staines (health sector), Roberto Tarallo (CFAA, public financial accountability systems). Additional contributions were received from Nicholas R. Burnett (education), Gordon Evans (public administration apparatus), William F. Fox (tax structures), Luc Laeven (financial relations between budget and public enterprises and banks), and Bernd Spahn (municipal finance). Irina Smirnov has provided very valuable support from the field during the preparation process. Zeljka Njuhovic has provided very efficient support for the organization of the mission work and translations. Armanda Çarçani has undertaken outstanding work in processing this report.

The PEIR team is indebted to the many government officials and agencies that provided key inputs and invaluable help throughout the preparation process, particularly those in the State Ministry of Foreign Trade and Economic Relations; State Ministry of Treasury; Central Bank of Bosnia and Herzegovina; Entity Ministries of Finance, Education and Health; Entity Aid Coordination Offices; Entity Pension Funds, Entity Health Funds, Entity Privatization Agencies; State and Entity Supreme Audit Institutions; State and Entity Statistical Offices, Cantonal Ministries of Finance, Education and Health, particularly in Sarajevo, Herzegovina-Neretva, Una-Sana, Central Bosnia, Tuzla and Herzeg-Bosnia Cantons; Union Bank and Central Bank, Profit Bank, Sarajevo Gas, PTT, Enorgoinvest, Elektroprivreda in the Federation; Kristal Bank and Elektrojina, UNIS Adrija, Integral Inzenjering, Vodovod, ZitoProduct, BINIS in Republika Srpska; and several municipalities in both Entities. The team also benefited from discussions with various international organizations, particularly, IMF, OHR, USAID, US Treasury, OSCE, DFID (Civil Service College), SIDA, GTZ, and EC-CAFAO.

The report was prepared under the sponsorship of Christiaan Poortman (Country Director and Regional Coordinator for South East Europe), and Kyle Peters (Sector Manager), who provided inputs into the design and analysis contained in the report. The report also benefited from comments received from colleagues within the Bank during different stages of production, particularly Armin Fidler, Betty Hanan, Neil S. Gray, John Hegarty, Joseph Ingram, Nedim Jaganjac, Maureen A. Lewis, Alister Moon, Helga Muller and Siew Chai Ting. The peer reviewers were Armando Araujo, Paul Bermingham, David Shand, and Anand Rajaram.

TABLE OF CONTENTS

ACKNOWLEDGEMENTS
EXECUTIVE SUMMARY.....i

INTRODUCTION 1

I. MACROECONOMIC AND FISCAL FRAMEWORK.....2
A.Bosnia and Herzegovina's Decentralized Governance Structure.....2
The Evolving Governance Framework: From Dayton to the Present.....2
Toward an Efficient and Integrated Governance Structure.....5
B.Macroeconomic Setting.....9
The War and its Aftermath.....9
Macroeconomic Outlook and Prospects.....11
C.Fiscal Picture and Sustainability.....15
Fiscal Outlook: A Snapshot View.....15
An Evaluation of the Size of the Public Sector.....21
Sustainability of Fiscal Deficits.....24

II. A DIAGNOSTIC OVERVIEW OF PUBLIC SECTOR EXPENDITURES.....28
A.An Integrated Approach to Public Expenditure Analysis in BiH.....28
B.Composition of Public Expenditures and Reform Prospects.....32
The Economic Composition of General Government Expenditure.....32
Goods and Services: Wages and Salaries versus Non-Wage O&M.....35
Subsidies.....41
Transfers.....42
Capital Spending.....46
The Functional Composition of General Government Expenditures.....47
Defense and Public Order and Safety.....49
Pension.....52

III. FISCAL DECENTRALIZATION AND SUB-NATIONAL EXPENDITURES.....59
A.The Division of Fiscal Responsibilities Among BiH's Multi-Tiered Governments.....59
Sub-National Fiscal Administration Structure.....59
Revenue Assignments.....60
Expenditure Assignments.....62
B.The Composition of Sub-Entity Public Expenditures.....65
Economic Composition of Sub-Entity Expenditures.....65
Functional Composition of Sub-Entity Expenditures.....67
C.How Well Balanced are the Present Intergovernmental Fiscal Finances?.....69
Vertical Fiscal Balances.....69
Horizontal Fiscal Balances.....70
Addressing Fiscal Imbalances.....73
D.Principles for Improvements and Policy Direction.....74
Addressing the Design and the Implementation of Proper Fiscal Decentralization.....74
Rationalizing and Prioritizing Expenditures.....76
Strengthening the Vertical and Horizontal Coordination of Fiscal Policies at the Central Level.....77

IV. SOCIAL SERVICE SPENDING, OUTCOMES AND REFORM OPTIONS.....78
A.Social Welfare and Child Protection..... 78
Institutional and Policy Context..... 79
Beneficiaries and Delivery Systems..... 80
Financing and Expenditures 82
Recommendations 86
B.Education 87
Institutional and Policy Context..... 88
Delivery Systems and Policies..... 89
Financing and Expenditures 91
Education Outcomes and Quality..... 97
Recommendations 98
C.Health 99
Institutional and Policy Context..... 99
Delivery Systems and Policies.....101
Financing and Expenditures 102
Health Outcomes and Quality.....106
Recommendations 111

V. PUBLIC EXPENDITURE FRAMEWORK: INSTITUTIONAL DIMENSIONS..... 113
A.Introduction.....113
B.Budget Planning Process and Legal Framework.....114
C.Towards Making the Budget an Effective Policy Tool.....121
D.Improving Budget Execution Through Treasury System.....124
E.Streamlining Public Financial Accountability.....128
Financial Controls in the Budget Processes.....128
Public Sector Accounting and Reporting.....130
Public Sector Audit 132
Public Procurement.....138
F.Medium-term Reform Priorities.....142

Tables

Table 1.1 BiH - Administrative Structure 2
Table 1.2 BiH - Division of Responsibilities 2
Table 1.3 Key Economic Indicators, 1990-2001 11
Table 1.4 Consolidated General Government Balances, 1999-2000 18
Table 1.5 Evolution of General Government Spending: European Transition Economies 22
Table 1.6 Consolidated General Government Fiscal Deficit, 2000 25
Table 1.7 Required Primary Deficit Reduction, BiH 27
Table 1.8 Required Primary Deficit, Federation 27
Table 1.9 Required Primary Deficit, Republika Srpska 27
Table 2.1 Summary General Government Accounts By Level of Government 31
Table 2.2 Economic Composition of Consolidated General Government Accounts, 1990-2000 33
Table 2.3 Economic Composition of Consolid. General Gov. Revenues and Exp. in BiH and CEECs 34
Table 2.4 Share of Public Employment to Total Employment 36
Table 2.5 Spending on Veterans' and Family Benefits, 1998-2001 43
Table 2.6 Functional Composition of Consolidated Government Expenditures 2000 48
Table 2.7 Primary Expen. of the Consolidated Central Govern. by Function in Europe 1999-00 48
Table 2.8 Defense Expenditures, 2000 49
Table 2.9 Main indicators of pension system operating in BiH, 2001 53
Table 2.10 Federation Pension Indicators, 1991-2001 53
Table 2.11 Pension systems in Former SFRY Republics 57
Table 3.1 Sub-National Public Expenditures, 2000 60
Table 3.2 Entity Revenues, 2000 60
Table 3.3 Entity Expenditures, 2000 65
Table 3.4 Functional Composition of Federation Expenditures, 2000 68
Table 3.5 RS-Disparities in Local Revenue Capacity and Tax Collection 72
Table 3.6 Per Capita Outlay - Selected Municipalities 73
Table 4.1 Social Welfare Staff in CSWs: BiH and Former SFRY Republics, latest year 82
Table 4.2 Federation Cantonal Expenditures for Social Welfare, 1999-first half 2000 83
Table 4.3 Federation Cantonal Child Protection Spending, 1999-2000 84
Table 4.4 Social Welfare & Child Protection Spending in RS, 1999-2000 85
Table 4.5 Public Primary Schools, BiH, 1996-2001 90
Table 4.6 Estimated Net Enrollment Rates, 2001 90
Table 4.7 Public Secondary Schools, BiH, 1996-2000 90
Table 4.8 Higher Education Institutions and Enrollments, 2001 91
Table 4.9 Public Spending per Student by Level of Education 94
Table 4.10 Share of Salaries in Total Entity Spending, 1999-2000 94
Table 4.11 Student-Teacher Ratios by Level of Education, 1998 95
Table 4.12 Tracing Higher Education Students, Federation, 1999-2001 95
Table 4.13 Education Expenditure by Cantons, Federation, 2000 96
Table 4.14 Public Spending Per Student by Level of Education – Selected Cantons and RS, 2001 96
Table 4.15 Public Spen. per Primary Student as a Share of Public Spend. per Secondary Stud., 2001 96
Table 4.16 Percent Shares of Different Education Levels in Public Spending, 1997-2000 97
Table 4.17 Health Sector - Revenues and Expenditure, BiH, 1997-99 103
Table 4.18 Federation - Health Revenues and Expenditures, 1999 104
Table 4.19 Actual and Required Health Insurance Contribution Revenues in the Federation, 2000-01 105
Table 4.20 RS - Health Revenues and Expenditures, 1999 105
Table 5.1 Public Procurement Spending in BiH, 2000 140

Boxes

Box 1.1 Comparative Analysis of BiH's Sub-National Government Expenditures 3
Box 1.2 What Does the Definition of "State" in BiH Corresponds to in a Federal Government Context? 5
Box 1.3 Merits of Greater State Role in the BiH Economy: a Selective Analysis 6
Box 1.4 Examples of Fiscal Coordination Mechanisms in other Federal Governments 8
Box 1.5 BiH's Donor Assistance Program..... 9
Box 1.6 A Summary of Economic and Structural Reforms, 1996-2001 10
Box 1.7 Features of Present Economic Outlook 12
Box 1.8 Improving Export Capacity 14
Box 1.9 Improving Investment Efficiency 14
Box 1.10 Fiscal Risks and Vulnerabilities: A Qualitative Assessment 23
Box 1.11 The Parameters of the Fiscal Sustainability Analysis 26
Box 2.1 An Illustrative Consolidated General Government Budget Framework for BiH 29
Box 2.2 Present Initiatives for Reform of Civil Service Legislation 39
Box 2.3 Diagnostic Survey of Corruption in BiH: Selective Indicators for the Public Sector Institutions 40
Box 2.4 The Beneficiary Composition of the BiH's Veteran's Program: Main Weaknesses 44
Box 2.5 Key Elements of Pension Reforms in BiH, 1998–2001 55
Box 3.1 Overlapping Responsibilities Across Governments: The Case with Settlement of Refuges and the Displaced..... 63
Box 3.2 Subsidiarity Principle in Brief..... 64
Box 4.1 Main Social Welfare and Child Protection Programs in BiH 79
Box 4.2 How Are School Budgets Determined in BiH?..... 92
Box 4.3 Constitutional Description of Functional Assignments in the Federation's Health Sector 100
Box 4.4 Flow of Funds within Health Sector in BiH 102
Box 4.5 Main Features of Private Payments for Health in BiH.....104
Box 4.6 Perceived Quality of Care in BiH Health Care Systems 108
Box 4.7 Designing Health Care Policies for Competitive Market Economies.....110
Box 5.1 Off-budget Resources: The Case of Privatization Receipts.....117
Box 5.2 Main Steps in Budget Process.....118
Box 5.3 Medium-Term Expenditure Framework and Budgeting Cycle 122
Box 5.4 Budget Execution Prior to the Closure of the Payment Bureaus.....125
Box 5.5 Transitory Arrangements for the Treasury System.....126
Box 5.6 The Structure of the Supreme Audit Institutions in BiH 135
Box 5.7 External Audit Legislation - Provisions in Need of Strengthening 137
Box 5.8 Measures of Corruption in Public Procurement in BiH 138

Graphs

Graph 1.1 BiH: Expenditure by Sub-National Governments 3
Graph 1.2 Federation BiH: Comparative Intermediate Government Expenditures 3
Graph 1.3 Consumer Price Indices..... 13
Graph 1.4 General Government's Size, Actual Versus Predicted..... 24
Graph 1.5 General Government's Size, Actual Versus Predicted, BiH vs. CEECs..... 24
Graph 2.1 Public Sector Spending in Wages and Salaries (latest available data)..... 35
Graph 2.2 General Civilian Government Employment 36
Graph 2.3 Ratio of Public Sector Wages to Manufacturing and Financial Sector Wages..... 37
Graph 3.1 Federation Municipalities: Proportion of Displaced Persons 64
Graph 3.2 Republika Srpska Municipalities: Proportion of Displaced Persons 64
Graph 3.3 Total Per Capita Revenue Across Cantons, 1999-2000 71
Graph 3.4 Municipal Revenues by Canton in the Federation, 2000 71

Graph 3.5 Per Capita Budgetary Expenditures Across Cantons, 1999-2000 73
Graph 3.6 Per Capita Budgetary Expenditure - Disparities Across Cantons, Functional Composition, 1999-2000 73
Graph 4.1 Comparative Social Welfare and Child Protection Spending..... 78
Graph 4.2 Consolidated General Government Expenditures on Education, Comparative Analysis 94
Graph 4.3 General Budget Expenditure per Student, Relative to Per Capita GDP, 1999..... 94
Graph 4.4 General Secondary Students as a Percent of all Secondary Students across Cantons, 2001.... 96

Annexes

Annex I A Standard Framework for Fiscal Sustainability 144
Annex II Tax Structure and Assignment/Sharing System in BiH 146
Annex III Expenditure Assignments in BiH 147
Annex IV Summary of Procurement Risks Factors and Recommended Actions.....148

EXECUTIVE SUMMARY

Bosnia and Herzegovina (BiH) has made significant strides in nation building and economic transformation against a backdrop of devastating war. The combination of large-scale donor assistance, sound economic policies, and the initiation of structural reforms has yielded tangible results in reconstruction and economic recovery. BiH has also begun slowly integrating both internally and into the world economy. Nevertheless, despite BiH's impressive record of macroeconomic stability, the staggered pace of reforms, particularly in areas critical to the supply side of the economy (notably, the harmonization and reform of tax structures, the labor and financial market reforms, and the regulatory reforms benefiting the investment climate), have kept the economy too dependent on aid flows and overly dominated by the public sector.

With much of the post-war reconstruction well under way, a continuing decline in the magnitude and concessionality of donor assistance is inevitable. In addition, progress in policy reforms, instead of emergency reconstruction and reform needs, is increasingly determining the size of foreign assistance. In the period ahead, BiH needs to make considerable adjustment in the external current account and the fiscal account. Along with reducing the reliance on external financing, adjustments are needed to shift the origins of the external imbalance from public investment to private sector activities. Clearly, a more vibrant and outward-oriented private sector is becoming increasingly critical to maintaining the momentum of growth as well as the economy's access to large but diversified inflows of external capital. Equally important are adjustments to public non-reconstruction expenditures, which are currently not only too high and too pro-administrative, but are also highly inefficient in allocative terms and in terms of cost-effectiveness. Furthermore, additional pressures, coming from the budgetary costs of large scale, military downsizing and privatization, domestic arrears clearance programs, social programs and institution/capacity building needs, are likely in the period ahead.

BiH's peculiar governance structure and evolving policy and institutional setting compound the challenges of this medium-term adjustment agenda. If the adjustment process is not well coordinated, well focused on development needs, and kept within financial constraints, it could aggravate present fiscal fragilities, diminish growth prospects, and undermine BiH's hard-won gains in political stability. This report is aimed at helping the authorities identify the priority fiscal policy and institutional issues and reform options on which the medium-term adjustment agenda will need to focus. The main messages are:

- A weak internal drive for harmonization and coordination is hampering the nation building and efficiency benefits of decentralization—the underlying reasons for BiH's extremely decentralized federal system—by translating into fragmentation. The costs, both economic and social are enormous, because fragmentation is discouraging foreign investment and labor mobility; increasing business costs; denying equitable access to services; hindering the efficient use of public resources; and impeding the operation of basic public control and accountability mechanisms. Equally important, it is inducing policy paralysis.
- The present size and scope of public spending is well beyond the levels that can be sustained with BiH's future resource availability and if the transition objective of private sector-led growth is to be achieved. Actual fiscal deficits are out of line with financeable debt-output ratios and reasonable macroeconomic targets over the medium term. A significant fiscal adjustment is required.
- The design and implementation of proper fiscal decentralization is also central to BiH's fiscal adjustment in the medium term. The present sources of vertical and horizontal fiscal imbalances, overlapping responsibilities across governments, and inefficient mechanisms for financing and delivering services with geographic spillovers are not only significantly increasing fiscal pressures, but are also leading to poor outcomes, especially in social service delivery.
- The continued reform of budget management and financial acountabity systems is essential to meet the requirements of strategic planning and prioritization of fiscal operations across competing demands, as well as fiscal discipline and the efficient delivery of public services—capacities all critical to establishing a sound strategy for fiscal adjustment and reform.

MAIN FINDINGS AND RECOMMENDATIONS

Macroeconomic and Fiscal Stance

Driven by generous aid flows and facilitated by overall macroeconomic stability, BiH's post-war economic revival has been impressive compared with that of other post-conflict economies. Initial strong real growth rates of 86 percent in 1996 and 40 percent in 1997 underpinned this success, with growth decelerating to about 6 percent per annum during 2000-01 and to an estimated 5 percent in 2002. The still strong, but rapidly fading, growth performance reflects decelerating aid flows as reconstruction efforts mature. It also reflects the economy's continued dependence on aid flows with authorities only recently accelerating reforms that would maintain growth momentum by enabling the private sector to grow at a faster rate.

Reconstruction efforts in the early years were reflected in the pace of growth in externally financed imports on the external account, and were mirored in the growing public investments in the fiscal account. As the reconstruction phase winds down, concurrent improvements in both the external and internal imbalances have begun, albeit owing primarily to the phasing out of donor financed reconstruction expenditures. Nevertheless, these adjustments alone will not be sufficient to ensure medium-term fiscal sustainability and the viability of external payments.

This is because ***not only reconstruction spending, but also non-reconstruction spending, has expanded significantly.*** The latter was financed with domestically generated revenues which recovered in parallel with the economic recovery. Over time, a major portion of the non-reconstruction budget (over 60 percent by 2000) has increasingly been allocated to two categories only: wages and transfers, with transfers to war invalids absorbing most of the latter. This picture reflects the fiscal fragility to which BiH is increasingly exposed. Besides the rigid wages and social transfers, the difficult challenges in dealing with excessive military spending, and the gradually increasing, though comfortable, debt service spending, leave little room for maneuver as the growth of available resources normalizes. Moreover, a greater portion of domestically generated revenues will need to be reallocated to finance public investments in the period ahead as donor resources shift away from reconstruction financing.

Tax revenues recovered rapidly but the tax burden is still too high, reforms are far from complete, and collection capacity is fragile. After an initial strong rebound, the growth rate of tax revenues slowed down over time owing to progressive tax reforms, which broadly reduced rates on major taxes, and a slowdown in economic growth. Failure to effectively address the high rate of tax evasion and the fraud practices originating during the war has also delayed gains from the revenue-enhancing aspects of the tax reforms (e.g., from efforts to broaden the tax base). BiH's consolidated general government tax revenues diminished to 38 percent of GDP in 2000, with the tax revenues of the two Entities comprising nearly equivalent shares of their respective GDP. *These ratios, however, still leave BiH one of the highest-taxed economies in Central and Eastern Europe (CEE). The tax burden is crowding-out the development of the private sector, informalizing the economy, and facilitating generalized tax evasion.*

While the last three years have seen a major move toward establishing a modern tax system, much remains to be done to further simplify tax structures, to further rationalize tax rates, and to introduce major improvements in tax collection and compliance. These reforms will, however, be taking place at the very time that BiH needs to rely increasingly on its domestic revenue capacity. Therefore, while a further reduction in BiH's very high tax burden is desirable over time, it will be critical to avoid sharp reductions and fluctuations in revenue collection, which has been the immediate consequence of tax reforms to date. This becomes all the more critical to smoothing the medium term fiscal adjustment burden, given that the resource cushion provided by external inflows to date will be diminishing in the period ahead.

Additional pressures on expenditures are likely in the period ahead. There are three major pressure points: first, the extraordinary level of donor assistance is phasing out; second, much needed tax reforms rule out any compensation for this decline through raising the tax burden over and above its present highs; and third, additional pressures on public spending are rising rapidly, even in the short run. Chief among these spending pressures are: (i) pressures at the State level as its role evolves in line with the improving economic integration both within

the country and with the EU; (ii) frozen foreign exchange deposit claims from the pre-war/war era, which, once the proper modality is designed, will begin to be paid back regularly; (iii) domestic liabilities and claims originating from past payment delays to civil servants, veterans and their families, and pensioners; (iv) the accelerated return of refugees and their demand for services such as health care, education, and physical infrastructure; (v) military demobilization; and (vi) the unavoidable costs of downsizing public sector operations, whether through public administration or large-scale privatization, which is lagging behind.

The Entity's fiscal position is also exposed to explicit risks arising from contingent liabilities as well as from deferred deficits—particularly of local governments—that remain outside the budget. Although not quantifiable, these risks originate mainly from three sources: (i) the financing modalities of Entity/sub-Entity-owned enterprises—which design and implement their own expenditure and investment programs with no formal government control/oversight—involving borrowing, often with guarantees, from the commercial banks that Entities/sub-Entities either own or control; (ii) the operation of public utilities with severe resource constraints and unsustainable pricing policies; and (iii) the present, often implicit, subsidization policies for social assistance to households or for operational support to ailing enterprises.

External inflows remain the primary but not the only source of deficit financing with recourse to arrears. Under the Currency Board arrangement and with conservative fiscal policies, which prevent domestic government borrowing, external grants and loan aid remain the only *formal* means of deficit financing in BiH. Nevertheless, *recurrent payment delays—in wages, transfers, pensions, and payments to suppliers and between extrabudgetary funds—have been another instrument that both Entities and their local governments have relied on to maintain expenditure expansion in response to resource constraints and, occasionally, for short-term liquidity management.* With pension reforms in late 2000, and with increased commitment to controlling public outlays in 2001, financial discipline and transparency have been improved. Nevertheless, containing wage pressures still remain a problem and payment delays appear to remain in place at the local government level, where fiscal oversight is difficult to practice at present. The gradual extension of the newly established Treasury systems to local government will be an important step to improve overall financial discipline in the period ahead.

Debt repayments are comfortable despite reliance on external financing as a main source of deficit financing, but avoiding future pressures will require a well-designed fiscal sustainability strategy. Foreign assistance to date, with a grant component of 73 percent, has provided the bulk of the financing of public sector deficits. Therefore, despite large imbalances, deficits have not been translated into higher debt-to-GDP ratios and debt service has remained at comfortable levels. Nevertheless, in the two-to-three year period ahead, BiH's debt service burden will be on an increasing path as principal payments have started falling due in late 2001. Moreover, over the last three years there has been a continued shift in donor assistance away from purely capital transfers toward concessional credits, a pattern that can be expected to continue in the future as the focus of donor assistance shifts from reconstruction to structural reforms. The volume of concessional lending available to BiH has also started diminishing. *These factors certainly aggravate the present fiscal fragility and make a well-planned fiscal sustainability strategy all the more urgent*.

Fiscal adjustments to date remain forced and ad hoc rather than strategically planned. Despite ongoing efforts to integrate them, the virtual separation of recurrent and capital budgets in BiH, the weak planning capacity, and the painfully fragmented present resource management practices make it difficult to strategically plan and initiate the required expenditure adjustments before they are forced. The sustainability of the economic recovery process requires that both recurrent and investment spending decisions be made strategically with a medium-term vision of development needs and the public sector's role in the economy. *The State and the Entity governments are jointly establishing these principles in their economic development strategy. However, for these principles to be effectively applied, the strategy would need to be translated into a monitorable implementation plan within a medium-term macroeconomic framework.*

The present level of public expenditures as a share of GDP is excessive by most norms and is not sustainable in the medium term. Despite a significant post-war decline to date, compared with

the predicted size of the public sector justified with the structural parameters of the BiH economy (46 percent of GDP), the actual size of the general government (62 percent of GDP in 2000) is excessive in BiH—respective Entity ratios are predicted on the order of 46 percent of GDP in the Federation (15 points lower than the 2000 level) and 48 percent of GDP in the Republika Srpska (12 points lower than the 2000 level). *While providing a measurable benchmark rather than defining an exact future size of the public sector in BiH, these results point to the substantial need for rationalizing public spending in BiH. The adjustment process will be made easier if the economy is recovering rapidly, thereby creating more room to maneuver, because public expenditure can rise in nominal terms even when its share in GDP is to be reduced.*

While fiscal stability has been maintained to date, thanks to donor support and conservative fiscal policies, a significant fiscal adjustment is required in order to consolidate macroeconomic stability under the Currency Board arrangement. The actual fiscal (primary) deficit, at over 9 percent of GDP, is far out of line with the requirements of "financeable" debt-output ratios in the medium term. Our estimations show that, at best, a primary deficit of 2.5 percent of GDP can be financed even under the favorable medium-term parameters of a "reform" scenario. A falling away from the "reform" scenario would clearly further increase the fiscal adjustment burden, as foreign inflows would be lower in size and less favorable in concessionality, forcing a higher fiscal adjustment. BiH's already high tax burden makes it clear that the bulk of the fiscal adjustment will need to be made in public expenditures.

Salient Features of Public Expenditures

Despite their different fiscal management structures and their different needs for, and background of, post-war reconstruction and recovery, there are no major differences between the present fiscal stances of the two Entities. Both Entities must address a similar set of issues in rationalizing their tax and expenditure policies. The benefits of joint policy design and harmonized implementation would have a significant payoff in containing the pressures that could result from the necessary reforms by facilitating economic integration.

This report has analyzed the expenditure structure of Entity and Sub-Entity governments with a view to illustrating the range of issues that the expenditure policy reforms will need to confront in the short to medium term. It should be noted that the intention is not to provide a fully detailed reform blueprint, which would require a thorough, comprehensive review of overall expenditure programs with a medium term vision—not an easy task in BiH with the present fragmented fiscal accounts. However, the analysis does seek to highlight reform options for selective expenditure categories and sectors that account for a significant portion of total public spending and/or are candidates for considerable improvement in equity and efficiency gains (wages and salaries, operations and maintenance, capital spending, defense, pensions, veterans' transfers, social assistance and child protection, health, and education). In this respect, the report provides guidelines for the kind of analysis that needs to be undertaken by all government units in order to achieve comprehensive reform of public finances in BiH.

Public sector spending on <u>wages and salaries</u> (W&S) is disproportionately high in BiH. It absorbs a significant portion of the Entities' GDP (about 20 percent in the Federation and about 15 percent in the RS) and their budgetary resources (about 30 percent of the Federation's on-budget resources and 35 percent of the RS's), with the shares being particularly disproportionate in the Federation. Similarly, W&S spending represents an extremely heavy burden on sub-Entity budgets (about 48 percent of total canton spending and 35 percent of total municipal spending in the Federation and 45 percent of total municipal spending in the RS).

All in all, the share of W&S in total public spending in BiH is twice as high as that in the CEECs on average. There are two important factors behind this outcome: (i) BiH has one of the largest shares of public sector employment in total employment compared to more developed economies, with the Federation's ratio being particularly disproportionate; (ii) public sector W&S levels are relatively high vis-à-vis the rest of the economy.

Rationalization of the W&S bill is, therefore, one of the BiH's first priorities. This, in turn, demands (i) restricting recruitment and compensation policies as well as civil service reforms within a comprehensive public administration reform agenda; (ii) controlling overall wage increases in the public sector and spillover effects on public enterprises' wages; and (iii) reducing public sector employment in areas where there is clearly overemployment, particularly in defense. The authorities are increasingly aware of these challenges and, as an initial step, have initiated a major reform and downsizing in the defense sector in 2002.

W&S spending is crowding-out operations and maintenance (O&M). Outlays for O&M seem to be the most compressed expenditure item in BiH. They are disproportionately low when compared with spending on W&S. BiH has the lowest ratio of non-wage to wage outlays among transition economies in the region: the ratio of W&S spending to non-W&S is 1.3 for the RS, and an outstanding 2.2 for the Federation relative to an average of just below 1.0 for the region. These figures reflect the situation in 2000 in BiH, the first post-war year when on-budget public spending was cut, with the reduction in O&M spending accounting for more than half of the overall reduction in both Entities. Since then, BiH's ratio appears to be deteriorating further as non-W&S spending is being further squeezed. The underfunding of non-wage O&M will result in inefficient use and underuse of capital investments and will further undermine the quality of service delivery in BiH. Clearly, striking a balance between spending on W&S and spending on O&M is another urgent priority in BiH.

Decentralized Operation of the Public Sector in the Federation Imposes Higher Costs. While disproportional spending on W&S is a problem in both Entities, the Federation displays a relatively more distorted picture than the RS. This is explained by higher employment levels in the Federation's public sector, both as a share of its total employment and as a share of its population relative to the RS. Problems of revenue shortfalls and overruns in the W&S bill are also translating into a significantly more repressed non-wage O&M spending in the Federation than in the RS. The Federation's extremely decentralized administrative structure, with its multiple ministries at the Federal and cantonal levels and its many duplicative functions, is the major factor contributing to this outcome. It is, thus, of the highest priority in both Entities, but particularly in the Federation, to streamline public administration.

In addition to its affordability, there is an urgent need for improving the public sector's effectiveness through administrative reforms. Expenditure policy reforms will generate adequate savings and bring lasting changes only if they are undertaken simultaneously with reforms to improve the efficiency and effectiveness of public administration. A well-functioning public administration plays a key role in implementing policies conducive to the long-term strategic objectives of the government. Establishing an effective public administration requires much more than a well-selected, properly trained, and fairly paid public sector labor force. It also requires a human resource base that operates with a clearly defined set of functions and responsibilities at each government level. But it is also important that policies are implemented smoothly within this structure, from a clear decision-making process that integrates well-articulated policy priorities with existing fiscal constraints. Good coordination among different government levels, in turn, is a critical element of smooth policy implementation.

Most of these building blocks for an effective public administration are absent in BiH. In the period ahead, the effectiveness and speed of the ongoing reform process depend on building a public administration with the necessary capacity, continuity, and incentive to undertake policy reforms. A number of factors will require special attention to ensure the effectiveness of the reform efforts in BiH:

First, a comprehensive survey/census of existing human resources in the public sector is essential to provide a basis for the design of the reforms as well as for the monitoring during the implementation phase. Second, public administration reform must be set/implemented within a State-coordinated strategy across all governments, based on a uniform set of principles consistent with EU standards, in order to avoid a series of ad hoc, disconnected initiatives which would only exacerbate the fragmentation in BiH. For this purpose, initial efforts to improve the civil service legislative framework will need to be integrated into a broader

public administration reform strategy and expanded urgently to cover the Federation, where the issues are most pressing and difficult and where about 70 percent of civil servants in BiH are employed. Third, the full and consistent support of the domestic leadership at all levels of government is critical to the sustainability of public administration reforms.

On-budget capital spending, at about 3.4 percent of GDP, is relatively low in BiH when compared with other countries in the region. However, at present this is more than compensated by donor-financed, off-budget spending of a public investment nature. Since 1999, donor-financed capital expenditures are gradually being phased out, with a notable decline in disbursements, which were nearly halved between 1999 and 2000. While it is early to draw conclusions on the emerging pattern, regrettably, on-budget (i.e., domestic) public sector investments in both Entities have also appeared to be on a declining path. Moreover, the available limited data suggest that sub-Entity governments in the Federation allocate half of their capital budget for "capital grants" and net lending, which essentially provide financing partly for loss-making enterprises and partly for municipalities and public utility companies (both cantonal and municipal). The participation of sub-Entity governments in these types of financing schemes creates a dependency of ailing enterprises and off-budget companies on budgetary resources and conveys the wrong signals for the maintenance of local infrastructure. Therefore, this participation should be minimized. In the period ahead, Entity and sub-Entity governments, in strong co-ordination, will need to reallocate a portion of their own-budget resources for contributing to domestically financed "direct" investments and for providing adequate counterpart funding to externally financed projects.

Equally important is introducing financial discipline into the management of the local utility companies through a utility tariff policy based on full cost recovery and complete separation of the costs of utility services from political influences/concerns related to the social condition of the population served. Consideration should also be given to the formation of associations of municipalities or of public-private partnerships to improve the efficiency of service delivery and to take advantage of economies of scale in the management and delivery of utility services (e.g., water and sewerage treatment, garbage collection).

The defense sector remains excessively large and expensive. The gradual downsizing taking place since the conclusion of DPA is not yet significant enough to align BiH's defense expenditures with European standards. Official budgetary allocations to defense are 4.4 percent of GDP (2000), more than twice as high as the average for the developed European countries and for the transition CEE countries in the region. When the sizable off-budget defense spending and arrears are included, BiH's defense spending increases to about 9 percent of GDP, almost equivalent to total spending on economic services (9.6 percent of GDP) and close to total spending on education and health services (14.1 percent of GDP). Clearly, the rationalization of defense spending along with a significant improvement in expenditure reporting and financial discipline remain urgent priorities if defense spending is to be brought down to 2 percent of GDP by 2005, the target-spending ratio set by the Joint Restructuring Steering Board.

It is equally important to align the internal spending structure of the sector with that in NATO member countries. Currently, about 70 percent of the Federation's defense spending and 85 percent of the RS's defense spending is allocated to W&S and related compensations. In contrast, NATO standards typically require that only about 40 percent of defense spending be allocated to W&S. This requires that the bulk of the defense cuts will have to be concentrated on reducing personnel costs, both in the Army and in the Ministry of Defense. As a general principle, downsizing should rely on severance pay and benefits rather than on special concessions for early retirement, as special concessions adversely affect pension payments and sustainability.

The Entity governments have already committed themselves to significant demobilization during 2002, which is being implemented. But, in addition, every effort should be made for the proper accounting of spending on both a cash and an accrual basis, and for the integration of defense resources and expenditures fully into the Entity budgets in order to restore transparency, accountability, and financial discipline to the sector. In the case of the Federation, success depends critically on the long overdue integration of the

Bosniac and the Croat components of the Army. Present arrangements are effectively doubling military spending and severely undermining transparency. Exemptions on the payroll contributions of the defense sector should also be eliminated, and indirect transfers/subsidies granted to the sector should be brought directly into the budget.

***Pension* reforms to date in both Entities, and the integration of the Federation pension system, conclude a difficult chapter in the post-conflict reform process, allowing both Entities to refocus their efforts on further improving financial discipline, transparency, and accountability in their pension systems.** This report takes stock of the major traditional pension reforms that both Entities have implemented and emphasizes their importance as steps toward (i) aligning benefit levels with the realities of future resources in the long term; and (ii) aligning BiH's pension system with that of its neighbors. But the reform element that was and still is most critical to short-term financial sustainability is the definition of the new indexation rule—it has the effect of (temporarily) compressing the distribution of pensions (except minimum) to balance the pension finances until such time as revenues are sufficient to provide the benefit levels as determined by the legal formula.

The design of the indexation formula was a response to a number of important factors that aggravate the war-caused fragility in pension finances in BiH, making it difficult to predict the pension resource flow and causing significant pension arrears. These factors include: (i) the tendency to promise high pension increases despite the tight resource envelope owing to the dramatically high ratio of pensioners to contributors; (ii) indirect income subsidization policies through significant contribution relief; (iii) the irregularity of contributions, which often mirrors irregular W&S payments across the economy; and (iv) contribution avoidance through underreporting of wages and the informalization of the economy.

In the medium term, the strength of the pension system in BiH depends critically on the continued economic growth, regularization and formalization of W&S payments and the expansion of formal sector employment combined with a slower rate of new pension awards. If these conditions can be ensured, the current indexation formula could then be revised so that pensions would maintain their real value through, say, price indexation. A number of measures would need to be taken in order to achieve this objective: (i) applying the indexation mechanism in accordance with the law; (ii) refraining from awarding pensions in place of severance benefits during the forthcoming restructuring and privatization of large enterprises and the demobilization of the military; (iii) refraining from providing payroll contribution exemption/relief as an implicit income transfer to civil servants and an implicit subsidy to financially unviable industries; and (iv) enforcing the existing financial planning and reporting rules for the Pension Funds.

In the short term, there also remains the challenge of ensuring that pensioners in the Brcko District are successfully integrated into the existing Entity schemes without further fragmenting BiH's pension system. Finally, in the medium to long term, there remains the challenge of fully harmonizing pension polices in BiH, and ensuring their portability, so that labor mobility is not hindered. Similarly, it should be borne in mind that, as in number of other countries in the region (e.g., Slovenia), the Entities' policy reforms to date could fall short of resolving long term sustainability *if the payroll contributions are to be reduced to reasonable levels*. Systemic reforms involving an increased role for private, funded pension schemes—such as those introduced in Poland and Hungary and more recently in Croatia and FRY Macedonia—could be considered in the future, as BiH's newly reformed pension system and its financial markets matures, to further contain replacement rates and to benefit from the merits of diversifying among retirement income sources.

BiH has one of the most extensive and generous veterans' entitlements across Europe and globally. Veterans' transfers constitute the single major social transfer channeled by the Entity budgets contributing not only to fiscal pressures but also to budget constraints for other social assistance programs. In both Entities, recorded budgetary transfers to veterans translate into significant spending in GDP terms, at around 3-4 percent of GDP. In addition, beneficiaries of the program receive significant indirect transfers, resulting in substantial forgone revenues from health contributions and co-payments, and tax and customs revenues, with the exemptions from the latter

subject to considerable abuse. It is clear that the generous benefits granted under the program—with the legislated entitlements far above available resources—are unsustainable and due to budget constraints in both Entities has lead to an increasing accumulation of arrears. This, coupled with the poor targeting rules of the system (the program is biased toward both family beneficiaries and veterans with lower categories of disability in both Entities) has resulted in a system that transfers a large level of benefits, but does not provide protection to its most vulnerable beneficiaries.

Restoring sustainability of the veterans' assistance programs requires urgently addressing wide-ranging issues on institutional dimensions, targeting, eligibility, and affordability. Key among the recommendations in the short-term are: (i) elimination of parallel benefit systems in each Entity and harmonization of the legal frameworks within and between the Entities (considering the return of former combatants from one Entity to the other); (ii) major simplification and rationalization of entitlements for all beneficiary categories to improve the targeting of the system along the lines described in detail in the report (see page 45); (iii) institutionalization of a recertification process for disabled veterans and survivor families; (iv) harmonization of identification criteria for disabled beneficiaries across the disability programs and across any survivor pension programs; (v) integration of data recording on veteran and family beneficiaries and expenditures under a single registry; (vi) reorganization of the transfer system to channel transfers directly from the Entity budget to the beneficiaries.

<u>The social welfare and child protection</u> (SWCP) system in BiH has increasingly been facing financial crisis with an as yet unfinished transition from humanitarian relief to a more coherent and sustainable system. In both Entities, but particularly in the Federation, the share of SWCP programs in GDP is low relative to neighboring transition countries. Although, in principle, basic legislated entitlements—mostly inherited from the former SFRY system—are similar across Entities, they have become irrelevant in many areas in the face of resource constraints. The report identifies two main issues: (i) only a small proportion of those registered actually receive benefits, with the majority eligible only for social services; and (ii) decentralized financing mechanisms allocate resources in inverse relation to the regional incidence of poverty, with only ad hoc protection for the most vulnerable in poorer areas. As a result, many areas in both Entities are effectively without a basic cash safety net for the poorest and most vulnerable—only as few as one-quarter of the severely poor may have been receiving cash benefits in recent years. Resource constraints have affected child protection programs particularly severely in the Federation, where many cantons terminated these programs.

The system is also characterized by unclear division of responsibilities across governments in each Entity, poor coordination between different benefit programs within the system, a high possibility of double dipping from multiple sources, and largely an ad hoc eligibility criteria, with local offices using their discretion in rationing the beneficiaries. The Centers for Social Work (CSW), which are by and large responsible for the implementation of social welfare programs, are hindered by: (i) a lack of common standards and regulations for the work of CSWs; (ii) little networking between CSWs, limiting the coherency of programs and the prevention of abuse in the system; (iii) limited access to programs for clients who are restricted to services provided by the municipality in which they live; (iv) lack of professional education or licensing programs; and (vi) lack of coordination with other social service providers in the same area.

More broadly, the institutional framework for SWCP in BiH also facilitates limited emphasis on social welfare and child protection. This is well examplified by the under-funding of SWCP (with the notable exception of child protection in the RS) which is in stark contrast to veterans' benefits—provided in nearly all cases regardless of income level and in amounts multiplying the level of spending on SWCP. Therefore, in addition to a more equitable allocation of the existing social welfare spending, improvements will require the reallocation of resources, particularly from veterans' programs. Given the political voice of veterans' groups relative to more marginalized and disbursed SWCP beneficiaries, this will be a difficult but critical challenge that both Entities will need to face if the authorities' poverty reduction commitments to address the needs of the most vulnerable are to be met.

This report reviews key SWCP programs and presents a range of possible policy and institutional reforms in the short to medium term. The key recommendations are: (i) redefinition of the institutional responsibilities of social protection on the basis of the planned functional reviews of social protection; (ii) legislation of a new Social Protection Strategy in both Entities with an emphasis on realistic core set of entitlements, with clearly identified financing sources including transfers from the "Entity" budget to finance one or more core "poverty benefits" equitably, across-Entities; (iii) increasing the amount of cash benefits and limiting the provision of social services; (iv) establishing a sound regulatory framework for the CSWs; (v) establishing a legislative and regulatory framework to guide the interactions of public and NGO institutions in the system; and (vi) improving the coverage and consistency of budget classification in social welfare, including through establishment of a "client database".

BiH's excessively fragmented education system is hardly functional, with its high unit costs, mounting arrears, poor outcomes, and highly inequitable service provision. BiH's education system reflects a mixture of standardized systems inherited from the former SFRY and an extremely decentralized policy and institutional framework established in the post-conflict era. This mixture results in a system that is (i) excessively expensive, with major weaknesses in efficiency, equity, and quality of output; (ii) unable to exploit positive externalities that services such as education create by increasing productivity and the quality of life for the country as a whole; and (iii) unable to play its facilitating role in BiH's economic transition process.

Overall, the share of education spending in GDP is significantly higher in BiH compared to spending in the CEECs and in EU countries (spending per student at every educational level is about twice as high as in Western Europe). Moreover, a disproportionately large share of budgetary allocations for education in both Entities is spent on W&S and only a residual amount is allocated to O&M spending, with the latter often absorbed by utility payments. Despite this, the education sector functions with significant wage arrears of between three and six months in the RS and in most of the cantons in the Federation.

Particularly outdated features of the system are (i) an input-driven budgeting system based on rigid specialized learning standards, which make the system expensive and provide no incentive to increase efficiency; and (ii) a curriculum and education structure that is focused on memorizing rather than on learning, especially at the secondary level. Similarly, higher (tertiary) education remains largely dominated by the public sector and operates in a supply-oriented mode, which is effectively divorced from the demands of the emerging new labor market.

The highly decentralized financing and provision of education result in wide disparities in per capita and per pupil education spending (and hence, education quality) across Entities and across cantons in the Federation, reflecting differences between economic development and fiscal capacities. Despite high spending, pre-school education is unavailable to the poor children who need it most to offset their relatively deprived backgrounds; access to academic secondary schools, and subsequently to tertiary education, is overall, much too limited and unequal. Overall, the present enrollment rates are dramatically low, except at the primary level, and the present system also remains weak in serving minorities, who are commonly segregated in separate schools or separate classrooms and are increasingly marginalized.

At the tertiary level, fragmentation results in a particularly inefficient system, creating wrong incentives for an expensive and inefficient higher education system, with each canton in the Federation tempted to create its own higher education institution. Moreover, there are no mechanisms at present for the mutual recognition of higher education degrees across different governments in BiH, nor are there transparent methods for students from one Entity or canton to enroll in higher institutions in another.

Comprehensive policy and institutional reforms, with a particular focus on reducing fragmentation is imperative in the short to medium term. Key reforms are: (i) establishing a federal expenditure equalization fund in the Federation to equalize spending per pupil, especially in primary education, and to equalize the central spending level per pupil in the RS; (ii) preventing further expansion of vocational secondary enrollments while encouraging the expansion of academic secondary

enrollments; (iii) replacing complex current formulas for determining school and university budgets with simpler formulas; and (iv) improving transparency and comprehensiveness in education and education finance data within a framework that would allow regular monitoring and consolidation of the data at the central level in both Entities.

Concerning specifically tertiary education (i) assigning tertiary education, ideally, to the State or, at minimum, to the Federal government in the Federation, although the longer-term objective should be creating an environment for gradually transferring tertiary education services fully to the private sector; (ii) introducing a transparent mechanism whereby attendance at universities is financed across cantons and across Entities; (iii) establishing a mutual recognition mechanism in higher education throughout the country through the new Higher Education Coordination Board; and (vi) linking higher education supply directly to demand and instituting a formal system of fees.

Compared to other social sectors, ongoing reform of the health sector is both broader and in a more advanced state, yet deeper reforms are needed to ensure the financial sustainability of the system and overcome prevailing weaknesses in the efficiency, equity, and quality of health services. Health spending in BiH—at 8 percent of GDP—is extremely high, more than triple the average for the developed European countries and double the level in transition CEECs. Public health revenues fall well short of financing all the legislated entitlements. This results in implicit rationing, with many people failing to receive the level of publicly provided care envisaged in the legislation. Increasingly, privately delivered care is closing the gap—currently, at least one-third of all care delivered. Indeed, once private spending on health is considered, total health spending in BiH becomes considerably higher (as high as 13 percent of GDP).

While privately delivered care is perceived as more efficient in BiH, it is less equitable, as it is available only to those with high incomes. This further exacerbates the present equity issues resulting from the fragmentation of the health system, particularly in the Federation, where each canton is responsible for organizing, managing, financing, and providing health care. Recent arrangements for Federal solidarity and the redistribution of funds for selected tertiary services hold out the hope that equity issues will be addressed more broadly over time, and at the State level and in the other social sectors.

In addition to fragmentation, BiH's expensive health sector reflects inefficient allocation of expenditures, clinically inefficient approaches to care, poor compliance in revenue collection, and weak systems of management for the sector as a whole. The current complicated input-based formula for payment to hospitals leads not only to high expenditures but also to arrears, albeit largely unrecorded.

Another contributing factor to financial fragility is that the intended sources of insurance contributions for socially and economically disadvantaged groups (e.g., intra-EBF and budgetary transfers) have proved unreliable and inadequate. Therefore, the public health insurance system is balanced precariously on a very narrow base of formal employment, which is mostly in the public sector. Information systems that are needed for the efficient functioning of the health system and for efficiency-enhancing improvements are also under-developed. Health insurance funds are still developing systems to track individual contribution histories and the care for which providers seek reimbursement.

While most available health indicators in BiH are acceptable for low-income countries, BiH's health sector, like others in Eastern Europe, under-emphasizes health promotion and disease prevention. The extreme fragmentation of the health delivery system in BiH, however, makes it much harder to effectively address this weakness. In the period ahead, the most important medium-term challenge is to reintegrate the system to better exploit economies of scale in the delivery, financing, and administration of health care.

This report provides an overview of reform actions that are needed to improve both financial sustainability and health outcomes over the medium term. Key recommendations are: (i) narrowing the public sector's role within the health system, focusing particularly on disease prevention; (ii) assigning, in the Federation, functions with positive externalities, especially primary care, to the Federal government; (iii) pursuing, at a minimum, broader coordination of goal-setting, policymaking, regulation, and management functions across the Entities through the State government; (iv)

introducing (in the Federation), or implementing (in the RS) hard budget constraints for health facilities and providers that have contracts with the health insurance funds; (v) introducing clear rules for the administration of private payments; (vi) rationalizing and optimizing the network of health facilities to reduce the system's fixed costs and to release resources for financing actual care for patients; (vii) coordinating health care and rationalizing facility capabilities across Entity borders, and, in the Federation, across cantonal borders; and (viii) strengthening procurement processes for equipment and materials.

Fiscal Decentralization Framework

A large sub-national share in expenditures requires an understanding of the present status and performance of BiH's unique system of intergovernmental fiscal relations—one of the subjects on which this report focuses. The main message of the report is that reforms in intergovernmental fiscal relations are essential if BiH's decentralized fiscal management structure is to enforce fiscal discipline, channel scarce public resources to development priorities, and ensure more equitable and efficient delivery of public services. These reforms need to address three critical challenges: (i) increasing the State's role in the economy as an integrative force and central authority; (ii) addressing the design and the implementation of proper fiscal decentralization; and (iii) strengthening the vertical and horizontal coordination of fiscal policies.

Increasing the State's role in the economy as an integrative force and central authority. Over the last five years, with the impetus of donors, major strides have been made toward establishing the State, equipped with the functions envisaged in the Dayton Peace Accords (DPA). The State's role as an economically viable central government that can guide and monitor the creation of a single economic area throughout BiH is only recently being explored under the rule of more liberal governments. In its present form, there are two major constraints to the State in effectively performing such a role: first, the State is accorded few of the powers normally associated with national governments under decentralized systems (e.g., defense, social welfare, fiscal equalization, debt management, and macroeconomic stabilization); second, the State has no adequate own-fiscal capacity for smoothly carrying out an expanded role.

The challenge in the period ahead is to eliminate these constraints within the DPA framework without increasing the public sector's role in the economy. The next several years will be especially critical to initiate the gradual integration of the BiH economy into EU structures. The experience to date clearly suggests that greater central government guidance will facilitate the coherent and timely meeting of these challenges. The establishment of effective budgetary and foreign aid/borrowing monitoring/co-ordination polices at the center will also facilitate donor coordination. Last but not least, greater State guidance in the reform process could help ensure that the benefits of the reforms are expanded to allow for a broad-based increase in living standards and to address equity issues.

Addressing the design and the implementation of proper fiscal decentralization. At present, the basic DPA-set fiscal management and legislature structures are in place. Nevertheless, despite the appearance of clear rules in revenue and expenditure assignments across BiH governments, a series of specific issues remains to be addressed to ensure the provision of minimum services across the BiH and to enhance the public sector's operational efficiency. These issues are:

(i) Eliminating overlapping responsibilities across governments. Social welfare, health and education services, and the settlement of refugees and displaced persons are areas in which different governments are assigned different aspects of the same service, often with no clear financing/coordination arrangements. This results in inconsistent service delivery, high overall administrative spending, confusion about the true size of public spending, and waste due to double-dipping by beneficiaries, particularly in social welfare spending. As emphasized by the sector reviews in this report, responsibilities (e.g., policy, regulation, financing and delivery) in these sectors need to be clearly defined, with service provision kept at the least cost level.

In this endeavor, the settlement of refugees and displaced persons requires urgent attention. A high percentage of displaced persons in the population of practically every municipality in both Entities represents a major, and sometimes unbearable, burden on local budgets, particularly for smaller municipalities with a low tax capacity. Although

municipalities should deliver these services—as they possess advantages in assessing local needs—the regulation, the financing, the monitoring, and the general coordination of such programs should be centralized, preferably at the State level, in order to provide uniform, minimum level, and good quality public services for this segment of the population.

(ii) Developing mechanisms to effectively finance and deliver services critical for productivity and poverty alleviation and services with positive externalities. Both Entities face the challenge of preventing the large differences in access to fiscal resources across sub-Entity governments from being translated into large differentials in the supply of public services. This is particularly important for those public services with major positive externalities to BiH and to the Entities as a whole, but which are broadly assigned to the Entities and Sub-Entities, respectively. Education, health and social welfare services clearly fall into this category and require particular attention, since they are important to productivity and poverty alleviation.

This report emphasizes that, at a minimum, policy decision and financing responsibilities for basic elements of these social services should be considered State and/or Entity functions/programs and should be assigned to a higher level of government (ideally, eventually to the State level). More specifically, these include (i) primary education; (ii) primary health care (including preventive treatment of contagious diseases, and a basic health package to the needy); and (iii) social assistance to the poor. In addition, tertiary education will need to be treated similarly, although the longer-term objective should be to create an environment for gradually allowing the private sector to assume a greater role in the provision and financing of tertiary education.

(iii) Identifying/addressing vertical and horizontal imbalances. The absence of adequate State own-source revenues and the wide differences in sub-Entity tax capacities create significant pressures for fiscal imbalances in BiH. In the period ahead, the present negotiated State finance system will need to be replaced with a system that will provide the State with an adequate share of BiH's tax revenues and, hence, with fiscal autonomy. Reducing wide fiscal disparities at the sub-Entity level, on the other hand, requires tools that will complement the tax allocation schemes, the only major domestic sub-Entity resource base at present. The two most effective such tools are equalization transfers and better targeting of budgetary grants, with the former often constituting a large share of sub-national government revenues around the world. A well-designed equalization transfer system could achieve vertical balance by passing additional revenues down to local governments; improving horizontal equity in access to public services; and accounting for externalities in service delivery.

It is also necessary to improve the potential of taxes and tax assignments in addressing fiscal imbalances. To this end, the reform agenda should encompass the following: (a) reconsidering the assignment rules for profit and wage taxes (which, at present, favor the residence of economic activity) to allocate them more evenly from the center and/or benefit from them for equalization transfers; (b) increasing the effectiveness of property taxes, especially as a robust revenue source for municipalities; (c) providing local authorities with some autonomy, at the margin, on "local own taxes"—e.g., by allowing local authorities to set the rates of their taxes (such as the property tax) within a bandwidth; and (d) assuring the predictability and reliability of sub-Entity revenues by requiring that changes in tax policy with implications for sub-Entity revenues only become effective at the beginning of a fiscal year.

Strengthening the vertical and horizontal coordination of fiscal policies at the central level. The establishment of central policy/implementation coordination and a negotiation platform between BiH governments is critical to the sustainability of the structural reform process, to effective economic integration, and to the robustness of the supply response. The objective should be establishing a sufficient degree of formal vertical co-ordination in BiH's bottom-heavy system which will ensure (i) limiting countervailing or contradictory legislation; (ii) improving the policy effectiveness and the pace of reforms; (iii) resolving conflicts; and (iv) ensuring the enforcement of greater accountability and transparency in fiscal management.

To this end, a State-coordinated effort would be instrumental in promoting a permanent dialogue and cooperation with the Entities. A *Standing Committee for Coordinating Fiscal Policies* could be set up at the ministerial level, comprised of the

State Minister of Foreign Trade and Economic Relations, the State Minister of Treasury and the Entities' Ministers of Finance, and some key line ministers of the Entities. This Committee, with the support of a Technical Secretariat, would propose, review, and monitor the fiscal policy framework. This committee should also have a leg in each Entity, so that similar coordinating bodies can ensure an integrated intra-Entity coordination/negotiation forum. Given the extent of its decentralization, it is advisable to have the coordinating body established as a secretariat in the Prime Minister's Office in the Federation.

Institutional Dimensions of the Public Expenditure Framework

Expenditure policy reforms do not guarantee the needed outcomes unless they are implemented within a framework of sound budgetary institutions and processes, and financial accountability mechanisms. Over the last six years, BiH has made significant progress in improving, inter alia, budget and foreign debt management frameworks as well as budget support and control systems through the operations of a Treasury and independent Supreme Audit Institutions (SAIs). The report's main message is that these reforms not only need to be aggressively enforced and implemented, but also broadened and deepened, if BiH's public expenditure management (PEM) and financial accountability systems are to help authorities meet the medium-term challenges of fiscal adjustment and reform. The crucial elements of the medium-term PEM reforms are discussed below.

Preparing a More Comprehensive Resource Framework. This report identifies a number of major systemic obstacles in preparing a comprehensive resource framework. These include (i) the separation between investment and recurrent budget planning; (ii) the disconnect between the budgetary management and the management of the EBF resources; (iii) the fragmented resource management that places little emphasis on consolidating externally financed expenditures and off-budget domestic resources, such as privatization receipts and off-budget earmarked resources. The total amount of identified resources that remain unaccounted for in the resource framework, both at the Entity and the sub-Entity level, is extremely large—equivalent to over 45 percent of total Federation resources and over 35 percent of total RS resources in 2000.

The integration of fiscal resources into the overall resource framework is, therefore, essential to the preparation of a realistic and effective budget in BiH. This would require (i) reorganizing the aid-management function in each Entity to ensure direct information flow to the Ministry of Finance (MoF) consistent with the budget process, (the objective should be integrating capital and recurrent spending into one budget); (ii) systematizing the timing of information collection from donors to make it compatible with the timing of the budget cycle; (iii) preparing an inventory of off-budget fiscal resources with a view to rationalizing and incorporating them into the budget, starting with fiscal year 2003 (these resources could still be directed to their original use, but they must be included in the budget submissions and subject to the same budget controls as other public fiscal resources); (iv) integrating privatization receipts under the budget of their final beneficiary. It should be borne in mind that, while they have a social security nature, BiH's EBFs do not lend themselves to integration into the budgetary framework, but their reporting should be improved by enforcing the requirements of the Organic Budget Law for better scrutiny.

Improving Budget Policy Coherence and Decision Making. The fiscal management framework is a key factor in effective and coherent budget policy and decision making, since it defines the way in which executive and legislative powers are exercised and decisions are taken with regard to economic/sector policies and resource allocations. BiH's fragmented fiscal management (with its multi-tiered independent executive and legislative powers) and its weak centers of government (with their limited capacity for promoting binding and sustainable budget decisions and policy outcomes) mean that achieving consensus and policy coherence is a difficult challenge.

Addressing these challenges calls for a two-pronged strategy. First, it requires establishing formal policy harmonization and coordination channels between the State and the Entities, between the Federation and its cantons, and within the cantons themselves. In turn, an effective consultation process would require facilitating tools (a consolidated fiscal framework, joint sector strategy

plans/implementation outcome reviews, etc). Second, it requires effective organizational arrangements and operating rules, and high quality support that will improve the policy formulation and review capacity at the center of government.

Improving the Effectiveness of the Budget as a Policy Tool. The effectiveness of the budget as a policy tool is determined by the ability of the budget process to discipline policy choices and to direct expenditure decisions toward policy priorities. For this purpose, the budget process will need a time frame consistent with those of the overall policy objectives, which have their full budgetary impact over time. This is all the more important in BiH, given that structural reforms are gaining increasing importance in BiH's economic development as the reconstruction phase comes to an end. Developing a medium-term fiscal perspective is also essential to the realism of the authorities' poverty reduction strategy.

Although their budget process and institutions were in the early stages of development, in early 1999 both Entities embarked on a challenging reform program aimed at achieving an integrated approach to budget preparation in the form of a medium-term expenditure framework (MTEF). These efforts involved (i) consolidating the foreign financed investments into the budgets; (ii) improving the linkage between the policy planning process and resource allocation; (iii) strengthening the economic policy and forecasting functions in the MoFs and the programming capacities within the line ministries; and (iv) improving intra-Entity coordination in budget planning.

The MTEF exercise met a number of its objectives. Most important, it raised the governments' awareness of the weaknesses in the present budget planning modality and made them aware of the kind of information, capacity-building and coordination requirements that are needed for a better policy focus in allocating budget resources. Nevertheless, a number of factors posed challenges to sustaining and further developing the exercise once the external technical assistance was scaled back in 2001. These factors included organizational and staffing constraints in the Entities; underdeveloped planning and programming capacities in the line ministries; and difficulties in ensuring a regular flow of external financing data to the MoFs. Challenges in maintaining reasonable coordination between the MoF and the line ministries, even at the same level of government, have also been considerable.

Continuing to address these weaknesses must be priority of the authorities in the near term. The report provides specific recommendations to this end. One of the crucial steps will be to enhance the Organic Budget Law and to increase reliance on by-laws, implementing regulations and operational guidelines for phasing in the requirements for a stronger link between policy and spending plans and of the medium-term fiscal framework.

Strengthening the Capacities for Budget and Sectoral Planning. In the context of the initial MTEF phase, both Entities have made efforts to establish capacities for macro-fiscal management in MoFs and, to a lesser extent, for policy and programming in line ministries. But these functions remain underdeveloped and largely understaffed. Moreover, the present fragmented fiscal management and reporting lines do not provide adequate fiscal data for reasonably comprehensive fiscal analysis/monitoring work to be carried out. If the State and the Entities are to take a more prominent role in developing macro-fiscal programs in BiH and in improving the predictability of their respective overall resource frameworks (and hence their budget performance) capacity building in fiscal management will need to be one of the priority tasks in the period ahead.

Improving Budget Execution through Treasury System. The institution of a computerized Treasury General Ledger (TGL) system both at the State and the Entity levels this year constitutes a major step toward increasing transparency and accountability in the budget execution and increasing the availability of timely and accurate information in the budget planning and decision making process.

As the authorities move forward, a number of issues will need to be addressed to reap the full benefits of a sound Treasury system. First, expansion of the system to the sub-Entity level should take account of the Entities' unique governing structures and should aim at facilitating a less fragmented fiscal monitoring system with unified standards for accounting and reporting. While the design of the broader Treasury system in the Republika Srpska can follow a more classical model of a unitary entity with a relatively centralized budget, the

design of the system in the Federation requires special attention to its ten fiscally autonomous cantons. Second, ensuring the efficient use of idle cash balances and improving the management of arrears requires the Treasury Single Accounts to be fully operational. Third, while the eventual coverage of the EBFs in the Treasury system is desirable, a phased approach will smooth out the process of increasing the coverage of the Treasury systems.

Streamlining Public Financial Accountability. The strength of the public expenditure management systems in maintaining aggregate fiscal discipline and in allocating resources efficiently depends, to an important extent, on how well the institutions for financial accountability function. Key elements of an effective financial accountability function (i.e., an adequate institutional framework and processes for budgeting, accounting, reporting, and auditing), as well as sound and transparent procurement rules, are either being developed or being introduced in BiH. BiH's country financial accountability (CFAA) and country procurement assessment (CPAR) studies have reviewed, jointly with this report, the present legal and institutional frameworks in financial management and accountability with a view to helping authorities define the priorities of the medium-term reform agenda. The main messages are as follows:

First, the budget monitoring and evaluation functions, which at present are narrowly focused on fiscal performance, need to be expanded to cover budget policies and programs. However, effective and broad monitoring and evaluation of this nature requires good quality fiscal data and regular and systematic reporting from authorized departments. While the computerized treasuries constitute a major step in this direction, their absence at the sub-Entity level requires special attention to improve sub-Entity fiscal data and reporting.

Second, an enabling environment for proper parliamentary budget oversight in BiH is another area needing attention. This would require establishing/empowering Parliamentary Public Accounts Committees (or Parliamentary Budget/Finance Committees) provided with a legislative budget oversight function at all key levels of government.

Third, BiH's new budget classification and chart of accounts need to be consolidated in a structured budget classification that, preferably, uses the functional, economic, and administrative categories that are compatible with the IMF's Government Finance Statistics. This would not only significantly improve policy analysis, but it will also allow close monitoring of the actual implementation of policy priorities. Both are critical, inter alia, for the effectiveness of fiscal management as well as for ongoing work on the preparation of the Poverty Reduction Strategy.

Fourth, despite the existence of a fairly clear and detailed framework for financial reporting—based on International Accounting Standards (IAS)—existing accounting practices do not actually follow the applicable accounting policies and procedures, and actual practices are not well documented. Reversing this practice would require strengthening the enforcement powers of standard-setting bodies, and phasing in the implementation of IAS-based accounting standards (which are clearly too demanding for the current capacity of BiH's public institutions) based on real needs.

Fifth, in parallel with the introduction of internal financial control functions as an integral element of the new Treasury system, adequate internal audit functions need to be systematically developed across government institutions in BiH. The objective should be to strengthen managerial accountability and controls, especially at the sub-Entity level, where establishing a Treasury system will take time. For reasons of capacity building and cost-effectiveness, this task should be seen as a sequenced, medium-term process, starting with the establishment of small, centralized, and highly professional internal audit departments within the MoFs (independent from the various departments and agencies; in other words, solely answerable to the Minister) at each Entity and the cantons, working across the various governmental institutions.

Sixth, beyond the continued need for capacity building in the SAIs, there is a need to institutionalize working relations and collaboration between SAIs and the respective Parliamentary Public Accounts Committees (as the latter become established) and between SAIs and bodies in charge of governmental internal audit functions. There is also a need to create a legal basis for permanent

legislative oversight of the SAIs, through the establishment of dedicated Parliamentary Audit Committees. In the near term, it is also necessary to complete the process of redefining those provisions of the State and the Entity audit legislation that are either diverted from the original uniform legal framework or defined vaguely during the process of their adoption. An equally important step is anchoring the institutional mandate of SAIs to the State and Entity Constitutions, as originally planned.

Seventh, there is an urgent need to overhaul the public procurement system, which is underdeveloped and which has weak legislative and institutional frameworks and a weak enforcement regime. Effectively dealing with these weaknesses demands (i) the adoption of new, harmonized procurement laws at the State and Entity levels, supported by a comprehensive set of harmonized implementing regulations; (ii) the establishment of dedicated procurement units within the State Ministry of Treasury, the Entity MoFs, and the cantonal MoFs with adequate enforcement powers; and (iii) the development of the necessary support systems, including a countrywide training strategy with a long-term outlook. Moreover, if these efforts are to effectively deal with the present weaknesses, they should take note of the actual practices that pose high risks to the principles of economy, efficiency, accountability, and open competition in public procurement, which are presented in this report. The commitment on the part of the authorities to embark on this process during 2002, with EU assistance, provides hope for rapid progress on this front, which would help reduce the cost of public services in BiH.

REFORM STRATEGY: POLICY SEQUENCING

Fiscal adjustment and continued institution-capacity building are at the top of BiH's economic reform agenda. This report concludes that neither BiH's future resource availabilities nor its objective of private sector-led growth are consistent with the present size and scope of the public sector. The report further concludes that a significant fiscal adjustment is required for medium-term sustainability—equivalent to 6.5 percent of GDP based on 2000 primary fiscal deficit. Such an adjustment would position BiH to reduce its reliance on external financing and help it shift the origins of the external imbalance from public investment to private sector activities. Equally important are inter-sectoral and intra-sectoral adjustments to public non-reconstruction expenditures, which are currently not only too high and too pro-administrative, but also highly inefficient, in allocative terms and in terms of cost-effectiveness.

BiH's extremely decentralized fiscal management structure aggravates the challenges of expenditure reform. The present sources of vertical and horizontal fiscal imbalances, overlapping responsibilities across governments, and inefficient mechanisms for financing and delivering services with geographic spillovers are not only significantly increasing fiscal pressures, but are also leading to poor outcomes, especially in social service delivery.

Needless to say, expenditure policy reforms will generate adequate savings and bring lasting changes only if they are implemented within a framework of sound budgetary institutions and processes, and financial accountability mechanisms, and if they are undertaken simultaneously with reforms that improve the efficiency and effectiveness of public administration.

Given its decentralized structure, a well functioning public administration in BiH requires much more than a well selected, properly trained, and fairly paid public sector labor force. First, it requires a human resource base that operates with a clearly defined set of functions and responsibilities at each government level. Second, it requires a clear decision-making process that integrates policy priorities with existing fiscal constraints. Hence, good coordination among different government levels is critical to smooth policy implementation. Otherwise, existing policy paralysis and asymmetry cannot be effectively addressed.

Expenditure rationalization and prioritization, intergovernmental financial reforms and institutional reforms are complementary. Nevertheless, the extent and complexity of these reforms means that the authorities will have to assess carefully the priorities and sequencing of the reforms while understanding

the interdependencies among the various reform components.

Considerable progress has already been made, as most components of the broad fiscal reform agenda are either at an advanced stage of implementation (e.g., tax reforms, health and pension finance reforms, budget execution and external audit reforms) or being initiated (e.g. expenditure rationalization reforms concerning defense and veteran transfers, social welfare reforms, budget planning, internal audit, and procurement reforms). Thus the basic underlying preconditions for the reforms proposed in this report are in place.

Ideally, reforms of public resource/expenditure management and financial accountability systems should advance first in order to establish a sound framework for design and implementation of the medium-term fiscal adjustment. Despite early initiation of institutional reforms, slow reform progress as well as limited implementation capacity has so far produced mixed results. As a result the reforms most essential for disciplining policy choices and directing expenditure decisions toward policy priorities—e.g. those aimed at improving comprehensiveness of the resource framework, budget policy coherence and decision making, and overall budget planning capacity—remain the most far behind. This equally applies at all levels of government with the lower levels also lagging behind in improving budget execution, transparency and accountability. Similarly, planning and programming capacities at the sectoral level remain underdeveloped—e.g. in education and health, complex input-driven budgeting systems are contributing to high costs and low efficiency. Progress in sectoral reforms has also been severely hindered by the fragmentation of fiscal management and reporting lines.

Therefore, one of the key conclusions of this report is that implementation of public expenditure management reforms is essential for the effectiveness of medium-term fiscal adjustment and reform. The reform agenda should be centered around the following priorities:

- Establish a comprehensive and integrated fiscal resource framework, and effective reporting and monitoring channels, at both the Entity and the national level, to manage a credible aggregate fiscal program (see pages 114-118 and 124);
- Strengthen the institutional capacities, in terms of both human resources and processes, for budget and sectoral planning with a medium-term vision and a performance-oriented approach (see pages 119 and 129);
- Strengthen financial accountability systems. Particularly urgent is the need to establish effective internal audit and public procurement systems, and to facilitate their effective operation to maintain fiscal discipline as well as the efficient use of BiH's increasingly tight resources (see pages 128-140).

While pursing these institutional reforms over the medium term, increased attention will need to be given in the short-term to strategic expenditure policy reforms rather than ad hoc and short-sighted fiscal adjustments. The report provides guidelines for the kind of analysis that needs to be undertaken by all government units to achieve comprehensive expenditure policy reform (see pages 28-35). It also, highlights reform options for selective expenditure categories and sectors that account for a significant portion of total public spending (see pages 35-52 and 65-69) and/or are candidates for considerable improvement in equity and efficiency gains (see pages 78-111). The most pressing areas for expenditure policy reforms are:

- Significant rationalization of spending on public administration, defense and public order and safety;
- Reallocation of a greater portion of Entity and sub-Entity own-budget resources, in a closely coordinated manner, for operations and maintenance and for contributing to domestically financed direct investments and for providing adequate counterpart funding to externally financed projects;
- A broad-based policy and institutional reform in social welfare to achieve a more equitable allocation of existing social welfare spending and to reallocate cash transfers from veterans' programs, which are subject to considerable abuse, to social welfare and child protection programs;
- A broad-based policy and institutional reform in education to reduce fragmentation and improve equity, paying particular attention to ensuring equal access to primary education, expanding academic secondary school enrolment, reducing unit-costs in education and creating an efficient system of tertiary education;

- Introduction of financial discipline into the management of the local utility companies through a utility tariff policy based on full cost recovery and a complete separation of the costs of utility services from political influences/concerns related to the social condition of the population served.

The most critical reform components, where simultaneous implementation of reform elements will be necessary, are "rationalization of public administrative spending (i.e. W&S)" along with "public administrative reforms" in order to improve efficiency and effectiveness of public administration, as proposed in this report (see pages 21-22 and 35-40). Obviously, the former objective would require a good diagnostic analysis and adequate sequencing to focus on those segments of the public administration where spending is most dis-proportional—defense and public order and safety. The underlying causes of high health and education spending are less clear and requires better data and further analysis. The report also highlights that the decentralized nature of the public sector in the Federation imposes higher costs in public administration and particularly in service delivery.

Similarly, major elements of intergovernmental financial reform (see pages 74-77) and social service spending reforms (see pages 86, 98 and 111) should go in tandem in order to enforce fiscal discipline, improve vertical fiscal imbalances, channel scarce public resources to development priorities, and ensure more equitable and efficient delivery of public services. The top priorities are:

- Re-formulation of policy-decision and financing responsibilities for basic elements of education, health and social welfare spending. This, in turn, requires a hard-headed assessment by the BiH authorities as to whether the basic elements of social services should be assigned to a higher level of government, ideally State or, else Entity, given that these services are critical for poverty alleviation and productivity and that they imply major positive externalities to BiH and to the Entities as a whole;
- Elimination of overlapping responsibilities across governments in social welfare, health, and education services and in the settlement of refugees and displaced persons.

Finally, expenditure reforms and re-assignments need to be considered simultaneously with the reforms aimed at further rationalizing/simplifying tax structures, improving tax assignments and/or introducing equalization transfers to maintain overall fiscal balance, improve equity, and avoid an increase in the public sector's size and scope.

INTRODUCTION

Over the medium term, Bosnia and Herzegovina (BiH) will go through a critical phase of fiscal adjustment and deeper economic reforms as it moves to orient its economy to the market and to increased integration with the rest of the Europe. With much of the post-war reconstruction well under way and donor flows on a diminishing path, maintaining the momentum of the growth demands accelerated progress in structural policy and institutional reforms. The strength of the reform process is also at the center of BiH's continued access to foreign assistance, a critical factor in alleviating the medium-term fiscal adjustment burden.

A key finding of this Report is that the present size and scope of public sending can not be sustained. Neither BiH's future resource availabilities nor its objective of private sector-led growth are consistent with the scale of the public sector. Existing fiscal deficits are out of line with the requirements of financeable debt-output ratios and reasonable macroeconomic targets over the medium term. Thus, a significant fiscal adjustment is required. BiH's already high tax burden makes it clear that the bulk of the fiscal adjustment will need to be made in public expenditures.

This challenge is complex and daunting: along with reducing the reliance on external financing, adjustments are needed to shift the origins of the external imbalance from public investment to private sector activities. Equally important are adjustments to public non-reconstruction expenditures, which are currently not only too high and too pro-administrative, but also highly inefficient, in allocative terms and in terms of cost-effectiveness.

BiH's extremely decentralized fiscal management structure aggravates the obvious challenges of these expenditure reforms. The present intergovernmental fiscal relations will, therefore, need to be put under the microscope in order to identify reform opportunities for effectively enforcing fiscal discipline, for channeling scarce public resources to development priorities, and for ensuring more equitable and efficient delivery of public services.

Needless to say, reaping benefits of expenditure policy reforms requires that they be implemented within a framework of sound budgetary institutions and processes, and financial accountability mechanisms.

This report is aimed at helping the authorities identify the priority fiscal policy and institutional issues and reform options on which the medium-term adjustment agenda will need to focus. It is undertaken jointly with BiH's Country Financial Accountability Assessment (CFAA) and Country Procurement Assessment Report (CPAR), and it integrates findings of all three studies concerning public expenditure policy and institutional frameworks. The report is divided into five chapters:

Chapter I briefly describes BiH's evolving governance framework, assesses its macroeconomic and fiscal stance, looks at the size of the public sector, and analyses the sustainability of BiH's fiscal stance.

Chapter II reviews the composition of consolidated general government spending, undertakes an in-depth analysis of selected expenditure categories and outlines potential reform elements, based on an inclusive fiscal framework established by the Report.

Chapter III looks at the present status and performance of BiH's unique intergovernmental fiscal relations with a view to outlining principles for improvement and policy direction that would address some of the inefficiencies in BiH's decentralized fiscal management structure.

Chapter IV assesses public spending in the social sectors, the largest single area of domestically budgeted public spending with a significant sub-Entity role in management, financing, and service provision. The analysis looks at how effective, efficient and equitable the present modality of social service delivery and how it can be improved.

Chapter V assesses BiH's public expenditure management and financial accountability systems with a view to helping authorities define the medium-term reform agenda directed to forge a stronger link between the policy priorities and budget, improve fiscal discipline, and strengthen transparency and accountability of fiscal management.

I. MACROECONOMIC AND FISCAL FRAMEWORK

This Chapter briefly describes Bosnia and Herzegovina's evolving governance framework (section A), assesses its macroeconomic stance (Section B), looks at the size of the public sector and analyses the sustainability of fiscal policies (Section C) to put the discussion on policy and institutional aspects of public expenditures in the rest of this Report into a context.

A. BOSNIA AND HERZEGOVINA'S DECENTRALIZED GOVERNANCE STRUCTURE

The Evolving Governance Framework: From Dayton to the Present

1.1 More than six years have passed since the new government structure for Bosnia and Herzegovina (BiH) was first established. As envisaged in the Dayton Peace Agreement (DPA), BiH has evolved into a single sovereign state with a decentralized administrative structure: the State of Bosnia and Herzegovina is the central authority and the Federation and Republika Srpska (RS) are its two constituent entities. This multi-tiered governance structure was further expanded in March 2000, when the Brcko territory was declared an Autonomous District of Bosnia and Herzegovina.[1] The two Entities are politically, administratively, and fiscally autonomous. They also have different governance structures: the Federation is decentralized, being composed of 10 cantons[2] with significant fiscal authority, and their constituent municipalities. The RS is centralized, with relatively few functions decentralized to its constituent municipalities and no mid-level governments (see Table 1.1). The political system is a parliamentary democracy, with a tripartite presidency at the State level. The State and Entities operate under democratically elected legislatures. The Brcko District presently operates under the transitional supervisory authority of the Office of the High Representative (OHR)[3] and will do so until its final status has been clarified.

Table 1.1 BiH - Administrative Structure

Tiers of government	Jurisdiction				
	State	Federation	RS	Brcko	Total
Central	1				1
Entity		1	1		2
Canton		10			10
Municipality		84	63	1	148
Autonomous District					1
Total	**1**	**95**	**64**	**1**	**162**

1.2 This structure operates with a significant decentralization of the decision-making power to the sub-national governments. In their respective jurisdictions, the Entities exert all public functions not expressly assigned to the State by the State Constitution (see Table

Table 1.2 BiH - Division of Responsibilities

State	Entities and/or Sub-Entity Governments
Monetary policy (currency board).	All other economic and social sector policies.
Overall foreign relations policies.	Foreign relations with bilateral and multilateral institutions.
Trade and customs policy.	All other tax policies and tax administration.
Regulations on international and inter-Entity criminal laws, telecommunications system, transport system, and traffic control.	Intra-Entity affairs/justice and police; regulation of intra-Entity systems of transportation and telecommunications.
Immigration, refugees, and asylum policies.	Defense, resettlement and reconstruction provision of public services, social security system.

[1] The District of Brcko, although bound by the State Constitution and subject to some horizontal coordination with the Entities, has its own legislative body, judicial system, and administrative procedures, but at present it is not represented in the State apparatus.

[2] The Federation is a multi-ethnic Entity comprising two major ethnic groups: Bosniacs and Croats. While most of its cantons are near mono-ethnic, there are two mixed-cantons and many municipalities populated with both ethnic groups. Republika Srpska is largely a mono-ethnic Entity with a majority Serb population. With the accelerated rate of return in recent years, comprising both refugees and displaced persons, the regional ethnic diversity has been broadened, although it still remains limited.

[3] The OHR was established to oversee the implementation of the DPA and has the final authority in the interpretation of the DPA concerning civilian matters.

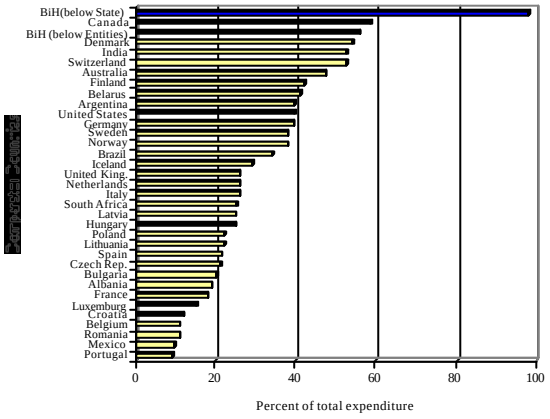
1.2 for a summary overview of State and Entity responsibilities). Measured by the extent of its expenditure decentralization, BiH is extremely decentralized by international standards (see Box 1.1). The State government accounts for only a marginal portion (1.5 percent) of on-budget consolidated BiH general government expenditures.[4] The consolidated Federation government accounts for nearly three-fourths of BiH expenditures and the RS for the remaining approximately one-fourth. Within the Entities, decentralization to the municipal level is limited, but significant decentralization to the cantons exists in the Federation. Together, the cantons and municipalities are responsible for over half of the total consolidated Federation general government expenditures, with the Federation exhibiting perhaps one of the most decentralized governance structures in Europe.

Box 1.1 Comparative Analysis of BiH's Sub-National Government Expenditures

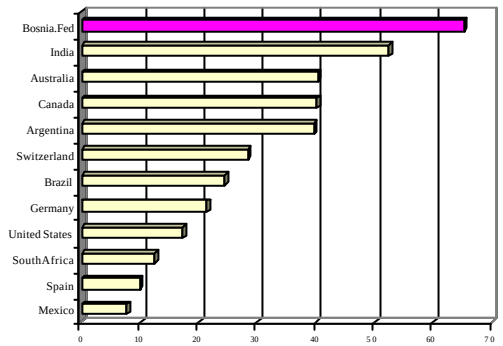
BiH's unique feature is that it encompasses not only two distinct political and administrative Entities but also a very decentralized fiscal system in one of its Entities (the Federation). The constituent cantons of the Federation have their seats in the Federation Parliament and their own Constitutions. The respective cantonal assemblies also have the power to pass and enforce laws in their respective jurisdictions. In the RS, as a unitary Entity, laws are enacted only by the center (i.e., the RS Republican Assembly). In both Entities, the municipalities' fiscal powers are regulated by Laws on Local Self-Government, under the respective Constitutions—cantonal Constitutions in the Federation, and the Republican Constitution in the RS.

While conceptually distinct from political and administrative viewpoints, intergovernmental fiscal relations (e.g., the degree of fiscal decentralization) have, in practice, varied substantially across countries, whether the country is a federation or whether it has a unitary structure. For example, some federations (e.g., Mexico) still maintain a highly centralized fiscal structure, while in many unitary countries (e.g., the Scandinavian countries) fiscal policies are highly decentralized. The aggregate sub-national government expenditure share in BiH is quite high, as compared with both standards of federation countries and the European countries in general. The share of public expenditures is 98 percent at the *sub-State level*, and 56 percent at the sub-Entity level in BiH as a whole (Graph 1.1). Furthermore, the share of *intermediate* government expenditure in the Federation is also high (75 percent) as compared with other federal governance structures around the world (Graph 1.2).

Graph 1.1 BiH: Expediture by Sub-National Governments (comparative shares)



Graph 1.2 Federation: Comparative Intermidiate Gov. Expenditures



Data sources: (i) Official data and staff estimates; (ii) World Bank DEC sub-national database initiative, (iii) GFS/IMF (most recent years available—between 1994-98); and (iv) Teresa Ter-Minassian, "Fiscal Federalism in Theory and Practice," IMF, 1997.

[4] This refers to the State's administrative expenditures, i.e., expenditures net of debt service payments, which are transferred to the State by the Entities according to the final beneficiary principle.

1.3 Similarly, measured by the extent of its tax decentralization, BiH's structure has unique features. There is considerable separation between the level of government setting tax policies and the level implementing tax policies and receiving tax revenues. The State is responsible for setting the trade and customs policy, yet it has no significant independent revenue sources other than some limited fees, and depends entirely on transfers from the two Entities for undertaking its functions. In the Federation (which collects over two-thirds of total BiH revenues), tax policies are set by the Federation government, but ownership of tax revenues between the Federation and cantons is determined by strict tax assignment, with cantons and municipalities receiving two-thirds of the total Federation revenues. The RS (which collects close to one-third of total BiH revenues) sets tax policy and collects and owns all tax revenues in its territory, with its municipalities receiving approximately one-third of major indirect taxes.

1.4 BiH's decentralized governance structure was designed to facilitate nation building by promoting political stability and democratic representation in the decision making process. While decentralization in BiH is not promoted primarily as a means of achieving more efficient delivery of services as in many other countries, in theory it is consistent with the EU principle of *subsidiarity*, which, by bringing the decision making process closer to the beneficiaries of policies, tends to maximize allocative efficiency. In practice, however, due to lingering disputes among ethnic groups and to many as yet unmet policy and institutional prerequisites for the effective operation of such an extremely decentralized structure, the political and the efficiency gains expected from decentralization are yet to be realized.

1.5 The operation of the government apparatus to date in BiH demonstrates that the largest obstacle to the nation building and efficiency benefits of decentralization is the low political tolerance for building the State as a much needed integrative force and for harmonization and cooperation between the tiers of the government. While federal systems are designed to accommodate a certain degree of diversity and policy asymmetry, there are *thresholds* beyond which the lack of harmonization translates into fragmentation, becoming a serious impediment to the free movement of economic activity and hence the growth and prosperity. The costs, both economic and social, are enormous because of the implied policy paralysis that has been evidenced in BiH by the pronounced time necessary to reach many decisions and the uncoordinated and often conflicting decisions resulting from fragmentation.[5]

1.6 The daunting challenges of the unfinished post-war economic recovery and structural reform agenda in BiH make these costs all the more significant. Fragmentation is discouraging much needed foreign investment and labor mobility; increasing business costs; informalizing economic activity; limiting opportunities for the integration of large numbers of refugees and internally displaced persons and demobilized soldiers into the economy; denying equitable access to services; and impeding the operation of basic public control and accountability mechanisms, with significant erosion in tax collection and service efficiency. Moreover, preventing these costs from translating into a sharp slowdown in economic recovery is becoming increasingly difficult as the emergency aid phase gradually ends. In the period ahead, only a coordinated and coherent policy and institutional reforms will maintain the sustainability of the current aid-dependent fiscal stance by facilitating continued access to increasingly performance-determined external financing.

[5] The severity of this practice has clearly led to the increasing use by OHR of its authority to step in to ensure both the introduction and the soundness of final decisions. Between December 1997 and November 2000, OHR intervened on over 160 occasions to impose or repeal a government or parliamentary appointment, decision, or law at the State or Entity level. In total, 63 appointments have been rescinded.

Toward an Efficient and Integrated Governance Structure

1.7 Despite recognizing the above-mentioned costs—increasingly so under more liberal governments since 2000—BiH policymakers have yet to set the right *threshold* for efficient decentralization, with the international community continuing to champion harmonization and policy coordination. The longer-term existence of BiH as a rebuilt country with an economy oriented to the market and to increased integration with the rest of the Europe depends on its enabling the *subsidiarity* principle mentioned above to contribute to the efficient operation of decentralization. The rest of this report places a special emphasis on major challenges that the BiH governments need to face in this undertaking. In the following discussion, the three critical challenges requiring urgent attention are outlined:

- Increasing the State's role in the economy as an integrative force and central authority
- Addressing the design and the implementation of proper fiscal decentralization
- Strengthening the vertical and horizontal coordination of fiscal policies and the accountability and transparency of fiscal management.

1.8 ***Increasing the State's role in the economy as an integrative force and central authority***. Over the last five years, major strides have been made toward establishing the State, equipped with the functions as envisaged in the DPA. Nevertheless, rigid interpretation of the DPA's intent, especially by BiH's early conservative governments, often hindered these efforts, with the donors providing the driving force. The State's role as an economically viable central government that can guide and monitor creation of a single economic area throughout BiH is only recently being explored under the rule of more liberal governments.

Box 1.2 What Does the Definition of "State" in BiH Corresponds to in a Federal Government Context?

In BiH, the term "state government" refers to what would be considered the national or federal government in other federal systems. The term "entity governments" is analogous to "state or provincial governments" in other federal systems. The canton governments in the Federation also resemble state or provincial governments. Against this conceptual clarity, there are numerous variations of division of powers across federal systems. Generally the following powers are vested at the federal level: defense, social welfare, foreign relations, currency and debt, fiscal equilization and economic union, although the latter is often a shared responsibility. In all federal systems, the national government has an independent revenue raising capacity (for further discussion on the topic, see Watts, R., "Comparing Federal Systems," McGill Queen's University Press, 1999).

1.9 In its present form, there are two major constraints to the State in effectively performing such a role: first, the State is accorded with very few of the powers normally associated with national governments under decentralized systems that would allow the execution of such role (see Box 1.2); second, the State has no fiscal capacity for smoothly carrying out an expanded role. The challenge in the period ahead is to eliminate these constraints within the DPA framework, without increasing the public sector's overall role in the economy over and above its present highs (see Section C).

1.10 *Strengthening the State's role*. As noted in Box 1.2, around the world, in addition to a few functions that the State is responsible for in BiH (e.g., the monetary and foreign relations function), major functions such as defense, social welfare, fiscal equalization, debt management and macroeconomic stabilization functions are normally delivered at the State/national level, although the latter is often a shared responsibility. In Bah, a greater State role in these areas would certainly enhance economic efficiency. In this undertaking, the factors determining the role that State could play in BiH could best be judged against (i) the potential benefits expected from a more efficient, adequate, and equitable delivery of services involving economies of scale (i.e., implying nationwide supply such as growth-enhancing social and sectoral policies and an overall macroeconomic policy framework); (ii) policy coordination and harmonization coming from the center (particularly with respect to economic policy and European integration); and (iii) administrative savings owing to better policy coordination from the center.

1.11 In the near term, in a limited number of cases, the greater State role is already consistent with the State's current responsibilities in BiH, such as foreign trade, inter-entity transportation, and international communications. In other cases, delegation of some responsibilities by the Entities to the State should result because of the gains involved and because such delegation is necessary for EU accession. Many regulatory policies (such as health, banking, and consumer protection), as well as telecommunications, environmental policies, administration of some taxes such as customs and VAT, and certain aspects of resettling displaced persons (such as property rights and pension and health insurance rights,) can be more efficiently administered and/or coordinated at the State level. Uniform State-set policies in these areas will not only lower business costs but will also ensure the countrywide distribution of benefits. While an in-depth analysis of the State's specific role in each of these areas is beyond the scope of this report, a few examples of the merits of expanding the State's role are provided in Box 1.3.

Box 1.3 Merits of Greater State Role in the BiH Economy: A Selective Analysis

Regulatory policies constitute a good example of policies with positive externalities, where State-set policies will maximize the benefits occurring to all BiH citizens. For instance, under the existing system, air and water pollution standards will not be adequately addressed at the Entity level, because each Entity will set policy based only on its own benefits, but the gains of any policy action will be geographically diffused across BiH. Under-regulation of these environmental standards is therefore possible, a problem that can be overcome with State-set policies. An initial step toward the introduction of uniform regulatory frameworks was taken in 2001 with the establishment of a State-wide Communications Regulatory Authority and an agreement for the establishment of a single State regulatory agency in the power sector.

Similarly, shifting customs administration from the Entities to the State level could go a long way toward ensuring consistent policy implementation across BiH and enhancing compliance. At present, customs policies are set at the State level but customs administration is an Entity function. Entity level administration provides incentives for tax competition through divergent practices, e.g., in the valuation of goods that lower effective duty rates. For example, the RS values coffee for customs duty purposes based on invoices, and the Federation values coffee according to international prices. Adoption of an approach with lower valuation permits either Entity to reduce the effective duty rate and thereby attract a greater share of imports. The net effect is reduced tax revenues and a distorted location of economic activity that ultimately works to the disadvantage of both Entities. The introduction of the State Border Service in 1999 provides an environment conducive to the operation of the customs administration at the State level, should the Entities and the State agree on reorganizing the customs administration in the medium term.

In the medium term, BiH governments are committed to introduce VAT as an obvious replacement for the sales taxes since EU members are permitted neither national nor sub-national sales taxes. The underlying elements of a VAT structure—such as which level of government sets policy on bases and rates, owns the revenues, and administers the tax—are separable. Establishing policymaking and administration role at the State level would be most efficient. Consistent tax bases, rates, and administrative practices across-BiH are essential to operating an efficient VAT structure and limiting business compliance costs. Furthermore, much of the VAT revenue will be collected and the required rebates will be determined at customs, so that the State operation of both the customs administration and the VAT will provide for administrative synergies. Regarding the ownership of the VAT revenues, should the VAT be used to finance the State budget, the revenue ownership should largely remain in the Entities with the State receiving a portion of the VAT, determined by its expenditure responsibility. Obviously, for effective operation of such a tax system, where the level of government setting and implementing tax policy and the level of the ownership of the tax revenue are separated, the State and the Entity governments must agree before any changes in the VAT policies can be made. A number of countries, including provinces for which Canada administers the VAT, Australia, and Papua New Guinea, have integrated such requirements into the operations of their respective VAT systems.

1.12 Another area in which the present system remains ineffective is the overall *systematic* economic policy coordination and monitoring.[6] A critical first step in this direction is enforcing regular economic policy/information reporting both within the Entities and between the Entities and the State. At present,

[6] An initial formal economic policy co-ordination at the State level was introduced in March 2000 with the establishment of an inter-entity Joint Coordination Committee (JCC) chaired by the State Ministry of Foreign Trade and Economic Relations. The JCC has developed, through a participatory process, "An Economic Development Strategy Global Framework" and an initial "Poverty Reduction Strategy."

such rules are absent making an analysis of the true economic stance at either Entity or at the BiH level a painful yet incomplete exercise—a good example is the long and difficult process through which the consolidated analytical framework for this report has been established (see Chapter II). This means that State's present role in consolidating the monetary and limited financial sector information should be deepened and broadened to cover fiscal and public debt monitoring and consolidation. This, in turn, requires establishing a capable State body assigned to these tasks within a well coordinated bottom-up reporting channel. Eventually, establishing these State capacities will be essential for EU accession, since the expectation will be to interact with a single economic body capable of meeting and maintaining membership criteria in an economic policy front.

1.13 The BiH has already begun facing the challenges of integrating its political and economic structures in order to meet the preconditions for acceptance into the wider European family. The EU has developed an 18-step *roadmap* that identifies the initial steps needed to begin a discussion on EU accession. The *roadmap* requires actions in the political, economic, and human rights areas. Several of these actions require a greater State role in customs and border control, business practices such as copyrights and consumer protection, sectoral standards, human rights, and public broadcasting. Reflecting the present limited ability to act jointly and tackle comprehensive reforms consistently on a broad front, only 8 of these steps have been implemented to date. Lack of adequate progress has not only been delaying the initial discussions for EU accession but also resulted in postponement of planned Donor Conferences/Consultative Group Meetings since last year—a third such postponement in a row since 1999, due to the slow pace of implementation of reforms in general.

1.14 All-in-all, the next few years will be critical for the completion of a significant agenda of as yet unmet postwar recovery and transition challenges with a view to integrating the BiH economy into the EU structures. The experience to date clearly suggests that greater central government guidance in the design and enforcement of the necessary policy responses will facilitate the coherent and timely tackling of these challenges. The establishment of effective budgetary and foreign aid/borrowing coordination/monitoring polices at the center will also facilitate donor coordination, which is critical to the sustainability of growth and macroeconomic stability (see Sections B and C). Last but not least, greater State guidance in the reform process could help ensure that the benefits of the reforms are expanded to allow for a broad-based increase in living standards and to help address equity issues concerning, particularly, refugees and the internally displaced.

1.15 *Improving State Finances.* The effective operation of the State depends on the State's access to an adequate own-source revenue base. At present, a small set of fees for documents and passports is the only own-source State revenue, and it finances less than 30 percent of the State's operating expenditures. The remaining operating expenditures are financed through a transfer scheme instituted in 1998.[7] While there have been occasional problems with the timeliness of the flow of funds from the Entity budgets to the State budget, the present transfer scheme has provided the State administration with a dependable stream of resources. This, in turn, has eliminated the practice of systemic wage arrears and substantial delays in debt service payments and has established a mechanism of coordination between the State and the Entities in budget execution.

1.16 Nevertheless, the present negotiated system is inflexible as regards accommodating any viable adjustments to the State budget during the course of the year and provides each Entity with veto power over

[7] This scheme is based on financing the State's administrative expenses according to negotiated transfers from the Entities (two-thirds from the Federation and one-third from the RS) and its external debt service expenditures according to the final beneficiary principle in external borrowing by the Entities through the State.

the capacity of the State to undertake its functions[8]. At present, the State and Entity budgets are being prepared and executed with assistance from the IFIs (which prevents these disadvantages of the existing system from hindering the State's operations). However, consistent with the objective of establishing a self-reliant economic management structure in BiH, these disadvantages will need to be addressed so that they do not become an impediment to the State's operations.

1.17 ***Addressing the design and the implementation of proper fiscal decentralization.*** Since mid-1997, the State and the Entity governments have intensified their efforts to establish Dayton-mandated intergovernmental financing arrangements. At present, the basic DPA-fiscal management and legislature structures are in place. Nevertheless, despite the appearance of clear rules in revenue and expenditure assignments across BiH governments, a series of specific issues remains to be addressed for ensuring provision of minimum services across the BiH and to enhance the public sector's operational efficiency. These issues are: (i) eliminating overlapping responsibilities across governments; (ii) developing mechanisms to effectively finance and deliver services with geographic spillovers, such as higher education and health; and (iii) identifying/addressing vertical and horizontal imbalances. Chapter III of this report focuses on these issues and provides reforms options towards addressing them in the medium term.

Box 1.4 Examples of Fiscal Coordination Mechanisms in other Federal Governments

- In Canada, conferences are held between the Prime Minister and provincial premiers and between the federal Minister of Finance and his provincial counterparts; conferences are also held between the provincial leaders or Ministers of Finance without federal participation;
- Inter-provincial trade agreements have been negotiated between Canadian provinces; a social union agreement, setting out the framework for federal-provincial cooperation in social programs was signed by the federal government and nine provinces;
- Canadian provinces create ministries of intergovernmental relations to coordinate the numerous interactions with the federal government;
- In Malaysia, the Constitution requires a National Finance Council with a representative from each state be consulted;
- In Germany, the Bundesrat (second chamber) is comprised of state representatives;
- In Switzerland and the United States, cantonal or state representatives vigorously lobby federal legislators;
- In numerous systems, intergovernmental officials' committees exist at the sector or departmental level;
- In Australia and India, expert commissions are created to advise on fiscal and regional equalization issues.

1.18 ***Strengthening the vertical and horizontal coordination of fiscal policies and accountability and transparency of fiscal management.*** Although federal systems provide for policy independence at sub-national levels, effective federations use a variety of co-ordination mechanisms to ensure policy harmonization at a broad level or for joint production of services (see Box 1.4 for few examples). There are also many instruments available to make these mechanisms work effectively, such as mandates, guidelines, floors, ceilings, contracts signed between various levels of governments, as well as transfers of many types. As noted above, such arrangements have not yet been institutionalized for systematic horizontal[9] and vertical[10] fiscal policy and administrative cooperation between BiH governments.

1.19 A harmonized fiscal system can be achieved through a combination of central control or coordination and a formal coordination and/or negotiation platform between governments with independent decision making capacity. The establishment of such formal mechanisms for fiscal coordination in BiH is the only viable instrument for (i) limiting countervailing or contradictory legislation; (ii) improving policy coherence, effectiveness and pace of reforms; (iii) resolving conflicts; and (iv) ensuring the enforcement of

[8] At the time of its establishment, the existing transfer system was chosen as a politically acceptable second-best alternative to other options, which would provide the State with a more flexible and regular stream of revenues. The first-best alternatives involved providing the State with a fixed percentage of specific tax revenues from the Entities, such as customs revenues, or introducing State taxes. These alternatives are now becoming more feasible sources of State finance as both transfer of customs administration to the State level and introduction of a VAT are being evaluated.

[9] Between the Entities and between sub-Entity governments within the Entities.

[10] Between the State and the Entities and between central and local governments within the Entities.

greater accountability and transparency in fiscal management. The final form of the fiscal coordination can be worked out between the Bosnian authorities, but the objective should be to establish a sufficient degree of formal vertical coordination in BiH's bottom-heavy system. As was well expressed by Prud'homme, *"Coordination is the essence of polyphonic music. The part of every instrument must have its own horizontal coherence and its interest: this is melody. But at every moment, all instruments must be vertically coordinated and synchronized: this is harmony."* [11]

B. MACROECONOMIC SETTING

The War and its Aftermath

1.20 Before the 1992-95 civil-war, BiH was one of the lower income republics of the former Socialist Republic of Yugoslavia (SFRY). In 1990 its GDP was estimated at US$10.6 billion, or over US$2,400 per capita. Nevertheless, it had a relatively diversified economy, a well developed industrial base, ranking among the leaders of the region, and a highly educated labor force. Unlike other centrally planned economies, its economy was relatively open (the share of total trade in GDP was over 35 percent) and was market-oriented (with more than half of its exports directed to Western markets). All these factors augured well for the country's relatively smooth and successful transition to a market economy, building on the initial steps that the SFRY took in this direction in the late 1980s. However, war interrupted this process, shattering the economy, halting economic reforms, and completely disintegrating the governance framework with a severe collapse in discipline and accountability in the public sector, by its end in late 1995.

Box 1.5 BiH's Donor Assistance Program:

The donor assistance program set out an emergency financing requirement of US$5.1 billion to provide across-the-board financial and technical assistance for ensuring sustainable growth and employment creation. It is designed to prevent bottlenecks in all areas of infrastructure and major public services, attract home the millions of refugees and displaced persons by ensuring minimal living standards, and establish institutions for economic management with an emphasis on the development of the private sector and the transition to a market economy.

This initial priority reconstruction and reform program come to a formal end in 1999, though un-disbursed commitments are expected to disburse over the next two and three years. By end-2001, more than two-thirds of the total donor assistance had been disbursed, with tangible results in all targeted areas. Overall, reconstruction objectives have been achieved more successfully with the bulk of war damaged economic and social infrastructure being brought closer to prewar availability levels, while structural reform progress had been slower than hoped.

1.21 The conclusion of the DPA (see para.1.1) and the implementation of a major donor assistance program starting in 1996 set the stage for economic recovery and reconstruction in BiH. In order to consolidate economic recovery into sustainable growth over time, the recovery program was built on three main pillars: reconstruction and recovery from damage sustained during the war; establishment of a new governance structure for the country with consistent and harmonized policies across its largely autonomous multi-tiered governments; and, the re-starting of the process of transition to a market economy (see Box 1.5). Implementation of this program was built upon an economic policy framework aimed at macroeconomic stability. The framework complemented the restrictive monetary policies envisaged by the DPA (whereby the Central Bank is required to function as a currency board)[12] with a conservative fiscal policy, limiting the fiscal deficit of the consolidated public sector to levels compatible with the available sources of foreign financing.

1.22 The structural elements of the program were designed to be broad-ranging and to be implemented on a fast track to help the country make up the time lost during the war years, while reconstruction and reform needs were largely being financed through generous, up-front donor support (see Box 1.6). The

[11] Remy Prud'homme, "On the Dangers of Decentralization," Policy Research Working Paper, 1252, 1995 p.30.

[12] This rule was set for the first six years of the Central Bank's operation with the State Parliament having the discretion to decide its abolishment. The Central Bank was established in mid-1997.

reform program encompassed the establishment of key central and local public sector governance structures, trade and price liberalization, the reform of the social sectors and labor market policies, and restructuring and privatization in the banking and enterprise sectors. These reforms have begun to redefine the roles of the public and private sectors toward a market-based economy, albeit at a slower pace than hoped.

Box 1.6 A Summary of Economic and Structural Reforms, 1996-2001

- *Monetary Policy*: Issuance of the national currency and establishment of the Central Bank of Bosnia and Herzegovina. Use of a fixed exchange rate as a nominal anchor through the currency board arrangement.
- *Prices*: Liberalization of a wide range of prices and few direct subsidies. Slow but steady convergence of price levels and movements between the two Entities.
- *Banking System:* Establishment of institutional and regulatory banking frameworks. Closure of the payments bureau and transfer of payment operations to commercial banks. The Bank privatization program has gained momentum, and majority government ownership of the banking sector has been reduced to 10 percent in the Federation and about 5 percent in RS.
- *Tax Reform*: Harmonization of inter-Entity sales and excise taxes and the reform of tax administration. Establishment of rules for tax revenue ownership and distribution mechanism in the case of inter-Entity trade. Strengthened border and customs services.
- *Fiscal Policy*: Maintenance of overall fiscal discipline by strictly limiting fiscal deficits to levels that are compatible with external financial resources, thus avoiding domestic borrowing. Establishment of a legal and institutional framework for external debt management at the State and Entity levels. Major pension reforms aimed at introducing financial sustainability, accountability, and transparency. Reform of health finance system for the introduction of efficient and transparent resource management and equity in access to tertiary services.
- *Governance and Pubic Administration:* Establishment of a framework for modern treasury systems. Legal and institutional frameworks for State and Entity Supreme Audit Institutions. Continued progress on improvements to budget coverage, accounting and planning. Strengthened legal and judicial frameworks.
- *State Enterprises*: Adoption of a legal framework for privatization and restitution and ongoing privatization of a significant number of SMEs.
- *Foreign Investment*: Liberalization of movements of capital. Equal, but not preferential, tax treatment for foreign investors and no restrictions on foreign shareholdings in Bosnian companies. Adoption of a legal framework for foreign direct investment.
- *Trade Policy*: Introduction of a countrywide customs tariff regime and a very liberal and open external trade policy. Further gradual liberalization of trade vis-a-vis Stability Pact countries in the region. Process toward WTO membership initiated in 1999, but still at early stages.

1.23 During the last five years, the combination of sound economic policies, structural reforms, and large-scale donor assistance has yielded positive results (see Table 1.3). Annual economic growth has averaged about 25 percent per year in real terms between 1996 and 2001—though this has been on a very low base.[13] The emerging structure of the composition of the output indicates a sharp shift away from industry to the services sector, as in other transition economies, with the later accounting for 60 percent of BiH's GDP in 2000-01. For the first time since the onset of the economic recovery process, the year 2001 revealed signs of a surge in imports of intermediate goods, which might be signaling an expansion of the industrial sector beyond reconstruction-oriented production. Unemployment fell from an estimated 70 to 80 percent in early 1996 to about 35 percent in 2001. Inflation has fallen progressively to the lower range of single digit rates, and confidence in the new domestic currency has been restored. Reforms of the Payment Bureau and banking system have begun paying off with recent signs of improvement in the banking system's financial intermediation capacity. Significant public sector and financial market reforms have been put in motion. The main infrastructure networks have been largely rehabilitated. This, coupled with improvements in the political and security situations, have created the conditions for sustained improvement in refugee and internally displaced persons returns since 1999. Significant progress has also been achieved in removing barriers to the movement of goods within the country. Last but not least, over the last two years, BiH has slowly begun to integrate both internally and into the world economy.

[13] Owing to the later start of donor assistance and economic recovery, and the limited integration with the international economy, incomes are lower in RS than in the Federation.

Table 1.3 Key Economic Indicators, 1990-2001[1]

	1990	1995	1996	1997	1998	1999	2000[e]	2001[e]
GDP (US million)	10,633	1,867	2,741	3,423	4,169	4,540	4,252	4,796
Per capita GDP in current US$	2,429	456	660	816	1,042	1,135	1,093	1,222
Federation	n.a.	606	899	1,167	1,418	1,458	1,373	1,453
Republika Srpska	n.a.	953	540	733	704	821	806	873
Real GDP growth	n.a	n.a	85.8	36.6	9.9	9.9	5.9	5.6
Federation	n.a.	105.7	105.6	36.2	8.2	9.5	7.0	7.0
Republika Srpska	n.a.	-38.1	31.4	37.9	15.8	11.3	2.6	1.9
Industrial Production Growth								
Federation	n.a	n.a	n.a	36.0	24.0	11.0	9.0	12.0
Republika Srpska	n.a	n.a	n.a.	27.0	23.0	2.0	6.0	-13.0
Average monthly net wages (KM)								
Federation	666	n.a	168	266	329	375	425	433
Republika Srpska	666	n.a	50	90	170	216	299	305
CPI, % change, (end year)								
Federation	114	-12.4	7.7	13.6	1.8	-1.0	4.0	3.1
Republika Srpska	114	117.6	-17.7	-10.0	5.6	14.0	12.2	5.6
External Sector								
Exports (US$ million)	1,990	152	336	575	697	649	732	850
Imports (US$ million)	1,700	1,082	1,882	2,333	2,656	2,502	2,348	2,299
Current Account Balance (US$ million)	n.a.	-193	-748	-1,060	-789	-971	-909	-789
Current Account Balance (% of GDP)	n.a.	-10.3	-27.3	-31	-18.9	-21.4	-21.4	-20.9
Financing Sources (on Capital Account; US$)								
Capital Transfers[2]	n.a.	n.a.	842	574	517	520	396	346
Net Lending	n.a.	n.a.	20	125	122	147	162	197
FDI	n.a.	n.a.	0	0	100	90	150	130
Financing Sources (on Capital Account; % of GDP)	n.a.	n.a.	31.4	20.4	17.7	16.7	16.7	14.0
Consolidated Public Sector Finances[1]								
Expenditures (% of GDP)	n.a.	n.a.	85.6	60.0	64.4	71.9	63.9	60.0
of which: Public Investment (%of GDP)	n.a.	n.a.	29.4	19.5	15.8	17.8	11.0	12.3
Revenues (%of GDP)	n.a.	n.a.	75.5	58.0	57.7	61.0	54.4	54.0
Balance (% of GDP)	n.a.	n.a.	-10.1	-2.5	-6.7	-10.9	-9.5	-6.0

[1] Covers consolidated general government expenditures (on- & off-budget; commitment basis), including State, Entities, Brcko District. & EBFs.

[2] Estimates for 2000 a nd 2001 are preliminary and subject to revision.

Source: Official data, World Bank and IMF estimates.

Macroeconomic Outlook and Prospects

1.24 Driven by generous aid flows and facilitated by overall macroeconomic stability, BiH's post-war economic revival has been impressive compared with that of other post-conflict economies.[14] Initial strong real growth rates of 86 percent in 1996 and 40 percent in 1997 underpinned this success with growth decelerating to about 6 percent per annum during 2000-01 and to an estmated 5 percent in 2002. The still strong but speedily fading growth performance reflects a combination of external and internal factors: among the external factors were the negative economic impact of crisis in the region, particularly in Kosovo, and the last two years of drought and flood which hit the agriculture sector particularly badly, while the major internal factor has been the slow and volatile pace of reforms reflected in increasingly decelerating aid flows, at a rate faster than originally envisaged.

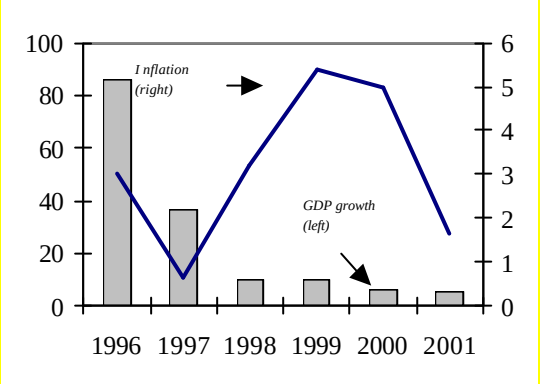
1.25 Despite gaining significant momentum with the improving political openness and stability since 1998, the volatile pace of reforms, particularly in areas critical to stimulating the supply side of the economy—notably in the harmonization and reform of tax structures, the labor and financial market reforms, and the regulatory reforms for improving the investment climate—have kept the economic recovery too dependent on aid flows (see Box 1.7). As a reflection of this, the economic revival has largely been stimulated by the reconstruction-oriented public investment expenditures—financed almost entirely with donor resources—as well as by consumption expenditures—increasing in tandem with rapidly recovering real earnings and relatively strong remittances. With the public sector dominating the economy,

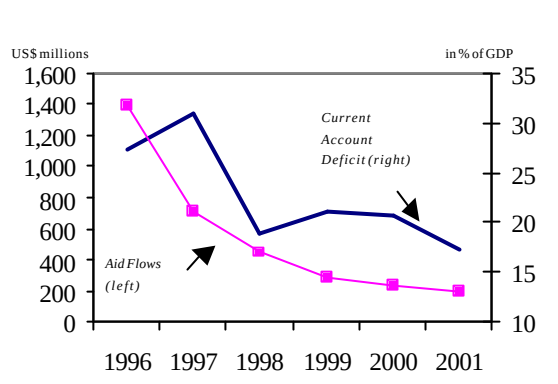
[14] Other post conflict countries have also experienced rapid recovery, but the steep of the rebound in growth has not come close to that of BiH. For example, after the advent of peace, real GDP growth rates were in the range of 6-7 percent per year. In the case of Nicaragua, GDP growth rates were only 3-4 percent during the first peace years. Countries which had in common with BiH a central planning legacy, in addition to financing requirements, such as Cambodia or Vietnam, did not experience at the time of peace the same strong growth rates (7 percent and 9 percent, respectively).

the private sector is still in its infancy, accounting only for 35 percent of economic activity. Despite the highly liberal trade regime, the economy's export capacity remains weak and narrow, reflecting a slow recovery in domestic production. The investment climate is yet to become conducive to high and sustained private capital inflows, with both local and foreign investors perceiving BiH as a high risk business environment.[15] Inflows of foreign direct invetsment (FDI) remain fairly low,[16] although there are encouraging signs of increasing investor interest in the banking sector. These difficulties of the business environment are compounded by the limited financial intermediation capacity of the domestic banking sector, with interest rates as high as 40-60 percent on short-term credits and 24 percent on long-term credits[17] despite credible macroeconomic policies.

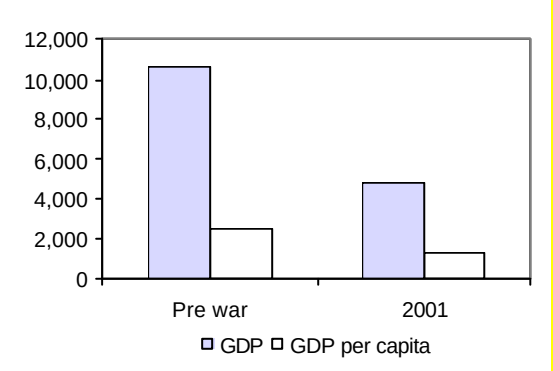
Box 1.7 Features of Present Economic Outlook

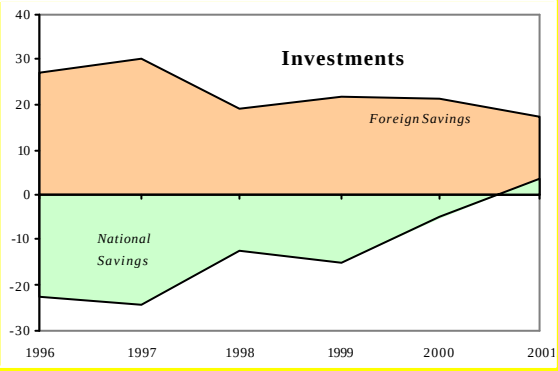
Inflation is stabilizing at single digit lows, but economic growth remains aid dependent.





Output reached only about half of its pre-conflict level, yet based on the strength of foreign assistance with domestic savings just restarting to support economic growth.





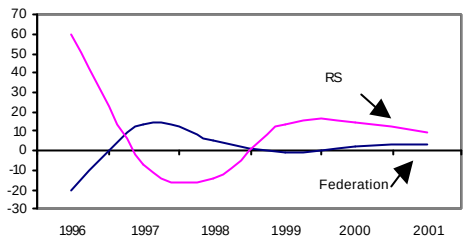
Source: Official data and staff estimates.

[15] Among the factors constituting impediments are the lack of a single economic space, large state involvement in the economy, poor legislative enforcement, lack of a sound and modern financial sector, and fragile public finances. For a detailed evaluation, see FIAS (2000), "Bosnia and Herzegovina: Commercial Legal Framework and Administrative Barriers to Investment."

[16] Compared to other countries of similar per capita income at 2.6 percent of GDP, BiH has been a poor performer in terms of attracting FDI. Deterrent factors such as political uncertainty, slow progress in privatization, and low enforcement of the legal framework have kept FDI low to date.

[17] Commercial banks' rates (particularly lending rates) in BiH have remained high despite the adoption of the Currency Board and a stable macroeconomic environment. The recent entry of foreign investors in the banking sector and the reforms and policies that have begun to strengthen the banking system are expected to improve the borrowing terms.

Graph 1.3 Consumer Price Indices, % Change (e.o.p)



1.26 With economic recovery depending much less on the strength of economic revival than necessary, the high growth rates to date have allowed the post-war output to reach half of its pre-war level—considerably lower than at least two-thirds recovery expected at the onset of the donor assistance. After the initial rebound in employment growth that reduced measured unemployment by more than half to its present highs (35 percent), labor demand has remained stagnant, as the real economy has not been able to generate more jobs.[18] Moreover, the benefits of economic growth and price stabilization enjoyed over the post-war era have not been broadly shared. Regional imbalances continue to exist with intra-regional economic convergence remaining slow, except for inflation rates (see Graph 1.3). It should be noted that although across Entities, the Federation remains more prosperous than the RS, regional inequalities within the Federation remain very high given its extremely decentralized structure with a low tolerance for intra-Entity equalization transfers (see Chapter III).

1.27 In the period ahead, a continuing decline in the magnitude and concessionality of donor assistance to levels associated with more normal development needs is inevitable with the formal end of the initial priority reconstruction and reform program in 1999.[19] Moreover, with much of the post-war reconstruction well under way, progress in policy reforms, instead of emergency reconstruction and reform needs, will increasingly determine the size of future foreign assistance. Over the last two years, donors have begun sharply responding to the stop and start nature of reforms that are critical to the sustainability of growth by postponing the annual pledging conference to a future date set in line with the improved progress in implementation. Therefore, looking forward, the BiH governments will have to (i) manage a sizable adjustment in the external current account (running a deficit at 21 percent of GDP) and in the fiscal account (running a deficit over 10 percent of GDP) in order to contain spending pressures without destabilizing the macroeconomy; (ii) achieve the creditworthiness needed to assure access to other sources of financing in the medium term; and (iii) establish a growth momentum that can be sustained based increasingly on the strength of the BiH economy and ensure that the benefits of this growth are broadly shared across the country.

1.28 The large external and internal imbalances were somewhat unavoidable in the post war era, given the extent of the damages to the economic and social infrastructure and the extremely depressed economic activity. The active reconstruction efforts in the early years were reflected in the speed of growth in externally financed imports on the external account, with a mirror effect in the growing public investments in the fiscal account. Nevertheless, not only reconstruction spending but also non-reconstruction spending have expanded significantly, as the latter was financed with domestically generated revenues, which recovered in parallel with the economic recovery (see Section C and Chapter II). As the reconstruction phase winds down, concurrent improvements in both the external and internal imbalances have begun, albeit owing primarily to the phasing out of donor financed reconstruction expenditures. Nevertheless, these adjustments alone will not be sufficient to ensure medium-term fiscal sustainability and the viability of external payments (see Section C).

[18] Because of the large informal economy in BiH, which is estimated to be between 20-40 percent of GDP, the actual unemployment could be lower. Nevertheless, even factoring this in, unemployment remains high in BiH by any transitional country standard.

[19] The remaining allocations under this program are expected to be fully disbursed over the next two to three years.

1.29 In addition to the need for an overall reduction in the external current account deficit, BiH must make important adjustments to shift the origins of the deficit from public investment to private sector activities over the next several years. A more vibrant and strongly outward-oriented private sector will be increasingly important to lowering the current account deficit as well as promoting output growth and growth in foreign direct investment (see Box 1.8). It will be necessary to offset the reduction in overall investment levels by taking reform measures that will help ensure increasing investment efficiency (see Box 1.9). Public recurrent expenditures, which are currently too pro-administrative, will need to be reallocated to growth-enhancing sectors; fiscal costs of the social benefits system will have to be streamlined and contained; and appropriate provisions will have to be made for the operation and maintenance of the new investments (see Chapters II and III). While debt service coverage is now comfortable, with increasing reliance on domestic resources and in light of the Currency Board's prohibition of money or domestic financing, significant downward adjustments in fiscal deficits will eventually have to be made to service external debt while meeting development needs (See Section C). These efforts will need to be complemented by institutional measures that will ensure the efficient management of public resources, which will become increasingly tight and more expensive in the period ahead (see Chapter V).

Box 1.8 Improving Export Capacity

The room for further recovery of the export base is large: by 2000, exports had reached only one third of its pre-war level. BiH's trade regime is quite liberal, providing a strong basis for recovery in the sector. The free trade agreements that BiH has recently concluded with neighboring countries have already begun to further stimulate exports by fully liberalizing the trade taxes. Strong export growth in the coming years will depend on further re-orientation of trade toward larger and more stable markets, and in line with BiH's comparative advantage, implying a diversification of exports toward higher value added and human capital intensive products. Most fundamentally, the speed of the required changes will depend on the pace of privatization and restructuring efforts. Containing labor costs will also be important to maintaining competitiveness, and foreign direct investment could provide valuable linkages to foreign markets. In turn, the current low levels of domestic savings would have to be reversed in order to finance and support the emergence of a dynamic private sector.

Box 1.9 Improving Investment Efficiency

Much of the inefficient heavy industry inherited from SFRY is already dormant or was destroyed during the war. The growth momentum in the coming years is expected to come not so much from further investment as in the past seven years, but from a variety of efficiency improvements. Specifically, one would expect to see: (i) recovery of underutilized capacity; (ii) elimination of egregious waste of labor, capital and materials; (iii) efficiency gains from a more appropriate combination of capital and labor; (iv) efficiency gains from resource allocation toward goods in which the country has a comparative advantage or in which there is unsatisfied consumer demand; and (v) output expansion via new net investment and employment increases in the SME sector.

1.30 The shift toward greater private sector determination of the trade balance should be reflected in increasing recourse to domestic savings—hence reduced reliance on external sources of savings as the current level of domestic savings at 1.6 percent of GDP is well below the levels required to sustain long-run growth. At the same time, it is important to maintain the economy's access to large but diversified inflows of external capital and to channel these inflows into the most productive arrears. Managing such a shift in the modality of external financing will, in turn, require improvements in creditworthiness and in the investment climate. A recent World Bank study on this subject[20] clearly demonstrates that BiH's path to creditworthiness over the medium to long term critically depends on redoubling reform efforts, maintaining access to concessional funding (albeit at reduced levels) and sustaining moderately high growth rates (not less than 5-6 percent) that would bring the economy capacity to its pre-war levels by the end of the decade. The study also emphasize that even under such favorable circumstances, the country's external financing

[20] See "Bosnia and Herzegovina: Towards Financial Sustainability and Creditworthiness," ECA-PREM, 2001.

requirements over the current decade remain considerable and debt service indicators enter a deteriorating path, requiring a very careful debt management strategy.[21]

1.31 Looking forward, BiH's policy makers will need to place an increased emphasis on improving the depth and pace of structural reforms and fiscal capacity if the country is to catch up with the time lost in preparing the conditions for addressing current vulnerabilities, while the donor assistance is still fairly large. Falling short of this target would require a forced domestic and external adjustment. A forced adjustment which is not accompanied by the necessary policies to address the current vulnerabilities would have further negative impact on growth prospects. It would severely increase fiscal pressures and could undermine the BiH's hard-won gains toward political stability. There has been an increasing recognition of these needs and risks among the BiH's policy makers since last year, which, as noted previously, has been reflected in increasing efforts to toward a viable economic development strategy for the country as a whole.

C. FISCAL PICTURE AND SUSTAINABILITY

Fiscal Outlook: A Snapshot View

1.32 ***The Policy and institutional structure for fiscal management is on an evolving track complicating the development of a sustainable fiscal framework.*** Building a policy and institutional framework for sound fiscal management has been one of the priority reform objectives in BiH since the immediate aftermath of the war. Initial efforts focused on collecting taxes, controlling expenditures, managing debt, and regulating trade and tariffs, along with establishing related minimum institutional capacities at all levels of government. Over the last three years, these efforts have broadened to focus on co-ordinated revenue and expenditure reforms in both Entities, with an emphasis on the simplification and harmonization of tax structures, the elimination of harmful tax competition, the rationalization and reform of social expenditure policies, increased transparency and control over the management of public resources, and legal and judicial reforms with an anti-corruption focus. The international community, by providing continued technical and financial support for these policy and institution-building reforms, has greatly facilitated the achievement of the reform objectives.

1.33 *Policy dimensions of the reforms.* The Entities have made significant progress in reforming and harmonizing indirect tax policies through rationalizing exemption policies, lowering rates, broadening the tax base, and harmonizing the point of indirect tax collection. Similar reforms are now being designed for direct taxes, while VAT is being considered as a replacement for the sales taxes. Excessively high combined taxes on labor, including wage taxes and social contributions, have been nearly halved from their post-war highs of about 80-90 percent of net wages. A rebate-based system has been established for directing the excise taxes on inter-Entity trade of goods to the place of consumption. A common, country-wide customs tariff regime and trade policy has been introduced with fairly liberal policies and tariff rates over half as low as the un-weighted average tariff rates prevailing in the region. The trade regime is now being further liberalized within the Stability Pact framework for South Eastern Europe (SEE).[22] General revenue and expenditure assignments between the State and the Entities, and within the Entities, have been introduced. Policy and institutional reforms aimed at strengthening financial sustainability, transparency, and the targeting of social transfers have been initiated. External debt rescheduling has been successfully

[21] The debt service pattern reflects the initiation, since late-2001, of principal repayments on the rescheduled debt and concessional loans incurred in the post-war period, which was expected.

[22] The framework promotes the creation of regional trade cooperation. In this context, Albania, BiH, Bulgaria, Croatia, Romania, the FRY Macedonia, and the FRY agreed on the creation of a network of bilateral free trade agreements by the end of 2002, thereby allowing for at least 90 percent of goods to be exchanged free of tariffs. As of February 2002, BiH's status in the Free Trade Agreement is as follows: with Croatia, applied from January 2001, with Albania and the FRY of Macedonia, under negotiations, and with the FR Yugoslavia signed on February 2002.

completed with both London Club and Paris Club creditors, eliminating a large part of the debt inherited from the SFRY.

1.34 *Institutional dimensions of the reforms*. Initial steps included the establishment of a basic fiscal management capacity and the adoption of legal and institutional frameworks for budget and debt management systems. Over the last three years, these efforts have been broadened, with a particular focus on addressing the increasing perception of widespread corruption in BiH.[23] As a result, promoting credibility, transparency, and accountability in public sector management has gained an increasing emphasis. To this end, the external audit function and supreme audit institutions have been established. A major reform of the payments system has been introduced, involving the re-integration of key public resource management and control functions to those public institutions where they normally belong for the transparent and efficient operation of the public sector. In this context, a Treasury system is being gradually established across key government levels, and inspection and internal audit functions are being gradually redefined. Initial tax administration reforms are also being broadened to improve cooperation between Entity tax administration systems and to effectively introduce anti-tax evasion and avoidance rules.

1.35 *Looking forward.* In order to fully appreciate these reform efforts, it should be borne in mind that they have been carried over in a rather ethnically charged environment, which compounds the obvious challenges of policy liberalization and market-oriented institution building reforms that other transition economies have often painfully experienced. Nevertheless, much remains to be done, as BiH is not only going through a transition process but is also undergoing a process of building a new State with a peculiar governance structure. Therefore, the development of a sustainable fiscal stance will take place in a complex and evolving policy and institutional setting, bringing uncertainties down the road. If it is not well coordinated, well timed, and kept within the financial constraints, this process could aggravate the present fiscal fragilities. Within this framework, several critical issues will need priority attention concerning (i) streamlining public administration; (ii) securing own-sourced financing for the State administration; (iii) formally coordinating public finance policies between the State and the Entities and within the Entities; and (iv) developing mechanisms for balancing revenue and expenditure assignments between BiH's multi-tiered governments against development needs and the need for rationalizing the role of the public sector in the economy.

1.36 ***Tax revenues recovered rapidly but reforms are far from complete and collection capacity is fragile.*** Peace, reconstruction, and the establishment of a basic tax policy and institutional framework facilitated a strong rebound in fiscal revenues in the aftermath of the war. Tax revenues almost doubled between 1995 and 1996 to nearly 50 percent of GDP, albeit with excessively high tax rates. After the initial surge, the growth rate of tax revenues slowed down over time with a real decline in tax revenue growth (net of social contributions) in 2000 owing to progressive tax reforms, which broadly reduced rates on major taxes, and a slowdown in economic growth. Failure to effectively address the high rate of tax evasion and the fraud practices originating during the war has also delayed gains from the revenue-enhancing aspects of the tax reforms (e.g., from efforts to broaden the tax base). The BiH's consolidated general government tax revenues diminished to 38 percent of GDP in 2000, with the tax revenues of the two Entities comprising nearly equivalent shares of their respective GDP (see Table 1.4).

1.37 While the last three years have seen a major move toward establishing a modern tax system, much remains to be done to further simplify tax structures, to further rationalize tax rates, and to introduce major

[23] The BiH's 2000 anti-corruption diagnostic survey reveals that public institutions, particularly revenue collecting and service delivering agencies, are perceived to be corrupt; governments and public institutions are perceived to be substantially prone to policy and regulatory capture; and lack of clear human management policies provides incentives for public officials to engage in bribery. For details see "BiH: Diagnostic Survey of Corruption" ECA-PREM, 2001.

improvements in tax collection and compliance (including through additional public revenue instruments such as property taxes, utility user charges, etc.). A full-fledged analysis of the tax system goes beyond the scope of this report. Nevertheless, the reform efforts need to pay special attention to (i) shifting the tax burden away from its present heavy reliance on consumption; (ii) providing the incentives for formalizing excessively large informal economy, as well as for developing the private sector; and (iii) improving the compatibility of the tax system with the EU norms. As noted above, some of the necessary reforms concerning direct taxes, VAT, further gradual reduction of taxes on labor and further trade liberalization within the Stability Pact are already being developed or are under way. These reforms will, however, be taking place at the very time that BiH needs to rely increasingly on its domestic revenue capacity. Therefore, while a further reduction in BiH's very high tax burden is desirable over time, it will be critical to avoid large reductions and fluctuations in revenue collection, which has been the immediate consequence of tax reforms to date. This becomes all the more critical to smoothing the medium term fiscal adjustment burden, given that the resource cushion provided by external inflows to date will be diminishing in the period ahead.

1.38 ***Public expenditures have dramatically increased as economic recovery and reconstruction have speeded up.*** Despite displaying a diminishing trend over their post-war highs of about 85 percent, total public sector expenditures as a share of GDP are substantial—64 percent in 2000—when expenditures financed by grant aid (6.5 percent of GDP) and loan aid (7.6 percent of GDP) from donors are included—both Entities respective rates averages around these aggregate levels (see Table 1.4). This has allowed public expenditures to remain at exceptionally high levels despite continuing downward adjustments since 1996. Nevertheless, the downward trend does not yet reflect a strategic scaling back in public spending, as it has mostly mirrored the diminishing donor-financed reconstruction investments.

1.39 ***But non-reconstruction expenditures have also expanded rapidly.*** With the reconstruction-oriented public investment spending being primarily financed by donors, domestically generated revenues have been mostly allocated to finance the public recurrent expenditures. The initial strong revenue rebound has allowed recurrent expenditures to recover rapidly from their extremely repressed war time lows by growing, on average real terms, about 20 percent annually during 1996-99. The contraction of domestic revenues in 2000 forced a downward adjustment in expenditures, though part of the adjustment was in the form of payment delays, a practice that the Entities have increasingly had recourse to as revenue growth slowed down between 1998-2000.[24]

1.40 The failure of successive BiH governments, governing on short cycles of two-years terms,[25] to resist pressures for the rapid recovery of public sector incomes and social assistance to their pre-war levels made it difficult to contain the expansion of expenditures during this period. In addition, the establishment of a new and heavy administrative public sector apparatus for a country the size of BiH contributed to rapidly growing expenditures. The massive unemployment in the productive sphere of the economy further aggravated this pattern with the public sector assuming the role of employer of the last resort. Over time, a major portion of the non-reconstruction budget (over 60 percent by 2000) has increasingly been allocated to two categories only: wages and transfers, with transfers to war invalids absorbing most of the latter. The rest is allocated primarly to material expenses (17 percent) and the military (8 percent).

1.41 This picture—which well describes the Entities' respective non-reconstruction expenditure structures, with small differences around the consolidated figures noted above—reflects the fiscal fragility to which BiH is increasingly exposed. The rigid wages and social transfers, the difficult challenges in dealing

[24] The expenditure growth will be higher if arrears (mostly recurrent) are taken into account.
[25] This practice will be changing with the forthcoming general elections scheduled for Fall 2002, whereby elections will be held every four years.

with excessive military spending, and the gradually increasing, though comfortable, debt service spending, leave little room for maneuver as the growth of available resources normalizes. Moreover, a portion of domestically generated revenues will need to be reallocated to finance public investments in the period ahead, as donor resources shift away from reconstruction financing. There is also increasing pressure on domestically generated resources as the State's role and responsibility are enhanced to facilitate economic integration to pave the way for EU accession. These factors point to the need for hard choices to be made for public expenditure prioritization in BiH if fiscal sustainability is to be maintained, which is essential for a Currency Board arrangement (see Section C and Chapters II and IV).

Table 1.4 Consolidated General Government Balances[1/], 1999-2000

	BiH			BiH	Federation	RS	BiH	Federation	RS
	1996	1997	1998	1999			2000		
Total Revenues (% of GDP)	75.5	58.0	57.7	61.0	61.7	57.5	52.1	51.9	51.7
Tax Revenues	49.3	39.7	42.6	41.6	42.2	39.9	37.6	37.8	36.9
Non-tax Revenues	3.5	3.2	4.3	7.6	7.6	6.2	7.7	7.8	6.5
Off Budget Grants	22.7	15.2	10.8	10.6	10.8	10.1	4.8	4.2	6.5
On Budget Grants	n.a.	n.a	n.a.	1.0	1.0	1.3	1.7	1.6	1.9
Total Expenditure (% of GDP)	85.6	60.6	64.4	71.9	72.3	68.9	63.9	63.9	60.5
Current Expenditure	56.2	41.0	47.0	49.5	48.6	50.1	49.1	49.8	45.8
o/w: Wages	11.3	9.0	14.0	16.1	16.5	13.4	15.5	16.4	12.0
Transfers	18.9	19.2	12.8	14.2	14.3	13.8	15.4	15.7	14.4
Defense[2/]	4.6	5.6	5.1	4.6	4.7	4.1	4.1	4.6	2.7
Interest Paym ents	0.7	1.2	1.2	1.9	1.1	3.8	2.1	1.9	2.9
Capital Expenditure	29.4	19.5	15.8	17.8	18.9	14.9	11.0	11.4	9.8
On Budget	1.3	1.8	2.2	4.1	4.7	2.2	3.4	3.4	3.2
Off-Budget	28.1	17.8	13.7	13.8	14.2	12.7	7.6	8.0	6.6
Arrears	n.a.	n.a.	1.6	4.3	4.4	3.8	2.7	1.9	4.9
Primary Deficit (% of GDP)	-9.4	-1.3	-5.5	-9.0	-10.2	-7.6	-7.4	-7.5	-5.9
Overall Deficit (% of GDP)	-10.1	-2.5	-6.7	-10.9	-11.3	-11.4	-9.5	-9.4	-8.8
Financing (%of GDP)[3/]	10.1	2.5	6.7	10.9	11.3	11.4	9.5	9.4	8.8
O/w Foreign Borrowing, Net	n.a.	n.a.	5.1	6.6	6.6	7.6	6.2	6.7	3.9
O/w Arrears	n.a.	n.a.	1.6	4.3	4.4	3.8	2.7	1.9	4.9
Memo Items:									
% of Total Revenues									
Domestically generated revenues	69.9	73.9	81.3	80.7	80.7	80.2	87.9	89.3	83.8
External Grants	30.1	26.1	18.7	19.3	19.3	19.8	12.1	10.7	16.2
% of Total Expend. (on-&off-budget)									
Wages	13.2	14.9	21.8	23.8	24.3	20.5	25.4	26.4	21.1
Transfers	22.0	31.6	19.9	21.0	21.1	21.1	25.2	25.3	25.8
Defense[1/]	5.3	7.5	7.1	6.8	7.0	6.3	6.7	7.5	4.9
Off-budget Capital expenditures	32.8	29.3	21.2	20.4	20.9	19.4	12.4	12.8	11.9

1/Expenditures include commitments. GDP figures refer to each Government level's GDP. 2/Excludes off-budget defense spending and arrears, which is only available for 2000. 3/Includes small privatization receipts for 1999-2000.
Source: Official data and staff estimates..

1.42 ***Fiscal adjustments to date remain forced and ad hoc rather than strategically planned.*** Despite recent efforts to integrate them, the virtual separation of recurrent and capital budgets in BiH, weak planning capacity, and painfully fragmented present resource management practices make it difficult to strategically plan and initiate required expenditure adjustments before they are forced. This, combined with bias in the allocation of resources toward maintaining rapid income expansion, resulted in budgetary cuts that concentrate disproportionally on material and operation and maintenance expenditures, with marginal containment in military and social transfers (see Chapter II).

1.43 Though 2001 has marked a change in the practice, recurrent payment delays have been another instrument that both Entities have relied on to cope with the resource constraints. The stop-go nature of structural reforms have impeded the BiH governments' ability to sustain a steady course of budgetary support from donors as a means of alleviating resource constraints during this period. Public investment spending has mainly followed the pattern of reconstruction assistance with a major downward adjustment between 1996 (29 percent of GDP) and 2000 (11 percent of GDP). While most of the reduction to date has occurred as a natural consequence of the completion of most of the emergency reconstruction and

rehabilitation projects, the sustainability of the economic recovery process requires that future investment decisions be made strategically with a medium-term vision of development needs and the public sector's role in the economy. More important, adjustment efforts for both recurrent and investment spending would need to be made within a medium-term fiscal framework that would provide a basis for efficient and equitable resource allocation consistent with hard budget constraints (see Chapter V). As noted previously, the State and the Entity governments are jointly establishing these principles in their economic development strategy. However, for these principles to be effectively applied, the strategy would need to be translated into a monitorable implementation plan within a medium-term macroeconomic framework.

1.44 ***External inflows remain the primary but not the only source for deficit financing with recourse to arrears.*** Under the Currency Board arrangement and with conservative fiscal policies which prevent domestic government borrowing, external grants and loan aid remain the only formal means of deficit financing in BiH (at about 12 percent of GDP in 2000). Nevertheless, as noted in the previous paragraphs, both Entities and their local governments relied on arrears accumulation to maintain expenditure expansion in response to resource constraints and, occasionally, for short-term liquidity management. Wage, transfer, and pension arrears as well as arrears to suppliers and intra-extrabudgetary fund arrears become common practice. The size of arrears became a serious impediment to smooth budget execution by 2000, especially in RS and for both Entities pension funds. With pension reforms in late 2000—forcing commitments to match resources—and increased commitment to controling public outlays in 2001—involving a shift from arrears accumulation toward arrears clearance—financial discipline and transparency has been improved. Nevertheless, while these measures have constrained the growth of expenditures, containing wage pressures still remains a problem, and payment delays appear to remain in place at the local government level, where fiscal oversight is difficult to practice at present. The gradual extension of newly established Treasury systems to local government will be an important step to improve overall financial discipline in the period ahead (see Chapters II and V).

1.45 ***Debt repayments are comfortable despite reliance on external financing as a main source of deficit financing, but avoiding future pressures requires a well-designed fiscal sustainability strategy.*** Foreign assistance to date, with a grant component of 73 percent, has provided the bulk of financing of public sector deficits. Therefore, despite large imbalances, deficits have not been translated into higher debt to GDP ratios, and debt service has remained at comfortable levels—at 2 percent of the Federation's GDP and 3 percent of RS's GDP, with the later reflecting RS's relatively high share in old debt (the debt. inherited from the former SFRY) compared with the size of its economy. The real economic growth rates, staying well above the average real interest rates on foreign debt, have also kept debt levels relatively stable.

1.46 Nevertheless, in the period ahead, BiH's debt service burden will be on an increasing path as principal payments have started falling due in late 2001. Moreover, over the last three years there has been a continued shift in donor assistance away from purely capital transfers toward concessional credits, a pattern that can be expected to continue in the future as the focus of donor assistance shifts from reconstruction to structural reforms. The volume of concessional lending available to BiH has also started diminishing. These factors certainly aggravate the present fiscal fragility and make a well-planned fiscal sustainability strategy all the more urgent (see paras. 1.60-1.68).

1.47 ***Understanding the true size of the public sector is a challenge even after a tedious fiscal patchup.*** The highly decentralized governance structure with no means of formal coordination is mirrored in the highly fragmented and incomplete public financial reporting. At present, all levels of government, whether central or local, report only their own budgets, with an official consolidated general government framework virtually absent. The present budgetary practices also leave sizable public sector activity outside the budgets, including externally financed public capital expenditures and, to a lesser extent, certain defense

financing/spending and social transfers. The social funds,[26] public enterprises, and utilities all operate off-budget, with only *explicit* transfers and subsidies from the governments being presented in the budgets. Moreover, the persistence of expenditure arrears suggests that the actual size of government measured on a commitment basis is larger than is suggested by the cash-based reporting which BiH governments largely follow at present.[27] Finally, use of non-cash transactions, such as barter trade—whereby amounts owed and receivables among public-owned enterprises are settled in return for goods and services—has also been a common practice in BiH, undermining both revenue predictability and the transparency of budgets as well as contributing to large intra-public sector arrears accumulation.[28] Together, these factors make it difficult to measure the true size and scope of public sector operations in BiH, which severely complicates any analysis of expenditure policies.

1.48 This Report has made an effort to establish a consolidated general government framework based on the State budget, the central and local Entity government budgets, off-budget external financing that is estimated to be channeled into the public sector, extrabudgetary funds, and recorded arrears (see Chapter II). However, it is inevitable that because of the above-noted problems, this inclusive picture, while demonstrating how high the public sector's share is in the BiH economy, understates the true size of the public sector.

1.49 ***Additional pressures on expenditures are likely in the period ahead.*** Consolidated general public expenditures totaled about 64 percent of GDP in 2000, down from 72 percent in 1999—the respective Entity figures as a share of GDP are at around this figure. The available incomplete information suggests that the downward trend has continued in 2001, reflecting both a further slowdown in external inflows and better control on expansion of the expenditures. Nevertheless, public expenditures are expected to remain high (at around 60 percent of GDP) for 2001.

1.50 While fiscal stability has been maintained to date, thanks to donor support and conservative fiscal policies, the present level of public expenditures as a share of GDP is excessive by most norms and is not sustainable in the medium term. There are three major pressure points: first, the extraordinary level of donor assistance is phasing out; second, much needed tax reforms rule out any compensation for this decline through raising the tax burden over and above its present highs; and third, additional pressures on public spending are rising rapidly, even in the short run. Chief among these spending pressures are: (i) pressures at the State level as its role evolves in line with the improving economic integration both within the country and with the EU; (ii) frozen foreign exchange deposit claims from pre-war/war era which, once the proper modality is designed, will begin to be paid back regularly; (iii) domestic liabilities and claims originating from past payment delays to civil servants, veterans and their families, and pensioners; (iv) the accelerated return of refugees and the impact this is having on the demand for services such as health care, education, and physical infrastructure; (v) military demobilization; and (vi) the unavoidable costs of downsizing public sector operations, whether through public administration or large-scale privatization, which is lagging behind.

1.51 The Entity's fiscal position is also exposed to explicit risks arising from contingent liabilities as well as from deferred deficits—particularly of local governments—that remain outside the budget coverage. These risks originate mainly from three sources: (i) financing modalities of Entity/sub-Entity-owned enterprises—which design and implement their own expenditure and investment programs with no

[26] This comprises pension, health, and unemployment insurance funds in both Entities and Children's Fund in RS.

[27] Cash budgeting in an environment of widespread arrears accumulation by all levels of government makes it extremely difficult to gather reliable information on expenditure arrears.

[28] This practice became particularly risky during 2000, when, although prohibited by the budget law, the RS government had provided major tax off-sets against goods and services provided to government agencies by publicly owned enterprises. The tax off-sets have been discontinued since 2001 with the abolishment of the Goods Reserve Directorate.

formal government control/oversight—involving borrowing, often with guarantees, from the commercial banks that Entities/sub-Entities either own or control; (ii) operation of public utilities with severe resource constraints and unsustainable pricing schemes; and (iii) present, often implicit, subsidization policies for social assistance to households or for operational support to ailing enterprises.

1.52 The limited information, which is gathered mostly through interviews with various public officials as exemplified in Box 1.10, makes it difficult to estimate size and significance of fiscal risks that could arise from these three sources. Nevertheless, it clearly indicates that BiH's future fiscal position may suffer from further pressures arising from these fiscal risks. As a prudent policy stance bears fruit in terms of controlling these risks, the BiH governments should seek to identify the sources and likely financial implications of contingent obligations which already exist while controlling such obligations in the future by strengthening the regulatory framework within which the public sector operates, including establishing a monitoring capacity for enforcement. A vigorous implementation of [recently adopted] guidelines for public sector borrowing, including borrowing by the sub-entity governments and financial and non-financial public enterprises, will go a long way in this direction.

An Evaluation of the Size of the Public Sector

1.53 The economic literature provides a broad, theoretical perspective for guiding the optimal size and scope of government in liberalizing, transition economies. Nevertheless, it is widely accepted that in practical application the definition of optimum would vary with a country's unique demographic and structural characteristics as well as its voters' preferences, with no standard size and scope applicable to all countries. As a country in transition to a market economy, guiding principles for BiH policy makers in making choices about public sector interventions should be (i) alleviating (by methods as market conforming as possible) market failures for the efficient allocation of resources (by providing public goods and managing externality producing activities), and (ii) ensuring distributional equity for poverty reduction (by targeted social assistance and income redistribution). The literature also emphasizes the crucial role public sector interventions play in creating an enabling environment for the private sector as well as in designing a macroeconomic stabilization policy, as failures in these areas have often severely constrained attempts to liberalize the economy.

1.54 Within this framework, however, actual public sector intervention in BiH should be a function of its multi-tiered governments' ability and available resources. For illustrative purposes, a simple analysis of consistency of public sector expenditures with the resource constraints suggests that, if in the period ahead, the ratio of domestically generated revenues to GDP is held at its present highs of 45 percent, then a major expenditure adjustment (equivalent to about 19 percentage points of reduction in GDP terms) will be needed for the fiscal situation to become sustainable in a framework in which BiH depends on the strength of its own economy rather than on major donor aid.

1.55 Nevertheless, the maximum sustainable level of expenditure does not necessarily indicate the desirable level. With its present high ratio of taxes to GDP, BiH is one of the highest-taxed economies in Central Europe, where, as noted previously, the tax burden is crowding-out the development of the private sector, informalizing the economy, and facilitating generalized tax evasion. Therefore, a status quo scenario concerning the tax burden probably overstates the domestically generated likely resource envelope in the medium to long term. Obviously, a true fiscal sustainability analysis requires a deeper evaluation of the parameters of macroeconomic stability and financial sustainability, which is undertaken in the next section. Nevertheless, the underlying messages of both analyses are the same: present public sector expenditures are well beyond the levels that can be sustained with BiH's future resource availabilities and if the transition objective of private sector-led growth is to be achieved.

1.56 An alternative approach in assessing the public sector's interventions involves comparing the size and scope of BiH's public sector spending with other countries, especially transition countries. This analysis is carried out in detail in the next three chapters, with a view to assessing efficiency and equity aspects of key sectoral spending as well as its impact on economic growth and social indicators. Undertaking this analysis at an aggregate level below, using the conventional ratio of public spending-to-GDP as a measure of the public sector's size, helps to put an emerging picture of BiH into a context. As reflected in Table 1.5, despite a significant post-war decline to date, the public sector's present share in the BiH economy is strikingly large compared with other transition economies in the region: economies which achieved good progress in transforming their economy tend to have significantly smaller public sectors than BiH, with the average being about 40 percent of GDP, while in those transitional economies where social welfare expenditures continue to have a heavy weight in determining general government expenditures or where progress in reforms has been slow, the public sector remains large, averaging close to 45 percent. In most transitional economies in the region, however, average general government expenditures declined drastically from about 50-60 percent at the onset of transition in 1998-90 to at around 40 percent by 1997 as the government's role in the economy has adjusted to facilitate private sector development.

Table 1.5 Evolution of General Government Spending: European Transition Economies (percentage of GDP)

Country	Pre-Transition[1]	Transition[2]	1997	1998	1999	2000	Change[3]
Albania	50.5	43.8	29.5	29.8	32.6	31.4	-19.1
Bosnia[4,5]	40.6	85.6	60.6	64.4	71.9	63.9	23.3
Bulgaria	61.6	45.9	33.5	35.8	41.2	41.9	-19.7
Croatia[5]	40.6	39.8	51.3	53.9	56.2	51.3	10.7
Czech Repul	68.7	52.2	40.9	40.8	42.1	43.8	-24.9
Hungary	60	59.2	44.9	43	43.4	n.a.	-16.6
Macedonia	n.a.	47.4	35.3	35.8	37.7	36.6	-10.8
Poland	48.5	50	45.8	44.6	43.9	42.6	-5.9
Romania	40.2	42	33.9	35.6	37.4	35.6	-4.6
Slovenia[5]	40.6	46.2	43.2	43.6	44.4	43.6	3

[1]Corresponds to average 1988-90. 2. Corresponds to 1992. 3. Change between 2000 and average 1988-90. 4. Data for Transition correspond to 1996. 5. Data for 1988-90 correspond to SFRY.

Source: SIMA Database, World Bank and staff estimates.

1.57 This comparison highlights another feature peculiar not only to BiH but also to the other former SFRY republics in the comparator group: compared to pre-transition averages, using the former SFRY general government public spending ratios for this purpose, the public sector's present size is higher, with the increase as large as 23 percentage points in the case of BiH.[29] This reverse pattern largely reflects the post-conflict nature of public spending in these economies, which makes the transition even more challenging. In the case of BiH, in addition to extraordinary spending pressures arising from a particularly destructive conflict, these complicating factors include the institutional costs of becoming an independent state with a particularly complicated governance structure;[30] the large number of refugees and internally displaced persons; de facto underutilized or unemployed former public employees with special needs; political and social constraints to labor mobility; and an oversized defense sector. Certainly, these complicating factors should be considered not as justification for maintaining the status quo, but as emphasizing the need for a much greater effort in policy and institution-strengthening reforms, which will help BiH catch up with the progress other transition economies have achieved in redefining the role of the public sector in their economies.

[29] BiH's GDP is underestimated owing to informal sector, which should be factored-in into the analysis.

[30] Becoming an independent state carried new requirements such as having to establish new institutions and functions, the cost of which was previously shared with other republics of the former SFRY in the pre-independence period. In this process, BiH added two entirely new multi-tiered layers of government. Regarding new functions, the sole establishment and maintenance of a "foreign service" per se is quite costly for a country the size of BiH.

Box 1.10 Fiscal Risks and Vulnerabilities: A Qualitative Assessment

Recent crises in emerging economies have highlighted the risks to government finances that are posed by the contingent liabilities. It is now widely recognized that any assessment of fiscal sustainability should include all government activities (direct and contingent) that are undertaken by and on behalf of the government. A "Fiscal Risk Matrix" developed by the World Bank provides a framework that captures all types of fiscal risks that governments face regarding their obligations. Direct liabilities are defined as obligations whose outcome is predictable. In contrast, contingent liabilities are obligations triggered by a discrete event that may or not occur.

Fiscal Risk Matrix

Liabilities	**Direct** (obligation in any event)	**Contingent** (obligation if a particular event occurs)
Explicit Government liability as recognized by a law or contract	Foreign and domestic sovereign borrowing (loans contracted and securities issued by central Government) Budgetary expenditures Budgetary expenditures legally binding in the long term (civil servants' salaries and pensions)	State guarantees for non-sovereign borrowing and obligations issued to sub-national Governments and public and private sector entities (development banks) Umbrella state guarantees for various types of loans (mortgage loans, student loans, agriculture loans, small business loans) Trade and exchange rate guarantees issued by the state State guarantees on private investments State insurance schemes (deposit insurance, income from private pension funds, crop insurance, flood insurance, war-risk insurance)
Implicit A moral obligation of Government that reflects public and interest-group pressures	Future public pensions (as opposed to civil service pensions), if not required by law Social security schemes, if not required by law Future health care financing, if not required by law Future recurrent costs of public investments	Defaults of sub-national Government or public or private entities on non-guaranteed debt and other obligations Cleanup of liabilities of entities being privatized Banking failure (support beyond state insurance) Failure of a non-guaranteed pension fund, employment fund, or social security fund (protection of small investors) Default of central bank on its obligations (foreign exchange contracts, currency defense, balance of payments stability) Bailouts following a reversal in private capital flows Environmental recovery, disaster relief, military financing

Source: World Bank Website: Quality of Fiscal Adjustment

In the case of BiH there is some anecdotal evidence of implicit direct and contingent liabilities that are potentially important sources of fiscal risk. Since there are no official estimates of activities performed outside the budget, a qualitative assessment is the only tool that can be used to evaluate fiscal risks.

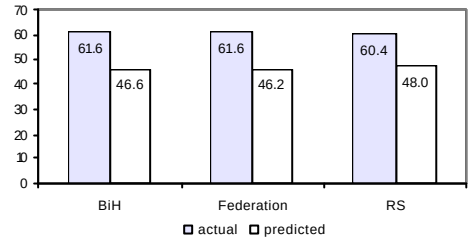
The qualitative information suggests that existing public sector guarantee operations, carried over in an environment with complete lack of a regulatory framework, are an important source of fiscal risk, due particularly to the poor financial state of both public-owned banks and public enterprises. Although it appears that there are no substantial explicit government guarantees at the Entity level (particularly in the Federation, with a mixed anecdotal reference to the likely significance of Entity level guarantees in RS), at the cantonal and municipal level, guarantees appear to be extended to banks for business loans to publicly-owned enterprises; programs exist to direct lending at subsidized interest rates—e.g., anecdotal evidence reveals that a local government had extended to a municipal clinical center a guarantee for a foreign loan of a relatively sizable amount. There is also anecdotal evidence that some of the guarantees extended carry high risk—e.g., a publicly-owned bank has extended guarantees to a publicly-owned utility company that are larger than its equity capital. Another publicly-owned bank has an exposure to a publicly-owned refinery company of about twice its equity capital and to a public-owned energy company that roughly equals its capital base. The fiscal risk involved in this practice is compounded by the fact that these public-owned banks are not properly covered for potential losses with their coverage against loans often below the required level of reserves.

Another major source of fiscal risk is the quasi-fiscal activities run outside the budget by certain state-owned enterprises. The utilities sector especially has been used as an indirect vehicle for implementing subsidization policies, which in some cases have imposed severe costs in their fragile finances. For instance, public utilities have provided services (gas and electricity) to households at subsidized rates (and in some extreme cases for free, due to the culture of non-payment) and have little capacity for collection enforcement. There have already been signs of financial distress, which, at least in one case, have forced a local government to transfer resources to avoid defaults on obligations of a municipal utility company (gas) in addition to assuming the payments on service charges (gas bill) on behalf of 14,000 households. Moreover, the slowness of the process of a centralized privatization system has immobilized local decision-making in dealing with these problems. As a consequence, the depletion of the capital stock in public utilities risk is increasing, and the public services delivery risk deteriorating even more in the medium to long term.

The complicated web of intra-public transfers/subsidization has other worrisome examples: there are cases where profitable public-owned enterprises are being used to support insolvent and financially distressed industries such as mining. For instance, a public-owned enterprise has agreed to purchase coal from local mines at twice the world market price. The risk that this enterprise would incur in future losses is high, as this coal is of inferior quality, providing half of the energy compared with world quality coal. All these types of fiscal pressures are explicit government liabilities and their future budgetary impact should be assessed jointly with the current discretionary expenditures when fiscal policy is designed.

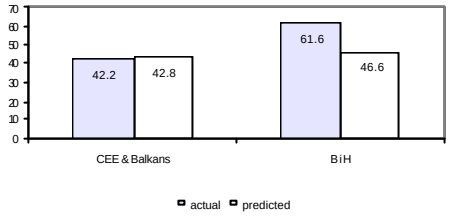
1.58 An alternative, more systematic approach to assessing the appropriateness of the public sector's share in BiH's economy in a cross-country context, is to apply a model that aims at predicting the size of the public sector based on quantifiable structural determinants of public spending—such as demographic factors, income levels, social parameters, and financial constraints.[31] Given the values for such structural parameters in BiH and its constituent Entities, the model predicts that public expenditure in BiH would be in the order of 47 percent of GDP (15 points lower than its current level), with respective Entity ratios predicted in the order of 46 percent of GDP in the Federation (15 points lower than the current level) and 48 percent of GDP in Republika Srspka (12 points lower than its current level) (see Graph 1.4). Consistent with the simpler analysis above, the actual size of the general governments turns out to be far higher than the predicted size justified with the structural parameters of the BiH economy.

Graph 1.4 General Government's Size, Actual Versus Predicted (% of GDP)



1.59 Regarding cross-country differences, unlike BiH, at their present stage of transition, the other CEE economies have shown, on average, actual levels of expenditure almost equivalent to their predicted values (see Graph 1.5).[32] While providing a measurable benchmark rather than defining an exact future size of the public sector in BiH, these results point to a substantial scope for rationalizing public spending in BiH relative to other transition economies by vigorously broadening and deepening the structural reforms in the next few years. *This process will be made easier if the economy is recovering rapidly, thereby creating more room to maneuver, because public expenditure can rise in nominal terms even when its share in GDP is to be reduced.*

Graph 1.5 General Government's Size, Actual Versus Predicted, BiH vs CEECs (% of GDP)



Sustainability of Fiscal Deficits

1.60 The above discussion illustrates that, as in most other transition countries, BiH's fiscal stance is at the center of the difficult transition process to a market economy. What is imperative in the case of BiH, however, is that the present high fiscal imbalances need to be redressed with a view to achieving a smooth transition from aid dependency to market-based growth. In this undertaking, the sustainability of the fiscal stance requires developing an expenditure policy framework that meets the following two criteria: (i) it is well aligned with available financing sources without needing recourse to explosive borrowing or unviable financing policies such as arrears accumulation; (ii) it meets minimum social needs and allows for private sector development. This section analytically enhances the discussion so far on fiscal stance by analyzing the parameters needed for satisfying the first criteria. To this end, what follows assesses the financeable deficit levels that are compatible with the available financing sources, with requirements for stable and affordable external borrowing and with growth and inflation targets that would help BiH converge to its pre-war economic strength within this decade.

[31] See Barbone, L. and R. Polastri, "Hungary's Public Finances in an International Context," in Public Finance Reform during the Transition, World Bank, Washington D.C., 1998.

[32] The other transition economies included in the regression were: Albania, Bulgaria, Croatia, Czech Republic, Hungary, Macedonia, Poland, Romania, Slovakia, and Slovenia.

1.61 The starting point for the analysis is the definition of the fiscal deficits in BiH. The official deficits figures, whereby each level of government reports its narrowly defined cash balances—suggesting deficits in the range of 0.7-2.2 percent of GDP—are misleading for any meaningful fiscal analysis. Broader coverage of the government, including local governments and important extrabudgetary funds, reveals much higher deficits. Correcting these figures further by including off-budget capital expenditures, arrears and off-budget defense spending reveals even higher deficits (see Table 1.6). As both the size and the financing modality of deficits have macroeconomic implications, our analysis is built on such a broader definition of the consolidated general-BiH and general Entity budgets, and broader possible coverage of these budgets based on recorded financial transactions. However, the caveats discussed in paras 1.44-1.48 applies regarding constraints to this exercise.

Table 1.6: Consolidated General Government Fiscal Deficit, 2000

(in Percent of Respective GDPs)	BiH	Federation	RS
"Budgeted" Deficit	3.7	3.7	3.9
Deficit with Capital Spending (I)	6.5	7.5	4.0
Deficit with Arrears (II)	6.7	5.6	8.8
Deficit with Off-budget Defense Spending (III)	7.2	7.9	5.2
"True" Deficit with Arrears Capital Spending & Off-budget Defense	*11.5*	*9.9*	*9.7*
"True" Primary Deficit	9.4	9.8	6.8

Source: Official figures and World Bank estimates

1.62 As noted previously, the aid transfers and concessional lending from donors have been the primary source of deficit financing in BiH. This is expected to continue in the period ahead under the Currency Board rule and the conservative fiscal rules which prevent domestic borrowing.[33] Fiscal imbalances under this financing modality, although large, have not been translated to date into a sizable accumulation of public debt owing to the large share of aid transfers within the total inflows. Similarly, the highly concessional, "loan-aid" nature of the lending has kept interest spending at comfortable levels. With the favourable terms of rescheduling on old debt inherited from SFRY, and high economic growth rates exceeding by large margins the interest rates on the external public debt, the debt-to-GDP ratio (DR) has been fairly stabilized at about 67 percent of GDP.

1.63 Prior to asking the key sustainability question about what levels of fiscal deficit can be financed without destabilizing the DR ratio,[34] it is worth noting another useful indicator of indebtedness, which is particularly relevant in the case of BiH—namely the net present value (NPV) of debt, a measure that takes into account the degree of concessionality.[35] Since BiH's external debt is contracted on concessional terms with an interest rate below the prevailing market rate, the NPV based DR ratio is considerably lower (47.9 percent of GDP) than the DR ratio based on the face value of the debt.[36] Nevertheless, measured on both terms, BiH's external debt compared with that of countries from SEE and countries of similar per capita income (lower-middle income countries) is relatively large.[37] Despite this, present debt-servicing ratios are more favorable in BiH[38] given the concessionality of the lending. It should, however, be kept in mind that the generosity of concessionality relates to the past obligations. In the period ahead, exceptional inflows to BiH will be diminishing, while principal payments on rescheduled debt will increasingly be falling due. Both of these factors imply an increase in future debt servicing.

[33] Although constituting a financing source, the privatization receipts are not a regular source, and, therefore, are not relevant for the analysis of long term fiscal sustainability.
[34] See Annex I for the description of a simple sustainability framework.
[35] Over 60 percent of the estimated US$4 billion reconstruction assistance provided up to end-2000 has been disbursed in the form of grants, and the rest under very concessional terms.
[36] Conceptually, the acquisition of a given volume of liabilities at concessional terms amounts to the issue of a certain (smaller) volume of debt at market terms coupled with the receipt of a unilateral transfer (a grant).
[37] Despite rescheduling and consolidation agreements, BiH's debt to GDP ratio ranks second in the SEE region, after Bulgaria, though it is important to bear in mind that BiH's high debt-to-GDP ratio is partly due to the sharp output collapse after the war.
[38] As of end-2000, payments due on total external obligations were only 7 percent of total exports of goods and services and 11 percent of the Entities' budget revenues.

1.64 This picture suggests that an assessment of the DR ratio that could be considered stable in BiH would need to evaluate, to the extent possible, the likely future course of external financing modalities against the country's financing requirements and debt-carrying capacity for sustaining economic recovery. A recent World Bank study has explored these questions.[39] This discussion uses its results as a benchmark while assessing the fiscal sustainability below. It should be noted that these questions are especially relevant in the case of RS, where the debt burden is much higher (82.9 percent of GDP as opposed to estimated sustainable rate of 62.4 percent of GDP) than it is in the Federation (60.4 percent of GDP as opposed to estimated sustainable rate of 55.7 percent of GDP), while economic growth is relatively sluggish and inflation is higher. Although there are recent signs of increasing economic convergence in the economies of the two Entities, this in itself would not align the RS's debt burden with its debt carrying capacity, unless an appropriate fiscal strategy is developed.

Box 1.11 The Parameters of the Fiscal Sustainability Analysis

The long-run targets concerning growth assume that, under a stable reform effort, recent aggregate rates of moderately high growth (at around 6 percent) will be sustained in the period ahead on a path that could take the economy to its pre-war state by the end of this decade. It is also assumed that the Entity's economic growth patterns will further converge under ongoing reform efforts to create a single economic space. With the continuation of the Currency Board arrangement (CBA), domestic inflation is assumed to stabilize at around 3 percent, converging to the expected average longer-term Euro area inflation rates, and the exchange rate is assumed to remain fixed vis-a-vis the Euro. This makes growth performance and interest rates on external public debt primary determinants of BiH's fiscal stance. The interest rates are assumed to stay at the low range of EU area rates, assuming that BiH will undertake the necessary reforms to maintain its access to aid and concessional lending, albeit at a lower scale. Finally, for simplicity, it is assumed that the seignorage revenues (in terms of the seignorage earned in the form of interest income on foreign asset holdings in the case of BiH) will continue to accrue solely to the Central Bank.

1.65 The following discussion analyzses the fiscal stance of the BiH economy for the decade, as of 2000, the most recent year for which data permit a consolidation exercise at BiH and Entity levels. To this end, we have estimated the "financeable" primary fiscal balance[40] that will be required to stabilize the DR ratio over the medium to long term based on parameters described in Box 1.11. As a measure of the DR ratio, we use the ratio that resulted from our detailed analysis of expected and required foreign financing inflows to BiH as noted in para 1.64.

1.66 A comparison of the financeable primary balance with the actual primary balance demonstrates the extent of the adjustment necessary to achieve fiscal sustainability over the medium-term, assuming no external shocks. Table 1.7 presents the results concerning both the overall BiH and the Entity fiscal stances. The results clearly show that the actual deficits are out of line with the requirements of a stable DR ratio for all interest rates, even under the strong reform and growth assumptions. For example, assuming a very favorable interest rate of 3.5 percent on public debt—comparable more or less to present effective rates—the deficit needs to be brought down by 6.9 percentage points of GDP at BiH's current debt levels. The necessary fiscal adjustment at each Entity is over 7 percentage points of GDP in the Federation and over 4 percentage points of GDP in the RS. It should, however, be emphasized that the DR ratios for both Entities, on which these estimates were built, reflect continued access to a fairly favorable stream of the aid and loan aid under the above outlined parameters of "reform" scenario[41] (see Box 1.11). A falling away from the

[39] See "Bosnia and Herzegovina: Towards Financial Sustainability and Creditworthiness," ECA-PREM, 2001.

[40] The primary fiscal balance is the overall fiscal balance before the interest due on public debt. It reveals how compatible the revenue and expenditure policies are with a sustainable fiscal stance, one which will not lead to an unsustainable increase in debt service that will limit resources available for future needs of the government. The larger the differential between the actual and the financeable primary deficit, the higher the additional adjustment efforts needed to restore the fiscal sustainability.

[41] The "reform" scenario has assumed an optimistic scenario whereby, in the period ahead, half of the required external financing would come in the form of grants as opposed to debt accumulating flows and the rest in the form of concessional lending. In addition, relatively significant FDI inflows are assumed to provide further non-debt creating financing. In the real world, the concessionality of future flows will most likely be correlated with the country's commitment to, and progress, in reforms.

"reform" scenario would clearly further increase the fiscal adjustment burden, as the foreign inflows would be lower in size and less favorable in concessionality, forcing a higher fiscal adjustment.

Table 1.7 Required Deficit Reduction; Growth 6 percent, Sustainable Debt Ratio (in percent of GDP)

	Bosnia and Herzegovina			Federation			Republika Srpska		
Interest rate	Financeable Deficit	Actual Deficit	Required Deficit Reduction	Financeable Deficit	Actual Deficit	Required Deficit Reduction	Financeable Deficit	Actual Deficit	Required Deficit Reduction
3.5	2.5	9.4	6.9	2.4	9.8	7.4	2.7	6.8	4.1
4.0	2.3	9.4	7.1	2.2	9.8	7.6	2.5	6.8	4.3
4.5	2.1	9.4	7.3	2.0	9.8	7.8	2.3	6.8	4.5
5.0	1.9	9.4	7.5	1.8	9.8	8.0	2.0	6.8	4.8
5.5	1.6	9.4	7.8	1.6	9.8	8.2	1.8	6.8	5.0
6.0	1.4	9.4	8.0	1.4	9.8	8.4	1.5	6.8	5.3
Memo Item:									
Nominal debt	57.8			55.7			62.4		
NPV of Debt	44.6			43.0			48.2		

1.67 Finally, because of BiH's relatively high DR ratio as well as present and expected future reliance on foreign inflows for deficit financing, both the output growth and the interest rates on foreign debt have a significant impact on the financeable deficit. Tables 1.8 and 1.9 show the sensitivity of the financeable deficit that would be required to stabilize the DR ratio to various streams of growth and interest rates in the Federation and RS, respectively. The required improvement in financeable deficit increases with the interest rates and decreases with the growth rates. In general, higher growth rates create more room for debt issue and therefore provide relief in the necessary adjustment burden for any given interest rate. *In fact, in the case of BiH, a strong private-sector led growth effort could greatly help to further smooth the fiscal adjustment burden by keeping aid flows at affordable lows and attracting higher FDI, both of which would have a considerable impact on reducing the need for debt issuance.*

Table 1.8 Federation-Required Primary Deficit[1] (in % of Fed. GDP)

Variable assumptions

Foreign interest rate (%) ⇒ / Real growth rate (%) ⇓	3.5	4	4.5	5	5.5	6
2	0.7	0.5	0.2	0	-0.2	-0.4
3	1.1	0.9	0.7	0.5	0.3	0.0
4	1.6	1.3	1.1	0.9	0.7	0.5
5	2.0	1.8	1.6	1.4	1.1	0.9
6	2.4	2.2	2.0	1.8	1.6	1.4
7	2.9	2.7	2.5	2.2	2.0	1.8
8	3.3	3.1	2.9	2.7	2.5	2.3

1/ Building on financial sustainability study, nominal debt ratio target equals 56 percent of GDP (equivalent NPV is 45 percent).
Source : Staff estimates.

Table 1.9 RS-Required Primary Deficit[1] (in % of RS GDP)

Variable assumptions

Foreign interest rate (%) ⇒ / Real growth rate (%) ⇓	3.5	4	4.5	5	5.5	6
2	0.8	0.5	0.3	0.0	-0.2	-0.5
3	1.2	1.0	0.8	0.5	0.3	0.0
4	1.7	1.5	1.3	1.0	0.8	0.5
5	2.2	2.0	1.8	1.5	1.3	1.0
6	2.7	2.5	2.3	2.0	1.8	1.5
7	3.2	3.0	2.8	2.5	2.3	2.0
8	3.7	3.5	3.2	3.0	2.8	2.5

1/ Building on financial sustainability study, nominal debt ratio target equals 62.4 percent of GDP (equivalent NPV is 48.2 percent).
Source : Staff estimates.

1.68 The impact of higher interest rates, for any growth rate, on the other hand, will be a major reduction in financeable deficits, which means a parallel increase in the necessary adjustment burden. In this respect the sensitivity exercise is quite illustrative of the implications of a switch to market rates on fiscal sustainability. While BiH is far from meeting the creditworthiness requirements for accessing the commercial markets in the medium term, *the sensitivity results strongly underline the benefits of achieving the necessary fiscal adjustment on a reasonably fast track while the country continues to access significant concessional lending.*

II. A DIAGNOSTIC OVERVIEW OF PUBLIC SECTOR EXPENDITURES

This Chapter describes the merits of an integrated approach to public expenditure analysis in Bosnia and Herzegovina (Section A), and reviews the composition of consolidated general government spending (Section B). It undertakes an in-depth analysis of selected expenditure categories that does not formally involve shared responsibilities across governments and it outlines potential reform elements, based on an inclusive fiscal framework established by the Report.

A. AN INTEGRATED APPROACH TO PUBLIC EXPENDITURE ANALYSIS IN BIH

2.1 ***A "Consolidated Budgetary Framework" Is the Only Means of Understanding the Size, Composition, and Scope of Public Sector Operations in an Economy.*** Chapter I discussed the virtual absence of a "consolidated budgetary framework" in BiH, as well as the challenges faced in instituting a properly inclusive one. In addition to the legacy of conflict, which has severely constrained coordination among the constituent ethnic groups of BiH, the extreme fragmentation of public financial information in BiH seems to be explained by two factors: (i) the rigid interpretation of fiscal autonomy granted to the major tiers of the government, as there is no obligation for an information flow across the public sector; and (ii) as yet limited appreciation of the critical role a "consolidated budgetary framework" plays in policy analysis and formulation even within the same tier of government.

2.2 *Why does the comprehensiveness of budget coverage matter?* Poor budget coverage works against the efficient strategic planning and prioritization of fiscal operations across competing demands that are based on hard-budget constraints. This, in turn, impedes the ability to establish a sound strategy for fiscal adjustment and reform—a critical task that the BiH governments will need to undertake in the period ahead. Inconsistencies between financial accounting and budgeting systems across governments in BiH make it all the more challenging to improve the budget coverage. The rest of this section presents the illustrative consolidation exercise that was undertaken in order to establish a reasonably comprehensive diagnostic basis for public expenditure analysis in BiH.[42]

2.3 ***An Illustrative Consolidation Analysis of Budgetary Framework:*** Our analysis is built on the Government Finance Statistics (GFS) definition of the general government budgetary framework, which is described in Box 2.1 along with its application in the case of BiH. This methodology for government accounting provides a much broader coverage of public resources and expenditures than does the current coverage of the government accounts in BiH, where social security funds and municipal government accounts are particularly omitted.

2.4 Another aspect of the present consolidation exercise is that it has expanded the official budgets of government units to include *recorded* information concerning three types of financing, which are allocated to spending of a public nature, to better approximate the true size and scope of public sector operations. These are off-budget donor assistance, arrears, and privatization receipts—together equivalent to about 30 percent of resources officially budgeted in 2000, mirroring an equivalent rate of understatement of public spending.

[42] This consolidation exercise follows through with the principles of the Medium Term Expenditure Framework that was piloted at the Entity level over the last several years under the World Bank's Second Public Finance Structural Adjustment Credit (see Chapter V).

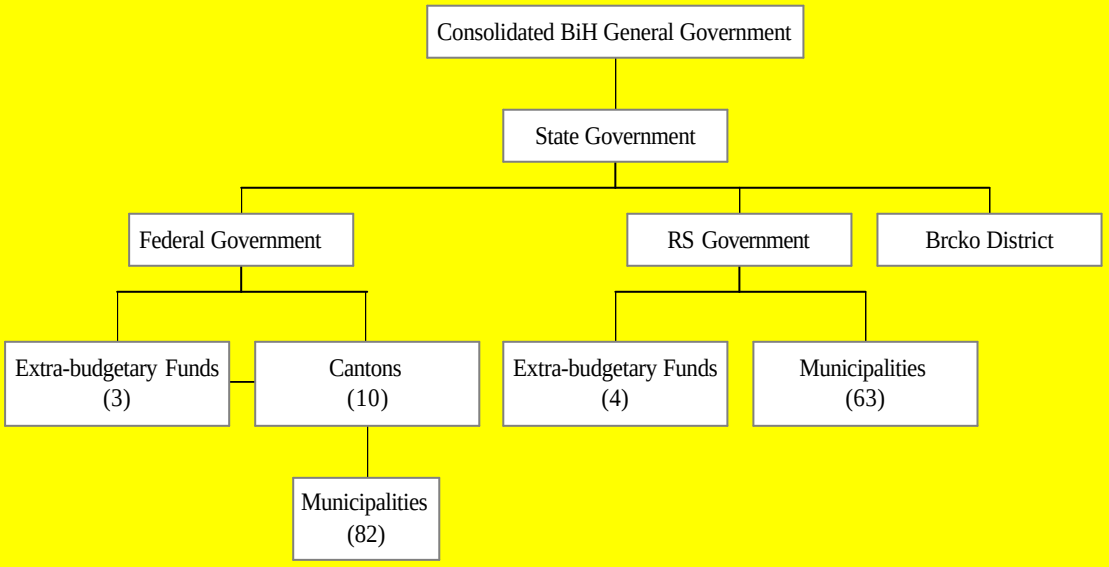
Box 2.1 An Illustrative Consolidated General Government Budget Framework for BiH

According to the IMF's Government Finance Statistics (GFS), the General Government (GG) is the combination of *all government units of a country*, whereby government units are institutional units that carry out the functions of government as their primary activity. That is, they have legislative, judicial, or executive authority over other institutional units within a given area. The financial flows arising from enterprises—financial and non-financial—owned by the government are, in general, excluded from the government financial statistics and only their *net profits or losses* and net transactions between them and the government units are recorded in the government accounts. Often, operating losses are covered by subsidies: in this case only these subsidies ought to be recorded. The same happens with the monetary authority.

In the case of BiH, the Consolidated General Government includes the following government units: the State; the Entity governments—including the Federal government in the Federation and the Central government in RS; the Extrabudgetary Funds—including the Pensions, Health, Employment, and Children (the last only in RS) Funds; cantons in the Federation, municipalities and the Brcko District. Given the broad fiscal autonomy granted to Entity governments in BiH, there are also merits in establishing consolidated general government accounts at the Entity level. This comprises all revenues and expenditures of government units at or below the Federal government (the Federation) and the central government (RS) (see Chart below).

In order to present an integrated financial view of the General Government that avoids duplication of revenues and/or expenditures, it is necessary to *eliminate* (net-out) all transactions *among* government units at the time of aggregating, (i.e, *consolidating)*, all government levels. In order to consolidate the financial flows of two government units, say the Federal government of the Federation and the State government, one has to eliminate the transfer paid by the Federal government to the State, both from the expenditure side of the federal government budget and from the revenue side of the State, and then add all remaining revenue and expenditure items. As a result of the consolidation, the only remaining recorded transactions, in principal, are those carried out between government and non-government units (i.e., transaction with households, private and public agencies *outside* the general government).

The bulk of the transfers in BiH are between the Entities' governments and the State; and within the Entities, between the cantons and the municipalities in the Federation and between the central government and municipalities in RS as well as between the Entities' governments and the Extrabudgetary Funds, when they choose to cover the deficits of the Extrabudgetary Funds. Besides eliminating inter-governmental transfers between different government levels, a consolidation exercise also eliminates the payments that as employers, Entities' governments, cantons and municipalities have to make to the Extrabudgetary Funds for the employer's share of the contributions to the social funds.



2.5 Finally, there are number of caveats concerning the consolidation exercise. First, as described previously, the comprehensiveness of the exercise is bound by (i) the existence of difficult-to-capture off-budget fiscal operations, especially concerning defense, social assistance and subsidies carrying direct

costs for the governments; and (ii) many quasi-fiscal operations carrying indirect costs that are already being incurred or that might eventually have to be incurred by the governments (see paras. 1.47-1.52 in the Chapter I). Second, since, official functional classification of expenditures are absent, we have made an effort to develop a functional classification of expenditures for 2000, including the externally financed off-budget expenditures, albeit without municipalities owing to the lack of necessary information. Finally, the detailed consolidation analysis could not be expanded to 2001, since the necessary information concerning external assistance and sub-Entity governments, accounting for over 60 percent of overall BiH general government accounts, was unavailable at the time of its preparation. Nevertheless, important fiscal developments since 2000 have been reflected in our discussions.[43]

2.6 ***The Consolidated General Government Account: What Does it Reveal?*** Table 2.1 presents the general government accounts for 1999-2000 according to the methodology discussed above. It allows the overall evaluation of general government accounts both on a consolidated country level and at key government levels. It should be emphasized that the table presents the consolidated financial flows of each government—i.e., the transfers each government unit received from other government units are netted-out from its revenues; and the transfers each government unit made to other government units are netted-out from its expenditures. As a result, each government's revenue account shows only the revenues it received from outside the government (i.e., its "own" revenues); and its expenditure account shows only spending to support its own activities (i.e., not for supporting the other government units). Nevertheless, transfers between government units in BiH are marginal, except in the case of the State, which receives its share of the revenues in the form of transfers from the Entities.

2.7 This comprehensive approach to general government accounts helps to illustrate the complexity of the fiscal operations in BiH. Table 2.1 shows that each of the general government units controls a fairly significant portion of the overall public resources in BiH, except the State—the national government. Against the background of limited horizontal and vertical fiscal coordination across BiH, this translates into an extremely fragmented public resource management, which hinders efficient use of resources and constrains the capacity to adapt to changing needs and requirements of a post-conflict, transition economy. The implications of these limitations become all the more significant when the staggering 64 percent weight of the public sector in the economy (both overall in BiH and in each Entity) is taken into account.

2.8 Particularly notable in the table is the significant share of social security funds (EBFs) and municipalities in the total on-budget resource base, with the former accounting for over one-third of the overall BiH total resources and the latter close to one-tenth. Similarly, they each account for a significant portion of the Entities' on-budget resources. Therefore, any fiscal analysis that does not properly account for social security funds and municipalities can only be partial—that is, limited to about 60 percent of each of the overall BiH and Entity fiscal operations. At present, both Entity governments are exposed to this limitation, with resources accounted for by both these general government units not included in budgets presented to the Parliament by either Entity.

2.9 The comprehensive approach also reveals that expenditures financed from on-budget resources[44] account in general for only about 70 and 80 percent of the total on- and off-budget spending during 1999

[43] It is also not possible to expand it to cover period prior to 1999-2000, since successive changes in the budgeting practices broke down the consistency of the data between the pre-1999 and post-1999 period.
[44] Including privatization receipts and areas accumulation.

and 2000, respectively, with the rest financed by off-budget donor assistance. This means that between 20 and 30 percent of total public spending would be lost if the donor inflows are not fully accounted for in the analysis during this period. This analysis also shows continuing significant dependency on external assistance to finance public services, albeit on an increasingly diminishing scale. Given the unavoidable further decline in donor assistance in the period ahead, it becomes increasingly urgent for BiH governments to develop a joint strategy for prioritization and better targeting of public spending against hard-resource constraints.

Table 2.1 Summary General Government Accounts By Level of Government[1]

	as % of respective GDP				as % of BiH Consolidated General Government			
	1999		2000		1999		2000	
	On Budget[2]	On and Off Budget	On Budget[2]	On and Off Budget	On Budget[2]	On and Off Budget	On Budget[2]	On and Off Budget
Revenue								
BiH	51.2	61.8	50.9	55.5	100.0	100.0	100.0	100.0
State	0.4	0.4	0.3	0.3	0.7	0.6	0.5	0.5
Federation	52.0	62.8	51.5	55.5	75.0	75.0	73.2	72.6
Federation Government	12.0	12.0	13.3	13.3	17.3	14.4	18.9	17.4
EBFs	15.8	15.8	17.2	17.2	22.8	18.9	24.5	22.4
Cantons	20.5	20.5	17.5	17.5	29.6	24.5	24.9	22.8
Municipalities	3.6	3.6	3.5	3.5	5.2	4.3	4.9	4.5
Off Budget Grants	..	10.8	..	4.2	..	12.9	..	5.4
RS	47.4	57.5	46.8	53.3	24.3	24.4	25.4	26.6
Central Government	31.2	31.2	30.6	30.6	16.0	13.2	16.6	15.2
EBFs	11.5	11.5	12.0	12.0	5.9	4.9	6.5	6.0
Municipalities	4.8	4.8	4.2	4.2	2.4	2.0	2.3	2.1
Off Budget Grants	..	10.1	..	6.5	..	4.3	..	3.2
Expenditure								
BiH	58.9	72.7	57.6	64.9	100.0	100.0	100.0	100.0
State	0.7	0.7	0.7	0.7	1.2	1.0	1.3	1.1
Federation	58.4	72.5	56.7	64.8	73.1	73.6	71.1	71.9
Federation Government	14.5	14.5	14.1	14.1	18.1	14.7	17.7	15.7
EBFs	18.6	18.6	18.2	18.2	23.4	18.9	22.8	20.2
Cantons	20.8	20.8	19.9	19.9	26.1	21.1	25.0	22.2
Municipalities	4.5	4.5	4.4	4.4	5.6	4.5	5.5	4.9
Off Budget Exp.	..	14.2	..	8.0	..	14.4	..	8.9
RS	57.8	70.4	55.6	62.2	25.7	25.4	26.8	26.6
Central Government	36.2	36.2	33.7	33.7	16.1	13.1	16.2	14.4
EBFs	16.5	16.5	17.6	17.6	7.3	5.9	8.5	7.5
Municipalities	5.1	5.1	4.5	4.5	2.3	1.8	2.2	1.9
Off Budget Exp.	..	12.7	..	6.6	..	4.6	..	2.8
Balances								
BiH	-7.7	-10.9	-6.7	-9.4	100.0	100.0	100.0	100.0
State	-0.3	-0.3	-0.5	-0.5	4.4	3.1	7.2	5.1
Federation	-6.4	-9.7	-5.3	-9.3	60.6	65.8	54.8	67.9
RS	-10.4	-12.9	-8.8	-8.9	35.0	31.1	37.2	26.7

[1] Only intergovernental trasfers are consolidated at each government level (see Box 2.1 for details). Brcko District is included under BiH.
[2] Includes arrears (except for defense, estimates for which are available only for 2000) and privatization receipts.
Source: Official data and staff estimates.

2.10 As explained earlier, in the absence of such a strategic approach, disproportional cuts in non-wage spending, arrears accumulation, and various quasi-fiscal operations, especially at the local government level and in the public enterprise sector, become a common response to shrinking public resources. For instance, foreign financing, which is ruled to be the only major financing source according to the BiH's conservative macroeconomic policies, accounted for only about 30-40 percent of on-budget deficit financing during 1999-2000, with the rest accounted for by arrears accumulation in both Entities. With increased expenditure controls, there has been some change in this approach since 2001, however, these controls or expenditure cuts are not yet being pursued as part of a broader fiscal strategy.

B. COMPOSITION OF PUBLIC EXPENDITURES AND REFORM PROSPECTS

2.11 The macroeconomic and fiscal analysis in the previous chapter illustrated that public expenditure policies are at the center of BiH's fiscal adjustment in the medium term. The analysis noted that a number of pressure points call for expenditure reduction along with improvement in the allocation and efficiency of expenditures in the medium term. These pressure points are: (i) a diminishing overall resource envelope, reflecting both the scaling down of foreign assistance and the highly desirable objective of lowering the BiH's high tax burden; (ii) likely pressures to increase spending, coming from social programs, institution/capacity building needs, the budgetary costs of large scale privatization and military downsizing, and domestic arrears clearance programs that are being scheduled; and (iii) BiH's exceptionally large public sector, limiting the opportunities for the growth of private sector.

2.12 This section will analyze general government spending with a view to illustrating the range of issues that the expenditure policy reforms will need to confront in the short to medium term. In order to guide future orientation of reforms, we also undertook a comparative analysis of BiH's expenditure structure with that of the structures observed in transition countries in Central and Eastern Europe (CEE). It should be noted that our analysis does not intend to provide a fully detailed reform blueprint, which requires a thorough, comprehensive review of overall expenditure programs with a medium-term vision, a task hard to undertake in BiH with the present fragmented fiscal management. However, the analysis does seek to highlight reform options for selective sectors accounting for a significant portion of total public spending and/or displaying an expenditure picture which is out of line with other transition economies. It should be emphasized that expenditure policy reforms do not guarantee needed outcomes unless they are complemented by reforms in budgetary institutions and processes as discussed in the last chapter of this report.

The Economic Composition of General Government Expenditure

2.13 Table 2.2 presents the consolidated BiH general budget by key government units classified by economic categories according to the methodology described above, while Table 2.3 presents a comparative analysis of the economic composition of BiH expenditures with that in other transition countries, though it needs to be interpreted cautiously, taking into account the post-conflict nature of the BiH economy. Together, these tables highlight a number of features defining the present structure of BiH and Entity budgets. These feature are outlined below and are examined in detail in the rest of this section.

- *Public spending is exceptionally high in BiH, a feature valid for both Entities.* In GDP terms, on-budget public spending in BiH is 18 percentage points above that of the countries in the comparator group. Expectedly, BiH's public sector spending is even higher when donor financed off-budget public spending is taken into account. On the positive side, there has been a downward trend in public spending in both Entities since 1999. However, the bulk of the reduction has been concentrated in donor financed off-budget public spending.
- *BiH also displays a very high ratio of overall revenues to GDP even if the off-budget donor grants are not taken into account.* Within the comparator group of transition countries, BiH has the highest ratio of overall revenues to GDP (about 11 percentage points over the average) and the second highest share of tax revenue to GDP (over 6 percentage points above the average).
- *Wages and salaries (W&S) emerge as a disproportionate component of the budget in BiH,* absorbing more than twice as much in terms of GDP as the average for the rest of the countries.[45] Both Entities allocate a very significant portion of their GDP (about 20 percent in the Federation and about 15 percent in the RS) and their budgetary resources (about 30 percent of the

[45] It is worth noting that the highest spending countries in wages and salaries are all former SFRY Republics.

Table 2.2 Economic Composition of Consolidated General Government Accounts[1], 1990-2000 (in % of GDP)

	1999				2000			
	BiH GG	State	Federation	Republika Srpska	BiH GG	State	Federation	Republika Srpska
Tax Revenues	41.6	0.0	42.2	39.9	39.5	0.0	40.3	36.9
Non-tax revenues	7.6	0.4	7.6	6.2	7.8	0.2	8.0	6.5
Foreign. Grants (on-budget)[2]	1.0	0.0	1.0	1.3	1.7	0.0	1.6	1.9
Transfers from other Government Tiers	0.0	2.2	0.0	0.0	0.0	2.6	0.0	0.0
Capital Grants from Donors (off-budget)[2]	10.6	0.0	10.8	10.1	4.8	0.0	4.2	6.5
Total Revenues&Grants (on-budget)	50.4	2.6	50.9	47.4	49.4	2.9	50.3	45.2
Total Revenues&Grants (on and off budget)	61.0	2.6	61.7	57.5	54.4	2.9	54.5	51.7
Total expenditure (on-budget)	53.8	2.6	53.7	52.4	53.1	2.9	54.0	49.1
Curent Expenditure	49.5	2.6	48.6	50.1	49.1	2.9	49.8	45.8
o.w/Wages and contributions	16.1	0.4	16.5	13.4	15.5	0.3	16.4	11.8
o.w/Goods and services	9.3	0.3	8.2	11.0	8.5	0.5	7.5	9.3
o.w/Military	4.6	0.0	4.7	4.1	4.1	0.0	4.6	2.7
o.w/Debt service	1.9	1.9	1.1	3.8	2.1	2.1	1.9	2.9
o.w/Subsidies	1.0	0.0	1.0	1.0	1.3	0.0	1.1	1.8
o.w/Transfers to households	14.2	0.0	14.3	13.8	15.4	0.0	15.7	14.4
o.w. DPs and Refugees	0.3	0.0	0.1	0.8	0.4	0.0	0.3	0.4
o.w. transfers to war invalids	3.4	0.0	3.6	3.3	3.5	0.0	3.6	3.1
o.w/Transfers to the state government	0.0	0.0	0.3	0.5	0.0	0.0	0.5	0.6
Capital Expenditures (on budget)	4.1	0.0	4.7	2.2	3.4	0.0	3.4	3.2
Donor Financed Capital Expen. (off-budget)[2]	13.8	0.0	14.2	12.7	7.6	0.0	8.0	6.6
Financed Through Privatization Receipts	0.3	0.0	0.3	0.0	0.6	0.0	0.8	0.1
Financed Through Arrears (unallocated)[3]	4.3	0.0	4.4	3.8	2.7	0.0	1.9	4.9
Total Expenditure (on-budget & w/arrears)	58.1	2.6	58.1	56.2	56.1	2.9	55.9	54.0
Total Expenditure (on- & off-budget)	67.6	2.6	67.9	65.1	60.9	2.9	62.0	55.7
Total expenditure (on- & off-budget & w/arrears)[4]	71.9	2.6	72.3	68.9	63.9	2.9	63.9	60.6
Total Deficit (on-budget)	-3.4	0.0	-2.8	-5.0	-3.7	0.0	-3.7	-3.9
Total Deficit (on-& off-budget)	-6.6	0.0	-6.1	-7.6	-6.5	0.0	-7.5	-4.0
Total Deficit (on- & off-budget w/arrears)	-10.9	0.0	-10.5	-11.4	-9.5	0.0	-9.4	-8.9
Memo Items:								
% Share in Total Expenditures (on budget)								
Wages and contributions	29.9	14.9	30.7	25.5	29.2	8.8	30.9	24.0
Goods and services	17.2	11.9	15.3	21.1	16.1	16.5	13.8	18.9
Military	8.5	0.0	8.8	7.8	7.7	0.0	8.6	5.6
Debt service	3.5	72.7	2.0	7.2	4.0	74.1	3.5	5.9
Subsidies	1.9	0.0	1.9	1.9	2.4	0.0	2.0	3.7
Transfers to the Households	26.4	0.5	26.7	26.2	28.9	0.6	29.1	29.3
Capital Expenditures (on budget)	7.6	0.0	8.8	4.3	6.3	0.0	6.3	6.4
% Share in Total Expenditures (on- & off-budget)								
Current Expenitures	73.2	100.0	71.7	77.0	80.6	100.0	80.4	82.2
Capital Expenditures	26.4	0.0	27.8	22.9	18.0	0.0	18.3	17.5
% Share in Total Expenditures (on-budget w/arrears)								
Financed Through Arrears Accumulation	7.4	0.0	7.6	6.8	4.9	0.0	3.4	9.1

[1]Includes State, Entity and Sub-Entity Governments, Brcko District (under BiH), and EBFs (Social Security Funds).
[2]Excludes off-budget foreign financing of defense.
[3]Expenditures not captured by cash based budget accounting.
[4]Unaccounted defence expenditures, which can only be estimated for 2000, is not included. (See Table 2.3)
Source: Official data and staff estimates.

Federation's on-budget resources and 35 percent of the RS's on-budget resources) to wages and salaries, with the shares being particularly disproportionate in the Federation.[46]

- *Outlays for non-wage goods and services, which represent allocations for operations and maintenance (O&M), seem to be the most compressed expenditure item.* They are disproportionately low when compared with spending on wages and salaries, with BiH showing the lowest ratio of non-wage to wage outlays. In GDP terms, they also accounted for more than half of the reduction in on-budget public expenditures in both Entities between 1999-2000, the first post-war year when on-budget public spending was cut, albeit slightly. This trend has continued to date.

[46] Budgetary defense spending, most of which is allocated for wages and salaries, is treated as part of the total wage bill.

Table 2.3 Economic Composition of Consolidated General Government Revenues and Expenditures in BiH and CEEs (in % of GDP)

	Avg. [1]	*BiH* [2/3]	*BiH* [3/4]	*Albania*	*Bulgaria*	*Croatia* [3]	*Czech Rep* [3]	*Hungary*	*Macedonia*	*Poland*	*Romania*	*Slovak Rep.*	*Slovenia*
Total Revenue and Grants	38.2	49.4	54.4	20.3	40.3	45.9	41.5	43.8	34.0	41.0	33.7	37.9	43.6
Current Revenue	37.7	47.3	47.3	20.3	39.9	45.3	41.9	42.6	33.9	38.8	33.3	37.9	43.3
Tax revenue	32.9	39.5	39.5	15.8	31.2	41.4	37.2	36.1	31.6	32.0	29.8	33.2	40.8
Non-tax revenue	4.8	7.8	7.8	4.5	8.0	3.9	4.7	6.6	2.4	6.8	3.5	4.7	2.5
Total Expenditure	41.4	60.2	67.8	30.7	40.5	51.3	43.1	47.8	35.8	43.3	36.6	40.7	44.2
Current Expenditure	37.0	49.1	49.1	25.5	35.9	45.3	37.5	43.3	33.8	40.2	33.2	35.8	39.6
Goods and services	13.9	28.1	28.1	10.2	17.4	23.6	12.3	14.9	12.0	16.6	13.6	10.1	8.1
Wages and salaries [5]	7.1	19.6	19.6	4.8	5.3	12.4	3.8	7.7	8.6	8.5	5.5	5.3	9.3
Other G&S	6.9	8.5	8.5	5.4	12.1	11.2	8.5	7.2	3.4	8.1	7.4	4.8	1.3
Subsidies	2.7	1.3	1.3	0.5	1.7	2.7	8.2	2.2	0.1	3.6	1.6	4.5	1.7
Other current transfers	16.3	16.6	16.6	7.0	12.7	17.1	20.3	17.8	21.8	16.9	13.1	18.2	17.7
Interest	3.6	2.1	2.1	7.8	4.1	1.8	1.1	6.8	1.9	3.1	4.8	3.1	1.4
Capital Expenditure	4.3	3.4	10.9	5.2	4.6	5.2	5.6	4.2	1.9	3.1	3.4	4.9	4.6
Arrears		2.7	2.7										
Unaccounted Defense Expen.		3.4	3.4										
Net Lending and unallocated		1.6	1.6										

[1] Unweighted average over available information, excluding BiH.
[2] Excludes off-budget financed "public" type of spending and revenues (i.e. grants)
[3] Information for the year 2000.
[4] Includes off-budget financed "public" type of spending and revenues (i.e. grants)
[5] Includes on-budget defense W&S.
Source: World Bank Live Database and World Bank Country Studies.

- *Social security and social assistance expenditures are the second largest spending item after wages and salaries.* Represented under "Other current transfers," their size puts BiH at the high end of the comparator group. In both Entities, they account for a sizable one-third of the on-budget spending.
- *Reflecting the favorable terms of external borrowing and debt rescheduling arrangements, as well as the prohibition of domestic borrowing, the debt service burden is comfortable.* In GDP terms, interest payments are at the lower end within the comparator group. Their share in on-budget spending also remains reasonable.[47] Nevertheless, reflecting RS's relatively high debt burden inherited from the former SFRY, the interest payments in the RS account for a much larger proportion of consolidated budget spending than in the Federation, at about 6 percent.
- *Recorded subsidies seem low, but the probability of their understatement is high.* Subsidies are at the lower end within the comparator group; nevertheless, as explained earlier, implicit subsidies, especially at the local government level, seem to be widespread, which calls for cautious interpretation of the subsidies.
- *Domestically financed capital spending, channeled through the budget, is relatively low.* However, this reflects substantial donor-financed reconstruction spending outside the budget. Once such off-budget "capital-like" spending is added, overall capital spending becomes very high (11 percent of GDP in 2000), although BiH is not comparable to other transition countries, because of its conflict history. However, it might be useful to note the average size of capital spending in those transition countries with no recent conflict history. Over time, as donor-financed reconstruction spending is phased out, BiH governments will need to re-allocate a portion of their own-budget resources to provide adequate counterpart funding for externally financed projects, and to contribute to domestically financed investments.
- *Domestically generated revenues fell short of covering current expenditures even with limited domestic capital spending.* At present, domestically generated revenues fell short of financing even salaries, O&M expenditures for public services, and social transfers, with large arrears accumulation across the BiH economy. If economic recovery is to be continued without compromising fiscal sustainability, then the rationalization and prioritization of available resources against hard-budget constraints is unavoidable.

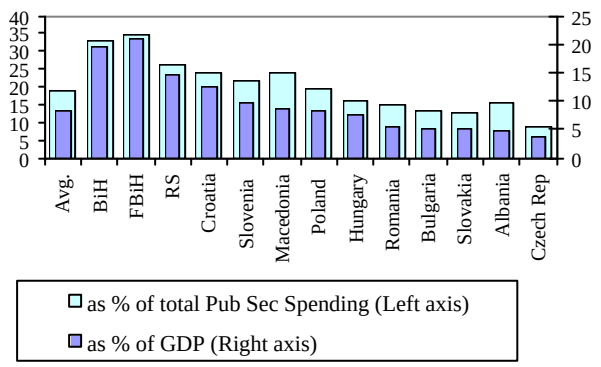
[47] It should be noted that although foreign-loan financed capital expenditures remain outside the budget, along with their financing source, the full cost of external borrowing (i.e., debt service) from official sources are recorded in the Entity budgets.

2.14 The above summary analysis highlights the fact that despite their different fiscal management structures, and their different needs for and background of post-war reconstruction and recovery, there are no major differences between the present budgetary structures of the two Entities. *They both must address a similar set of issues in rationalizing their tax and expenditure policies as they move into a more advanced stage of their post-war evaluation. In almost all aspects of such an agenda, the benefits of joint policy design and harmonized implementation would have a significant pay-off in containing the unavoidable pressures that may result from necessary reforms by facilitating the economic integration—an increasingly critical factor in sustaining economic recovery. In turn, a rapid economic recovery will create more room to maneuver in expenditure policy reforms because public expenditure can rise in nominal terms even when its share in GDP is reduced.*

Goods and Services: Wages and Salaries versus Non-Wage O&M

2.15 ***Wages and Salaries (W&S) the Largest Component of Budgets.*** Public sector spending on W&S is disproportionately high in BiH, a feature equally valid for both Entities. The public sector's size in BiH, measured by the general government spending-to-GDP ratio, is exceptionally high to begin with; within this envelope, however, the amount spent on W&S (about 20 percent of GDP in 2000) stands out as almost three-times the average for CEE transition economies and higher than most of the more developed EU economies. This shows that public spending in BiH is not only too high but that its economic allocation is also significantly *biased* toward W&S at the expense of the other needs.

Graph 2.1 Public Sector Spending in Wages and Salaries (latest available data)



Sources: Official data & staff estimates for BiH; WB data sources.

2.16 This *bias* becomes clearer with a comparative analysis of the share of W&S in total public spending in BiH relative to that in the CEECs: BiH's ratio bears no parallel with any other CEEC, with W&S bill in BiH accounting for over 33 percent of total on-budget public spending in 2000 compared with the corresponding average CEE ratio of 17.3 percent (see Graph 2.1). Moreover, wage arrears are not included in the above figures since our estimates for arrears could not be precisely broken down by economic composition. Factoring them in means even higher share of W&S bill in BiH's total public sector spending.

2.17 *Why is BiH's W&S bill so disproportionate?* A number of factors explain the high levels of W&S spending in BiH. Key among them are the structural characteristics of the post-war labor market and the public sector's wage policy. At the end of the long period of conflict, much of the heavy industry inherited from the former SFRY, which was dominating economic production, was either destroyed or dormant. Notwithstanding the positive implications this had in forcing a shift in industrial production away from inefficient activities, it left a severe mark on the employment capacity of the productive sector of the economy. To date, the jobs generated in the emerging private-sector-dominated services sector, together with what has remained operational in the

Table 2.4 Share of Public Employment to Total Employment

BiH	27
Federation	28
RS	24
Finland	24
France	21
Hungary	21
Canada	17
Czech Rep.	15
Irlande	15
Portugal	15
Spain	15
United States	15
Germany	12
Turkey	9
Korea	4

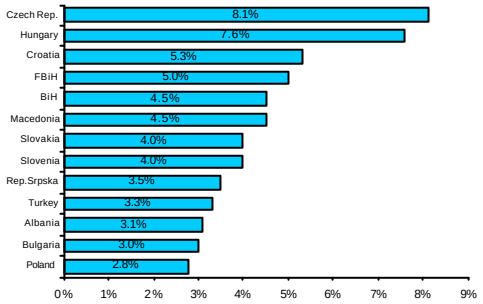
Source: OECD Public Management Service, 2001

public-sector-dominated industries, have only partially compensated for lost employment possibilities. As a result, unemployment remains painfully high by any transition country norms.[48]

2.18 Against this background, employment in the *non-economic* sector of the economy, which we use as a proxy for public sector employment,[49] has had a different reaction to the process of post-conflict recovery and transition from that of the *economic (i.e., productive) sector* of the economy. While employment levels grew significantly in the non-economic sector, especially through 1998, as the BiH's public administrative apparatus was being re-established, the increase in employment in the economic sector remained much more limited. This is clearly revealed by the fact that the ratio of employment in the economic-sector to employment in the non-economic sector has fallen from pre-war levels of 5.6 (i.e., there were 5.6 workers in the economic sector for each person working in the "non-economic" sector) to post-war levels of just around 2.8.[50] Reflecting this pattern, BiH has one of the largest shares of public sector employment in total employment when compared with more developed economies, with the Federation's ratio being particularly disproportionate relative to the countries sampled in the Table 2.4. Moreover, recent data indicate that this picture remains unchanged, as the employment ratio of the economic sector to the non-economic sector continues to grow, indicating that public sector employment is increasing at a rate faster than the increase in employment in the rest of the economy.

2.19 *Then the next question is whether the public sector is overstaffed, resulting in the high public sector W&S bill? Or whether the public sector's W&S levels are too high, translating into a high W&S bill?* The existing limited information seems to indicate that the high W&S bill is more the result of relatively high W&S levels in BiH's public sector vis-a-vis the rest of the economy. At 4.5 percent of the population, BiH's general government "civilian" employment does not seem excessive relative to a sample of transition economies shown in Graph 2.2, while the Federation, with its 5 percent ratio, is at the relatively higher end of the group. Nevertheless, it should be noted that available public employment indicators might omit/underestimate State and local government public employees, creating a risk of understatement of the above ratio for BiH. It should also be noted that the comparison with other countries concerns only the

Graph 2.2 General Civilian Government Employment
(As a percentage of population)



Source: An International Statistical Survey of Government Employment, World Bank, 1997; for BiH: Staff estimates based on the Federation Office of Statistics and the RS Institute of Statistics.

[48] It should be noted that while the official employment data are unreliable since they do not capture (i) those who are employed but not officially registered and (ii) informal sector jobs (which, together, are perceived to be large in BiH), the unemployment rate after roughly accounting for these factors is estimated as still too high, at about 20 percent.

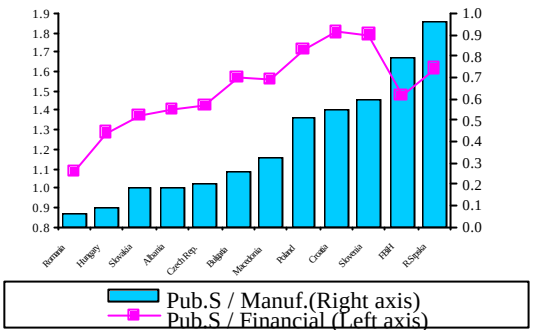
[49] This category includes, inter alia, administration, education, health, and social welfare.

[50] It should be noted that this number might have been inflated by the existence of wait-listed workers who are counted as employed in both the public and private enterprise sectors but are proportionally more numerous in the latter.

level of civilian employment and therefore omits the defense sector, which is clearly overstaffed in BiH,[51] with the size of the Army equivalent to close to 1 percent of the population (see paras 2.48-2.52).

2.20 In assessing the extent to which the W&S levels in BiH explain its high public W&S bill, we compared BiH's W&S levels in public sector with those in the industrial and financial sector. As shown in Graph 2.3, average W&S in BiH's public sector is very high relative to the industrial sector when compared with other regional economies. At the Entity level, the Federation's public sector W&S levels are on average 67 percent higher than the industrial W&S levels, and the RS's public sector W&S levels are on average 86 percent higher than the industrial W&S levels.[52] The BiH picture seems even more distorted when the comparator group is expanded to include countries in Europe and Central Asia (ECA), which on average display public sector W&S at the same level as industrial W&S.[53] These results are relatively less pronounced if the same analysis is made for W&S in the financial sector: in this case, while the RS' ratio of W&S in the public sector relative to the financial sector remains above the average ratio for the comparator group, the Federation's ratio falls below this average[54] (see Graph 2.3). A broader cross-sectoral comparison of W&S in the Federation and RS indicates that W&S in the public sector are in general high, ranking third highest relative to all other sectors in the BiH economy.[55]

Graph 2.3 Ratio of Public Sector Wages to Manufacturing and Financial Sector Wages



Source: de Tommaso and Mukherjee, Government Employment and Wages database 2001; for BiH, own estimates based on FBiH Federal Office of Statistics and RS Institute of Statistics.

2.21 Nevertheless, the latest available information indicates that W&S are not evenly high across the public sector, and that there is significant sectoral variation in wage levels within the public sector. In general, W&S is relatively higher in public administration than in other public sector units, reflecting the dis-proportionately high W&S for defense and police in both Entities.

[51] See OHR/OSCE Joint Consultative Commission Reports on "The Affordable Armed Forces in the Federation and Republika Srpska" (2002).

[52] This situation, however, is not uniform across different educational strata of employees. In fact, while the better educated public sector employees may feel that wages in the private sector are more competitive, on average, it seems that public sector wages are higher than in the private sector when compared with other regional countries.

[53] The average for the ECA Region was taken from: de Tommaso and Mukherjee, Government Employment and Wages database 2001.

[54] However, wage comparisons across sectors, when based on salaries collected from administrative sources, may be affected by the different levels of informality across sectors. In fact, administrative sources tend to reflect the formal part of the economy and to leave out the informal economy. More importantly, administrative sources tend to underestimate even salaries paid by formal employers. In fact, enterprises tend to under declare wages as a way to reduce their tax liabilities. This is less likely to happen, however, in the (non-enterprise) public sector. While this would bias public to non-public wage ratios, there is no presumption that the overall incidence of this factor is higher in BiH than in other countries. Nevertheless, in order to avoid this problem we refer to the only available source of household-based survey information on wages and salaries across sectors (the 1997 CIET survey), which by its survey nature better captures the informal part of the labor market.

[55] After the Financial Sector and the real estate, renting and business activities in the Federation, and after the financial sector and the electricity, gas and water supply sector in the RS. The comparison is made out of a total of 17 sectors in the Federation and 15 in RS.

2.22 Clearly BiH's public sector has become unaffordable. This is reflected in the frequent delays in W&S payments in public administration, with an accumulation of significant arrears since 1998. Efforts by both Entity governments to contain the wage bill to save 9 percent in the Federation and 15 percent in RS in late 2000 were only partially successful. Rationalization of the W&S bill in BiH should be given priority to achieve fiscal sustainability and to allocate adequate resources for the growth-enhancing sectors. This, in turn, demands that restrictive recruitment and compensation policies as well as civil service reform be undertaken within a comprehensive public administration reform agenda (see paras 2.26-2.29). The Bosnian authorities are increasingly aware of these challenges and, as an initial step, have committed themselves to a major reform and downsizing in the defense sector starting in 2002.

2.23 ***W&S Spending is Crowding-out Non-wage O&M.*** Striking a balance between spending on W&S and spending on O&M is another urgent priority. The present indicators point to a biased prioritization of W&S spending over non-W&S spending (i.e. O&M) in BiH when compared with the other transition economies in the region. The ratio of W&S spending to non-W&S spending is 1.3 for RS and an outstanding 2.2 for the Federation relative to the sample average of just below 1.0 for the region (see Table 2.3). These figures reflect the situation in 2000 in BiH, the first post-war year when on-budget public spending was cut, with the reduction in O&M spending accounting for more than half of the overall reduction in both Entities. Since then, BiH's ratio appears to be deteriorating further as non-W&S spending is being further squeezed.[56] Underfunding of non-wage O&M will result in inefficient use and underuse of capital investments and will further undermine the quality of service delivery in BiH, which calls for urgent attention to adequately fund non-wage O&M.

2.24 ***Decentralized Operation of the Public Sector in the Federation Imposes Higher Costs.*** As noted above, while disproportional spending on W&S is a problem very much common to both Entities, the extent of the problem differs across Entities. The Federation displays a relatively more distorted picture than RS: In the Federation both the share of GDP spent on the public sector W&S bill (16.4 percent) and the share of the W&S bill in total public spending (31 percent) are significantly higher than the respective shares in RS (11.8 percent and 24 percent, respectively). This is explained by higher employment levels in the Federation's public sector both as a share of its total employment and as a share of its population relative to RS. Problems of revenue shortfalls and overruns in the W&S bill are also translating into a significantly more repressed non-wage O&M spending in the Federation than in RS. The Federation's extremely decentralized administrative structure, with its multiple ministries at the Federal and cantonal levels and its many duplicative functions is the major factor contributing to this outcome. It is, thus, of the highest priority in both Entities, but particularly in the Federation, to streamline public administration along the lines outlined in paras 2.26-2.29.

2.25 **Recommendations:**

- Contain salaries in public administration;
- Contain overall wage increases in the public sector and spillover effects of public enterprises' wage awarding through control over wage increases in the public enterprises;
- Contain the expansion of the public sector labor force;
- Reduce public sector employment in key areas, particularly in defense;
- Identify services that could be contracted-out without affecting the quality of service provision and that, thereby, could generate savings for the public sector.

[56] The available information for 2001 points to a significantly deteriorated W&S-to-O&M ratio of over 4 at the Federal government level in the Federation and over 2.7 at the central government level in RS.

2.26 ***Beyond a Fiscal Approach: Improving Public Sector's Effectiveness through Administrative Reforms.*** The above analysis indicated a case for public administration reform from an *affordability* perspective. Nonetheless, expenditure policy reforms will generate adequate savings and bring lasting changes only if they are undertaken simultaneously with reforms that will improve the efficiency and effectiveness of the public administration. A well functioning public administration plays a key role in implementing policies conducive to the long-term strategic objectives of the government. Establishing an effective public administration requires much more than a well selected, properly trained and fairly paid public sector labor force. It also requires a human resource base that operates with a clearly defined set of functions and responsibilities at each government level. It is also important that policies are implemented smoothly within this structure, arising from a clear decision-making process that integrates well-articulated policy priorities with existing fiscal constraints. Good coordination among different government levels, in turn, is critical element of smooth policy implementation.

2.27 Most of these building blocks for an effective public administration are absent in BiH.[57] The BiH's multi-tiered governments operate within a very fragmented institutional structure, resulting in policy fragmentation and overlapping mandates.[58] Moreover, personnel and payroll controls are weak, hiring decisions are informal and not always based on merit—with patronage networks playing a role in hiring and promotion decisions—job standards are lacking, performance is never assessed, and pay is inconsistent across the public sector.

Box 2.2 Present Initiatives for Reform of Civil Service Legislation

A first step toward providing an appropriate legal framework has been taken by the State and RS governments with the preparation of modern civil service laws. These efforts were assisted by the OHR at the State level, and by the British Government's Department for International Development (DFID) in RS. The legislative work in RS constitutes an element of a broader public administration reform initiative, which involves supporting institutional measures (e.g., ministerial consolidation). While these efforts are coordinated to a certain degree, in the absence of a broader, harmonized strategy, the Federation, where the institutional fragmentation poses the highest challenges, has not yet embarked on similar reforms, except public administration reforms piloted by several cantons with the assistance of OSCE. Initiation of similar efforts in Federation, where 70 percent of civil servants in BiH are located, is essential for achieving tangible benefits through the civil service reform in BiH. It is also essential that all three levels adopt a harmonized framework both countrywide and with the EU standards.

2.28 Therefore, in the period ahead, public administration reforms will require a two-pronged strategy: (i) refocusing the role and core functions of governments on the best delivery of effective economic and sectoral strategies, including the consolidation of ministries and the rationalization of the number of existing agencies; and (ii), a civil service reform with a view, not only to enhancing the quality and affordability of public services, but also developing them as an institutional counterweight to politically sustained societal divisions (see Box 2.2). The case for strengthening public administration is also anchored in the need to confront the existing scope for corruption, which is perceived as high in BiH according to the results of a diagnostic survey undertaken in 2000 by the World Bank upon the authorities' request (see Box 2.3).

2.29 ***Design Parameters Critical to the Success of the Administration Reforms.*** A number of factors will need to be given special attention for the effectiveness of reform efforts in BiH, given its unique and complex governance arrangements:

[57] Unlike most other Eastern European governments, no substantive progress has yet been made to address these issues in BiH within a comprehensive framework.

[58] Governance is shared among 14 political units (i.e.: the State, the two Entities, the 10 cantons and the Brcko District), each possessing constitutional and legislative authority. Each of these political units has between 6 and 12 ministries, totaling some 181 ministers; a vast administrative apparatus for a country the size of BiH.

Box 2.3 Diagnostic Survey of Corruption in BiH: Selective Indicators for the Public Sector Institutions:

The survey results highlight the fact that the politicization of public sector administration in BiH is facilitating corruption. Selective results of the Survey, which are presented below, clearly call for public administration reform. The State and the Entities are currently preparing, through a wide participation from the society, a comprehensive action plan for determining the priorities in fighting corruption. Important elements of the necessary public administration reforms will be included in this anti-corruption plan:

- 57 to 80 percent of surveyed public officials believe that bribing for promotions and transfers exists;
- 54 to 79 percent of respondents believe that bribing for hiring exists;
- 60 to 80 percent of respondents believe that bribing for easy assignments exists;
- approximately one-third of respondents indicated that those who do not participate in bribery are ostracized, victimized or forced to leave;
- the perceived incidence of bribery was much lower in institutions with clear, written personnel guidelines;
- perceptions of bribery are higher in institutions where personnel policy is influenced by political connections, affiliations, or pressure;
- corrupt practices are felt to be higher at senior levels;
- 60 to 90 percent of respondents think that colleagues run businesses on the side; and
- 67 percent believe that corruption influences regulatory/legal decisions.

A Note on Survey Coverage: The Survey aggregates the perceptions of public managers, public officials, private sector employers, and the general public across a wide range of issues relating to the prevalence and nature of corruption in BiH. The public sector institutions surveyed include: customs, police, taxation, health, education, judiciary, municipalities, publicly-owned enterprises.

- *Assign high priority*. The effectiveness and speed of the ongoing process that will put Bosnian authorities back in charge of setting strategic long-term development priorities depends on building a public administration with the necessary capacity, continuity, and incentive to undertake complex policy reforms. Similarly, the road to European integration, where BiH acts as one unit within a larger confederation, cannot be accomplished without a deep reform of its institutions, including public administration. The tasks is thus both imperative and urgent.
- *Provide for an overall strategy*. Although federal systems tolerate differences between and across levels of government, the pursuit of diversity at sub-national levels should not undermine the national government. If public administration reform proceeds as a series of ad hoc, disconnected initiatives, the resulting institutional structure will exacerbate the fragmentation in BiH rather than redressing societal cleavages. Instead, public administration reform must be set/implemented within a State-coordinated strategy across all governments based on a uniform set of principles consistent with EU standards.
- *Establish for an integrated approach*. The initial efforts to improve the civil service legislative framework will need to be integrated into a broader public administration reform strategy and expanded urgently to cover the Federation, where the issues are most pressing and difficult, and where about 70 percent of civil servants in BiH are functioning. Experience in other countries indicates that a broader public administration strategy, linked to reforms in public expenditure management, government decision-making, local self-government, accountability systems, anti-corruption, and government restructuring, is needed to ensure that civil service reform results in fairer, more effective government performance. This Report focuses on many of these critical components with a view to guiding the design of a comprehensive medium-term reform agenda.
- *Reinforce the anti-corruption program*. The results of the diagnostic corruption survey speak to the strong linkage between corruption and politicization within the public service. Given the mutually reinforcing nature of these problems, strategies to create a depoliticized, meritocratic public service should be closely linked with any broader anti-corruption initiative.
- *Align with fiscal and policy priorities*. BiH has the most expensive public service in the region. Therefore, any government restructuring strategy will need to be aligned with fiscal and policy

considerations. Direct and indirect costs of restructuring public administration will need to be adequately estimated and factored in across the public sector (e.g., severance payments packages, pension costs for early retirement).

- *Precede with a good diagnostic*. Creating a modern and efficient public administration in BiH entails many difficult challenges; nevertheless, relatively little is known about the existing structure, especially the human resource base. *A comprehensive survey/census of existing human resources in the public sector is essential for providing a basis for the design of the reforms as well as for monitoring during implementation phase*. It is desirable to assign a separate government unit in charge of the rationalization of public sector employment[59] with the authority to access information regarding employment across different levels of the public sector. The overall objective of this exercise should be assessing the current structure of employment according to the existing needs, identifying areas of duplication, and carrying out an employment rationalization plan.
- *Provide strong domestic political support*. The sustainability of these types of reforms requires full and consistent support from the domestic leadership at all levels of government in a coordinated manner. It also requires their communication externally to the public and internally to the public service to counter opposition. In light of the protracted nature to date of public administration reforms in BiH, a series of targeted measures is required in the near term, such as the planned defense sector reforms during 2002.

Subsidies

2.30 Explicit subsidies in BiH are relatively small (1.3 percent of GDP; about 2 percentage points of on-budget current expenditures); and are concentrated in agriculture and public enterprises—respective ratios at the Entity level are 1 percent of the Federation's GDP and 1.8 percent of RS's GDP, all together significantly lower than the average for CEECs (see Table 2.3). However, they show signs of continued expansion in both Entities although, overall, the share of total on-budget expenditures in GDP has been gradually diminishing since 1999. Particularly in the Federation, the Federal government envisages, in GDP terms, a 1.4 percentage point increase in subsidies in 2002 compared with the previous year, to be allocated mainly to low-impact agriculture and employment generation programs. These explicit subsidy schemes, on the other hand, fail to indicate the implicit subsidies provided off-budget to publicly owned enterprises (among others, to the steel industry in the Federation, and oil refinery in the RS), local utility companies, and households.[60] Given the Entity governments' significant present role in the productive sector of the economy—through the ownership and control of industry—it is quite likely that the implicit subsidies are, at minimum, as large as the explicit ones. In many cases they are being used to postpone the resolution of enterprise crises while, in some cases, they are facilitating further financial distress in publicly owned companies (when implicit social subsidies are made to households through these companies) and in social security institutions (when payroll contribution relief is provided selectively).

2.31 **Recommendations:**

- Make explicit all forms of subsides and transfers and create a rationalization plan;
- Enforce proper recording of all forms of explicit and implicit subsidies (e.g., tax exemptions, contribution relief, credit lines with subsidized interest rates, guarantees called upon etc), among other means, through strict implementation of the [recently adopted] "Regulation on Sub-Entity Borrowing".

[59] Although currently different government bodies monitor a sub-set of overall public sector human resources, there is no single administrative unit with an overall view of the public sector labor force.
[60] For examples see Box 1.10 in Chapter I.

Transfers

2.32 Current transfers in BiH comprise transfers to social security institutions (EBFs), households, utility companies owned by local governments, and inter- and intra-governmental transfers. They are about average when compared with the regional economies, though the region is characterized by high transfers to households, mainly in the form of pensions and health outlays. Current transfers represent about 17 percent of GDP in BiH (about 18 percent in the Federation and 16 percent in the RS).[61] They account for a sizable one-third of total on-budget expenditures in both Entities. A major portion of these are transfers to households, which accounts for about 15 of GDP in both Entities, with the rest mainly allocated to non-profit institutions in the absence of any significant intergovernmental or intra-governmental transfers.

2.33 Nevertheless, unlike the region's economies, a significant share of the transfers to households in BiH are categorical transfers intended to improve the welfare of those most affected by the war. These include transfers to war veterans and invalids (most recently, close to 4 percentage point of GDP in both Entities) and refugees and displaced persons (less than 0.5 percentage points of GDP in both Entities). The former transfers constitute the single major social transfer channeled by the Federal government budget in the Federation and the central government budget in the RS, contributing not only to the fiscal pressures but also to budget constrain for other social assistance programs. Because of the special weight of these programs in the Entity's fiscal stance, their more detailed review is presented below.

2.34 As with subsidies, transfers show signs of continued expansion since 1999, at the time of the overall reduction of on-budget spending as a share of GDP. The increase in the Federation is particularly significant, owing to the sharp increase in transfers to the pension fund since 2001. While part of this increase is explained by extraordinary transfers aimed particularly at pension-arrears clearance, the other part is due to the increase in regular transfers for systematizing the payment of pensions (i.e., it indicates an increase in the dependency of the system on the budget transfers). Transfers to the pension fund are discussed in para 2.63-2.65; transfers for social assistance, mainly at sub-Entity level, are discussed in Chapter IV, along with specific recommendations.

2.35 ***Veterans' Benefits and Programs.*** Increasing fiscal pressures from veterans' programs have been a major concern in BiH. In the Federation about one-quarter of the entire Federal budget has been spent in recent years on benefits for disabled veterans and families of soldiers killed in the war. These programs also receive significant additional financing from cantons/municipalities, although this financing is not quantifiable owing to poor reporting practices.[62] In addition, transfers from the Croatian budget to the Croat component of the system and from the Employment Fund to the Bosniac component of the system provided further significant supplementary financing through 2001. The former transfers[63]

[61] The fact that overall BiH spending in transfers as a share of GDP is lower than that in each of the two Entities is explained by the deduction of the transfers from the Entities to the State in the consolidation.

[62] Veterans' spending is often reported collectively with other social protection spending, giving a false impression of significant social protection spending, when the available information suggests that the line item is dominated by veterans' spending (this equally applies in the case of reporting by municipalities in RS). The limited reliable information suggests that cantonal spending is significant—e.g., Sarajevo Canton has spent about 15 percent of its sizable 2000 current budget on war monuments and graveyard maintenance. Cantonal budgets typically include direct allocations to veterans' and related associations in the cantons to support their operating costs, as well as grants for businesses, payments to demobilized soldiers, supplements for those who received military medals, and support for contributions to the heath insurance system. To give some sense of the orders of magnitude, health insurance contributions alone would be equivalent to around 0.4 percent of the Federation's GDP in 2001.

[63] In 2000, Croatia and BiH agreed on two principles: (i) reductions in the transfers from Croatia; and (ii) increased transparency through direct transfer to the Federation veterans account, as opposed to the Croat component of the system. Starting from 2002, the Croatian Government intends to restrict its transfers to around HRK70 million per year, mostly for pensions to Croat veterans, which are distinct from veteran disability benefits.

Table 2.5. Spending on Veterans' and Family Benefits, 1998-2001

	1998	1999	2000	2001
Federation				
Trasfers from Entity Budget (KM mln)[1]	209.3	207.9	240.2	265.5
As % of total Federal budget	26.0	26.0	24.7	22.7
As % of Federation budget	3.7	3.4	3.6	3.6
Plus: Transfers from Croatian budget (KM mln)[2]	na	38.7	30.4	19.6
Plus: Trasfers from Emloyment Fund (KM mln)	na	43.9	41.5	0.0
Total as % of Federation GDP	*na*	*4.7*	*4.7*	*3.9*
RS				
Transfers from Entity Budget (KM mln)[3]	46.6	73.9	81.3	105.5
As % of Entity budget	10.0	9.6	7.9	12.7
As % of RS GDP	*2.9*	*3.4*	*3.2*	*3.7*

1. Funds were divided 75% for veterans of the Bosniac army and 25% for veterans of the Croat army until 2001.
2. Converted from HRK at period average exchange rate.
3. Includes civil victims of war.

Sources: Federation Min.of Veterans/Directorate; Federation MoF& RS MWCV&L.

have been scaled down since 2000 and the latter transfers, which were unlegislated, ceased as of 2001. In RS, up to 13 percent of all central government expenditure has been on veterans' benefits, with a significant additional local level spending as in the Federation.[64] While the overall spending seems much less than in the Federation, it is in fact broadly comparable if measured as a share of total Entity and sub-Entity spending since the central government in RS accounts for the majority of public spending (see Table 2.5).

2.36 In both Entities, recorded budgetary transfers to veterans translate into significant spending in GDP terms, at around 3-4 percent of GDP. In addition, beneficiaries of the program receive significant indirect transfers, resulting in substantial forgone revenues from health contributions and co-payments, and tax and customs revenues,[65] with the exemptions from the latter often abused by favors to ineligible beneficiaries. The generous benefits granted under the program, however, have become increasingly unsustainable since 1998, with budget constraints in both Entities leading to an increasing accumulation of arrears on veterans' transfers.[66] This, coupled with the poor targeting rules of the system, has resulted in a system, which is increasingly unable to provide secure protection for its most vulnerable beneficiaries.

2.37 This picture, however, falls short of revealing the actual "costs" of the various legislated entitlements in both Entities, which have not been paid in recent years on the basis of annual decrees, allowing for the suspension of specific benefits owing to budgetary constraints. In the Federation, such arrears are estimated to be around KM1.5 billion (20 percent of GDP). While in principle a portion of these obligations have been settled through privatization vouchers, there are an increased number of court actions to obtain settlement in cash, creating a serious potential contingent liability for the budget. In RS, non-disabled veterans are covered by benefits in the existing law, but payments to date have been suspended because of budgetary constraints. Fiscal risks from contingent liabilities are also significant in RS, where beneficiaries of the RS veterans' program can lodge claims with the courts for emotional damage caused by injury and/or loss of a family member.[67]

2.38 If the sustainability of the veterans' assistance programs is to be restored, then wide-ranging issues on institutional dimensions, targeting, eligibility, and affordability will need to be addressed. Policymakers in both Entities recognize this; however, political and social sensitivity surrounding veterans' benefit reforms have considerably slowed the required legislative reforms over the last three years. The challenges that this process involved are also made harder by existing fragmented institutional arrangements. In the Federation, although veterans' and survivor family programs are the federal

[64] For RS, this sum includes payments for civil victims of war, which accounted for around 5.6 percent of spending in 2001.
[65] Preliminary estimates by customs officials in 2001 were that around *KM158 million* in potential revenues were lost across the two Entities in the previous three years from exemptions on car duties.
[66] RS was able to pay only 75 percent of 2000 budgetary allocations and the Federation only 80 percent of 2001 budgetary allocations, translating into eight to nine monthly payments during these years.
[67] Compensation awards by the courts to date have ranged between KM5,000 and KM200,000 and have been financed through the budget.

responsibility,[68] the legal frameworks and administrative structures remain divided between two ethnically managed components (i.e., Bosniac and Croat). The Federal government is in general responsible for the payment of cash assistance to veterans' program beneficiaries, while it is the responsibility of cantons to finance and provide services and other benefits such as health care and housing. The cantons have their own ministries and their ability to provide additional benefits varies with their resource availabilities.[69] Progress in integrating the legislative and administrative frameworks has accelerated only since 2001. In the RS, the system is fully managed at the Entity level, although municipalities may elect to support veterans with additional services and compensation (e.g., by providing housing). As in the Federation, the extent of these additional benefits varies significantly across the Entity, and there is no proper reporting on these activities to the Entity.

2.39 In both Entities, fragmented management of the system makes it difficult to monitor double counting between invalidity and family beneficiaries and between "primary" family beneficiaries, such as spouses, and "co-beneficiaries" of other family members. In the case of RS, the planned introduction of a single database for beneficiaries and expenditures is expected to address this problem. In the Federation, there is a major reassessment process planned in 2002-03 in parallel with the adoption of a new unified law on veterans' benefits.

Box 2.4 The Beneficiary Composition of the BiH's Veteran's Program: Main Weaknesses

In all three programs, the number of family beneficiaries is high as a share of the total. This is most noticeable in the Bosniak component of the Federation system, where family beneficiaries account for over three-quarters of the total—their number increased by 20 percent between late 1999 and 2001, which may partly reflect more serious efforts to collect reliable data. Only in the Croat component of the Federation system do disabled veterans outnumber family beneficiaries. The existence of benefits for parents, grandparents, and in some cases siblings distinguishes the BiH programs from most of these in the world, even the most generous such as these in the United States. All together, this is not only a deteriorating targeting, but it also created a major source of expenditure pressures in the system.

A high proportion of disabled veterans are in lower categories of disability: around two thirds in the Bosniak and Croat programs in the Federation and 60 percent in the RS. It is important to note that many of the lower category veterans are capable of work and in many cases have regular employment. In contrast, the number of beneficiaries in the higher categories (60 percent and above, using a common EU standard for civilian disability systems) is not too high, ranging from 30 percent in the Croat program in the Federation to 41 percent in the RS program, suggesting that benefits focused on narrower beneficiary categories would significantly contribute to financial sustainability.

2.40 Last but not least, the BiH has one of the most extensive and generous veterans' entitlements across Europe and globally. Further, the present composition of beneficiaries presents a program biased toward both family beneficiaries and veterans with lower categories of disability in both Entities, a major factor in poor targeting and financial pressures in the system (see Box 2.4). The benefit levels are high relative to wages, which becomes more pronounced when the present high levels of unemployment are considered. While there is a wide disparity between the minimum and maximum benefit levels, monthly benefits can be as high as the average monthly wage (KM700 in 2001) in the Federation and more than twice as high as the monthly wage (KM432 in 2001) in the RS. The high benefit levels are largely explained by the existence of dual legal structures, which allows both Entities to provide supplementary entitlements.[70]

[68] The Federation's Ministry of Veterans and Disabled Soldiers' Affairs was established in December 1999. Previously, there was a Directorate of Veterans' Affairs, responsible to the Prime Minister's Office, which in effect was comprised of two sections—one for each ethnicity.

[69] Of the 10 cantons in the Federation, 9 have a Ministry for Veterans Affairs, while in Herzegovina-Neretva Canton there are two directorates for veterans-one for each ethnicity. The cantonal ministries were only formed after the establishment of the Entity Ministry in 1999, and are founded, staffed and financed by the cantons.

[70] In the Federation, the so-called IMO decree provides supplementary benefits for invalids and survivor families for the Bosniak component—e.g., for the Bosniak system, the average permanent invalidity benefit for a disabled veteran under the basic law was

2.41 **Recommendations:** Clearly, the current veterans' assistance programs, with the legislated entitlements far above available resources, and with the ad hoc rationing of available resources, are not sustainable. The reform agenda needs to be carefully designed, on the one hand, to ensure much needed protection for the most disabled veterans and the nuclear family members of killed or deceased veterans and, on the other hand, to ensure fiscal sustainability. This will require difficult prioritization decisions among existing entitlements and beneficiaries. The following recommendations are aimed at addressing the existing problems against the background of veterans' and disability systems in the region and around the world:

- ***Harmonization of the legal frameworks:*** Legislative reforms in each Entity are needed to:
  - Unify the Bosniac and Croat legal frameworks in the Federation, including eliminating the supplementary (IMO) benefits as a parallel system; the regulations under the new legislation should clarify roles and responsibilities for disability assessment under the unified system.
  - Eliminate benefits under the 1998 decree as a parallel system in RS.
  - Harmonize the legal frameworks between the two Entities to the maximum extent possible, taking into account different economic possibilities of the Entities in terms of absolute entitlement levels. This process is particularly important in the light of the return of former combatants from one Entity to the other. Each Entity also needs to ensure that it makes payments to its own beneficiaries even when resident in the other Entity.
- ***Entitlements and beneficiaries:*** Major simplification and rationalization of entitlements is urgently needed:
  - For *disabled veterans*: (i) consider removing those with disabilities below 50 or 60 percent from benefit entitlement (though not from the system altogether)—the 60 percent threshold is usually the norm in many disability systems in Central and Western Europe; (ii) eliminate disability pensions and supplements under the veterans' system, in the interests of simplification of the system.
  - For *survivor families*: (i) eliminate benefits for *grandparents and siblings* (these entitlements do not exist in other veterans' systems around the world); (ii) for *parents*, target benefits on those most in need (i.e., parents who have no income, pension or other source of support such as surviving children). This will entail major fiscal savings[71] and ensure that benefits are focused on those whom the deceased soldier would in reality have had to support; (iii) for *spouses*, ensure that restrictions related to remarriage and other events are introduced and enforced; (iv) for *children*, reduce the maximum age for benefits under the veterans' system to 18 or 22;[72] and (v) for all *family beneficiaries*, simplify the benefit structure so that there is a more limited number of benefits which are simpler to administer and monitor.
  - For *non-disabled veterans*, there should be no benefits, whether cash or in-kind. BiH cannot afford to support able-bodied adults in the current environment.
  - For *all beneficiary categories*: (i) eliminate all customs exemptions, which have proved a major source of lost revenues and abuse; (ii) if the systems retain exemptions on health insurance contributions, confine the exemption to a narrower range of beneficiaries, and find other sources to cover contributions of others; (iii) limit access to coverage of health co-payments to a much narrower range of beneficiaries. Such wide access to exemptions risks undermining the needed efforts of the health system to generate greater cost recovery and

KM74 in 2001, but with supplementary benefits this increases to KM175. In the RS, the decree of 1998 provides additional benefits for invalids only.

[71] For example, in the Federation around KM30 million annually in 2001 terms, about 11 percent of present budgetary allocations.

[72] There is no justification for the veterans' system subsidizing children beyond school or undergraduate levels. In all countries in the region and the world, children at university are from better-off backgrounds on average and such an extended benefit for the better-off is hard to justify.

limit unnecessary use of the health system; (iv) closely review the many benefits such as free transportation, housing, etc., to better assess fiscal and other costs of programs, and consider rationalizing such entitlements substantially; and (v) to the extent that reduction or elimination of certain beneficiary categories proves too difficult, consider the wider use of income-based or other targeting in order to qualify for benefits.

- ***Recertification and the beneficiary identification process:*** Adopt a two-prong approach to:
  - Institute a recertification process for disabled veterans and survivor families. Obligatory revision procedures currently considered in both Entities are highly unusual in the context of European and international administrative law.[73] They are burdensome and costly, and this report recommends other means of control and monitoring, intended to obtain the same results but with lower costs. This is particularly relevant to the standard revision procedure involving legal, Ministry of Defense and medical checks.
  - Harmonize identification criteria for disabled beneficiaries across the disability programs and across any survivor pensions programs.
- ***Regularize the system of payment:*** Shift to a system whereby transfers to the beneficiaries are made directly from the Entity budget to the beneficiaries, which will go a long way in improving the transparency, accountability, and timeliness of information on budget execution.
- ***Institutional roles and information systems:*** Improve the reliability and timeliness of the data on veteran and family beneficiaries and expenditures, and integrate recording under a single registry, allowing for information exchange with the other parts of the social welfare system.

Capital Spending

2.42 On-budget capital spending, at about 3.4 percent of GDP, is relatively low in BiH when compared with other countries in the region. However, at present this is more than compensated by donor financed, off-budget spending of a public investment nature. To date, off-budget, donor financed spending has played a key role not only in restoring the bulk of war damaged economic and social infrastructure closer to pre-war availability levels, but also in supporting the development of the private sector and in providing poverty alleviation for the most vulnerable. It is estimated that out of US$5.1 billion pledged for the priority reconstruction and reform program, about US$4 billions was disbursed at end 2000. At present, the donor financed capital projects are implemented through Project Implementation Units (PIUs), by non-civil-service personnel, outside the core of the BiH government. While PIUs have proved essential to the smooth and accountable implementation of the large scale emergency reconstruction program, especially in early post-conflict years, they also exacerbated the fragmentation of public resource management, imposing additional challenges in integrating this type public spending into the budgets (see Chapter V).

2.43 Since 1999, donor financed capital expenditures are being gradually phasing out with a notable decline in disbursements, which were nearly halved between 1999 and 2000. Moreover, both the composition and the sectoral distribution of assistance have changed over time. There is a tangible shift away from purely grants toward concessional lending: the ratio of grants to credits in the Federation was reduced from 4.4 in 1996 to just 1.1 in 2000; and it was reduced from 2.4 in 1998 to 1.7 in 2000 in RS. There has also been a shift away from reconstruction and public sector institution-building to direct production enhancing activities. In line with this trend, the share of lines of credit in total donor

[73] Governments in both Entities have mentioned possible reductions of 25-30 percent in beneficiary numbers from such a process. This Report considers that this is to be a substantial overestimate, and that reductions in the order of 5 percent are more likely based on past efforts at recertification.

assistance, particularly for SME development schemes, has significantly increased.[74] While it is early to draw conclusions on the emerging pattern, regrettably, on-budget (i.e., domestic) public sector investments in the Federation also declined during 2000, by more than a percentage point of Federation GDP. The on-budget public sector investments have also been on a declining path in RS since 2001.

2.44 One of the key budget management challenges in the period ahead is to fully integrate the capital spending into the budget and to strike a balance between overall current and capital expenditures and domestically and externally financed capital expenditures (see Chapter V). As noted in paragraph 2.13, at present, domestically generated revenues fall short of financing even current expenditures. In addition, available information suggests that in the Federation the major portion of the limited domestically financed capital spending has been allocated for capital grants (including grants to loss-making public enterprises) rather than direct investment. These imbalances in present budgetary allocations point to the need for a pro-active budget management oriented towards achieving savings in those areas where spending is disproportionately concentrated and ensuring adequate financing for both investments in areas dictated by development needs (including adequate counterpart financing for financed projects) and O&M activities. Needless to say, it is equally important to improve the efficiency of investments (see Box 1.9 in Chapter I).

2.45 **Recommendations:**

- Expand the budget coverage to fully account for all sources of public capital spending
- Improve domestic investment reporting in terms of both coverage and scope
- Introduce an integrated and vertically and horizontally well coordinated budget planning/programming strategy with a medium-term vision
- Develop and systematically implement a gradual program of expenditure rationalization and prioritization (see Chapter V).

The Functional Composition of General Government Expenditures

2.46 Table 2.6 presents the estimated consolidated[75] functional classification of expenditures for government units including the State; the Federal government, the cantons and extra budgetary funds of the Federation; and the central government and the extra budgetary funds of RS for the year 2000.[76] This breakdown excludes municipalities owing to lack of municipal data by functional classification of expenditures.[77] We have presented on-budget public expenditures and total expenditures including donor financed, off-budget expenditures separately. Owing to insufficient information on the functional classification of recorded arrears, these are omitted in this analysis. As in the previous section, we will inform our analysis by referring to a comparable analysis in other transition and non-transition European countries (see Table 2.7). While differences in the structural characteristics of countries result in different

[74] For example, in the Federation, lines of credits have increased from 10.6 percent of the total donor financed activities in 1996 to 36 percent in the year 2000.

[75] For the sake of comparability with other countries, we have netted out not only intergovernmental transfers but also employers' payroll contributions to the social security and health funds, following the 1985 GFS methodology of the IMF. The latest version of the GFS (2001) departs from this practice, but country specific information based on this new methodology is not yet published.

[76] The analysis is limited to the year 2000 since in the absence of proper official functional classification, estimates provide only an illustrative analysis built on official data on administrative and program allocations and sectoral allocations of donor financing.

[77] Existing limitations in fiscal information at the municipal level make it impossible to estimate the functional allocation of municipal spending. Nevertheless, a functional classification of public sector spending that leaves out municipalities facilitates its comparison with other countries, since the IMF's GFS publishes functional breakdowns excluding municipalities. Similarly, owing to data constraints, the Brcko District is also omitted under the functional classification, although this does not have a significant impact on the analysis due to owing to the District's small 2000 budget.

demand patterns for public services and, hence, differences in the sectoral composition of public spending, countries with comparable development levels show certain regularities in their spending. In this regard, the allocation of the more advanced transition countries could signal areas of likely realignment of sectoral spending for BiH in the medium term, notwithstanding the differences in relative structures and the recent past.

Table 2.6 Functional Composition of Consolidated Government Expenditures[1] 2000

	in % of GDP						in % of total expenditure					
	BiH	Federation	Republika Sprska	BiH	Federation	Republika Sprska	BiH	Federation	Republika Sprska	BiH	Federation	Republika Sprska
	(on-Budget)			(on-& off-Budget)			(on-Budget)			(on-& off-Budget)		
Central Government Services	2.5	1.9	3.4	2.8	1.9	4.2	5.1	3.7	7.7	4.9	3.3	8.2
Defense[2]	4.4	4.7	3.5	4.4	4.7	3.5	8.8	9.3	7.8	7.7	8.0	6.8
Public order and safety	4.3	4.4	4.0	4.4	4.4	4.3	8.7	8.7	9.1	7.7	7.5	8.5
Education	6.0	7.0	3.3	6.4	7.3	4.0	12.1	13.8	7.5	11.2	12.4	7.9
Health	7.3	8.3	4.6	7.7	8.4	5.8	14.8	16.4	10.3	13.5	14.4	11.5
Social Insurance	15.8	15.9	15.6	16.1	15.9	16.4	32.1	31.4	35.3	28.3	27.2	32.3
Housing - Utilities	0.8	0.9	0.5	1.3	1.2	1.3	1.9	1.2	2.2	2.2	2.1	2.5
Culture, recreation and religion	0.5	0.6	0.3	0.5	0.6	0.3	1.0	1.2	0.6	0.9	1.0	0.6
Energy and fuels	0.1	0.0	0.2	0.9	1.1	0.2	0.1	0.0	0.4	1.5	1.9	0.5
Agriculture	0.6	0.4	1.2	1.0	0.6	2.1	1.2	0.7	2.7	1.7	1.0	4.1
Mining and mineral resources	0.2	0.3	0.0	0.8	0.9	0.6	0.5	0.6	0.0	1.4	1.5	1.2
Traffic and communications	1.5	1.3	2.1	1.8	1.6	2.2	3.1	2.5	4.8	3.1	2.7	4.3
Other economic activities	0.9	1.0	0.5	4.5	6.0	0.5	1.8	2.0	1.2	7.8	10.2	1.1
Not classified under main groups	4.5	4.0	5.0	4.6	4.0	5.4	9.1	7.9	11.2	8.1	6.8	10.7
TOTAL EXPENDITURES	49.3	50.6	44.4	56.9	58.5	51.0	100.0	100.0	100.0	100.0	100.0	100.0
o.w. Defense, Pub.Order & Safety[2]	8.6	9.1	7.5	8.7	9.1	7.8	17.5	17.9	17.0	15.3	15.5	15.3
o.w. Health & Social Insurance	29.1	31.2	23.6	30.2	31.0	26.3	58.9	61.6	53.1	53.0	54.0	51.6
Memo Item												
Defense with off-budget/arrears spend.	4.4	4.7	3.5	7.8	8.9	4.9	8.8	9.3	7.8	14.8	16.3	10.6

[1]Excludes municipal spending and unallocated arrears.
[2]Excludes off budget defense spending and arrears.
Source : Staff estimates.

Table 2.7 Primary Expenditures of the Consolidated Central Government by Function in Europe - 1999/2000 (% of GDP)

	Average Transition CEE [d]	*Avg. EU*	*BiH* [a]	*FBiH* [a]	*RS* [a]	*Albania*	*Bulgaria*	*Croatia* [a]	*Czech Rep.*	*Hungary* [b]	*Poland*	*Romania*	*Slovak Rep.*	*Slovenia*
In % of GDP														
General Public Services	2.1	2.1	2.5	1.9	3.4	2.8	3.4	1.6	1.1	2.2	1.3	1.1	2.3	3.3
Defense [c]	1.9	2.1	4.4	4.7	3.5	1.3	3.0	2.9	1.8	1.0	1.5	1.6	1.8	1.1
Public Order & Safety	2.0	1.0	4.3	4.4	4.0	2.5	2.4	2.7	1.7	1.7	1.3	1.5	1.5	1.6
Education	3.3	2.9	6.0	7.0	3.3	3.1	1.8	3.6	3.7	3.8	1.7	3.1	4.0	4.3
Health	4.4	2.0	7.3	8.3	4.6	2.4	2.0	6.7	6.5	2.6	0.4	3.6	7.0	5.6
Social Security & Welfare	14.2	13.1	15.8	15.9	15.6	8.0	11.7	18.2	13.8	13.2	18.0	11.3	10.9	17.6
Housing & Community Amenities	1.1	0.7	0.8	0.9	0.5	1.2	0.5	1.6	1.1	0.7	0.4	1.8	1.2	0.3
Recreational, Cultural & Religion	0.5	0.4	0.5	0.6	0.3	0.4	0.7	0.6	0.4	0.8	0.2	0.5	0.6	0.6
Fuel & Energy	0.2	0.2	0.1	0.0	0.2	0.0	0.8	0.0	0.2	0.0	0.2	0.0	0.2	0.2
Agriculture, Forestry and Fishing	1.1	0.9	0.6	0.4	1.2	1.8	0.7	1.0	1.0	1.6	0.6	1.1	1.5	0.9
Mining & Mineral Resources	0.3	0.3	0.2	0.3	0.0	0.2	0.0	0.5	0.2	0.1	0.2	0.8	0.2	0.1
Transportation & Communication	2.0	1.2	1.5	1.3	2.1	2.3	1.5	3.2	1.8	1.8	0.5	3.0	0.2	2.3
Research Affairs	0.0	0.0				0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.0
Other Economic Affairs & Services	1.0	1.3	0.9	1.0	0.5	0.5	1.7	0.5	1.4	1.1	0.2	0.5	2.8	1.0
Other Expenditures (excl. interest payments)	4.0	7.9	2.3	2.1	2.1	7.4	5.3	0.8	2.1	5.8	9.5	1.9	3.1	1.4
Total Expenditure	37.9	35.7	47.2	48.7	41.5	33.9	35.7	43.9	36.6	36.3	35.3	30.8	37.2	40.5
o.w. Social Spending	21.8	18.0	29.1	31.2	23.6	13.5	15.5	28.5	24.1	19.6	20.1	18.0	21.8	27.6
o.w. Public Order, Safety and Defense	3.9	3.1	8.6	9.1	7.5	3.8	5.4	5.6	3.6	2.7	2.7	3.1	3.3	2.7
Memo Item														
Off-budget Defense Exp. &Arrears (% of GDP)			4.4	4.2	4.8									
In % of Total Expenditures														
Defense [c]	5.1	5.9	9.2	9.6	8.4	3.9	8.4	6.6	5.0	2.8	4.1	5.0	4.8	2.8
Public Order & Safety	5.2	2.8	9.1	9.0	9.7	7.3	6.8	6.1	4.7	4.6	3.6	4.7	4.0	3.9
Social Spending	57.3	50.1	61.5	64.0	56.8	39.7	43.5	64.9	65.3	53.9	56.0	56.3	58.7	68.1
of which: Education and health	20.1	13.6	28.0	31.4	19.1	16.2	10.7	23.4	27.8	17.7	5.8	20.9	29.5	24.6

[a]For BiH and Croatia, data for the year 2000.
[b]For Hungary, data for the year 1998.
[c]Without Off-budget defense expenditures and defense arreras.
[d]Excludes BiH.
Sources: IMF, *Government Finance Statistics 2000*. For BiH and Croatia, World Bank estimates.

2.47 The reminder of this Chapter analyzes the trends in the key functional components of Entity level spending focusing on defense and public order and safety, and pensions. Chapter IV will expand this analysis to health, education, and social assistance and child protection—the largest single area of domestically budgeted public spending with a significant sub-Entity role in management, financing, and service provision. These categories alone account for over 35 percent of GDP at both the BiH and the

Entity levels, constituting about 70 percent of total public spending. Given their relative weight in total public expenditures, any analysis of expenditure rationalization must carefully analyze the size and scope of expenditures in these sectors. In addition, these sectors seem to be candidates for considerable indirect savings though efficiency gains. Nevertheless, these sectors are also critical to the social well being of a large majority of the population in BiH. Therefore, (i) expenditure rationalization should not focus exclusively on these sectors; and (ii) any expenditure rationalization in these sectors must be done only after thorough analysis and consultation. In that respect, this analysis illustrates the kind of analysis that needs to be undertaken by all government units in order to achieve a comprehensive reform of public finances in BiH.

Defence and Public Order and Safety

2.48 ***The Defense Sector Remains Excessively Huge and Expensive.*** The ongoing gradual downsizing since the conclusion of DPA has not yet been significant enough to align BiH's defense expenditures with European standards.[78] When judged by the official budgetary allocation to defense, BiH's defense spending stands at 4.4 percent of GDP (2000), more than twice as high as the average for the developed European countries (2.1 percent of GDP) and for the transition CEE countries in the region (1.9 percent of GDP).[79] When the sizable off-budget defense spending and arrears[80] are included, BiH's defense spending increases to about 9 percent of GDP, almost equivalent to total spending[81] on economic services (9.6 percent of GDP) and close to total spending on education and health services (14.1 percent of GDP). Clearly, the rationalization of defense spending, along with a significant improvement in expenditure reporting and financial discipline, remain urgent if defense spending is to be brought down to 2 percent of GDP by 2005, the target spending ratio set by the Joint

Table 2.8 Defense Expenditures, 2000 (in percentages)

	BiH	Federation	RS
Total Defense/GDP	8.9	10.1	5.9
Consolidated General Government Defense (CGGD)/GDP	4.4	4.7	3.5
Off-Budget Defense/GDP	4.7	5.5	2.4
Social Services/GDP	30.2	31.6	24.9
o/w Education&Health/GDP	14.1	15.7	9.8
Economic Services/GDP	9.6	11.4	5.2
Public Order and Safety /GDP	4.4	4.4	4.3
Public Order, Safety and Total Defense/GDP	13.3	14.5	10.2
Total Defense/Social Services	29.6	31.9	23.5
Total Defense/Economic Services	92.5	88.8	113.6
Memo Items			
CGGD/Total Genaral Government Spending	7.7	8.0	6.8
Total Defense/Total Genaral Government Spending	15.7	17.2	11.5
Defense Arreas/Total Defense Spending	39.1	42.4	24.2
Foreing Grants/Total Defense Spending	10.5	11.0	7.1
Average Transition CEE Defense/GDP	1.9	..	..
Average Transition CEE Public O., Safety&Defense/GDP	3.9	..	..
Average EU Defense/GDP	2.1	..	..
Average EU Public O., Safety&Defense/GDP	3.1	..	..

Notes: Non-defense expenditures include donor financed, off-budget expenditures.

Source: Official data; staff estimates,OSCE's Federation and RS Military Expenditure Reviews; RS Ministry of Defense Audit Report (RS-SAI)

[78] Following the DPA of November 1995, an estimated 425,000 soldiers were demobilized from the armies. Their reintegration into civilian life was facilitated by the World Bank's Emergency Demobilization and Reintegration Project through late 1999. In the Madrid Declaration of 1998, the two Entities committed themselves to a further reduction in force of 30 percent in two phases of 15 percent each in 1999 and 2000. This target has been achieved, with the demobilization of about 8,000 soldiers. Of this total, 6,000 soldiers are eligible for assistance in reintegration into civilian life under the World Bank's ongoing Pilot Emergency Labor Redeployment Project. The remaining some 2,000 soldiers have either left the country or found other jobs.

[79] The NATO norm is less than 2 percent of GDP.

[80] The defense sector has been operating with significant arrears, including on W&S, payroll tax contributions, material and services, equivalent to 42 percent of total defense spending in the Federation and 24 percent in RS.

[81] Including both on-budget and donor financed off-budget spending.

Restructuring Steering Board (see Tables 2.7 and 2.8).

2.49 The recently completed defense expenditure reviews for 2000[82] reveal, for the first time since the end of the conflict, detailed information about the size and scope of defense spending in each Entity. These reviews confirm important anecdotal information available earlier, characterizing defense spending in both Entities:

- Total defense spending is much higher than the budgeted amounts (about 54 percent of Federation defense spending and about 45 percent of RS defense spending remains off budget).
- The budgetary allocations are far from covering even W&S payments and the full cost of wage taxes and payroll contributions (these expenses exceed the budgetary allocation by more than twice in the Federation and by about 15 percent in RS).
- The defense sector operates with extraordinary arrears especially on W&S, along with taxes and payroll contributions (amounting to 84 percent of the entire budgetary allocation in the Federation and 31 percent in the RS) and on O&M (amounting to about 9 percent of budgetary allocations in the Federation and 42 percent in the RS). Large payroll contribution arrears, in turn, translate into resource constraints and volatility in the resource flow into the social insurance system. Similarly, arrears to suppliers, particularly to public utilities, challenge the financial viability of the sector, which is already under significant financial stress;
- Defense W&S is disproportionately high compared with average W&S (by 52 percent in the Federation and 47 percent in RS) and is kept even higher in net terms by significant payroll contribution relief, especially in the Federation, and arrears run on payroll contributions in both Entities;
- Foreign transfers to the Croat component of the Federation Army by Croatia (equivalent to 11 percent of total Federation defense spending—KM76.4 million in 2000) and to the RS Army by Yugoslavia (equivalent to 7.1 percent of total RS defense spending—KM10.6 million in 2000) helped keep defense spending over and above budgetary allocations, albeit at the cost of reduced transparency, accountability and financial discipline as well as delayed realization of the peace dividend in BiH that would be generated by lower defense spending.[83]

2.50 The above picture points to a need for urgent policy and institutional measures that would simultaneously address both the much needed cut in defense spending and improvement in budget management. Every effort should be made for the proper accounting of spending on both a cash and an accrual basis, and for the integration of defense resources and expenditures fully into the Entity budgets. In the case of the Federation, success in this endeavor depends critically on the long overdue integration of the Bosniac and the Croat components of the Army, effectively doubling the military spending and severely undermining transparency. Currently, about 70 percent of the Federation's defense spending and 85 percent of RS's defense spending is allocated to W&S and related compensations, and the remainder is allocated to a combination of operational and training activities as well as limited equipment purchase (the major part of the latter has already been provided by donors). In contrast, NATO standards typically require that around 40 percent of defense spending is allocated to W&S, with the rest to be allocated on equipment and other expenses. This indicates that if the internal spending structure of the sector is to be aligned with that in the NATO member countries, the bulk of the defense cuts will have to be concentrated on in reducing the personnel costs, both in the Army and in the Ministry of Defense.

2.51 If the defense spending-to-GDP target of 2 percent by 2005 is to be achieved along with the above-mentioned standard wage-to-non-wage spending ratio, this would require about 18,500-19,300

[82] OSCE undertook detailed defense expenditure reviews as of end-2000 in both Entities. In addition, the Supreme Audit Institution in RS undertook an audit of the Ministry of Defense.

[83] Data about external support for the Entity armies after 2000 is not available.

layoffs in the Federation's defense sector, and about 7000-7,600 layoffs in RS's defense sector. The Entity governments have already committed themselves to significant demobilization during 2002 (about 10,000 in the Federation Army, or 40 percent demobilization; and about 907 in RS Army, or 10 percent demobilization). The final schemes and cost estimates are being worked out. On the savings side, part of the peace dividend generated by lower defense spending will be consumed by the consequent expansion in social spending (severance packages, early retirement for qualified demobilized soldiers, etc.) particularly in the first year of adjustment. Nevertheless, when both the direct costs of the present defense spending, as indicated in Table 2.6, and the indirect costs in terms of deferred/forgone social contributions, taxes, service charges, and obligations to suppliers are considered together, there is a significant remaining peace dividend to be consumed by the social and economic sectors in BiH. The full benefits of the peace dividend will, however, remain unconsumed as long as two separate Entity armies remain.

2.52 In reshaping the labor force in the defense sector, both the Army and the administrative component (i.e. the Ministry itself), particular attention should be given to the educational attainment profile of the employees. The experience in Croatia shows that the profile of the administrative component of the defense sector is far lower than that for the rest of the public sector. The experience under the World Bank's demobilization and redeployment projects in BiH indicates that the same applies in the case of the Army component of the sector. To avoid adverse selection problems at the time of retrenchment, and to retain the better qualified employees, the retrenchment process should be carefully designed, including the crafting of severance packages that would contribute to the release of less qualified personnel.

2.53 ***Public Order and Safety Expenditures Are Similarly Large***. The public order and safety sector often remains interconnected with the defense sector in post-conflict countries. The sector includes activities as different as the judiciary branch of the government, the administration of the jail system, and the police. In post-conflict countries it is not uncommon for part of the retrenchment in defense personnel to be reallocated to police activities, a pattern observed in BiH during the initial demobilization phase after the conclusion of the DPA. This has contributed to the evolution of a sector that is next to the defense sector in size, placing BiH's relative spending on the sector at the very top (over 4 percent of GDP) compared to the average for the developed European countries (1 percent of GDP) and for the transition CEE countries in the region (2 percent of GDP).[84] When combined with total defense spending, BiH allocates a sizable 13 percent of GDP to these two sectors,[85] nearly equivalent to what has been allocated for each of the social security and education and health sectors. The total allocation for the economic sectors remains relatively much lower than this total, even after sizable donor-financed spending is included (see Tables 2.7 and 2.8). These facts apply equally to both Entities. As discussed above, there is undoubtedly a need for *net* expenditure rationalization in both sectors and, hence, a need for a special care in avoiding shifting the burden of retrenchment across these two sectors during the adjustment process.

[84] A section of the judiciary branch, the judicature, has benefited from salary increases as of 2000 significantly higher than for the rest of the public sector in BiH, which has contributed expansion in W&S spending in this sector.

[85] Unsurprisingly, the defense sector across Entities is fairly similar in size both as a share of GDP (4.7 percent in the Federation and 3.5 percent in RS) and as a share of total consolidated general government spending (8.0 percent of total spending in the Federation and 6.8 percent in RS). The spending patterns for the public order and safety sector are even more alike. The similarity becomes less pronounced when off-budget spending is considered, but this reflects relatively much larger foreign transfers to Federation than to RS.

2.54 **Recommendations:**

- Prepare a 2002-05 defense spending rationalization plan with a view to bringing total defense spending to a targeted level of 2 percent of GDP and to realigning the cost structure to NATO standards. Given the fact that the 2002 budgetary allocations to defense have already been reduced based on planned demobilization rates, any delays in implementation will mean a further significant increase in arrears over and above the already high levels.
- To avoid adverse selection problems at the time of implementing personnel reductions, the retrenchment should be carefully designed, including the crafting of severance packages that would contribute to the release of less qualified personnel.
- An immediate priority should be given to eliminating ethnically based management of the defense sector in the Federation, which effectively doubles the overall defense spending.
- Special attention should be paid to the indirect fiscal costs of retrenchment in the form of pensions and severance payments.
- As a general principle, severance pay and benefits should be used rather than granting special concessions for early retirement as special concession would adversely affect pension payments and sustainability.
- The transfer of defense personnel to police functions should be carefully monitored as the latter is already large relative to European standards.
- A focused expenditure review should be carried out to define the scope of public order and safety spending as a basis on which a rationalization plan should be designed.
- Budgeting, accounting, administration, and control over defense spending should be significantly improved to restore transparency, accountability, and financial discipline to the sector.
- Given the importance of spending on W&S, regular payroll audits should be carried out and non-cash benefits should be accounted for and factored in as wage expenses.
- Any exemptions on the payroll contributions of the defense sector should be eliminated, and indirect transfers/subsidies granted to the sector should be directly brought into the budget.
- Foreign assistance to the sector should be transparently directed through Entity governments and should be recorded in Entity budgets.
- The sector should identify and divest unnecessary real estate property and other non-core assets owned by the Army and the Ministry of Defense, reducing maintenance and administration costs.

Pension

2.55 The CEEC's transition experience, whereby a sharp decline in formal sector employment during the transition period is correlated with the level of income per capita—i.e., countries with lower income levels saw larger drops in the number of contributors to their social insurance systems—illustrates that even in the absence of the conflict, BiH's pension contribution base would most probably have deteriorated dramatically, resulting in a financial crisis. This process was attenuated by the destruction of productive capacity during the war period, which prematurely ended the financial viability of the pre-war scheme. The war also resulted in the fission of BiH's pension scheme into three separate, ethnically-based institutions. There were two pension funds in the Federation area, corresponding to the Croat-dominated (Mostar-MIO) and the Bosniac-dominated areas (Sarajevo-PIO), which continued to operate separately until their merger in January 2002. The third fund covers workers and pensioners in RS (RS-PIO). After the split, each fund operated according to its own rules and coped with the conflict-caused financial crisis in different ways.[86]

[86] The Sarajevo-PIO continued to calculate the level of pension that should have been paid according to pre-war legislation, thereby keeping track of mounting liabilities on an accrual basis. This resulted in explicit recognition of a massive and growing

2.56 ***The Strength of BiH's Pension System.*** Table 2.9 shows the basic indicators of the present pension system in the Entities. In the pre-independence year 1991, the ratio of pensioners to contributors in BiH—which, along with the contribution rate, determines the possible level of benefits that can be paid in a payroll tax financed scheme as in BiH—was about 1:3. It deteriorated dramatically to 1:1.3 by the end of the conflict, hovering around 1:1.4 in the Federation since then. In RS the situation is worse, with each contributing worker supporting more than one pensioner (1.08:1). As a result, even very high payroll taxes and budget transfers in RS produce an average pension that is less than 30 percent of income per capita. In contrast, a somewhat better ratio of pensioners to contributors in the Federation allows for much higher absolute and relative pension levels even though the pension spending to GDP ratio is lower. Many countries in Eastern Europe and Central Asia experienced significant deterioration in their contributor base during the 1990s. However, in only a few cases, such as Georgia, Albania and Ukraine, is the situation as dramatic as in BiH. In these countries, the collapse of the contributor base has resulted in drastic measures to shore up pension financing and, in most cases, the need for budgetary transfers.

Table 2.9: Main indicators of pension system operating in BiH, 2001

	Federation	RS	BiH
Pensioners	270,671	171,954	442,625
Contributors	410,808	160,000	570,808
Pensioners/Contributors	65.9%	107.5%	77.5%
Average pension (monthly KM)	160	70	125
Average pension, % of income per capita	64.6%	28.3%	50.5%
Pensions/GDP	8.2%	10.8%	8.9%

Source: Official data and staff estimates

2.57 Table 2.10 shows that the current pension levels in the Federation largely reflect the strong post-conflict recovery. After bottoming out in 1995, pension levels in 1996 were 12 percent of their 1991 levels and had steadily rebounded to 36 percent by 2001. This has been possible because the number of contributors increased by 25 percent while average wages more than doubled during the period. As a result, the average pension level tripled, despite a gradual reduction in the earmarked payroll tax rates for pensions during this period. By 2001, the average Federation pension was about two-thirds of income per capita, higher than the same ratio observed in most transition countries today. Nevertheless, this average masks significant variations in pension levels particularly among Sarajevo-PIO beneficiaries.[87] At the household level, these variations would translate into a wide range of poverty outcomes depending on the number and type of pensioners. As in other countries, poverty is likely to be concentrated among older females with widows' pensions—perhaps more so in BiH than elsewhere owing to the effects of the

Table 2.10: Federation Pension Indicators

	1991[1/]	1995	1996	1997	1998	1999	2000	2001	2001/1991
Pensioners	n.a.	220,343	240,561	241,885	249,712	268,587	270,671	281,974	n.a.
Contributors	n.a.	243,124	307,103	310,000	316,833	407,754	410,808	406,149	n.a.
Pens/Conts	32.0%	90.6%	78.3%	78.0%	78.8%	65.9%	65.9%	69.4%	217.0%
Average pension	473	23	55	98	145	151	160	169	35.7%
Average net wage	666	87	172	266	329	375	413	443	66.5%
Replacement rate	71.0%	26.0%	32.0%	37.0%	44.0%	40.0%	39.0%	38.0%	53.7%
Memo Item:									
Average pension/income per capita	139.0%		49.0%	53.0%	70.0%	66.0%	65.0%	63.0%	45.0%

[1/] Refers to all BiH.

Source: Official data and staff estimates.

liability for the fund in 1998. In the case of the Mostar-MIO and the RS-PIO, post-conflict records were not accessible. Therefore, the Mostar-MIO opted for paying every pensioner a flat amount based on revenues collected during each month. Its resource base was also enhanced by transfers from Croatia, allowing higher pensions relative to the other two funds. The RS-PIO, adopted an intermediate solution, whereby certification of the education level was used as a proxy for lifetime earnings and pension levels were differentiated into five categories.

[87] Although substantially reduced, the ratio of maximum to minimum pensions by 2001 was about 5:1.

conflict.[88] In contrast, some elderly households will receive two pensions and will have incomes well above the country average. This is usually the outcome in systems with the earnings-related benefit formula, which reinforces lifetime income distribution patterns and presumably rewards higher payroll tax contributions with higher pensions.

2.58 Despite the rising resource base of the system, one of the two Federation pensions funds, namely the Sarajevo-PIO, operated with mounting pension arrears because legally prescribed levels remained well above affordable levels through late-1998, when new legislation was introduced to eliminate the disparity between legal and actual pension payments.[89] This environment in which systemic quasi-fiscal liabilities have been created through legislation also reinforced the tendency for politicians to make unfunded promises by increasing pension levels over and above the amount that available resources could have financed. As a result, even after the 1998 pension reforms, payments delays and arrears accumulation continued in the Sarajevo-PIO until the introduction of a rigid indexation policy in late 2000 (see para. 2.61). Throughout this period, Sarajevo-PIO's financial sustainability was further reduced by indirect income subsidization policies for certain industries (e.g., steel) and the military through significant payroll tax relief for pension contributions. Finally, a number of other factors have aggravated the fragility not only of the Sarajevo-PIO finances, but in general of the overall pension system in BiH. These factors include: (i) irregularity of contributions, which often mirrors irregular W&S payments across the economy; and (ii) payroll tax or contribution avoidance through a combination of underreporting of wages and reliance on non-wage benefits in the formal economy and through informalization of the economy.

2.59 The strength of the pension scheme in RS, where the post-conflict economic recovery has made a late start, is relatively weaker in terms of both financial balances and pension levels. The most recent indicators show pension levels in RS to be half those in the Federation. Replacement rates are also about half, when expressed as a share of income per capita. In addition, the system operates with significant transfers from the central budget. Nevertheless, in an environment of resource shortages and continuous fluctuations in timeliness of contributions, delays in pension payments have also been a feature of the RS-PIO, though it prevented systemic arrears accumulation. This policy was reversed in late 1999, when a combination of a sharp increase in minimum wages and the indexation of pensions to monthly wage growth resulted in rapidly increasing pension expenditures without a matching enhancement in the pension resource base. The financial crisis became worse when an attempt was made to reduce the payroll tax contributions in 2000. To rescue the severely deteriorating pension finances, the RS government reversed the decision on minimum wages and payroll tax rates, and introduced, in 2000, a package of reforms (see Box 2.5).

2.60 ***Pension Reforms - An Iterative Process.*** The Federation, where the need for rapid pension reform was more pressing, initiated the reform process by adopting a new pension legislation in late-1998. The legislation equated actual with legal pension payments, thereby stopping the systemic accumulation of arrears; introduced a number of more traditional reforms to tighten the indexation rule, the eligibility criteria, the revaluation of past wages and the assessment base; and was a critical step toward both harmonizing pension policy and initiating the process of unifying the pension administration across the Federation. The Federation also adopted a strategy for the viable settlement of accumulated pension arrears through the privatization process and measures to improve the targeting of pensions via a

[88] Once completed, the ongoing poverty assessment for BiH will reveal the actual situation more clearly.

[89] Arrears by 1998 were equivalent to about 24 percent of the Federation GDP. The average pensioner was owed over KM 3,000 in missed or late payments. These claims were settled through privatization certificates which could be used for the purchase of shares in privatized firms, or the purchase of apartments or office space from the municipality. Alternatively, the certificates could be sold on the secondary market. However, the reported discounts were deep and most certificates would have received only 3-4 percent of their face value.

reduction in the disparity in pension payments. The initial traditional reforms were expanded in 2000 to include a gradual reduction of the accrual rate used in the benefit formula and a gradual increase in the earnings assessment base to a lifetime work profile. The introduction of a similar set of reforms in RS took longer, extending to late 2000, when new legislation was adopted. Box 2.5 outlines the key features of pension reforms to date in both Entities.

Box 2.5 Key Elements of Pension Reforms in BiH, 1998 - 2001

Federation

1998

- New indexation method tying pension adjustments to wage growth against availability of regular pension resources (quarterly reviews);
- Minimum years in service required for pension benefit increased from 15 to 20;
- Increase in the number of years used in calculation of pension base from 10 to 15 years;
- Gradual increase in retirement age from 60 to 65 by 2003;
- Tighter eligibility rules for family pensions and partial disability benefits;
- Clearance of arrears accrued until June 30,1998 through issuance of privatization vouchers;
- Establishment of preconditions for merger of the two pension funds in the Federation.

1999

- Decision on reduction of disparity between the minimum and maximum pension reducing max.-to-min. pension ratio from 11 to 5.

2000

- New indexation method tying pension levels above the minimum to availability of regular pension resources on a monthly basis, by application of pension coefficient
- Gradual increase in number of years used for calculation of pension base, from the last 15 best years to 40 years (lifetime profile) by 2015;
- Gradual reduction of the accrual rate from 2% to 1.50% in 2005; this implies reduction of pension base from 85% to 75% in 2005. The same base also applies to disability pensions.
- Legislation providing for the merger of the two pension funds in Federation, laying out procedure and deadlines for merger;

2002

- Merger of the two funds, with the new Federation PIO starting functioning as of January 1, 2002

Republika Srpska

2000

- New indexation method tying pension levels above the minimum to availability of regular pension resources on a monthly basis, by application of pension coefficient;
- Increase in number of years used for calculation of pension base, from the last 10 best years to a lifetime profile;
- Tighter eligibility rules for family pensions, disability pensions and for partial disability benefits;
- Gradual reduction of the accrual rate from 2% to 1.50% (male) and 1.33% (female) by 2004; this implies reduction of pension base from current 85% to 75% in 2004. The same base applies to disability pensions;
- Gradual increase in retirement age to 65 (male) and 60 (female), by 2006;
- Minimum years in service required for pension benefit increased from 15 to 20;
- Full pension history set at the point of 40 years (male) and 35 years (female);
- Establishment of preconditions for pension assessment according to the individual working histories, once the data becomes available, but no later than January 1, 2002 (see 2002 item below);
- Education-based coefficients for pension base calculations established to be used until the assessment-required data is available (see above and below items).

2002

- RS PIO currently undertaking necessary steps to complete ongoing pension assessment/reassessment by June 30, 2002.

2.61 All together, the reforms in both Entities is important for aligning benefit levels with the realities of future resources in the long term and, hence, it constitutes a positive step toward re-storing financial discipline in the BiH's pension system. But, the reform element that was and still is most critical to short-term financial sustainability is the definition of the indexation rule—it determines adjustments to pension

levels over time and therefore has an important impact on pension spending.[90] It aims at removing discretion in indexation by applying a formula that strictly limits future pension adjustments to those levels that would maintain a cash-flow balance on a monthly basis. Therefore, it has the effect of (temporarily) compressing the distribution of pensions until such time as revenues are sufficient to provide the benefit levels as determined by the legal formula prior to application of the coefficient. In order to protect minimum pensions from likely downward adjustments, the new rule applies to all pensions only above the minimum.

2.62 Financial stability was also considered a crucial reason for making progress on the institutional reform front i.e., the merger of the two Federation pension funds. The merger was essential not only to economic integration in the Federation area but also to the transparency and efficiency of the pension system, since the coexistence of two small, parallel pay-as-you-go schemes limited labor mobility and raised administrative costs. The new integrated Federation Pension Institute began operations in January 2002, ending the decade-long separation of the two schemes and constituting an important step towards rationalizing Federation social policy.

2.63 ***Present Status of the Pension Finances***. Owing to the significant mismatch between pension expenditures and the pension resource base, implementation of the new legislation, especially the new indexation formula, meant a forced reduction in the pension levels in both Entities. In the Federation, pensions paid by the Sarajevo-PIO dropped to 84 percent of their pre-reform levels during 2001. The initial drop was much more dramatic in RS with only 50 percent of pre-reform pensions being affordable at the introduction of the reforms; this increased to 63 percent by October 2001, as the collection of contributions improved.

2.64 As was intended, these polices have precluded the accumulation of systemic arrears to pensioners in both Entities. Nevertheless, the year 2001 has seen a significant increase (almost two-fold) in budgetary transfers to the Federation's pension funds owing to (i) the Federation Government's attempts to maintain the regularity of pensions with no further decline in pension levels—i.e. indexation co-efficient was implicitly frozen at 0.84; and (ii) clearance of unpaid military contributions to the pension funds due from 2000-01. The Federation government also began clearing pension arrears from previous years in 2001. About 40 percent of obligations due to pensioners were cleared, with the rest planned to be paid during 2002. The increase in the Federal Government revenues over their original 2001 plan allowed these deferred deficits from 1998-2000 to be financed without eventually crowding-out planned federal expenditures in other areas. But looking forward, the newly integrated Federation pension system remains financially fragile, requiring strict adherence to the indexation mechanism.

2.65 Similarly, RS pension finances remain fragile, with the continued dependence of the RS pension fund on budget transfers and a high ratio of pensioners to contributors. Between October 2001 and the present, pension payments have been further increased to 70 percent of their pre-reform levels. Nevertheless, the financial stance of the RS-PIO has been deteriorating since late 2001, resulting in a one-month delay in pension payments. This is due partly to a combination of a reduction in the payroll tax rate earmarked for pensions (from about 31 percent of net wage in 2000 to 24 percent in 2001), the abolishment of revenues coming from special taxes, and a reduction in budget transfers (from about KM23 million to KM10 million between 2000 and 2001). The RS-PIO is currently in the midst of moving back to benefit calculations based on the pre-conflict benefit formula (with certain modifications as described in Box 2.5) with a planned finalization date of mid-2002. This policy, while improving the

[90] In response to the growing financial stresses in their pension systems, both Entity governments embarked on preventing further liabilities by adopting a rigid version of the indexation provision in the new legislation. Nevertheless, these efforts were defeated in the Entity Parliaments, eventually leading to the imposition of the new indexation provision by the OHR in late 2000.

criteria for the determination of pension levels and harmonizing the rules between the two Entities, may actually result in an increase in pension benefits, despite the parametric reforms undertaken. This, in turn, will put further downward pressure on affordable monthly pension levels.

2.66 ***Looking Forward.*** To date, policy reforms undertaken in both Entities, and the integration of the Federation pension system, conclude a difficult chapter in the post-conflict reform process, allowing both Entities to refocus their efforts on further improving financial discipline, transparency, and accountability in their pension systems. These achievements also clear the way for the consideration of the type of reform measures that have been under discussion in neighboring countries over the past few years. Table 2.11 compares the current pension schemes operating in five former SFRY republics. The present stance of the Federation pension scheme has much in common with BiH's neighbors, while the RS scheme stands out as having the most difficult situation.

Table 2.11: Pension systems in Former SFRY Republics (latest)

	Bosnia and Herzegovina		**Croatia**	**Slovenia**	**Macedonia**	**FYR Serbia**
	Federation	*RS*				
Average monthly pension in US$	77	32	152	338	101	75
Pensioners/contributors	69%	108%	74%	67%	66%	82%
Payroll tax contributions for pensions	17.0%	15.8%	19.5%	24.4%	20.0%	19.6%
Pension spending/GDP	8.0%	10.8%	13.1%	12.1%	10.6%	11.3%
Post retirement indexation	As per available resources	as per available resources	50% wages/50% prices	indexed to net wages	moving to 80% prices/20% wages	50% wages/50% prices
Reform status	Parametric reforms passed through 1998-2000	Parametric reforms in 2000	Systemic reform passed; effective from July 2002	Modest parametric reforms in 2000	Systemic reform passed; in 2002	Parametric reforms to be implemented in 2002
% Population over 65	9.9%	9.9%	14.9%	13.7%	10.0%	13.6%

2.67 Pension reforms can be grouped into two types: those that involve changes to the parameters of the prevailing scheme, and systemic reforms. The Entities' policy reforms to date are an example of the first type of reform, but, as in many other countries in the region (e.g., Slovenia), they could fall short of resolving long term sustainability *if the payroll contributions are to be reduced to reasonable levels*. Systemic reforms involving an increased role for private, funded pension schemes—such as those introduced in Poland and Hungary and, more recently, in Croatia and FRY Macedonia—could be considered in the future to further contain replacement rates and to benefit from the merits of diversifying between retirement income sources.[91] Finally, in the short term there remains the challenge of ensuring that pensioners in the Brcko District will be successfully integrated into the existing Entity schemes without further fragmenting the BiH's pension system; and, in the long term, there remains the challenge of fully harmonizing pension polices in BiH, and ensuring portability, so that labor mobility is not hindered across BiH.

2.68 **Recommendations**: The medium-term strength of the pension system in BiH depends critically on the continued economic growth and expansion of formal sector employment combined with a slower

[91] A number of transition economies in Eastern Europe and the former Soviet Union have shifted toward mixed pension provision through the introduction of privately-managed, funded pensions. These take the form of individual, defined contribution accounts invested in the capital markets, which produce an accumulation that is typically converted into an annuity upon retirement.

rate of new pension awards.[92] If these conditions can be ensured though the active role of BiH's policymakers, the current indexation formula could then be revised over time so that pensions would maintain their real value through price indexation.[93] A number of measures would need to be taken in order to achieve this objective:

- Apply the indexation mechanism in accordance with the law and refrain from recourse to payment delays in order to maintain unaffordable pension levels. Slippage in arrears prevention policy is a major threat to fiscal sustainability in the medium term and could significantly postpone real improvements in pension levels;
- Refrain from awarding pensions in place of severance benefits during the forthcoming restructuring and privatization of large enterprises and demobilization of the military;
- Improve compliance in the formal sector and among the self-employed while actively pursuing the elimination of informal sector;
- Eliminate W&S payment delays and/or irregularities in planned budgetary transfers from being a destabilizer for the pension system;
- Refrain from providing payroll contribution exemption/relief as an implicit income transfer to civil servants and an implicit subsidy to financially unviable industries;
- Enforce the financial planning and reporting rules for the Pension Funds, including the enforcement of the presentation of the annual pension-budget plan to Parliament, along the lines legislated in the Organic Budget Laws;
- Identify and divest non-core real estate property and other assets owned by the pension funds to focus their operation clearly on pension administration;

[92] Return of refugees is another important factor that could affect the ratio of contributors to pensioners and therefore the affordable level of pay-as-you-go pensions.
[93] Most industrial countries have moved to price indexation of pensions in order to satisfy the public policy objective of providing effective longevity insurance.

III. FISCAL DECENTRALIZATION AND SUB-NATIONAL EXPENDITURES

This Chapter looks at the present status and performance of BiH's unique intergovernmental fiscal relations (section A), undertakes an overall analyses of composition of sub-Entity expenditures (Section B), and considers how well balanced the present intergovernmental fiscal finances are (Section C), with a view to outlining principles for improvement and policy direction that would address some of the inefficiencies in BiH's decentralized fiscal management structure (Section D).

A. THE DIVISION OF FISCAL RESPONSIBILITIES AMONG BIH'S MULTI-TIERED GOVERNMENTS

3.1 The performance of BiH's public expenditure policies and management systems can be fully understood only through a thorough understanding of its intergovernmental fiscal relations. The summary overview of the BiH's intergovernmental fiscal relations and governance structure given in Chapter I emphasized the fact that three issues require increased attention, if BiH's extremely decentralized fiscal relations are to operate efficiently and promote growth and prosperity: (i) increasing the State's role in the economy as an integrative force and central authority; (ii) addressing the design and the implementation of proper fiscal decentralization; (iii) strengthening the vertical and horizontal coordination of fiscal policies and the accountability and transparency of fiscal management. Chapter I elaborated on the first issue in detail. This chapter will focus on the other two issues, with an emphasis on the policy dimensions while the last chapter will elaborate on the institutional dimensions of fiscal management.

Sub-National Fiscal Administration Structure

3.2 As described earlier, the BiH's fiscal system provides the Entities with significant fiscal autonomy and the State with only limited powers and marginal own-revenue sources.[94] State functions that are not explicitly attributed by the Constitution can be enhanced if they are relinquished by both Entities. The administration of fiscal policy in each Entity is distinct. The Federation, which comprises 10 cantons and 84 municipalities, operates in a highly decentralized structure with very little vertical and horizontal cooperation among government authorities. RS, which comprises 63 municipalities, operates in an administratively and fiscally centralized structure, with little delegation of authority to local governments.

3.3 Reflecting its unique fiscal decentralization arrangements, both the size and the scope of the sub-national public sector in BiH is extremely high by the standards of federation countries. The share of aggregate sub-national public expenditures in consolidated BiH public expenditures is 97.9 percent. Similarly, at the sub-national level, the Federation, which constitutes about three-fourths of the consolidated BiH budget, has one of the most decentralized fiscal structures in the region,[95] with cantonal governments holding significant fiscal policymaking power on the expenditure side: the share of sub-Entity government expenditures (i.e., cantons and municipalities) in the consolidated Federation budget is estimated at about 75 percent including the extrabudgetary Funds (EBFs) and 43 percent without them.[96]

[94] State own revenue has represented less than 8 percent of its budget. The State is the country's ultimate guarantor of foreign debt; however, in line with their fiscally autonomous structure, foreign borrowing is usually allotted to the Entities, and the debt service is financed through transfers from the Entities' budgets according to the final beneficiary principle. In addition, the Entities carry the State's administrative budget in fixed proportions (two-thirds Federation, and one-third the RS).

[95] See Box.1.1 in Chapter I for a comparative discussion.

[96] In the Federation, the extrabudgetary funds (Health Insurance, Pension Fund, and Employment Funds) were largely being perceived and operated as cantonal funds till January 2002, when (i) a single Federation level pension fund was created, and (ii) a portion of health insurance revenues allocated to the Federation Health Insurance Fund to finance some tertiary health services

Table 3.1 Sub-National Public Expenditures, 2000		
	Entity Government	*Sub-Entity Government*
As a % share of:		
BiH[1]	97.9	55.9
Federation	24.9	75.1
RS	92.0	8.5

[1]Excludes off-budget expenditures.
Source: Official data and staff estimates.

In RS, which represents about one-fourth of the consolidated BiH budget, municipal governments account for only about 8.5 percent of the consolidated RS budget. In general, municipalities in both Entities have very little discretionary powers in fiscal matters, with municipal expenditures mostly reflecting the local implementation of decisions taken by cantonal/central governments[97] (see Table 3.1).

3.4 Both Entities use the concept of "City" to amalgamate and coordinate policies among urban municipalities. Cities are run by democratically elected Governing Councils that indirectly elect the Mayor to act as their Chief Executive Officer. There are four Cities in BiH: two in the Federation—Sarajevo and Mostar—and two in the RS—Banja Luka and Srpska Sarajevo. Cities run their own budgets, but they are partially financed by their municipalities and cantons (in the Federation) or Entity (in RS). In practice, the distinction between Cities and municipalities or towns, which has a bearing on outlay responsibilities and finance, is not always clear and is currently is being settled by largely politics or the Judiciary.

Revenue Assignments

3.5 The State legislates only customs policies and owns no tax revenue in BiH. All the remaining taxing powers (including tax policies, tax and customs administration, and the appropriation rights on tax proceeds) rests with the Entities and the Brcko District, each in their respective territories. In both Entities customs duties, excise taxes, and profit tax (except for some smaller corporations in the Federation) are "exclusively assigned" to the Entities (the road tax is also an Entity tax in RS). The sales tax and the personal income tax are the most important "shared taxes" in both Entities[98] (see Table 3.2). In the case of the Federation, these taxes are fully assigned to the cantons with each canton sharing them with their municipalities according to the cantonal "Law on the Allocation of Public Revenue." An exception is Sarajevo Canton, where municipalities rely heavily on subsidies (specially negotiated, extraordinary transfers) from the canton. In addition, the property tax (mainly a real estate tax), the property transaction's tax, and the road taxes are also shared between cantons and municipalities (see Annex II for a detailed presentation). In both Entities, taxes are shared on a derivation basis (i.e., the economic potential and resource endowments of sub-Entity governments determines their tax collection capacity/receipt).

Table 3.2 Entity Revenues, 2000									
Percent of Total On-Budget Revenues	*Federation Consolid.*	*Federal Gov.*	*Cantons*	*EBFs*	*Municipa.*	*RS Consolid.*	*Central Gov.*	*EBFs*	*Municipa.*
Tax Revenues	80.0	86.1	80.4	76.7	54.6	81.6	77.5	82.0	73.5
Indirect Taxes	46.7	83.6	59.6	0.0	40.4	43.6	57.4	0.0	50.6
Direct Taxes	33.3	2.5	20.8	76.7	14.3	37.9	20.2	82.0	22.9
Non-tax revenues	15.9	7.1	16.4	17.5	25.7	14.3	16.3	3.0	24.2
Foreign. Grants (on budget)	3.3	6.9	0.7	3.4	..	4.2	6.2	..	..
Transfers from other Government Tiers	0.0	0.0	1.9	0.8	19.7	0.0	0.0	15.0	2.3
Memo Items									
Total Revenues&Grants (on-budget) (%GDP)	50.3	13.3	17.9	17.4	4.3	45.2	30.6	14.2	4.3
Total Revenues&Grants (on&off budget) (%GDP)	54.5	..	..	..	..	51.7	..	..	..

Source: Official data and staff estimates.

(for details, see relevant sections of the report). Similarly, employment fund revenues were allocated in ratio of a 30 percent Federal government/70 percent cantonal governments in 2000 with the former mainly for covering the unfunded unemployment benefit obligations of cantons. In RS, they are administered by the central government.

[97] This modality reflects a deconcentration of Entity competences rather than a decentralization of fiscal decision-making powers, (i.e., devolution of autonomous competencies to local governments). The latter concept is as yet undeveloped in both Entities.

3.6 Taxing power rests exclusively with the Entity governments in order to retain a harmonized system in each Entity. Accordingly, cantons can legislate on a few of their own taxes (e.g. property, and property transactions taxes) and on tax sharing with their respective municipalities. In general, the potential of sub-Entity taxes as a direct policy instrument for improving the sub-Entity allocation of resources (e.g., the protection of the environment) and as a financing source remains largely unexploited in BiH. Municipal governments are especially accustomed to depend on shared taxes (constituting about 75 percent of their income stream), which creates perverse incentives since local authorities do not feel directly accountable for these resources.

3.7 Particularly neglected as the most efficient and potentially important local revenue source are the property taxes, although regulations exist "on paper" in both Entities.[99] This partly reflects problems inherited from the former SFRY regime (e.g., the property rights on public buildings and facilities are blurred and private property rights are largely undefined) and partly the legacy of the conflict (e.g., cadastres of both private and public properties are either outdated or practically non-existent). As a result, especially in the Federation, the sub-Entity tax structure became unnecessarily pulverized and complex, with a myriad of small surcharges and fees that are sometimes earmarked as extrabudgetary revenue to utility companies and for other special purposes (e.g., a fee on cars is earmarked to finance water in the Canton of Central Bosnia, or to education in Croat cantons).

3.8 Nevertheless, there are significant local non-tax revenues, particularly in the urban areas. These include local levies and surcharges, rents on local public properties,[100] concession and registration fees,[101] fines, and services and utility user charges. The majority of these local revenue instruments are regulated by the cantons in the Federation and the central government in RS. But user charges on utilities can, in principle, be established and adjusted by municipal councils according to their local conditions. In practice, however, service tariffs often remain unadjusted and fall short of fully recovering the costs. The collection ratio of the bills issued is also very low (reported to be between 20 and 30 percent in some cases). As a result, utility companies are in serious financial trouble across BiH with municipalities trying to support utilities through a series of direct and indirect budgetary transfer schemes. [102]

3.9 Although managed under distinct administrative and political modalities, the tax structures are becoming increasingly similar across Entities, reflecting significant harmonization reforms since 1997. Hence, major weaknesses in taxation in both Entities are, by and large similar, especially those stemming

---

[98] Depending on each canton's legislation, municipalities obtain 20-30 percent of the tax proceeds. In the RS their share is 26 percent.

[99] There is a framework for property taxation in both Entities, but this tax is not being exploited. It is often argued that its administration would cost more than can be collected. Moreover, the revenue from the property tax is to be shared with higher levels of government. Taxes on agricultural properties are typically suspended because of a low potential to generate income. Due to weaknesses in public accounting, there are also serious doubts on how incomes from government properties (rents) versus property tax proceeds have been interpreted and accounted for in BiH government statistics—whether as "property tax" or "rental of government property buildings—commercial and residential".

[100] Many municipalities, but especially the Cities of Sarajevo and Banja Luka, are said to be owners of considerable urban properties (mainly office buildings and houses), which are providing a regular income stream to the respective budgets. Notably, city officers have focused so much attention on these rents from properties to the point of confusing these income inflows with revenue from property tax when asked about the latter.

[101] For instance, the municipality of Visegrad reported that it receives a regular income stream from the concession of an area where the electricity generating company operates a dam. However, the regulatory framework for such charges is weak or non-existent, and there is no overarching strategy or plan for environmental control at the Entity or cantonal levels. Also, Tomislavgrad reported that, although any municipality in Herzeg-Bosnian Canton can legally charge car registration fees, it is the only municipality in the canton that collects it.

[102] For instance, municipalities either support their utilities with direct subsidies from the budget (without commitment), or by subsidizing certain groups of citizens (e.g., pensioners, for whom they pay the heating bill), or by covering unpaid bills on a contractual basis where the service is provided by private companies.

from revenue assignments among governments. In this context, three major issues require increased attention in the period ahead: (i) inequities resulting from derivation based tax assignment remain un-offset because there is no equalization mechanism, which results in wide regional differences in fiscal capacities; and (ii) absence of rules for sharing tax revenues between jurisdictions in cases where some component of the taxable activity takes place in more than one jurisdiction, such as profit tax (in the Federation) and wage tax (in both Entities); and (iii) local governments are highly dependent on tax-sharing revenues.

Expenditure Assignments

3.10 The general framework for expenditure assignments is that each government possesses all public expenditure responsibilities that are not expressly assigned to a higher government by the Constitution and/or laws in BiH.[103] In the face of the as yet incomplete division of many responsibilities, this principle leaves ample room for concurrent responsibilities and, hence, inefficiencies, under-provision of services, and waste of resources in BiH. Overall, the structure of expenditure assignments in BiH is a very complex one which, at present, operates at best with loose coordination in policy formulation and loose cooperation in policy implementation.

3.11 ***Exclusive Responsibilities.*** The Entity governments retain many functions that are typically performed by a national government in other countries. For instance, the Entity government has responsibility for defense, economic policies, regulation of financial institutions, fiscal policy, reconstruction programs, production and distribution of energy (including electricity transmission lines), highways, and railways (see Annex III for a detailed presentation).

3.12 In the case of the Federation, expenditure decisions are basically decentralized to the cantons, which perform a major role in the regulation, financing, and delivery of social services (i.e., education, health services, and social assistance) as well as local businesses, housing, cultural affairs, fire protection, tourism, and radio and television. Within this framework, two areas, in which the Federal government also retains exclusive responsibility are the "categorical" social assistance programs that include cash and other benefits for war veterans, and since January 2002, the administration of the newly integrated pension system. In RS, the expenditures assigned exclusively to the Entity government are more comprehensive and include most of the responsibilities on regulating, financing and delivering social services, which in the Federation are assigned to the cantons.

3.13 In both Entities, municipalities[104] play similar and only a minor role in the decision-making process in public spending, although their role in delivering services has been increasing, especially in the Federation. The municipalities' exclusive responsibilities are mainly in urban planning, utility functions, pre-schooling, the maintenance of primary and secondary school buildings, school bus transportation for students and teachers, physical education, ambulance services, health care supplies, culture, sports, and street lightning. In addition, the municipalities of RS are also responsible for local police and local roads.

[103] Entities possess all public expenditure responsibilities that are not expressly assigned to the State by the *State Constitution*. The same principle applies to the cantons, which exercise all responsibilities not expressly attributed to the government of the Federation by the *Federal Constitution*. In both Entities, the municipalities exercise local public functions according to their own *statutes*, which must be consistent with the respective *Entity's Constitution* (and the *Canton's Constitution in the case of the Federation)* as well as the *Laws on Local Self-Government*, which every canton (except Sarajevo) of the Federation and the RS has passed broadly defining expenditure responsibilities (own and delegated) for their respective municipalities.

[104] As an autonomous District, Brcko has assumed, since March 2000, most of the expenditure responsibilities previously under RS.

3.14 In the case of the Federation, municipal expenditure responsibilities have in general been decentralized asymmetrically across cantons. This asymmetry reflects not only political and ethnic considerations and uneven administrative and technical capacities, but also a lack of horizontal coordination among cantons. Furthermore, the Constitution of the Federation establishes that if the ethnic majority of the local population is different from that of the canton's majority, then cantons must delegate functions relating to education, culture, tourism, environmental protection, employment, social assistance, and radio and television to these municipalities or cities of their territory, creating room for further significant asymmetry in municipal functions and financing requirements. Owing to financing constraints, such delegation is limited at present.

3.15 In principle, municipalities are autonomous concerning their own expenditures and they can exercise local self-governance in undertaking their exclusive responsibilities in both Entities. However, owing to weak fiscal capacity at the local level and the absence of an equalizing mechanism, most municipalities are unable to assume their full functions and/or they accumulate substantial arrears in payments (delivery of utility services and social cash assistance for the poor are particularly difficult in these respects).

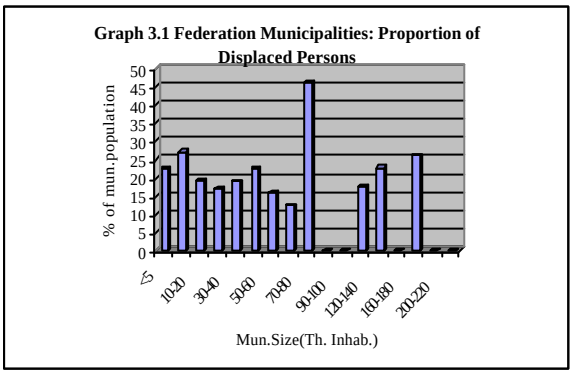
3.16 ***Joint/Concurrent Responsabilisations***. The State has a joint responsibility with the Entities for the administration of justice, the regulation of communications and public transportation systems, the implementation of policies regarding refugees and displaced persons, and the administration of citizenship. The Federation has joint/concurrent responsibilities with the cantons and municipalities for the enforcement of law and order, the implementation of health care policies, intra-Entity communication and transportation policies, and environmental policies, and the administration of social protection. The financing and administration of some education, health, and social protection services are also joint/concurrent in RS. While in some areas of joint/concurrent responsibilities (e.g., justice, citizenship, some elements of the regulatory framework, health care policies) ongoing reforms, especially in the context of the EU accession process, have gradually been improving clarity in the division of responsibilities across governments, in a number of important areas, the present structure leads to allocative and technical inefficiencies through a duplication or under-provision of services.[105] Examples of the latter include delivery of social services in general (see next chapter for a detailed discussion), services to refugees and displaced persons, and environmental policies.[106]

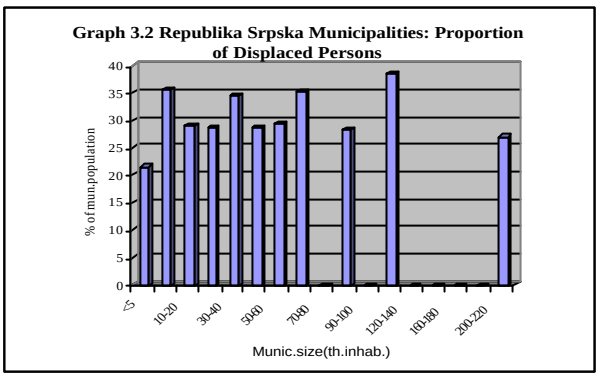
Box 3.1 Overlapping Responsibilities Across Governments: The Case with Settlement of Refuges and the Displaced.

The State is responsible for refugees until they return to BiH, the Entities are responsible for resettling the refugees (who become displaced or returned persons upon their return to BiH), and the municipalities are responsible for many aspects of reintegrating the returnees into the local community. Some attempts to coordinate these services exist, but the present system often results in inconsistent policies and gaps in service delivery, especially in the clarification of pension and health insurance rights. A high percentage of displaced persons exists practically every municipality across BiH and represents a major, and sometimes unbearable, burden on municipal budgets, particularly in the smallest municipalities with a low tax capacity. Although municipalities should continue to exercise the delivery of services to these groups as they possess clear advantages in assessing local needs, the regulation, the financing, the monitoring, and the general coordination of such programs should be centralized in order to maintain a uniform minimum level and quality of public services.

[105] For a more detailed discussion, see paras. 1.8-1.15 in Chapter I.
[106] For a more detailed discussion, see Box.1.3 in Chapter I.

3.17 The concurrent responsibilities run a particular risk of under-provision of services when they concern municipal functions, owing to the general weak fiscal capacity at the municipal level. A clear example is the settlement of displaced persons and refugees, who make up a high proportion of the municipal population in both Entities (on average, over 20 percent of the population in the Federation and 30 percent in the RS). Their share in the municipal population varies between 12 and 46 percent in the Federation and between 22 and 39 percent in the RS (see Graphs 3.1 and 3.2). This segment of the local population tends to have substantial needs for public services (e.g., housing, public utilities, and social assistance) but practically no tax paying capacity. An adequate financing of these needs only through the current derivation-based revenue assignments is beyond the capacity of municipal budgets, even taking into account the significant donor support channeled for the settlement of these groups. Therefore, the general coordination and financing of these programs at the center (preferably by the State) is necessary to maintain a uniform minimum level/quality of public services in a cost-efficient manner (see Box 3.1).





3.18 Overall, the division of public expenditure functions in BiH departs from the conventional principle of subsidiarity, especially when the role of the State government is concerned (see Box 3.2). Moreover, even when they are broadly consistent with the subsidiarity principle, the current arrangements fail to convey the right incentives for achieving the optimal allocation of resources, transparency of the decision-making process, and accountability to the citizens, which calls for continued review of and adjustments in intergovernmental fiscal relations in the period ahead. The following sections of this chapter and the next chapter elaborate further on these issues and present reform options.

Box 3.2 Subsidiarity Principle in Brief

This principle assigns public functions to the lowest possible level of government, unless they can be performed more efficiently at higher levels. As preferences and costs vary from place to place, efficiency gains can result from applying this principle. For most public services (except for national defense, foreign policy, monetary policy and financial market regulation, overall economic policy, environmental regulations and few other services) local decision-makers are in a better position to decide what services—in what quantity and of what quality, and to whom—should be provided. Moreover, local taxpayers should ideally pay for the public services they consume (equivalence principle).

In practice, however, local needs and tax capacity may differ, and, apart from equity concerns, consumption of certain public services ought to be considered of national interest due to the spatial externalities they involve (e.g., preventive vaccination campaigns, eradication of illiteracy, elimination of poverty). In the latter cases, an option can be the separation between delivery and financing—while delivery may be better performed locally, financing may be provided by a higher-level of government. An alternative option may be to reduce spatial externalities by horizontal intergovernmental financial compensation, or other forms of intergovernmental cooperation, so that the benefits of the services could be internalized without centralizing the provision of services.

B. THE COMPOSITION OF SUB-ENTITY PUBLIC EXPENDITURES

3.19 This section assesses the sub-Entity budgets by both economic and functional categories according to the methodology descried in Chapter II.[107] This analysis, combined with the deeper analysis of social sector expenditures in the next chapter, complements the range of important issues identified in Chapter II, issues which expenditure policy reforms will need to confront in the short to medium term.

Economic Composition of Sub-Entity Expenditures

3.20 Table 3.3 presents the sub-Entity expenditures classified by economic categories along with the consolidated Entity expenditures. The table highlights a number of features defining the present structure of sub-Entity budgets, which are, by and large, consistent with the main features of the consolidated BiH/Entity spending identified in Chapter II. In both Entities, sub-Entity governments allocate a very large portion of domestically generated revenues for current expenditures—with wages and salaries, non-wage O&M, transfers, and subsidies being the main expenditure items. Allocations for capital expenditures, while still constituting a relatively small share of both GDP and sub-Entity budgets, account for a larger portion of sub-Entity budgets, especially in the Federation, where cantons/municipalities support both local investments and the operations of public enterprises and utilities through capital grants. As noted earlier, while anecdotal information suggests a high culture of arrears accumulation at the sub-Entity level, there are no reliable arrears data, which makes it impossible to quantify the true size and scope of sub-Entity expenditures.

Table 3.3 Entity Expenditures, 2000

	Federation Consolid.	*Federal Gov.*	*Cantons*	*EBFs*	*Municipa.*	*RS Consolid.*	*Central Gov.*	*EBFs*	*Municipa.*
Percent of GDP									
Total expenditure (on-budget and unalloc. arrears)	55.9	15.0	21.0	18.1	4.4	54.0	35.8	17.6	4.5
Total expenditure (on-budget)	54.0	14.7	20.1	17.4	4.4	49.1	31.3	17.2	4.5
Curent Expenditure	49.8	14.1	17.3	17.2	3.8	45.8	28.4	17.1	4.3
o.w/Wages and contributions	16.4	1.5	9.6	4.9	1.5	11.8	8.0	3.3	2.0
o.w/Goods and services	7.5	0.4	3.0	2.9	1.2	9.3	6.0	2.3	1.0
o.w/Transfers to households	15.7	4.2	2.2	9.2	0.3	14.4	5.1	11.4	0.1
o.w/Military	4.6	4.6	..	..	..	2.7	2.7	..	..
o.w/Subsidies	1.1	0.4	0.5	..	0.1	1.8	1.4	..	0.4
o.w/Transfers to cantons or municipalities	..	0.4	1.2	..	..	..	0.1	..	..
o.w/Transfers to non-profit organizations	1.5	0.3	0.8	..	0.4	0.7	..	..	0.7
Net Lending	..	0.0	..	0.0	..	0.3	0.3	0.0	..
Capital Expenditures (on budget)	3.4	0.5	2.0	0.2	0.6	3.2	2.9	0.1	0.2
Purchase of Fixed Assets	1.2	..	1.1	..	0.1	..	..	..	..
Capital Grants	1.5	..	1.0	..	0.5	..	..	..	..
Use of Privatization Receipts	0.8	0.0	0.8	..	..	0.1	0.1	..	..
Unallocated Arrears	1.9	0.3	0.9	0.7		4.9	4.5	0.4	..
Donor Financed Capital Expen. (off-budget)	8.0	..	..	..	..	6.6	..	..	..
Unaccounted Defense Expenditures	4.2	..	..	..	..	1.4	..	..	..
Percent of Total Expenditures (on-budget)									
Curent Expenditure	92.2	96.2	85.9	98.9	85.6	93.3	90.6	99.2	95.3
o.w/Wages and contributions	30.3	10.5	47.8	28.5	34.5	24.0	25.7	19.2	45.3
o.w/Goods and services	13.8	3.0	14.8	16.4	27.7	18.9	10.3	13.2	21.9
o.w/Transfers to households	29.1	28.3	10.7	53.1	6.9	29.3	16.3	66.4	1.4
o.w/Subsidies	2.0	2.6	2.7	0.0	3.2	3.7	4.6	0.0	8.4
o.w/Transfers to cantons or municipalities	0.0	2.5	6.0	0.0	0.0	0.0	0.3	0.0	0.0
o.w/Transfers to non-profit organizations	2.8	2.2	3.8	0.0	9.6	1.4	0.0	0.0	15.1
Net Lending	..	0.0	..	..	..	0.4	0.6	0.9	0.0
Capital Expenditures (on budget)	6.3	3.6	10.2	1.1	14.0	6.4	9.1	0.8	3.4
Purchase of Fixed Assets	2.2	..	5.3	..	2.4	0.3	0.0	0.0	3.4
Capital Grants	2.7	..	4.8	..	11.6	..	..	..	..

Source: Official data and staff estimates.

[107] The caveats mentioned in para. 2.5 of Chapter II apply.

3.21 ***Current Expenditures.*** Revealing a combination of the high costs of a large bureaucracy and scarce resources, especially at the municipal level, *W&S* spending represents an extremely heavy burden on sub-Entity budgets: it accounted for about 48 percent of total canton spending and 35 percent of total municipal spending in the Federation (2000); and 45 percent of total municipal spending in RS (2000). Outlays for *non-wage O&M* is the second largest spending item after W&S, but is disproportionately low when compared with spending on W&S: the ratio of W&S spending to non-wage O&M spending is 2.1 for municipalities in RS and an outstanding 3.2 for cantons and 1.2 for municipalities in the Federation—the sample average for the region is just below 1.0.[108] As discussed earlier, this mix of spending points to inadequate maintenance and inefficient/under-use of capital stock as well as to poor quality of sub-Entity service delivery. It also points to over-employment at the sub-Entity level, an issue which has been supported by the anecdotal information indicating that budget cut policies at the sub-Entity level aim at preserving public employment by focusing primarily on investments, followed by O&M and if necessary, also on wages. Clearly, *this picture further underlines the need for urgent attention to improving the prioritization of resource allocation and the rationalization of public employment and wage policies* in BiH, which was discussed in detail in Chapter II.

3.22 The third important spending item at the sub-Entity level is *transfers*, or so called "current grants" as presented in individual cantonal and municipal budgets. The most important sub-Entity transfers are "transfers to individuals" by both cantons (10.7 percent of the budget) and municipalities (6.9 percent of the budget) in the Federation[109] and "transfers to non-profit organizations" by municipalities in the Federation (9.6 percent of the budget) and especially in RS (15.1 percent of the budget). Both of these transfer items are interpreted in a number of different ways across cantons and municipalities, which makes it difficult to understand their scope. The "transfers to individuals" appears to refer mainly to supplementary payments to war veterans and payments to civil victims of war as well as some specific type of limited social assistance payments. All these types of transfers are among the kinds of responsibilities that have been "delegated" to municipalities by the cantons, but often without the provision of adequate financing. The "transfers to non-profit organizations" appear to comprise a wide variety of transfers, ranging from support to NGOs that provide a particular social service (such as support for refugees and displaced persons) to support for fire brigades, churches, local sports/culture groups, citizens associations, and political parties. *To increase the effectiveness of transfer policies and to improve the efficiency of resource allocation for transfers, the following should be made near-term priorities: better classification and accounting of transfers, better targeting and eligibility rules in the allocation of transfers; and a clearer definition of the financing responsibilities of cantons in the Federation and central government in RS vis-à-vis their municipalities.*

3.23 Finally, sub-Entity *subsidies*, or so-called "current grants to public enterprises" as presented in individual cantonal and municipal budgets, mainly comprise financial support to local public utility companies in both Entities. Cantons also provide direct subsidies to public enterprises/industries that they own. As noted earlier, public utility services[110] are the exclusive responsibilities of municipalities in both Entities and they are delivered by companies owned by the municipalities which operate off-budget.[111] At present, these companies are operating under significant financial stress and questionable financial viability, which mainly reflects poor tariff policies.[112] Although this is not always acknowledged by local

[108] For a complementary discussion, see Table 2.3 and paras. 2.15-2.24 in Chapter II.
[109] These types of transfers are part of the central government budget in RS with very little direct municipal transfers—about 1.4 percent of the budget in 2000.
[110] These services include treatment and provision of potable water, sanitation, garbage collection, etc. Electricity is provided by the Entities' companies.
[111] In the Federation some of these companies belong to the cantons.
[112] Owing to poverty associated with the high incidence of refugees and displaced people in many municipalities and to the lack of political will for the reform of tariff policies and the restructuring of utilities.

officials/politicians, payment arrears (by both the public sector and households) for utility services have been building up, with potential fiscal spillover effects. In a number of municipalities (sometimes in cantons), this "invisible" debt has been compounded by explicit or implicit municipal guarantees—granted when there are suppliers or banks willing to give utilities credit—which also represent municipal (sometimes cantonal) contingent liability.

3.24 Apart from direct subsidies, financial relations between these companies and the municipal (sometimes cantonal) budgets are complex and unclear. There are cases of direct subsidization of households for utility services, cases of indirect compensation given to utility companies through extraordinary capital transfers, and also cases of mutual clearing of accounts (whereby the utility companies' receivables—either from the public sector or from households—are compensated with taxes to be paid by the utility companies).[113] Beyond these avenues, a frequent response of the municipal utility companies to resource constraints has been to let the equipment be used without maintenance. This reflects a destructive policy, which tends to aggravate the present situation and is certain to further jeopardize the quality and sustainability of public service delivery in the near future.[114] *Clearly, addressing these issues requires wide-ranging reforms, including the introduction of financial discipline, transparency, and accountability into the operation of both municipalities and public utilities, the re-formulation of tariff policies, and the institution of better utility management practices. Consideration should also be given to the formation of associations of municipalities or of public-private partnerships to improving the efficiency of service delivery and to take advantage of economies of scale in the management and delivery of utility services (e.g., water and sewerage treatment, garbage collection).*

3.25 ***Capital Expenditures***. As noted in Chapter II, capital expenditures are mainly a central government responsibility in RS with negligible direct municipal capital outlays. In the Federation, although cantons have been relatively more active in local public investment spending than the Federal government, only half of their overall capital budgets has been spent on "direct investment" in fixed capital formation—which constitutes only about 5 percent of total cantonal budgets and 1 percent of GDP. The other half of the capital outlays has been allocated for "capital grants" and net lending, activities which municipalities have also directly supported by allocating 12 percent of their own budgets. These forms of capital grants and lending essentially provide financing partly for loss-making enterprises and partly for municipalities and public utility companies (both cantonal and municipal). *The participation of sub-Entity governments in these types of financing schemes creates the dependence of ailing enterprises and off-budget companies on budgetary resources and conveys wrong signals for the maintenance of local infrastructure. Therefore, they should be minimized. In the period ahead, as donor-financed reconstruction spending phases out, sub-Entity governments will need to reallocate, in strong coordination with the Federal government, a portion of their own-budget resources for contributing to domestically financed local "direct" investments and for providing adequate counterpart funding to externally financed projects.*

Functional Composition of Sub-Entity Expenditures

3.26 The analysis in this section focuses on the functional composition of sub-Entity expenditures but does not include municipalities owing to lack of municipal data on the functional classification of expenditures. Therefore, the analysis concerns only the Federation, where the significant decentralization

[113] Most of these cases are from anecdotal evidence obtained from interviews, and systematic reliable statistics are not available at this time. For further discussion of these issues, see paras. 1.47-1.52 and Box 1.10 in Chapter I.

[114] Some municipal governments have reported that they are incapable of changing the present situation because their utility companies fall under the Federation's privatization policy. This prevents them from taking action to restructure the companies. Nevertheless, much could be done with regard to tariffs and the collection policy, if the local political commitment can be secured.

of service responsibilities makes the sub-Entity sectoral spending policies relatively more important than they are RS. However, a deeper analysis of the social sectors in the next chapter—the largest single area of domestically budgeted public spending with a significant sub-Entity role in management, financing, and service provision—gives a fuller picture of the respective roles that central, cantonal, and municipal governments play in these sectors.

3.27 Table 3.4 shows that, in line with the general division of responsibilities in the Federation, social expenditures (i.e., education, health, and social welfare) have a disproportionately large weight in cantonal expenditures, accounting for over 50 percent of cantonal spending (18 percent of Federation GDP). The next chapter puts social spending under the microscope in order to understand how effective and efficient this modality of policy-decision and service delivery are and how it can be improved. Another related feature of the present division of responsibilities is that the Federal government focuses its resources on "defense" (31 percent of budget[115]) and "categorical social assistance," namely, war veterans' benefits (28 percent of budget)—activities ***unrelated*** to growth enhancement and direct poverty reduction.

Table 3.4: Functional Composition of Federation Expenditures, 2000

				Federation	*Consolidated*
	Federal Government	*Cantons*	*EBFs*	*On-budget*	*With off-bud. capital*
Percent of GDP					
General Government Services	1.4	1.1	0.0	1.9	1.9
Defense (on-budget)	4.6	0.1	0.0	4.7	4.7
Public order and safety	0.9	3.9	0.0	4.4	4.4
Education	0.0	7.1	0.0	7.0	7.3
Health	0.1	0.5	7.8	8.3	8.4
Social Insurance	4.1	2.4	9.6	15.9	15.9
Housing - Utilities	0.0	0.9	0.0	0.9	1.2
Culture, recreation and religion	0.2	0.4	0.0	0.6	0.6
Energy and fuels	0.0	0.01	0.0	0.0	1.1
Agriculture	0.2	0.2	0.0	0.4	0.6
Mining and mineral resources	0.1	0.2	0.0	0.3	0.9
Traffic and communications	0.5	0.8	0.0	1.3	1.6
Other economic activities	0.1	0.9	0.0	1.0	6.0
Not classified under main groups	2.5	1.4	0.0	4.0	4.0
Defense (Off-budget and arrears)	4.2	..	..	4.2	..
Total Expenditures					
On-budget (I)	14.7	19.9	17.4	50.7	58.6
(I) + unallocated arreas and off-budget defense	18.9	..	..	56.8	64.7
Percent of Total Expenditures (on-budget)					
General Government Services	9.2	5.4	0.0	3.7	3.3
Defense	31.6	0.3	0.0	9.3	8.0
Public order and safety	5.9	19.5	0.0	8.7	7.5
Education	0.3	35.3	0.0	13.8	12.4
Health	0.5	2.7	44.7	16.4	14.4
Social Insurance	28.1	12.1	55.3	31.4	27.2
Housing - Utilities	0.1	4.7	0.0	1.9	2.1
Culture, recreation and religion	1.1	2.1	0.0	1.2	1.0
Energy and fuels	0.0	0.1	0.0	-0.7	1.9
Agriculture	1.0	1.1	0.0	0.7	1.0
Mining and mineral resources	0.9	1.0	0.0	0.6	1.5
Traffic and communications	3.3	4.0	0.0	2.5	2.7
Other economic activities	0.7	4.7	0.0	2.0	10.2
Not classified under main groups 1/	17.3	7.2	0.0	7.9	6.8

Notes: Excludes municipal data, which account for about 8 percent of consolidated Federation expenditures.
Source: Staff estimates based on official data.

3.28 The other significant cantonal spending items are public order and safety (20 percent of budget) and general government services (over 5 percent of budget), leaving relatively small residual resources for economic activities. As discussed earlier, compared with regional indicators, the combined Federation spending on public order and safety is extremely high (4.4 percent of GDP),[116] calling for a *coordinated* expenditure rationalization in the Federation. Concerning general government services, although the Federal budget represents only 70 percent of the cantonal budgets, the Federal government appears to spend close to twice as much of its budgetary resources as the cantons on administrative spending. This may reflect a relatively higher employment and a higher wage bill or a combination at the Federal level. A focused analysis of these issues would require better data than are currently available. *All in all, the above picture shows that the disconnect between the Federal and cantonal governments in policy formulation and implementation distorts resource allocations significantly; if this issue allowed to remain un-addressed, it will severely hinder growth and fiscal sustainability in the Federation.*

C. HOW WELL BALANCED ARE THE PRESENT INTERGOVERNMENTAL FISCAL FINANCES?

Vertical Fiscal Balances

3.29 Vertical fiscal balance concerns the question of whether available revenues for *each* tier of government are sufficient to finance its expenditure assignments. One approach for assessing this for each tier could be a measure of structural (ex ante) fiscal deficits. Owing to data constraints, however, the actual (ex post) budget deficits are usually the only assessable measure, which tends to be biased since higher-level government budgets tend to show most of the budget deficits. This is because access to financing mechanisms, including borrowing, by lower level governments is usually more restricted. The practice in BiH is no different in this sense[117] and this, together with many off-budget activities and arrears, makes actual deficits an even more unreliable measure of vertical imbalances.

3.30 Nevertheless, vertical imbalances could be approximated in the following ways: (i) narrowly defined, by the share of expenditures that sub-national governments are able to finance exclusively from their "own sources of revenues" (over which they have control); and (ii) broadly defined, by the share of expenditures that sub-national governments can finance with their tax revenues, including "shared taxes," but excluding "transfers." The former approach is more appropriate when government tiers have no control of the shared taxes, and the latter approach is more appropriate when they have at least some control over them.

3.31 In the case of BiH, since there are no shared taxes as a revenue source except in the case of municipalities, the narrow definition of vertical imbalances is a more relevant approximation in general. On the basis of this definition, there are considerable pressures for vertical imbalances at the State level and within the Entities. But the most important pressures are on the State and the municipalities because of their very limited own revenues as a source for financing their current responsibilities (e.g., in 2001 the State's own revenues could cover less than 30 percent of its operational expenditures, and in 2000 the municipalities' estimated own revenues could cover only about one-quarter of their expenditures in both Entities). Revenues of Entities and cantons, on the other hand, derive mainly from their own tax

[115] When off-budget defense commitments are taken into account, the *share of defense in Federal spending jumps to a staggering 57 percent.*

[116] The average expenditure for the developed European countries is 1 percent of GDP and for the transition CEE countries in the region it is 2 percent of GDP. For further discussion, see para. 2.52 in Chapter II.

[117] At present, only the Entities borrow from abroad although they may on-lend to lower tiers afterward. Moreover, cantons (especially the Canton of Sarajevo) have frequently absorbed (through the provision of "extraordinary" grants to municipalities) some recurrent and capital responsibilities that the lower level governments are unable to finance on their own on a regular basis.

revenues,[118] which are centrally set and collected in both Entities. Nevertheless, if not properly timed, coordinated, and supported by sound impact analysis, centralized tax policy changes could also turn into a source of vertical imbalance by diminishing the predictability of revenues for lower tiers of government. This has been the case in both Entities, where intensive indirect tax reform and harmonization efforts had the side effect of significantly upsetting sub-Entity fiscal balances in late 2000 and 2001.

3.32 Applying the broader definition of vertical fiscal imbalances (i.e., expanding municipal revenues to include shared taxes) diminishes pressure points for vertical fiscal imbalances at the municipal level only to a limited extent. In both Entities, this is due to a number of factors, including the municipalities' very limited discretion and autonomy over their own local revenues, and the delegation of important unfunded social service responsibilities to municipalities, especially concerning social welfare (see Chapter IV). As a result, municipalities often operate with frequent recourse to arrears and, when available, through transfers from cantons.[119] In RS, the new Law on Local Self-Government improves the tax sharing system by introducing a better targeting modality (based on development and needs indicators) into the revenue allocation mechanism.[120] Nevertheless, since the distribution of revenues still depends on local tax capacity, the new system will not by itself eliminate potential pressures for fiscal imbalances.

3.33 Given the evolving nature of fiscal policies and institutions in line with BiH's continuing nation-building and transition reforms, the pressure points for vertical imbalances will vary in the period ahead. Therefore, aside from addressing the above identified clear sources of vertical imbalances, there is also a need to introduce a mechanism at both the State and the Entity levels that will help review fiscal assignments every several years and propose necessary remedies. This could very well be undertaken by the establishment of a proposed formal fiscal coordination mechanism, which is an unconditional priority in BiH's present post-conflict evolution.[121]

Horizontal Fiscal Balances

3.34 A fiscal system is horizontally balanced if all peer governments (i.e., governments at the same level, such as cantons in the Federation and municipalities in each Entity) have a similar revenue capacity to finance their expenditure responsibilities. A vertically balanced revenue structure need not necessarily be horizontally balanced, because each peer government may have distinct expenditure needs and revenue raising capacities. Thus, some governments can be in a more favorable position to finance services than others.

3.35 In both Entities there are large revenue disparities at the sub-Entity level, reflecting both the diversity in the strength of local economies[122] (because allocations of revenues depend on local tax

[118] It should be noted, however, that tax capacity varies considerably among the cantons and, although aggregate transfers between the Federation and cantons are insignificant, some poor cantons still depend on extraordinary grants or non-tax revenue (e.g., Gorazde, Posavina).

[119] This is true even when the municipalities of the Canton of Sarajevo are excluded. Based on the budget execution of a selected municipality sample for the year 2000 (11 in the Federation, and 6 in RS), the need for extraordinary transfers has been high, although they vary widely across municipalities.

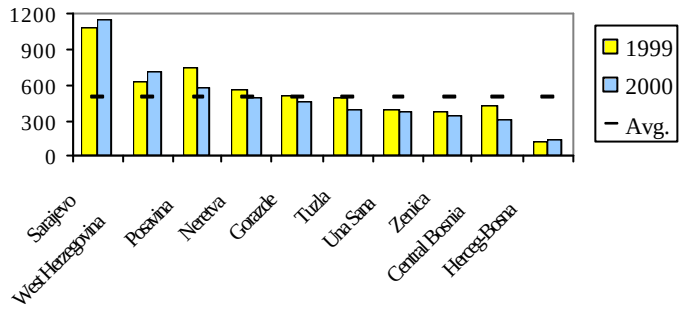
[120] Article 35 of the new Law categorizes local governments according to the degree of development (extremely non-developed, non-developed, and others), and applies varying tax shares of 60, 40, and 30 percent, respectively. The norms for classifying municipalities are also specified in the Law, which mentions indicators such as: the local average gross salary; the average amount of war damage; the number of refugees and displaced persons; the level of unemployment; and other criteria as established by the government.

[121] For more on this, see para. 1.18-1.19 in Chapter I and the next section.

[122] Naturally, sub-Entity economic bases (e.g., natural resource endowment, the level and organization of agricultural activities, the level of industrial development, employment, factor productivity) are unevenly distributed regionally. For instance, the Federation Statistical Office estimates, using pre-conflict methodology, per capita gross value-added in Sarajevo canton in 2000

capacity, which is, in turn, inversely correlated with regional poverty indicators) and the distortions inherent in the present tax allocation rules (e.g., profit and wage tax allocation rules in the Federation tend to favor the residence of economic activity). Further, these two forces also tend to reinforce each other, since the economy tends to be more dynamic in places where the revenues are directed.[123] In measuring peer government tax capacities, per capita incomes, wages, or resource endowments could be taken as good proxies, but reliable data for these variables are limited in BiH. Alternatively, per capita revenues collected locally could be used as an indicator for relative tax capacities. Measured in this way, disparities in sub-Entity tax capacities are quite large in both Entities.

Graph 3.3 Total Per Capita Revenue Across Cantons, 1999-2000 (KM, thousand)

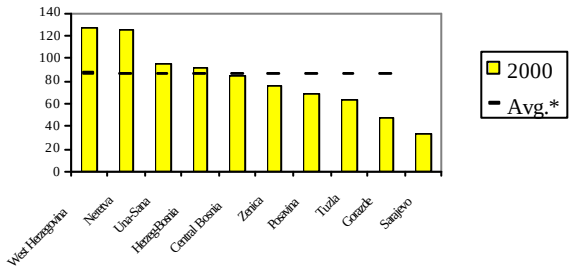


Source: Official data and staff estimates.

3.36 Graph 3.3 shows disparities in per capita revenues across cantons which are significant—ranging from a maximum of KM1,155 (Sarajevo) to a minimum KM120 (Herzeg-Bosnia)—with only 3 out of 10 cantons having per capita revenues above the total cantonal average while half of the cantons display per capita revenues below this total. The disparities become even greater when non-tax revenues are considered—with per capita non-tax revenues for 6 cantons equivalent to only 60 percent of the total cantonal average—reflecting significantly distinct local revenue raising efforts and economic conditions in each canton.

3.37 The disparities across municipalities in the Federation are also significant. Firstly, the municipal share in cantonal tax collection varies widely across cantons—between 6 percent (Gorazde) and 12 percent (Herzeg-Bosnia)—reflecting not only the distinct local tax capacities but also the tax sharing arrangements, the definition of which is at the discretion of cantons. Regarding the latter factor, for instance, Sarajevo Cantons is an outlier, where, in the absence of a Revenue Allocation Law, municipal revenues are largely dependent on discretionary transfers from the canton government—thus, their share in total taxes collected is only about 1 percent. This limits the revenue autonomy and reduces the accountability of municipal governments

Graph 3.4 Municipal Revenues by Canton in the Federation, 2000 (KM, per capita)



*Excludes Sarajevo Canton, where municipalities primarily rely upon budgetary transfers from canton.

Source: Official data and staff estimates.

(KM4,957) to be four times higher than in Gorazde Canton (only KM1,286), with a Federation-wide coefficient of variation of 0.5. In addition, the considerable proportion of refugees, and their spatial distribution, creates a considerable divergence between the total and the resident populations, with implications also for local tax capacity. A large number of refugees reduces the average local tax capacity of the total population.

[123] For instance, Sarajevo Canton collects much more in wage taxes because of a relatively strong economy. Also, many government jobs are located in Sarajevo, and compliance with wage taxes is greater for government jobs.

and local councils to their citizens. Second, as shown in Graph 3.4, per capita municipal revenues vary significantly across cantons. These disparities become much wider across municipalities, with a sample of 59 municipalities in the Federation revealing a per capita revenue variation coefficient of as high as 2.2.[124]

3.38 As would be expected, larger municipalities exhibit in general a much higher tax capacity.[125] For instance, excluding the municipalities of the Sarajevo Canton (the wealthiest canton, in which the government is located), the average variation coefficient of tax capacity in the Federation drops to 0.6, which is still high.

3.39 The RS also shows very high horizontal fiscal disparities across its municipalities, with a per capita revenue variation coefficient of 0.9—0.6 if the larger Banja Luka municipality, where the government is located, is excluded, which is still very high (see Table 3.5). On the other hand, reflecting simpler intergovernmental fiscal arrangements in RS, the horizontal disparities in tax capacity across municipalities in RS are not as dramatic as in the Federation, while the average tax capacity of municipalities is much lower (by about one-half) compared to the Federation.

Table 3.5 RS-Disparities in Local Revenue Capacity and Tax Collection

	All 63 Munic.		*Excl. Banja-Luka*	
	Tot. Rev.	*Loc. Tx.*	*Tot. Rev.*	*Loc. Tx.*
Number of Municipalities	63	63	62	62
Maximum Value in KM (per capita)	1588	341	824	341
Minimum Value in KM (per capita)	44	10	44	10
Average Value in KM (per capita)	249	56	227	55
Coefficient of Variation	***0.9***	***0.85***	***0.64***	***0.86***

Source: Republica Srpska Ministry of Finance and ex-Payment Bureaus.

3.40 In both Entities, in the absence of any mechanism to address these disparities in fiscal resources, low activity locations can only deliver fewer services and/or risk potentially larger fiscal imbalances. As in the case of tax capacities, the assessment of true "expenditure needs" in BiH is difficult owing to the limited consistent information on social, fiscal, and economic indicators across local governments. Moreover, the needs of the population have also been met by the provision of public services through off-budget operations, including foreign assistance. With these caveats in mind total per capita expenditures could provide a measurable indicator for sub-Entity expenditure variations. Measured in this way, disparities in sub-Entity expenditures are also quite large in both Entities.

3.41 Graph 3.5 shows disparities in total per capita budgetary expenditures across cantons, which are substantial—varying between KM1,085 in Sarajevo and KM312 in Una-Sana, with only three cantons being able to spend significantly above the per capita cantonal average. There are also wide disparities in per capita sectoral expenditures. As shown in Graph 3.6, this is the case even concerning essential cantonal government functions such as education and social assistance—with the relatively high respective variation coefficients of 0.6 and 0.9 across cantons.[126] The largest disparities are observed in those sectors where major donor assistance is available (such as energy and housing) or EBF resources, rather than cantonal budgets, constitute the main revenue source (such as health) and the lowest disparity

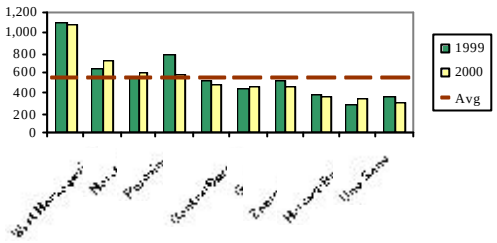
[124] These municipalities represent 87.6 percent of the Federation's population. The maximum per capita revenue value is KM15,383 (municipality of Centar Sarajevo in Sarajevo Canton) and the minimum value is KM17 (municipality of Prozor-Rama in Herzeg-Neretva canton).

[125] Besides the fact that these are relatively more prosperous localities themselves, there are also some agglomeration factors that help magnify their effective tax revenue. For instance, many enterprises prefer to collect their Corporate Income Tax (CIT) in the larger cities/municipalities, where they are registered or their headquarters are situated, rather than in the municipalities where they develop most of their normal businesses (production, selling).

[126] This does not mean, however, that the population of Herzeg-Bosna has had no public education or social assistance. Off-budget foreign assistance has, at least partially, compensated for these budgetary deficiencies.

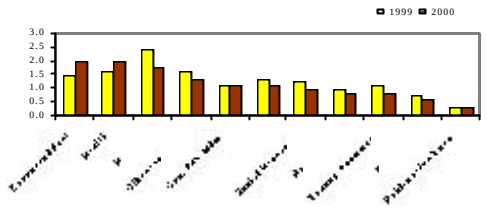
occurs in the case of public order and security, indicating both the relatively higher priority that cantons attach to administrative expenditures and the relative uniformity of wages across cantons.[127]

Graph 3.5 Per Capita Budgetary Expenditures Across Cantons, 1999-2000 (KM, thousand)



Source: Official data and staff estimates.

Graph 3.6 Per Capita Budgetary Expenditures - Disparities Across Cantons, Functional Composition (1999-2000)



Source: Official data and staff estimates.

3.42 The disparities in budgetary expenditures are also reflected at the level of municipal governments. As noted previously, these disparities, as well as reflecting local tax capacity and distinct expenditure needs, also reflect the high proportion of displaced persons and refugees, which is a major fiscal pressure especially for the medium size and small communities. The sample budgets, based on 11 municipalities[128] from the Federation and 6 municipalities[129] from the RS, show relatively large disparities in average municipal per capita expenditure in both Entities (see Table 3.6). Comparatively lower disparities in the case of RS largely reflect the fact that most expenditure decisions are centralized, and municipal responsibilities are relatively limited. It should also be noted that in both Entities, the disparities in municipal per capita expenditures are smaller for wages and related expenditures, which receive the highest priority in local on-budget spending decisions, and larger for capital outlays and subsidies, which receive the lowest priority in local spending decisions.

Table 3.6 Per Capita Outlay (Selected Municipalities)

Measure of:	*Federation Municipalities*	*RS Municipalities*
mean (in KM)	111.9	50.4
minimum value (in KM)	62.7	24.7
maximum value (in KM)	193.7	76.4
coefficient of variation	0.36	0.44

Source: Federation and RS Ministry of Finances and ex-Payment Bureaus.

Addressing Fiscal Imbalances

3.43 Most countries normally limit vertical and horizontal fiscal imbalances through the following means: (i) by providing some local government autonomy in raising revenue, at the margin, which reconciles the problem of vertical fiscal imbalances with local accountability—at minimum, this hinges on decision power on important local taxes (mainly the "property tax") and on user charges; (ii) by properly assigning the responsibilities for services with geographic spillover of benefits (such as education, health, roads) and/or ensuring their adequate financing so that the horizontal imbalances will be contained well; (iii) by providing compensatory grants or transfers that reduce horizontal fiscal disparities and ensure similar standards of public services for all citizens, at least for critical needs such as education, health, and social assistance for the most vulnerable.

[127] It should be borne in mind that the measured disparity in this category of municipal *budgetary* expenditure is likely to be magnified by the fact that housing receives significant foreign aid.
[128] Bihac, Cazin, Gorazde, Krupa, Livno, Novi Travnik, Tomislavgrad, Travnik, Tuzla, Zenica, and Ilidza. These municipalities represent 7 out of the 10 cantons, and cover 27 percent of the Federation's population.
[129] Celinac, Novi Grad, Pale, Prijedor, Rogarica, and Visegrad. These municipalities represent 13 percent of the RS' population.

3.44 In BiH, the legacy of conflict exacerbates both the need for and the challenges involved in addressing fiscal imbalances. Perhaps a first encouraging step in addressing these challenges in the Federation is the recently established solidarity system for the delivery of important tertiary health services. But given the considerable divergences in taxable capacities across regions in BiH, effectively dealing with equity issues requires a stronger emphasis on systematic transfers to places with greater expenditure needs and smaller revenue capacity, to limit at least the most egregious imbalances.

D. PRINCIPLES FOR IMPROVEMENTS AND POLICY DIRECTION

3.45 Many fiscal issues emphasized in this Report indicate that for fiscal policy to become a powerful tool for economic stability, social and economic development, and income distribution, BiH needs to significantly broaden and deepen its ongoing public finance reforms in the period ahead. In this endeavor, continued reforms in BiH's intergovernmental fiscal relations are the cornerstone of a better public sector performance that enforces fiscal discipline, channels scarce public resources to development priorities, and ensures efficient delivery of public services. These reforms need to address many challenging issues, especially concerning the relative roles of and governance rules in BiH's multi-tiered governments, which are only gradually taking their place in BiH's reform agenda. This section outlines the range of reforms in intergovernmental fiscal relations that the BiH governments need to confront in the short to medium term, especially if BiH's decentralized fiscal management structure is to facilitate the efficient and cost-effective operation of the public sector.

Addressing the Design and the Implementation of Proper Fiscal Decentralization

- *Strengthen the State's role.* Present economic efficiency and equity concerns could be addresed by increasing, over time, the State's role in financing and/or administering services that are normally delivered at the State/national level, such as defense, social welfare, fiscal equalization, debt management, and macroeconomic stabilization. Three factors should be considered in determining the role that State could play in these areas: (i) the potential benefits expected from more efficient, adequate, and equitable delivery of services involving economies of scale (i.e., implying countrywide supply such as growth enhancing social and sectoral policies and the overall macroeconomic policy framework); (ii) policy co-ordination and harmonization from the center (particularly with respect to economic policy and European integration); and (iii) administrative savings arising from better policy coordination from the center. In this undertaking, any increase in the State's fiscal role should be balanced against a reduction in the role of other governments, whether Entity or sub-Entity government, in order to avoid an overall increase in the size of the public sector in BiH.

- *Identify/address vertical and horizontal imbalances.* The absence of adequate State own-source revenues and the wide differences in sub-Entity tax capacities create significant pressures for fiscal imbalances in BiH. In the period ahead, the present negotiated State finance system will need to be replaced with a system that will provide the State with an adequate share of BiH's tax revenues and, hence, the fiscal autonomy. Reducing the wide fiscal disparities at the sub-Entity level, on the other hand, requires tools that will complement the tax allocation schemes—the only major domestic sub-Entity resource base at present. The two most effective such tools are equalization transfers and better targeting of budgetary grants, with the former often constituting a large share of sub-national government revenues around the world. A well-designed equalization transfer system could achieve vertical balance by passing additional revenues down to local governments; improving horizontal equity in access to public services; and accounting for externalities in service delivery.

- *Eliminate overlapping responsibilities across governments.* Social welfare, health, and education services, and settlement of refugees and displaced persons, are sectors where different governments are assigned to different aspects of the same service, often with no clear financing/coordination arrangements. This creates difficult challenges for consistent service delivery and results in high overall administrative spending, confusion about the true size of public spending, and waste due to double-dipping by beneficiaries, particularly in social welfare spending. Responsibilities (e.g. policy, regulation, financing, and delivery) in these sectors need to be clearly articulated, with service provision at the least cost level.

- *Design central policy instruments to assist local governments in supporting refugees/displaced persons.* The settlement of refugees and displaced persons requires a concerted effort among all levels of government, which goes beyond the scope of local governments. A high percentage of displaced persons in practically every municipality in both Entities represent a major, and sometimes unbearable, burden on local budgets, particularly for smaller municipalities with a low tax capacity. Although municipalities should exercise the delivery of their services—as they possess advantages in assessing local needs—the regulation, the financing, the monitoring, and the general coordination of such programs should be centralized, preferably at the State level, in order to provide a uniform minimum level and quality of public services for this segment of the population (see Chapter IV).

- *Develop mechanisms to effectively finance and deliver services critical for productivity and poverty alleviation and services with positive externalities.* Both Entities face the challenge of preventing the large differences in access to fiscal resources across sub-Entity governments from being translated into large differentials in the supply of public services. This is particularly important for those public services with major positive externalities to BiH and to the Entities as a whole, but which are broadly assigned to the Entities and Sub-Entities, respectively. Education, health, and social welfare services clearly fall into this category and require particular attention, since they are important to productivity and poverty alleviation. At a minimum, policy-decision and financing responsibilities for basic elements of these social services should be considered national and/or Entity functions/programs and assigned to a higher level of government (ideally, eventually to the State level). More specifically, these include (i) primary education; (ii) primary health care (including preventive treatment of contagious diseases, and a basic health package for the needy); and (iii) social assistance to the poor. In addition, tertiary education will need to be treated similarly, although the longer-term objective should be to create an environment for gradually transferring both the provision and financing of tertiary education services to the private sector (see Chapter IV).

- *Review, clarify, and strengthen municipal functions.* Unfunded mandates, especially in social welfare services, and the existence of very little discretionary municipal power in municipal fiscal matters are problems common to both Entities. One of the short-term priorities should be a thorough review and formal clarification of municipal functions in both Entities, with a view to ensuring adequate financing for critical functions. In this endeavor, the introduction of long overdue tax-sharing legislation for the municipalities in Sarajevo Canton (which collects 33 percent of public resources in the Federation) would go a long way to improving local decision-making power, allocative efficiency, transparency, and fiscal discipline in the Federation. In time, municipal functions in both Entities need to be adjusted to allow greater accountability, better responsiveness to service recipients, and more effective determination of local priorities. However, any further devolution down to the municipal level needs to be preceded by substantial improvement in the credibility, transparency, and accountability of municipal expenditure management. Moreover, economies of scale, better planning capacity, and the ability to account for benefit spillovers can all be obtained by the consolidation of several municipalities into a city for selected purposes.

- *Improve the potential of taxes and tax assignments in addressing fiscal imbalances.* In the period ahead, tax policies will continue to evolve to further modernize and simplify the tax structures and to harmonize them both internally and with the EU norms. These reform efforts should, first of all, be well informed in terms of the direction/outcome of expenditure policy reforms and in terms of sound impact-analysis on their own expected outcomes. The reform agenda itself should encompass the following: (i) reconsidering the assignment of profit and wage taxes (which, at present, favor the residence of economic activity) so that they are allocated more evenly from the center and/or may benefit from equalization transfers; (ii) increasing the effectiveness of property taxes, especially as a robust revenue source for municipalities, given their strong benefit-tax link at the municipal level; (iii) providing local authorities with some autonomy, at the margin, on "local own taxes," (e.g., by allowing local authorities to set the rates of their taxes within a bandwidth; the property tax is a good candidate for such practice); (iv) streamlining the myriad of earmarked fees/surcharges for financing community infrastructure and incorporating them explicitly into the budget; and (v) assuring the predictability and reliability of sub-Entity revenues by requiring any structural change in tax policy, with implications for sub-Entity revenues, become effective only at the beginning of a fiscal year, a rule that is applied by many countries around the world.

Rationalizing and Prioritizing Expenditures

- *Consolidate fiscal transactions at the Entity and sub-Entity budgets.* Only a well-informed strategic fiscal planning and prioritization process will effectively improve the sustainability, targeting, and efficiency of public sector operations. This requires a strong emphasis on (i) improving budget coverage by incorporating off-budget, earmarked public resources and public expenditures into the budget; (ii) improving the consistency of financial accounting and budgeting systems across governments; and (iii) establishing a sound consolidated budgetary framework at the center (at the State and the Entity levels) that will reflect the true size and scope of public sector operations across the country.

- *Review and improve the input mix and allocative priorities through strong vertical and horizontal coordination in each Entity.* The large sub-national/sub-Entity share in expenditures demands better prioritization of expenditures through close vertical and horizontal coordination to achieve fiscal sustainability and better outcomes for countrywide priorities. While in the short to medium term, priority should be given to establishing a proper balance between administrative spending and spending on O&M, social welfare, and growth-enhancing sectors (such as education and health), it is necessary to complement this effort with public administration reforms that improve efficiency, including a comprehensive civil service reform.

- *Review the criteria for capital grants to lower level governments.* As the relative importance of domestic investments increases in the period ahead, it becomes more urgent to create the right incentives for responsible investment and capital maintenance policies, especially at the sub-Entity level. In both Entities, cantons/municipalities should become fully responsible for financing and executing their own local investment projects in strong coordination with the Entity government and with the other sub-Entity governments when the geographical spillover benefits of investment decisions call for cooperation and/or joint-action. This would require establishing a sound regulatory environment for the sub-Entity borrowing and guarantee operations in order to facilitate their access to diversified financing sources in a transparent and accountable way. This can be done by expanding and legislating the [recently adopted] "Sub-Entity Borrowing Guidelines" through a coordinated effort between the State and the Entities.

- *Introduce financial discipline in management of the local utility companies.* Establishing a sound regulatory framework for utility companies is another urgent priority in BiH. This framework should focus first on ensuring a utility tariff policy based on full cost recovery and, second, on ensuring the complete separation of the costs of utility services from political influences or concerns related to the social condition of the population served. The latter should be addressed explicitly by more adequate instruments in the local government budget, such as current grants to the targeted population (e.g., the poor, the displaced, refugees) with the approval of the local council/assembly. The third task should be the regulation of the sector to facilitate/encourage cooperation among municipalities for joint provision of services (either by public or private companies) in order to exploit economies of scale (by merging/associating existing companies and expanding the areas they serve), including taking advantage of the outsourcing of services. Finally, there should be a new requirement ensuring that business plans for each local public utility company are submitted and approved by the municipal/city council, and providing company managers with full managerial autonomy subject to increasing their accountability for the outcomes of their plans and actions.

Strengthening the Vertical and Horizontal Coordination of Fiscal Policies at the Central Level

- *Establish a formal mechanism for fiscal coordination.* The establishment of central policy and implementation coordination, and a negotiation platform between BiH governments is critical to the sustainability of the structural reform process, effective economic integration, and the robustness of the supply response. The objective should be to establish a sufficient degree of formal vertical coordination in the bottom-heavy system of BiH, which will (i) limit countervailing or contradictory legislation; (ii) improve policy effectiveness and the pace of reforms; (iii) resolve conflicts; and (iv) ensure the enforcement of greater accountability and transparency in fiscal management. To this effect, a State-coordinated effort would be instrumental in promoting a permanent dialogue and cooperation with the Entities. A *Standing Committee for Coordinating Fiscal Policies* could be set up at the ministerial level, composed of the State Minister of Foreign Trade and Economic Relations, the State Minister of Treasury, and the Entities' Ministers of Finance, and some key line ministers of the Entities. This Committee, advised by a Technical Secretariat, would, depending on the subject, propose, review, and monitor the fiscal policy framework. This Committee should have a leg in each Entity, where similar coordinating bodies would ensure an integrated intra-Entity coordination/negotiation forum that would include the sub-Entity authorities. Given the extent of its decentralization, it would be advisable to have the coordinating body established as a secretariat in the Prime Minister's Office in the Federation.

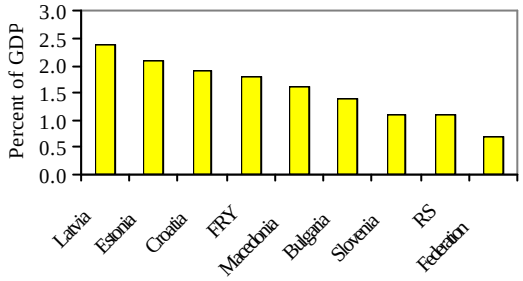
IV. SOCIAL SERVICE SPENDING, OUTCOMES AND REFORM OPTIONS

This Chapter assesses public spending in the social sectors, the largest single area of domestically budgeted public spending, with a significant sub-Entity role in management, financing, and service provision. The analysis considers how effective, efficient and equitable the present modality of service delivery in social welfare and child protection (Section A), education (Section B) and health (Section C) and how they can be improved.

A. SOCIAL WELFARE AND CHILD PROTECTION

4.1 ***Overview.*** The social welfare and child protection (SWCP) system in BiH faces a growing financial crisis, with an as yet unfinished transition from humanitarian relief to a more coherent and sustainable system.[130] In both Entities, the share of SWCP programs in GDP is low relative to neighboring transition countries, particularly in the Federation (see Graph 4.1). Moreover, in both Entities, decentralized financing mechanisms allocate resources in inverse relation to the regional incidence of poverty, with only ad hoc protection for the most vulnerable in poorer areas. As a result, many areas in both Entities are effectively without a basic cash safety net for the poorest and most vulnerable.

Graph 4.1 Comparative Social Welfare and Child Protection Spending (in % of GDP)



Source: Official data (latest available) and staff estimates.

4.2 Although, in principle, basic legislated entitlements—which are mostly inherited from the former SFRY system—are similar across Entities, they have become irrelevant in many areas in the face of resource constraints. Coordination between different benefit programs within the system is weak, the possibility of double dipping from multiple sources is high, and eligibility criteria are often ad hoc, with local offices using their discretion in rationing the beneficiaries. The system is also characterized by a lack of clarity in the division of responsibilities across governments in each Entity, and an institutional framework which facilitates limited emphasis on social welfare and child protection. Therefore, there is significant room for policy and institutional reforms that will help prioritize resources and improve the efficiency of the system. The following discussion reviews key SWCP programs and presents possible policy and institutional actions that could be taken in the short to medium term.

4.3 Prior to a focused SWCP analysis, it is worth re-emphasizing that the under-funding of SWCP in BiH (with the notable exception of child protection in RS) is in stark contrast to veterans' benefits—the other major cash benefits system. Veterans' benefits—provided in nearly all cases regardless of income level—accounted for around thirteen-times the level of spending on SWCP in the Federation and twice the level of spending on SWCP in RS, suggesting that there is ample room for better targeting of cash transfers in both Entities. Therefore, in addition to a more equitable allocation of existing social welfare spending, improvements will require the reallocation of resources from veterans' programs. Given the political voice of veterans' groups relative to more marginalized and disbursed SWCP beneficiaries, this will be a difficult but critical challenge for both Entities, if the authorities' poverty reduction commitments to address the needs of the most vulnerable are to be credible.

[130] "Social welfare" is defined to include both social assistance cash benefits and social services (see Box 4.1), while "social assistance" refers only to various cash benefits.

Institutional and Policy Context

4.4 In both Entities, SWCP programs provide both targeted cash benefits and social services, with the latter including range of counseling and placement services. Eligibility for cash social assistance is determined by membership in a designated "vulnerable social group" and by ability to work. Beneficiaries for social services may be self-referred or referred by the courts, hospitals or others in the community (see Box 4.1).

Box 4.1 Main Social Welfare and Child Protection Programs in BiH

Social Assistance Cash Benefits:

- A permanent cash benefit provided to those included in "vulnerable social groups" such as the elderly, persons with disabilities, orphans, etc., with no other source of income, no family support network and incapability to work. *In principle this is a monthly payment, but in reality many areas are only able to pay this a few times a year, if at all.* The amount of assistance is determined by the Entity legislation in RS (based on family size and income) and cantonal legislation in the Federation (though, to date, only four cantons have their legislation in place).
- One-time cash benefits provided on an as-needed basis to those who are in a desperate situation as determined by the local social service.
- Allowance for assistance and care provided by another person.
- Allowance for training of children and youth.
- Accommodation in a social protection institution or in another family;
- Assistance with health insurance contributions and utility bills of some social assistance beneficiaries (by direct payment to the service provider and done mainly in RS and Sarajevo).

Social Services:

In general, the system is mandated to respond to social issues in the community and exceptional situations as they arise. Specific services provided include:

- Monitoring and mediation in divorce and custody.
- Placement in institutional care.
- Counseling for juvenile delinquents and monitoring of compliance with court orders.
- Family counseling.
- Interventions in substance abuse cases.
- Support to families with individuals who have difficulties in development.
- Referral to special schools.
- Individual support and monitoring of those with difficulties in development including categorization process, etc.
- In some places, there are also shelters available for survivors of family violence and support groups for parents of children with difficulties.

Child Protection:

- Child allowances.
- Maternity leave.
- Support for unemployed mothers.
- Equipment for the newborn, and preschool education.
- Preventive health protection for children up to 10 years in RS.
- One meal during primary school; tuition and scholarships for pupils in the Federation.
- Additional benefits such as nutritional support for a child under six months, school meals, and vacation leisure activities.

4.5 Likewise, in both Entities, ministries with large portfolios are responsible for SWCP programs, with their primary focus on other demanding social programs such as pensions and refugee return in the Federation, and pensions and health in RS.[131] This limits policy development capacity, results in the relative neglect of SWCP programs, and dilutes the already weak authority of the center over local offices. In the

[131] In the Federation social and child protection (along with civil victims of war) is the responsibility of the Ministry of Social Affairs, Displaced Persons and Refugees, with the Office of Social and Child Protection at the Entity level providing guidance and monitoring program implementation. In RS, social and child protection falls under the responsibility of the Ministry of Health and Social Protection, with the civil victims of war being the responsibility of the Ministry of Veterans, War Casualties and Labor.

Federation, these problems are further aggravated by the fact that the responsible ministry in each canton may have a different portfolio from the Federation ministry—e.g., the cantonal ministry may be the Ministry of Health and Social Protection, or the Ministry of Labor, Health and Social Protection.

4.6 In the ***Federation***, SWCP is a shared responsibility between the Federal Government and cantons, though the Constitution does not precisely define the roles and responsibilities of each level. At present, the Federal government only sets the legislative framework, providing guiding principles and a structure of entitlements, and has no role in financing or implementation.[132] Cantons are responsible for further defining their programs in the cantonal legislation, particularly the financing and implementation arrangements. Each canton can also further allocate responsibilities for SWCP, either as a shared responsibility between the canton government and municipalities or as a municipal or cantonal responsibility entirely. To date, only four cantons have actually adopted their own SWCP legislation, which complicates the financing and implementation of programs. In practice, delivery of services remains at the municipal level in all cantons, with only one canton, Sarajevo, having a cantonal body that provides selected services upon referral from municipalities. The division of financing responsibility varies significantly across cantons, often with cases of disputes within cantons over the legal responsibility for financing program elements. In the case of child protection, which is covered under the same legislation as other social welfare programs, the implementation and financing responsibility rests with municipalities. In practice, however, the child protection system is non-functional in most Federation cantons.

4.7 The SWCP is also a shared responsibility between the central government and municipalities in *Republika Srpska*, with a fairly significant division between policy setting and financing/implementation in social welfare, but much more centralized management in child protection. Concerning child protection, the RS has a separate Children's Fund at the Entity level, which could be considered the only properly functioning social welfare agency in BiH.

4.8 In general, the present SWCP structure, whereby policies are set at a government level that is different from the level which finances and implements them, combined with poor coordination among governments, has resulted in the creation of significant un-funded mandates for many local authorities in both Entities. The analysis that follows clearly indicates the need for a system within which entitlements will be set against hard-budget constraints, and resources from the center will supplement local resources, with a view to providing equitable protection for the most needy.

Beneficiaries and Delivery Systems

4.9 ***Beneficiaries.*** Overall**,** there are about 260,000 beneficiaries for cash benefits and/or social service programs in BiH[133]—equivalent to around 7 percent of the population in each Entity. There are also about 125,000 beneficiaries registered for the child protection programs (about 2 percent of the Federation population and 6 percent in RS). However, beneficiary numbers need to be treated with great caution, since the extent of double counting with social assistance is perceived to be high and reporting rules are not consistently defined.

4.10 It is also important to note that registration for social services and cash benefit programs does not

[132] Law on the Basis of Social Protection, Protection of Civil Victims of War and Protection of Families with Children, September 1999.

[133] The number of beneficiaries for social services and cash benefits was 158,426 in the Federation (2000) and 100,531 in RS (2001). There are 41,204 beneficiaries for child protection programs in the Federation and around 84,000 in the RS.

imply entitlement to benefits, since registration is often rationed owing to resource constraints.[134] Only a small proportion of the registered actually receive benefits, with the majority eligible only for social services. Overall, it is estimated that roughly 2 percent of the BiH population are registered as *recipients* of cash benefits from the social welfare and child protection systems.[135] For instance, in RS only 13 percent of those registered actually receive benefits, with considerable variation across municipalities, ranging from as low as 2-3 percent in some municipalities to over 20 percent in others. Resource constraints affected child protection programs particularly severely in the Federation. Between 1998 and 2000, the number of child protection beneficiaries was halved, as many cantons terminated these programs, leaving Sarajevo as the only canton active in child protection (see para. 4.22).

4.11 While it is not possible to strictly evaluate the real need for targeted SWCP, owing to the absence of representative household survey data, comparisons between benefit recipient numbers and the available poverty information are instructive, and support a conclusion of widespread unmet demand. Estimates from the 1997 CEIT survey suggest poverty rates of just under 22 percent of households in the Federation and over 50 percent of households in the limited areas of RS where the survey was conducted. This, combined with respective Federation and RS poverty rates of around 9 and 24 percent, suggests that only about one-quarter of the severely poor may have been receiving cash benefits in recent years.[136] In the case of the Federation, cantonal indicators clearly suggest that there is a largely inverse relationship between the cantonal poverty rate and spending on social and child protection, which translates into hard-to-brake "vicious circles" of poverty and ineffective safety nets at present.

4.12 ***Delivery Systems.*** In both Entities, social and child protection programs are implemented by *Centers for Social Work (CSW),*[137] primarily at the municipal level.[138] An exception to this is the RS Children's Fund, where cash benefits are distributed by the Fund and CSWs are responsible for identifying program beneficiaries. All services provided by CSWs are free of charge to the beneficiary and access is limited to municipal residents, including registered temporary residents, such as the displaced and refugees. Nevertheless, in practice, CSWs are often reluctant to serve minority ethnicities.[139]

4.13 The CSWs operate with a fairly large proportion of "professional" staff (over 55 percent of total CSW staff in the Federation, and close to two-thirds in RS). Though there is no standard rule concerning staffing levels in social services, CSW staffing relative to population does not appear to be excessive in BiH—in fact, overall, BiH has more than double the client-to-staff ratio of some of its neighbors (see Table 4.1). Therefore, unlike the case of overall public administration in BiH, CSWs staffing policy should not particularly drive-up the administrative costs of the system, which in some localities are barely covered by the resources available for SWCP programs (see paras. 4.21 and 4.29).

---

[134] This is supported by the draft "Local Level Institutions and Social Capital Study" (WB, 2002), which reported very few respondents turning to CSWs in the event of financial crisis, and 35 percent of all respondents reporting social assistance as a service which was "non-existent"– the highest such score for any local public service.

[135] This compares with around 1.8 percent in Croatia and around 5 percent in Serbia.

[136] In the CEIT analysis, "poor" was defined as 60 percent of median per capita household income, and severe poverty as 30 percent of the same benchmark. While the survey was not rigorously representative and is somewhat out of date, it remains one of the more reliable sources of household data on poverty in BiH.

[137] In this report, "CSW" refers to both CSWs proper and social work services in areas without full CSWs. In relatively poor municipalities without a CSW, a Service or Office for Social Work is established to provide some of the services provided by a Center, such as placement in institutional care.

[138] In the Federation, 10 municipalities in two mixed cantons (i.e., Central Bosnia and Herceg-Neretva) have two ethnically divided CSWs. Some of these (e.g., Vitez and Gornji Vakuf/Uskoplje) are planned to be merged in 2002 as part of broader efforts to unify ethnically divided municipalities.

[139] The "Local Level Institutions and Social Capital Study" (World Bank, 2002), gives quantitative support for the disproportionate problems with CSWs of ethnic minorities, who were 50 percent more likely than the general population to report social welfare as being "non-existent" for them.

Table 4.1 Social Welfare Staff in CSWs: BiH and Former SFRY Republics, latest year

Country	*Total staff*	*Ratio to populat.*	*Ratio to registered clients* [1]
BiH (2000)	991	3,811/1	261/1
Federation	644	3,552/1	246/1
RS	347	4,291/1	290/1
Croatia (1999)	1,965	2,230/1	118/1
Serbia (2000)	2,400	3,200/1	45/1
Montenegro (2000)	320	2,052/1	66/1

[1/] Clients include those registered with CSWs for cash and/or services.
Source: Official data.

4.14 The CSWs play a crucial role in the implementation of social welfare programs in both Entities. At present, however, their efficiency in this role is constrained by the following problems: (i) lack of common standards and regulations for the work of CSWs; (ii) little networking between CSWs, which limits the coherency of programs and the prevention of abuse in the system, which is perceived to be significant in BiH; (iii) limited access to programs for clients, who are restricted to services provided by the municipality in which they live; (iv) few quality controls on social service interventions (including client privacy and confidentiality); (v) lack of professional education or licensing programs; and (vi) lack of coordination with other social service providers in the same area (both public, such as employment institutes, and non-public).

4.15 In addition, the reporting channels in the system are highly dysfunctional in both Entities. Existing systems focus on numbers of benefits rather than beneficiaries, and there are no consistent standards or incentives for regular bottom-to-top reporting and data consolidation. The absence of reliable administrative data will make it particularly difficult to assess the current system against the aggregate poverty profile, which is currently being prepared.

4.16 There are also many donors and non-governmental organizations (NGOs) active in the social welfare sector, comprising formal NGO organizations as well grassroots civil society groups.[140] These organizations were particularly important during and immediately after the war, including in the large scale food aid programs of the World Food Program. Many of the larger programs have now been terminated or have been significantly scaled back, with greater dependence on SWCP spending on local budgetary sources, especially since 1999.

4.17 Concerning coordination arrangements between the CSWs and the NGOs, while there are good examples of collaboration in the implementation of specific programs, formal systematic partnership arrangements are largely absent. Given the still important relative weight of the NGOs in the sector, it is necessary to develop such arrangements in the near term, along the modalities that are becoming increasingly common in other parts of Europe. Over time, the public sector should rely much more on partnerships with indigenous NGOs on social services provision.

Financing and Expenditures

4.18 As noted above, the two Entities have different degrees of decentralization in the financing of social welfare and child protection. ***In the Federation,*** financing responsibility has been fully assigned to the sub-Entity level, with each canton determining the final division of financing responsibility between cantonal government and municipalities. As a result, there is no standard financing model across cantons, though the majority of cantons opted for shared responsibility, with the bulk of financing directly from the municipal level. This modality results in considerable variation in the effective coverage of the safety net across the Federation, with relatively poor cantons providing only irregular marginal cash benefits, if anything at all,

[140] Although it should be noted that the boundaries between social welfare and other forms of humanitarian and development aid are difficult to define precisely (for example, with medical aid to social welfare clients).

while relatively well-off cantons are providing fairly significant and more regular benefits.[141] The situation within each canton is just as varied, with poor municipalities often paying no regular benefits in cantons where better-off municipalities are doing so. Wide variations in aggregate resource constraints and in financing modality across cantons play a role in this outcome.

4.19 As shown in Table 4.2, social welfare spending in the Federation was extremely low in 2000, both as a share of GDP (0.3 percent) and as a share of total public spending (0.6 percent). Nevertheless, even these low shares were improvements over 1999, when social welfare spending accounted for only 0.1 percent of GDP and around 0.2 percent of total spending. Moreover, there are large disparities in spending on *social welfare* across cantons ranging from as low as 0.2 percent of total cantonal budgetary spending (Posavina) to 1.1 percent (Una-Sana). Disparities in average spending per registered person were also significant across cantons—e.g., the canton with the lowest spending per registered person (Zenica) spent only 6 percent of the amount allocated by the canton with the highest spending per registered (West Herzegovina). This can also be seen in the ability of Sarajevo Canton to pay rental and utility benefits to social welfare beneficiaries in addition to their basic benefits, while many municipalities in other cantons were unable to pay any regular or one-time benefits.

Table 4.2 Federation Cantonal Expenditures for Social Welfare , 1999-first half 2000 (KM, thousands)

CANTON	*1999*		*Jan-Jun 2000*		*As % of total canton spending in 1999*
	Total	*o/w cash benefits and care*	*Total*	*O/w cash benefits and care*	
Una-Sana	1,275	806	724	480	1.2
Posavina	73	12	n.a.	n.a.	0.2
West Herzegovina	180	37	1,064	1,002	0.3
Gorazde	190	72	279	203	1.0
Tuzla	1,092	187	2,950	2,454	0.4
Zenica-Doboj	911	102	n.a.	n.a.	0.6
Sarajevo	1,273	478	3,198	2,779	0.3
Central Bosnia	692	206	n.a.	n.a.	0.7
Herzegovina-Neretva	n.a.	n.a.	n.a.	n.a.	0.4
West Bosnia	204	22	393	302	0.8
TOTAL	5,889	1,920	8,608	7,220	0.4
Memo items					
Total as % of Federation GDP	0.10	0.03	0.33 [1/]	0.27	
Total as % of Federation spending	0.19	0.10	0.58 [1/]	0.90	

[1/] Based on estimated annualized figures for 2000 and adjusting Entity GDP and cantonal spending for non-reporting cantons.

Notes: Cash benefits include total cost of all cash benefits plus the cost of institutional and foster care.

Source: Federation Ministry for Social Affairs, DPs and Refugees; Staff estimates.

4.20 Nevertheless, these low spending figures should be further qualified by the fact that they include the administrative costs of social welfare programs (explained largely by W&S payments), which have been relatively high—accounting in 1999 for as high as 86 percent of total cantonal social welfare spending in Posavina to as low as 37 percent in Una-Sana. Relatively poor cantons spent a larger proportion of their social welfare budget on social service provision and administrative costs. As noted earlier, this feature appears to mirror the resource constraints of the CWS, which are increasingly dramatic in localities with the greatest needs, rather than their over-staffing. The incomplete 2000 data, however, show encouraging signs of a positive shift in this balance of spending, with the administrative share of spending falling from around one-third in 1999 to only 16 percent. An understanding of whether this shift has continued requires more recent data, which were unavailable at the time of the preparation of this analysis.

4.21 The disparities in spending across cantons become more evident when spending on *child protection* is taken into account (see Table 4.3). Between 1999 and 2000, child protection programs collapsed in much of the Federation with only Sarajevo—the most well-off canton—continuing to pay child allowance, in addition to some payments for maternity leave allowance in Zenica and Una-Sana, and pre-school programs in West Herzegovina. The "Sarajevo divide" with the other cantons is therefore dramatically increased once child protection is taken into account. Sarajevo's child protection spending accounted not only for a large

[141] Anecdotal evidence suggests that the system operates, in many places, with significant arrears, ranging between 6 and 12 months.

Table 4.3 Federation Cantonal Child Protection Spending 1999-2000, (KM, thousands)

	1999	*2000*
Una-Sana	0	79
Posavina	0	0
Tuzla	0	0
Zenica-Doboj	794	2,133
Gorazde	0	0
Central Bosna	0	0
Herzegovina-Neretva	0	0
West Herzegovina	653	267
Sarajevo	13,358	16,194
Western Bosnia	0	0
TOTAL	14,804	18,673
Memo Items		
Total as share of Federation GDP	0.2	0.3
Total as share of municipal government spending	0.5	0.5

Source: Federation Ministry of Social Affairs, Displaced Persons & Refugees

proportion of the total SWCP spending in the Federation, but was more than twice Sarajevo's own spending on social welfare programs in 2000.

4.22 Estimating total spending on *institutional care* in either Entity is complex and no robust estimates exist.[142] This is in part because of multiple funding sources, which include: (i) transfers from CSWs for institutional clients from their locality; (ii) transfers from the pension funds for elderly insured clients or institutionalized dependents of insured; and (iii) direct payments from families of institutionalized people. While a precise estimate is not possible, the CSWs seem to provide for around 70-75 percent of total spending on institutions (about KM 4.3 million in 2000). The rest should have been covered by a combination of arrears and the above-noted sources.

4.23 To improve the efficiency of spending on institutional care, stronger coordination is needed with the international organizations, which have often supported social institutions and/or established new ones with little attention to the existing domestic networks. As a consequence, sustainability problems have increasingly becoming an issue with the ongoing phasing out of donor assistance. Therefore, it becomes critical to define benchmarks against which the operations and costing practices of the social institutions can be evaluated so that those that are no longer needed can be closed down. This should help the government shift the emphasis from institutional care to community-based care, as intended in both Entities. At the same time, the financing model for institutional care will also need to be revised, in order for current disincentives on non-custodial care can be removed, letting public financing "follow the clients," whether they are in institutional or alternative forms of care. Finally, these efforts would need to be informed by a consolidated picture of institutional spending, both from public and private revenue sources, as to date no single Federation-level agency appears to have such picture.

4.24 As in the Federation, the financing responsibility for social assistance in *Republika Srpska* had been fully assigned to the municipalities prior to August 2000, when resources from the Entity-level Social Solidarity Fund (SSF) were allocated to support *social welfare.*[143] Until its termination in September 2001, SSF resources (equivalent to 5 percent of municipal revenues) significantly enhanced municipal social protection resources and allowed many municipalities to provide, for the first time since the end of the conflict, basic social assistance benefits, as well as covering health insurance contributions for the poorest. The original intention of the RS government was to replace SSF resources with transfers from the Entity budget to municipalities. Instead, the emerging financing rules mandate municipalities to allocate at least 15 percent of local budgetary resources for social welfare spending. If adopted, this system could result in significant improvements in aggregate resource availability for the cash benefits and social services programs of CSWs. However, there would remain the fundamental problem of regional disparities, with even an increased share of an inadequate local budget insufficient to provide basic protection for the poorest. In addition, the experience of countries such as Croatia that have tried mandating fixed shares of

[142] Families may self-refer to an institution, in which case they are responsible for payment. Even in cases referred by CSWs, families may be asked to cost-share if assessed as able. Foster families receive financial support as determined by cantonal legislation. In recent years, there have been court cases by some social institutions against the municipality for beneficiary costs that have not been covered.

[143] SSF was funded by a payroll tax of 2 percent on gross wages as well as by earmarked revenues and administered by the Ministry of Finance.

local spending on social welfare demonstrates that legislative targets are not met where the center has no effective sanctions on non-compliant localities, or where localities define "social welfare" with increased flexibility in order to meet the mandated target spending share.

4.25 In the medium term, RS policymakers aim to shift to a system of direct budgetary support for either the entire social welfare spending or for selected benefits, with regular social assistance a strong candidate under the latter. This would appear to be the only effective way of ensuring equity in the coverage of core social welfare benefits, as proved by the positive experience of the operation of the child protection system.

4.26 In addition to the above financing sources, the system provides implicit subsidies through municipal utility companies, whereby heating utilities bills for selected CSW beneficiaries are subsidized by a surcharge on all users.[144] Although, this scheme is regulated by a government decree, it is not possible to estimate the actual amount of financing channeled to the social welfare system in this way, owing to lack of reliable information. Nevertheless, at least 10 percent of heating tariff revenues might very well have been allocated to operate this subsidy scheme.

4.27 Table 4.4 shows total SWCP spending in RS, which for social welfare is extrapolated from information reported by over half of municipalities.[145] Overall, total spending on SWCP as a share of GDP in RS is closer to regional comparators (especially for child protection) than in the Federation, though it is still very much at the lower end of the scale (see Graph 4.1). It should also be noted that social assistance spending in 2000 reflects in part the SSF revenues transferred from the center, which is no longer in place. The proposed new system is likely to bring some decline in overall spending in the period ahead rather than being revenue neutral or revenue-enhancing.

Table 4.4 Social Welfare&Child Protection Spending in RS, 1999-2000

	1999	*2000*
Social Welfare Spending[1]		
As % of total municipal spending	5.1	9.1
As % of GDP	0.3	0.4
Child Protection Spending[2]		
As % of consolidated RS gov. spending	1.7	1.2
As % of GDP	0.9	0.6
Spending on Institutional Care		
As % of total municipal spending[3]	n.a.	2.6
As % of consolidated RS gov. spending	n.a.	0.2
As % of GDP	n.a.	0.2
Total[4]		
As % of total municipal spending	5.1	11.7
As % of consolidated RS gov. spending	1.7	1.4
As % of GDP	1.1	1.2

1/ Estimated based on information from 37 municipalities for 1999 and from 30 municipalities for 2000.
2/ Financed by Children's Fund which is funded by earmerked payroll contributions, currently 1 percent each for employee and empoyer.
3/ Estimated based on official data and average RS wages.
4/ Excludes institutional care for 1999.
Source: Official data and staff estimates.

4.28 Moreover, wide variations in spending across municipalities also characterize the social welfare system in RS, with poorer municipalities allocating much smaller proportions of budgetary resources for social welfare—the variation between the lowest and highest spending municipality is 1:10, with much of low spenders resources often effectively absorbed by administrative expenditures. For example, while overall administrative spending by CSWs accounts for about half of total social welfare spending, poor municipalities such as Sokolac allocated as much as 90 percent of their total resources for administrative costs in 1999, with Banja Luka—relatively the most well-off—spending a much lower 37 percent. *Thus, as in the case of the Federation, the social welfare system provides the least security where the most vulnerable are probably located.* If this vicious circle is to be addressed, this would require establishing a system that

[144] Decision on subvention for electricity users from certain categories of households (RS Gazette, June 2001).
[145] Individual municipal data are available upon request.

would provide basic protection for the most needy across RS through equalization transfers from the center as authorities intend to consider. This would also ensure allocation of adequate resources for social welfare, which at present remain very low in RS, with the system biased toward child protection.

4.29 As noted earlier, *child protection* is financed through the Children's Fund, which is administered centrally and funded predominantly by earmarked payroll contributions.[146] This financing modality provides regular resources—benefits paid in recent years have been close to entitlements[147]—compared to experience with the other programs. Overall, about 60-70 percent of the available revenues are spent on child allowance, and the rest mainly on other benefits, with operating costs accounting for just over 3 percent of total expenditures.[148] Overall, the Fund demonstrates the positive impact of the central financing of benefits in terms of security of benefits, equity of coverage, and efficiency in administration

4.30 Spending on *institutional care* constitutes a relatively small portion of the total SWCP spending in RS.[149] Financing is fully a municipal responsibility, except in the case of beneficiaries from the Federation or other countries who were placed in institutions before the conflict. In these cases spending is financed from the central government budget (amounting to KM2.7 million in 2000). Estimates of spending at the municipal level are more difficult to obtain—a rough estimate suggest that municipal spending might have amounted to roughly KM3 million in 2000, an amount, which, like in the Federation, would have been financed from four main sources: local budgets, the pension fund, family payments and arrears. Like the Federation, the RS government intends to increase emphasis on community care over time, with the efficiency related issues discussed in para. 4.24 also applying in the case of RS, as well as the need for new financing rules and a consolidated expenditure analysis.

Recommendations:

- ***Institutional Framework.*** Redefine institutional responsibilities in social protection on the basis of the functional review of social protection to be undertaken in collaboration with the World Bank under the Social Technical Assistance Project (SOTAC).
- ***Social Welfare Policies.*** Develop and legislate a new Social Protection Strategy in both Entities with an emphasis on the following key aspects:
    - Determining a realistic core set of entitlements, with clearly identified financing sources. Civil victims of war should be covered under the system in the case of the Federation.
    - Ensuring that Entity budgets finance one or more core "poverty benefits" equitably, across Entity. While there are several options in designing such a scheme, the simplest approach, both administratively and politically, would be to finance such poverty benefits at the same base rate across all sub-Entity levels. This base rate could then be topped up from local level resources subject to hard-budget constraints.
    - Creating incentives for adequate allocations for social protection by local governments. If an Entity level poverty benefit is to be provided, the transfer of resources could be made

[146] Contributions were 1.5 percent employee and 1.5 percent employer of gross wage until early 2000 and have been 1.0 percent each since then. Although marginal, some donor financing has also been available for specific projects since 1998.
[147] It should be noted that the reduction in child protection spending in 2000 reflects half a percentage point cut in payroll contributions as part of the tax rationalization reforms, which have not created significant resource constraints for the system.
[148] Although financed from the payroll tax, benefits are available to families of both contributors and non-contributors, with the majority of benefits being the same across the Entity.
[149] In the case of self-reference or family-reference to an institution, the referee is responsible for the costs. Also if the family is determined to have the financial capacity to contribute there may be a cost-sharing arrangement. Foster families would also receive financial support as determined by the Entity in RS. The beneficiary and/or the birth family may also be expected to contribute to this.

contingent on a certain minimum local level of spending (e.g., 5-10 percent of local resources could be reasonable).

  - Developing sound targeting criteria based on resource constraints and administrative capacity (e.g., for means-testing and/or beneficiary identification according to monitorable eligibility rules). This assessment needs to be supported by findings from the recently completed LSMS.

- ***Balance between Resources for Benefits and Resources for Services***. In addition to the above-noted options for improving financing arrangements, reassess the balance between cash benefits and services to ensure that the present resource allocations actually reflect community needs and priorities.
- ***Institutional Care.*** Develop a clear strategy for institutional care reflecting a more formal commitment to a mixed system, which would include significantly more care in the community where feasible. This requires instituting a system, whereby "money follows the client" and local authorities have equal incentives to have clients in institutional care or in community-based care.
- ***Data Reporting System.*** Continue to improve the coverage and consistency of budget classification in social welfare. It is particularly important to establish a "client database" as envisaged under SOTAC to provide reliable and timely information to both local and Entity authorities and to detect cases of double counting (and possibly double dipping).
- ***Operations of CSWs.*** Establish standardized procedures for good professional practices in CSWs with a greater client focus. Particular attention must be given to defining clear rules and criteria against which social protection benefits are granted; to coordinating different social service providers at the local level; and to developing a program of continuous professional education for CSW staff, if skills are to be kept up to date.
- ***Role of NGOs in Social Welfare Provision.*** Develop legislative and regulatory frameworks to guide the interactions of public and NGO institutions in the system. They should include licensing standards and procedures, financing guidelines in cases of contractual service provision, reporting requirements, and monitoring and evaluation mechanisms. It is also necessary to consider the possibilities for the tax deductability of charitable donations to NGOs.

B. EDUCATION

4.31 ***Overview***. In BiH, over 630,000 students receive their education in a system that reflects a mixture of standardized systems inherited from the former SFRY and an extremely decentralized policy and institutional framework established in the post-conflict era. This mixture results in a system that is unable to (i) exploit major positive externalities that services such as education create by enhancing productivity and the quality of life for the country as a whole; and (ii) provide the critical facilitating role that the education system could play in the BiH's economic transition process. It also results in an excessively expensive system, with major weaknesses in efficiency, equity and quality of output in the sector.

4.32 Particularly outdated features of the system inherited from the former SFRY are curriculum and education structures which are both focused on the transmission of factual information rather than on learning outcomes—particularly at the upper primary level—and are excessively vocational, focusing on supplying a heavily industrial economy with a planned volume of skilled labor, which is no longer needed—especially at the secondary level. Similarly, higher (tertiary) education remains largely dominated by the public sector and operates in a supply-oriented mode which is effectively divorced from the demands of the emerging new labor market. Another feature inherited from former systems is an input-driven budgeting system, based on rigid specialized learning standards, which makes the system expensive and provides no incentive to increase efficiency.

4.33 The highly decentralized provision of education services imposes further challenges to operating with reasonable efficiency and effectiveness while denying equal access to quality education in many localities. In the present context, each Entity is responsible for developing its own education system, with no countrywide framework for setting joint policies. Moreover, this responsibility, including the financing aspects, is assigned to cantons in the Federation, which results in further fragmentation. As a result, the system is particularly inefficient at the tertiary level, creating wrong incentives for an expensive and inefficient higher education system.

4.34 Overall, public education spending in BiH is significantly high compared with European norms, with spending per student (adjusted for GDP per capita) at every educational level being nearly twice as high as in Western Europe.[150] This seems to be largely due to the high education W&S bill, with budgetary spending on maintenance and capital investment, along with instructional materials, being too low across the system. Despite high spending, pre-school education is unavailable to the poor children who need it most to offset their relatively deprived backgrounds; special education is insufficiently provided for; and access to academic secondary schools, and subsequently to tertiary education, is much too limited and unequal. The present system also remains weak in serving minorities, who are commonly segregated in separate schools or separate classrooms and are increasingly marginalized.

4.35 As in general in BiH, fragmentation in the sector is also mirrored in the lack of reliable and comprehensive data on the operation of the public system and private spending. Foreign transfers from Croatia remain unaccounted for, and it is difficult to understand municipal spending in education, particularly in RS. In addition, input and cost data cannot be linked to educational results because there are no appropriate assessment mechanisms. As a result, outcome and quality remain hard to determine, yet there are many sign of their continuing deterioration.

4.36 The above weaknesses make policy and institutional reforms in education increasingly critical, although, to date the driving force for reform has mainly been further ethnic division rather than educational enrollment and attainment. The present enrollment rates are very low, except at the primary level, compared to BiH's pre-conflict achievements and to the rates in Europe. At the same time, large numbers of refugees and displaced persons, along with other internal migration make enrollments highly unpredictable in BiH's context, which introduces additional challenges to the reform process. The following paragraphs assess the present status of the policy and institutional frameworks in education with a focus on the efficiency and equity of public spending and the quality of outcomes. The assessment concludes with an overview of reform actions needed to improve the financial sustainability and educational outcomes over the medium term.

Institutional and Policy Context

4.37 As noted above, the cantons in the Federation and the central government in RS are the key players in policy, administrative and financial matters in the education sector. In RS, a central Ministry of Education is responsible for policy oversight, planning and execution. In the Federation, this role is undertaken by the individual Ministry of Education in each canton and the Federal Ministry of Education at the Entity level. Moreover, in the majority Bosniac cantons of the Federation with sizable Croat minorities, there is a parallel Croat structure of institutions and administrative units, producing not only further fragmentation but also inefficiency and lack of transparency.

[150] While the BiH's GDP figure may be underestimated due to potentially high informal economy, the extent of the problem is still sufficiently high (based also on the comparative share of education spending in total public spending) to indicate a serious efficiency and structural issues in the sector.

4.38 The Federal Ministry of Education is mainly responsible for policy coordination across cantons. Nevertheless, it is as yet unable to carry out this role because of the heavily politicized functioning of the sector. The newly established Standards and Assessment Agency for general education and the Higher Education Coordination Board are expected to facilitate the much needed coherent education policy framework and the oversight at the Federal level.

4.39 ***General Education.*** Despite the fragmented structure, the regulatory framework for general education varies little across cantons in the Federation and/or between the Federation and RS, reflecting the common former SFRY heritage, whereby self-management had been guided by detailed rules of conduct. In practice, however, common regulations do not imply common standards, especially in the Federation, where there has been no system to ensure common education standards across cantons until the recent establishment of the Standards and Assessment Agency for general education. Several cantons have pedagogical institutes that are responsible for school inspection and the monitoring of education standards, although their responsibilities often overlap with the canton education ministries. Moreover, these oversight functions, whether the responsibility of the cantons or their pedagogical institutes, are very limited.

4.40 Within the Entities, administrative and financing responsibilities for pre-school in the Federation and for secondary schools in RS are assigned to municipalities, though school staff salaries are paid centrally in RS. In the Federation, in some cases cantons attempt to further increase municipal responsibilities, often to avoid fiscal obligations.[151] In both Entities, schools are governed by Boards, another feature inherited from the former SFRY self-management system. These Boards, which include municipal representatives, have no clearly defined role, particularly because schools have very little responsibility for managing their own budgets.

4.41 ***Higher Education.*** As noted above, higher education, which was a national responsibility under the former SFRY system, is an Entity responsibility, which is assigned further down to each canton in the Federation. At present, a joint policy framework and joint standards for the recognition or accreditation of universities, as well as mechanisms for the mutual recognition of university degrees, are all absent[152] in BiH, broadly, nationwide, and specifically, Federation-wide. Furthermore, in the Federation there is a strong incentive and tendency for each canton to create its own higher education institutions. In those cantons with a higher education institution, the canton controls the number of full-time new admissions. The DPA permits Entities or cantons in the Federation to shift the key responsibilities in higher education to upper levels, which could dramatically improve the delivery of the service and the quality of the outcomes, but there is as yet only low tolerance for discussing these options across BiH.

Delivery Systems and Policies

4.42 At present, ***pre-school education*** is not compulsory in the Entities. Compared to the former SFRY period, when pre-schools used to be linked to the place of employment, the pre-school system today has nearly disappeared along with large number of public enterprises, which were destroyed or became dysfunctional. The remaining pre-schools are largely concentrated in more affluent urban areas. While there is no specific information for RS, the Federation information suggests that there are about 100 pre-school institutions whose enrollment rate is estimated to be only about 4 percent[153] (see Table 4.6). As noted earlier, the supervision and occasional financing of pre-school education is the responsibility of

[151] For instance, in Neretva Canton, school maintenance has been made a municipal function without an adequate increase being made in municipal resources. Municipalities, which do not have a significant additional revenue generating capacity in the current context, are unable to meet this new obligation, and no maintenance is being undertaken as a result.

[152] Tuzla Canton is the only canton that has developed a legal framework for recognizing higher education diplomas.

[153] Operating with 1,200 staff and providing a range of custodial childcare and education to 9,400 children aged between 6 months and 6 years.

municipalities, though it falls under social services rather than under education.[154]

4.43 Eight years of ***primary education*** is compulsory throughout BiH. In some of the Federation's 10 cantons, compulsory education starts at age 6, in others at age 7. In RS, compulsory education starts at age 6. As shown in Table 4.5, primary education enrollments in both Entities have increased significantly through 1999-2000, reflecting both the rehabilitation of facilities and the return of refugee children, followed by an as yet unexplained reduction in 2001, especially in the Federation. Today there are about 385,000 children (260,000 in the Federation and 125,000 in RS) enrolled in over 1,800 schools.

Table 4.5 Public Primary Schools, BiH, 1996-2001

		1996	*1997*	*1998*	*1999*	*2000*	*2001*
Federation	Pupils (1000)	252	260	268	277	276	259
	Schools	898	943	976	1,013	1,029	1,086
RS	Pupils (1000)	126	131	128	126	n.a	124
	Schools	657	734	737	750	n.a	n.a
Total	Pupils (1000)	379	390	396	403	n.a	383
	Schools	1,555	1,677	1,713	1,763	n.a	n.a

Source: Federation and RS Office of Statistics (2001).

4.44 The estimated net enrollment rate is expected to be around the 93 percent range of the relevant age cohort.[155] There is a striking difference in school sizes across the Entities, with schools being much smaller in RS (average size, 168 pupils in 1999) than in the Federation (average size, 238 pupils in 2001). The primary education curriculum in both Entities is largely inherited from the former SFRY system, with modifications to date primarily focusing on accentuating ethnic differences more sharply. The curriculum is prescriptive, with detailed written standards, and focuses on teaching factual information based on required teaching time inputs rather than on educational outcomes. It requires a heavy load of instruction, organized by single subjects and requiring high teacher qualifications. The minimum number of weekly classes increases from 16 in grades 1-2 to 26 in grades 7-8. There has been some attempt to reduce the curricular load in the five purely Bosnian cantons under the guidance of the Sarajevo Pedagogical Institute. Nevertheless, changes to date appear to be only marginal.

Table 4.6 Estimated Net Enrollment Rates (in %), 2001

	Total (BiH)	*Federation*	*RS*
Preschool (0-6)	4.3	4.3	4.5
Primary (7-14)	92.8	92.6	93.2
Secondary (15-18)	72.6	73.7	70.6
Academic track	0.1	0.2	0.1
Other tracks	0.6	0.6	0.6
Tertiary (19-23)	24.2	25.6	22.1

Notes: Starting age for the primary school is assumed to be 7 since very few 6 year old children are enrolled in primary school in both Entities. Secondary school enrollments includes all the different tracks, academic, vocational, technical etc, though the majority are technical or vocational schools. They also include some three year programs, which are less favored in the labor market. This might lead to overestimation of secondary school enrollment rates.
Source: Official 2001-LSMS data and staff estimates.

4.45 ***Secondary education*** is not compulsory in either Entity. Both Entities provide three basic types of secondary education: (i) four-year gymnasiums (academic high schools); (ii) three-year vocational schools; and (iii) four-year technical schools.[156] Enrollment at the secondary level has been rising steadily

Table 4.7 Public Secondary Schools, BiH, 1996-2001

		1996	*1997*	*1998*	*1999*	*2000*	*2001*
Federation	Pupils (1000)	81	89	896	103	112	113
	Schools	171	183	189	190	204	206
RS	Pupils (1000)	45	50	51	52	n.a	58
	Schools	80	96	98	100	93	92
Total	Pupils (1000)	127	138	147	155	n.a	171
	Schools	251	279	287	290	297	298

Source: Federation and RS Office of Statistics (2001).

[154] In addition to municipal pre-schools, some primary schools also organize one-year kindergarten programs.
[155] Data on net enrollment rates, which would be a better indicator, are unavailable, and the gross rates may contain large numbers of repeaters and overage children who may mask an enrollment problem among children of the appropriate age. Some survey information would be useful to determine, even if roughly, the net enrollment rates in the education system.
[156] In addition, there are small numbers of other types of secondary school, including arts schools, secondary teacher training schools (for those who will teach primary grades 1-4), religious schools, and special education facilities.

since the end of the conflict (see Table 4.7). Nevertheless, the net enrollment rate at the secondary level remains low by Western European norms: it is estimated to be about 74 percent in the Federation and 71 percent in RS, which has implications for poverty, as education is linked with overall earning capacity in BiH as elsewhere in the world[157] (see Table 4.6). The reasons for the low secondary enrollment rate are not clear—they may reflect low supply or demand or a combination of the two. Certainly, in some areas there are no secondary schools within reasonable range of potential students, nor are there any transportation assistance schemes. Determining the reasons for low secondary enrollment should be an urgent priority in the sector, and this would require a sound survey information, population data and analysis.

4.46 Secondary enrollments are heavily concentrated in vocational and technical schools. Academic general education had only 26 percent of secondary school enrollment in the Federation in 2001,[158] up from 20 percent in 1996, but only about half of the OECD averages of 51 percent. The corresponding RS rate, at around 17 percent, is even lower.

4.47 Secondary education could be provided by private schools in addition to public schools. But there are only 6 private schools compared with 298 public schools. Differing from the primary level, the average school size in the Federation (549 in 2001) and RS (630 in 1999) is much more comparable, with a somewhat larger school size in RS.

4.48 There are seven ***higher education*** universities in BiH, five in the Federation and two in RS. As a reflection of the prevailing strong ethnic divisions in the sector, however, academic programs that existed before the conflict are now split according to ethnic background—e.g., there is now a University of Mostar-East and a University of Mostar-West. Moreover, in all Federation cantons except one (Tuzla), each faculty is treated as a legally separate institution. When various academies and graduate schools are added to these faculties, there are 102 separate legal entities providing higher education in BiH, with an average size of 623 students, about the same as a typical secondary school (see Table 4.8). If the large University of Sarajevo is excluded, this number falls to 482 students per institution, no larger than a typical primary school in an OECD country. While there are no private tertiary institutions, fees and other private financial contributions are common in higher education.

Table 4.8 Higher Education Institutions and Enrollments, 2001

	University	*Faculties*	*Academies*	*Graduate school*	*Total Institutions*	*Students*
Federation	Sarajevo	23	3	4	30	28,857
	Tuzla	8	1	..	9	7,538
	Mostar East	7	..	1	8	2,674
	Mostar West	8	1	1	10	4,942
	Bihac	5	..	2	7	3,231
	Tot.Federation	51	5	8	64	47,242
RS	Serb Sarajevo	13	10	..	23	6,737
	Banja Luka	12	2	1	15	9,549
	Total RS	25	12	1	38	16,286
Total-BiH		76	17	9	102	63,528

Source: Federation and RS Statistical Office (2001).

Financing and Expenditures

4.49 ***Financing Arrangements.*** The rules and regulations for financial planning in primary and secondary education are quite common across Entities, reflecting those in place under the former SFRY system. In the case of pre-school and higher education, however, this is usually no longer the case and the

[157] For instance, see Marcelo Bisogno and Alberto Chong, "On the Determinants of Inequality in Bosnia and Herzegovina," World Bank mimeo, November 2001.
[158] This overall average for the Federation conceals a range from 15 percent in Gorazde to 41 percent in West Herzegovina.

present system is quite arbitrary. In addition, while the system is almost entirely in the public sector[159] and remains largely publicly financed in the two former levels, private payments are becoming increasingly important in the two latter levels.

4.50 *Pre-school*. Pre-school is a municipal responsibility in the Federation, but largely an unfunded one. As a result, pre-schools are mainly privately financed with only a small amount of public funds being available for a few pre-schools; these funds are channeled partly through the Federal Ministry of Social Affairs and partly through the Ministry of Education.[160]

4.51 *General Education*. As noted previously, financing responsibility for general education is a cantonal responsibility in the Federation (though capital investments are currently being financed mainly by donor assistance channeled largely through the Federal government) and a central government responsibility in RS—though secondary education is considered a municipal responsibility. In addition, anectodal information indicates that Croat minority areas of majority Bosniac cantons in the Federation receive irregular transfers from sources (including Croatia) which remain difficult to identify and quantify. Except for these transfers, schools do not raise funds directly in either Entity.

4.52 The present approach to determining the financing needs in general education dictates the past standardized curriculum and input-based financing system—which itself perpetuates past inefficiencies with no incentives for change—in a new structure, where there is no longer centralized financing, with actual financing capacity in each Entity and in each canton varying considerably (see Box 4.2). Thus, both within RS and within every single canton, the former rules apply concerning, for example, equal salaries for teachers and the derivation of input-based funding formulas. Across Entities and cantons, however, there are substantial discrepancies in what is affordable owing to the wide differences in financing capacity (see paras. 4.61-4.65).

Box 4.2 How Are School Budgets Determined in BiH?

School budgets in both Entities continued to be determined by a complex former SFRY formula. The formula reflects the cost of standardized inputs (such as student numbers, classroom sizes, teaching and non-teaching staff, physical space, rural or urban location, and teachers' years of experience, etc.) that were considered necessary for delivering a centralized curriculum under the pre-war system, with equal pay for teachers and centrally defined indexes for O&M spending. In the case of the Federation, cantons make only minor adjustments to the budgeting formula. At present, the budgets are driven by staff salaries, which are determined first, followed by spending on physical plant derived using an index related to the salary bill. The budgets are therefore not very flexible in allowing room for reflecting differing needs across schools, except for class size and expenditures on physical plant which schools are allowed to adjust during the year, though in practice almost the entire amount is absorbed by utility payments.

4.53 Both Entities allocate a disproportionately large share of their budgetary allocations to education on W&S and only a residual amount for recurrent O&M spending; the latter is often entirely absorbed by utility payments, which results in the dilapidation of school facilities. As noted above, capital investments have largely been financed by donors, with almost no allocation from the domestic budgets. To date, donors have rehabilitated over 60 percent of the BiH's schools, but financing is increasingly being shifted away from physical rehabilitation toward institution-building, such as the establishment of information systems, assessment and quality assurance mechanisms, recognition of diplomas, etc. The sustainability of the present education financing modality is, therefore, diminishing and requires significant reforms in the

[159] In 2000, there were only 11 private schools in the Federation (2 pre-schools, 3 primary schools, 6 secondary schools and no higher education institutions). There are no data for RS.

[160] For instance, in Sarajevo Canton an intermediary "Children of Sarajevo" agency coordinates some 20 kindergartens containing some 2,300 children, with contributions from parents amounting to KM130 per month (equivalent to one-fifth of the average wage). In the Croatian part of the town of Mostar in Neretva Canton, some 500 children receive pre-school education under the supervision of the municipality with parents paying KM220 per month.

medium term (see paras. 4.66-4.67).

4.54 *Higher Education*. The financing arrangements for higher education are much less transparent than those for general education. This is mostly due to the following factors inherent in the system: (i) lack of accurate records on student numbers in terms of full-time equivalents; (ii) complex mechanisms for paying faculty members, most of whom may teach at more than one institution; (iii) present revenue reporting requirements, which do not cover revenues raised from non-public sources, though they are significant; and (iv) the assignment of higher education as a cantonal responsibility in the Federation, with no clear guidelines regarding admissions or financing mechanisms for students from localities other than those where higher education institutions might be located. If and when students receive financial support from their own canton, this support is usually informal with no financial records.

4.55 Unlike general education, for higher education there are no common budgeting formulas and/or regulations for determining financing plans and executing them across the Entities and across cantons in the Federation. Nevertheless, budgets are input-based as are those in general education, perpetuating inefficiencies and de-linking the provision of courses from student demand.[161] In addition, faculty salaries are set, using very low teaching loads as norms.[162] Similarly, budgets are planned based on the number of new students to be enrolled on a full-time basis, though the incidence of students dragging out their courses without making academic progress is very high in BiH, making budgets very arbitrary. In this respect, the absence of any control over part-time students, who simply remain enrolled notwithstanding their progress, and any mechanisms for converting part-time students into full-time equivalents are major problems weakening the financial planning capacity of the system.

4.56 There are two significant financing sources for higher education, one public, the other non-public, both of which remain effectively unrecorded. The former is Federation-specific source and it comes from cantons without higher education institutions, which finance their students' higher education bills in the other cantons.[163] The latter applies to both Entities and it concerns revenues such as fee revenues,[164] which are becoming an increasingly important financing source in both Entities. Nevertheless, faculties are not obliged to account for revenues raised from fees or self-financing, which makes it difficult to quantify them.[165] Based on anecdotal evidence, it is estimated that about half the university's financing today comes from such non-public sources.[166]

4.57 ***Public Education Expenditures - High and Inefficient.*** Overall, the share of education spending in GDP is significantly high in BiH compared with average spending in transition CEECs and in EU countries. The Entity indicators show that high BiH averages reflect relatively high Federation spending, with spending in RS being closer to European averages (see Graph 4.2). In turn, higher Federation spending reflects the costs of the extreme fragmentation in delivery of education services.

4.58 *Why is spending comparatively higher in BiH?* The high overall levels of spending in BiH reflect the high unit costs at all education levels relative to per capita GDP, which is twice as high in BiH as in

[161] For instance, there is a considerable demand for such courses as economics, a demand that is not fully met except through part-time enrollments.

[162] Each professor, however, normally holds up to 2.5 "full-time" positions.

[163] Several cantons with large Croat groups, for instance, transfer funds to the University of Mostar-West in Neretva Canton.

[164] There are two types of fees: one is the examination fee (imposed on all students) and the other is the tuition fee (imposed only on part-time students and students without public support).

[165] Only one university provided information on such private revenues (Mostar- East), where fee revenues increased from 7 percent of total revenue in 1996 to 37 percent by 2000.

[166] Received from universities in Sarajevo, Tuzla and Mostar West, all suggesting a similar pattern whereby over 50 percent of total university finance comes from private sources.

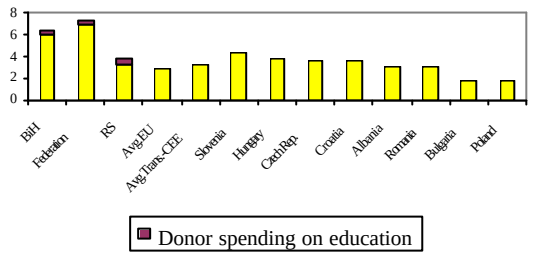
Table 4.9 Public Spending per Student by Level of Education (percentage of public spending per basic education student)

	Federation 1999	*RS 2000*	*Croatia 1999*	*OECD 1997*
Primary	100	100	100	100
Secondary	152	146	100	134
Tertiary	254	209	183	199

Source: Federation Office of Statistics (2001). RS Ministry of Education (2001). World Bank and OECD data.

Europe (see Graph 4.3). Unit costs at secondary and higher levels are especially high, except for secondary education in RS, which might be caused by the understatement of expenditures due to unrecorded municipal spending (see Table 4.9). This pattern seems to be due to three principal causes at all education levels, which concern fragmentation, budgeting modalities, and W&S costs, and also to a cause applying only to higher education, which concerns student attrition.

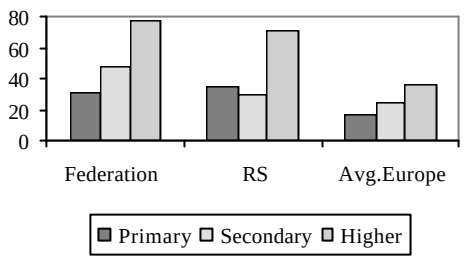
Graph 4.2 Consolidated General Government Expenditures on Education, Comparative Analysis



Note: Total spending including donor financed off-budget investments for BiH.

Source: Official data, IMF-GFS, and staff estimates.

Graph 4.3 General Budget Expenditure per Student, Relative to Per Capita GDP, 1999



Note: Based on on-budget public spending on education.

Source: Official data, IMF-GFS, and staff estimates.

- *Fragmentation*. As discussed in paras. 4.45-4.48, the average size of schools at all education levels is much lower in BiH than in Western European countries. Particularly at the tertiary level, the typical faculty is only the size of a secondary school in Western Europe. Therefore, economies of scale cannot be realized.[167]
- *Budget System*. As discussed in paras. 4.52-4.55, the financing modality in the sector, which remains largely along the lines of the former SFRY system, provides no incentive to reduce costs and increase efficiency.
- *Salaries and Wages*. As noted in para. 453, spending on W&S accounts for the majority of budgetary spending at all education levels in BiH. Nevertheless, the available information does not allow us to clearly identify the underlying reasons for this, although it suggests a number of possible reasons, which are listed below:
  - *The Share of Salaries*. Spending on salaries as a share of total education spending is higher in BiH than in OECD-European countries, but not dramatically so, except for higher education in RS[168] (see Table 4.10). Nevertheless, one should take into account that education spending is comparatively high in BiH and that, within this envelope,

Table 4.10 Share of Salaries in Total Spending (%)

	Primary	*Secondary*	*Tertiary*
Federation-1999	84	80	70
RS-2000	82	96[1]	81
OECD-1997	80	..	67

[1/] Total secondary education spending is likely to omit non-W&S spending by municipalities in RS.

Source: Official BiH & OECD data and staff estimates.

[167] Some services provided by the governments need a minimum scale in order to operate efficiently, a scale that may not be achieved by a single locality.

[168] At the secondary level in RS, this might be explained partly by the missing municipal funding for non-salary items.

budgetary spending on O&M and capital investment is very low, which means that W&S absorbs a disproportionately large share of the resources available for education.

- *Student:Teacher Ratios*. Given the high share of W&S in education spending, one might expect to see a particularly low student:teacher ratio in BiH. At first sight, this does not seem to be the case, except for few cantons in the Federation (Posavina and Central Bosnia) and with the notable exception of higher education (see Table 4.11). Compared to OECD norms (15), there are clearly relatively few students per teacher in higher education in the Federation (12) and, far too few students per teacher in RS (7). This is even more the case when it is taken into account that the higher education student numbers include all students, both full-time and part-time, with no standardization for full-time equivalency.

Table 4.11 Student-Teacher Ratios by Level of Education, 1998

	Pre-school	*Primary*	*Secondary*	*Gen. Sec.*	*VET Sec.*	*Tertiary*	*Inst.*	*Faculties*
Una-Sana	15	23	19	..	..	18	28	18
Posavina	7	15	12	8	15	..	..	..
Tuzla	12	22	17	18	17	11	10	9
Zen-Dob	7	26	15	13	16	9	9	10
Gorazde	16	19	14	..	11	..	..	..
Central Bosnia	..	12	13	..	..	..	..	..
Neretva-BOS	15	19	13	11	14	..	..	..
Neretva-Croatia	..	19	10	..	..	..	..	..
West Herz	21	19	18	14	19	..	..	..
Saraievo	14	21	16	24	15	10	9	..
Herz. Bos	10	19	12	10	13	..	..	..
Federation	*13*	*20*	*15*	*12*	*15*	*12*	*14*	*12*
RS	*19*	*18*	*18*	*14*	*21*	*7*	*6*	*8*
Croatia (1999)	13	16	11	..	..	14	..	..
OECD	*15*	*16*	*15*	..	..	*15*	..	..

Source: Federation Office of Statistics (2001); RS, Ministry of Education (2001); World Bank data (2000).

- *Excessive Benefits Relative to W&S.* Many teachers in the upper primary (5-8) and secondary (9-12) grades seem to be part-time in BiH. At the primary level, this reflects the very large number of single subject requirements in the curriculum, requiring specialized teachers. Part-time teachers receive part-time salaries but full-time benefits. These benefits could partly explain the very high overall levels of spending. Therefore, data on full-time equivalents (FTE) are also needed for upper primary and secondary teachers. The application of such equivalents could well reduce the student: teacher ratio at both the primary and secondary levels in BiH.
- *High Salary Levels*. Although high teacher remuneration (salaries plus benefits) could be another reason for the high share of W&S in education spending, the limited information suggests that W&S in the sector is relatively low compared to several other sectors in the public domain (e.g., public administration, defense, and health). This is one of the areas where further analysis requires better information.
- *Excessive Non-Teaching Staff*. Finally, the high salary bill could be explained by large numbers of non-teaching staff on the payroll, given that the student:teacher ratios in general appear reasonable, at least when not corrected for FTEs. As noted above, teaching and non-teaching staff numbers and salaries are needed for further assessment.

Table 4.12 Tracing Higher Education Students, Federation, 1999-2001

Year	*1999*	*2000*	*2001*
I	19,145	..	..
II	11,829	13,850	..
III	4,546	5,503	6,976
IV	3,044	3,663	4,084
V	666	783	745
VI	43	96	112

Source: Official data.

4.59 *Attrition in Higher Education*. A further explanation of the high unit costs in higher education is the excessive attrition rate in the tertiary sector, coupled with the long time it takes to graduate. In the Federation, for instance, only 7,000 of the 19,000 students who enrolled in the first year of university in 1999 had survived to the third year by 2001 (Table 4.12). Reportedly, only 15-20 percent of university students graduate on time.

4.60 ***Public Education Expenditures--Inequitable.*** There are wide disparities in per capita and per pupil education spending across cantons in the Federation and across Entities, reflecting differences between economic development and fiscal capacities (see Tables 4.13 and 4.14). For instance, education spending per capita at KM285 in Sarajevo is almost three times that in Gorazde at KM99. This reflects both

Table 4.13 Education Expenditure by Cantons, Federation, 2000				
Canton	*Total Edu. Exp (KM mln)*	*Education Exp. per capita (KM)*	*Education Exp. as share of GDP (%)*	*Education Exp. as a share of Tot. Exp. (%)*
Sarajevo	107	285	6.0	21
West Herz.	18	226	7.2	31
Herz. Neretva	39	183	5.6	25
Central Bosnia	38	165	7.7	28
Una-Sana	49	165	11.3	33
Tuzla	87	163	9.5	26
Posavina	7	155	8.5	22
Zenica Dob.	60	155	9.3	26
West. Bosnia	11	134	8.2	24
Gorazde	3	99	6.5	16

Source: Official data.

Gorazde's lower level of development and also its lower share of education in total spending. Similarly, education spending per primary student varies between KM623 in RS and KM1,098, in Sarajevo, and varies per secondary student between KM507 in RS and KM1,358 in Sarajevo. Since the two Entities and the cantons in the Federation are not homogenous in terms of age structure, geography, secondary and tertiary institutions, refugee situation, and the like, one would not expect spending per student to be identical in every place. However, the disparities in spending are so wide that it represents a source of inequity.

4.61 Within the Federation there is also considerable variation in the allocation of resources between primary and secondary education. Secondary spending per student in Sarajevo is almost twice as much as that per primary student, compared to roughly equal amounts in Gorazde (Table 4.15). RS seems to allocate fewer resources to each secondary student than it does to each primary student, although this might be due to lack of information on additional municipal financing for secondary education in RS.

Table 4.14 Public Spending Per Student by Level of Education (KM) Selected Federation Cantons and Republica Srpska (2001or latest available)					
	Federation Central Bosnia	*Federation Sarajevo*	*Federation Tuzla*	*Federation Neretva*	*RS*
Primary	669	1,098	757	800	623
Secondary	950	1,358	813	1,188	507
Tertiary	--	1,282	1,529	553	1,266

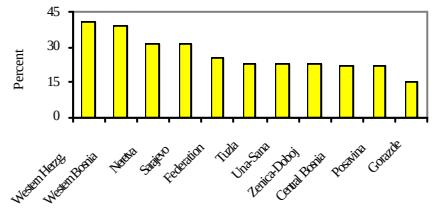
Source: Official data.

4.62 In the Federation, there is clearly a need for improving the equality of public spending on education. This can be achieved by the introduction of an equalization fund to be managed by the Federation government, as in the case of the recently introduced solidarity fund in the health sector (see next section). This fund could also be used to provide more support for quality. In RS, where the system is centrally financed, increased attention would simply need to be given to roughly equalizing financing per student across RS. This should involve a thorough assessment of municipal financing for secondary education in order to clearly understand total public spending on secondary education.

Table 4.15 Public Spending per Primary Student as a Share of Public Spending per Secondary Student, (2001)		
Federation	Neretva	0.71
	Central Bosnia	0.67
	Una-Sana	0.68
	Zenica Doboj	0.58
	Tuzla	0.79
	Sarajevo	0.55
	Gorazde	0.95
RS		1.23

Source: Official data.

Graph 4.4 General Secondary Students as a Percent of all Secondary Students across Cantons, 2001



Source: Official data, IMF-GFS, and staff estimates.

4.63 There is also an equity issue in the variations in the availability of academic or general secondary education relative to vocational secondary education across cantons in the Federation, (see Graph 4.4). Vocational secondary education remains the norm in all cantons but students in such cantons as Neretva, Sarajevo, Western Herzegovina and Western Bosnia have a much better chance of going on to general secondary education, hence they have greater chances to continue with higher education. Moreover, this ability to access higher education is clearly a problem for students in those cantons without universities and for minority students in cantons with universities.

4.64 Finally, while there appear to be no major gender equity issues in the education system in the Federation,[169] there does appear to be an equity issue for children needing special education—only 0.3[170] percent of all enrollment is in special education, compared with 2 percent in Western Europe; if anything, one would expect the proportion to be higher than the European average given the post-conflict nature of BiH.[171] There is also clearly an equity issue concerning refugee and minority access to the education system, as these groups are increasingly marginalized either in separate schools or in separate classes.

4.65 ***Public Education Expenditures - Unsustainable.*** The high level of education spending in BiH, especially in the Federation, and the present allocation of education spending with very little focus on O&M and capital investments, are not sustainable in the period ahead. At present, the education sector functions with significant wage arrears ranging between 3 and 6 months both in RS and in most of the cantons in the Federation. The introduction of both hard budget constraints and a more balanced appropriation of education resources is therefore critical in the period ahead, along with measures aimed at improving the efficiency and equity of education spending.

4.66 Primary education, which accounts for over half of total education spending in both Entities, is one area in which savings could be generated (see Table 4.16). This is not because secondary and higher education are more efficient, but because very low enrollment rates in these two levels suggest pressures for more spending as a much-needed increase in enrollment is achieved in the period ahead. Any expenditure adjustments in primary education should be made in the context of a mechanism that will more nearly equalize spending per pupil across the Federation's cantons and within RS.

Table 4.16 Percent Shares of Different Education Levels in

	Primary		*Secondary*		*Tertiary*	
	Federation	*RS*	*Federation*	*RS*	*Federation*	*RS*
1997	55.4	71.3	30.4	19.8	14.2	8.9
1998	53.0	57.8	28.3	30.1	18.7	12.1
1999	56.9	62.2	29.6	25.1	13.5	12.7
2000	..	61.5	..	22.7	..	15.8

Sources: Federation Office of Statistics (2001). RS Ministry of Education (2001); World Bank (2000) and OECD (1998) data sources.

Education Outcomes and Quality

4.67 Quality has two dimensions: what is supposed to be taught (curriculum, etc.), and what is actually taught and learned. In the absence of any assessment data, a thorough analysis of what is being learned and how this relates to inputs and costs is not possible in BiH. The partial evidence available, however, raises concerns about the present quality of education in BiH, a country that used to have high academic standards and a high learning achievement.[172]

- ***The curriculum and the structure of education are increasingly out-of-date, especially at the upper primary and secondary levels.*** At the same time, standards are too high. At the primary level, for instance, the entire curriculum is overloaded and the upper grades are dominated by single subject requirements rather than a more modern approach encompassing an integrated range of learning. At the secondary level, vocational education predominates, with higher unit costs and with less relevance to the modern economy than general secondary education. Vocational graduates learn specific skills that they may not be able to apply once they enter the labor force, while general graduates learn a

[169] In the Federation, 51 percent of pre-school students are girls and 52 percent of higher education students are female. No data are available for primary and secondary education in the Federation.
[170] Based on information given by Federal and cantonal ministry officials.
[171] Officials explain this outcome with the tendency to enroll students with special needs in regular schools in BiH with an objective of expediting their adoptation into a regular education environment.
[172] It is encouraging for the future, however, that a Standards and Assessments Agency, financed under the World Bank's Education III project, has recently been established with donor support in the Federation; it will be important to support its work thoroughly and to provide similar services in RS.

broader range of skills, including the critical skills needed to acquire skills. At all levels, standards are prohibitive and are also used to divide students at too early a stage into academic, and vocational streams. Academic secondary enrollments are about one-third of their level in Western Europe.

- ***All recent reform efforts have been narrowly focused*** on applying ethnic separation to the school system rather than on supporting integration and the establishment of a common core of learning in BiH.
- ***Teacher quality appears to be declining across BiH***, in large part no doubt reflecting low morale in the light of continuous salary arrears, but also because salaries are tied to seniority rather than to training or performance. There is no strategy for upgrading teaching skills via in-service programs and there are parallel programs in various secondary schools, academies, and universities, all uncoordinated. The present modality of training for specialized primary teachers is very unusual by international standards and highly inefficient; and the proportion of unskilled teachers, is increasing.
- ***There is insufficient spending on learning materials and teacher training.*** Almost all education spending goes for salaries and for running school facilities (utilities, etc.). This leaves very little (often nothing) for books, equipment, and teacher training.
- ***Physical facilities are inadequate.*** In some localities, primary schools operate in three shifts. While two shifts may be an efficient use of facilities, three per day raises questions about the amount of effective instruction that pupils receive. In addition, unless maintenance and capital investment are adequately increased, rapid deterioration of the education system's physical facilities is unavoidable.
- ***Faculty sizes in higher education are very low.*** Not only is this inefficient in view of the proliferation of many fragmented higher education institutions, but it also results in faculties that are too small to assure quality instruction.

Recommendations:

4.68 The BiH's excessively fragmented education system is hardly functional with its high unit costs, mounting arrears, poor outcomes, and highly inequitable service provision. A comprehensive reform of the system is very much needed, with an urgent priority to address critical data needs that will help formulate an informed reform strategy:

Reduced Fragmentation, Improved Equity

- Establish a federal expenditure equalization fund in the Federation in order to achieve more equalized spending per pupil, especially in primary education. Such a fund could also support other functions across cantons, such as standard-setting, assessment, teacher training, and the like. The equalization of the central education spending per pupil must also given priority in RS.
- Assign tertiary education to the central government, ideally to the State or at least to the Federal government in the Federation, although a longer term objective should be to create an environment for gradually transferring both the provision and the financing of tertiary education services to the private sector.
- Provide public funding for pre-school to better concentrate on poor children.
- Introduce a transparent mechanism whereby attendance at universities can be financed across cantons and across Entities.
- Establish the university, not the faculty, as the legal entity in higher education.

Financing and Budgeting

- Replace the complex current formulas for determining school and university budgets with simpler formulas, based largely on the number of students, their backgrounds, and the school's condition and location (in general education) and on demand and relative costs (in higher education). Expenditures agreed under such formulas should be expanded to include building maintenance and capital investment as well as instructional materials and teacher training.

- Expand budgets in higher education to include revenues from private sources.
- Introduce multi-year improvement and expenditure planning practices for schools and universities.
- Link higher education supply and fees more directly to demand.
- Design a strategy for reducing unit costs throughout the system.

Relevance, Standards, and Assessment

- Simplify and reduce the single subject requirements in the upper primary grades.
- Prevent further expansion of vocational secondary enrollments while encouraging the expansion of academic secondary enrollments.
- Establish a mutual recognition mechanism in higher education, throughout the country, through the new Higher Education Coordination Board.
- Improve teacher training, especially in-service training for primary teachers.
- Encourage the emergence of the almost non existent private sector.

Data and Analysis

- Improve transparency and comprehensiveness in education and education finance data within a framework that will allow regular monitoring and consolidation at the central level in both Entities. This is particularly urgent in RS, where key information is virtually unavailable.
- Introduce a system for converting part-time student and teacher numbers into full-time equivalents.
- Undertake an urgent analysis to understand why secondary enrollments are so low.
- Analyze the W&S at each education level with a view to clarify reasons for excessively high unit spending in BiH.

C. HEALTH

4.69 ***Overview***. The last several years have seen the beginning of wide-ranging reforms in the health sector, covering the scope, financing, costing, organization, and management of health care services. Today, reform in the health sector is much more advanced than in the other social sectors, including reform in the area of inter-Entity and intra-Federation cooperation. Nevertheless, the share of health spending in GDP remains unusually high, which, along with the prevailing weaknesses in the efficiency, equity, and quality of the health services, calls for deeper reforms, if financial sustainability is to be restored to the sector. As with the other social sectors, the most important challenge is to modernize health services, while reintegrating the system so as to allow better exploitation of economies of scale in the delivery, financing, and administration of health care in BiH. The following paragraphs assess the present status of the policy and institutional frameworks in health care, with a focus on the efficiency and equity of public spending and the quality of outcomes. The assessment concludes with an overview of reform actions needed to improve financial sustainability and health outcomes over the medium term.

Institutional and Policy Context

4.70 The State government has no explicit role in health in BiH, and the two Entities are fully responsible for all aspects of health policy and administration. Within the Federation, this responsibility is further divided among 10 cantons. Thus, all-in-all, the health sector consists of 12 distinct health systems that are loosely coordinated: one is in RS; 10 are in each canton in the Federation; and another is in the Brcko District.[173]

[173] At present, the Entities and the District are working on a much needed arrangement for providing the District population with access to the tertiary care facilities of the clinical centers in the Entities.

4.71 In ***Republika Srpska***, health care is regulated by the central government[174] within a fairly simple institutional structure with three main institutions: (i) the Ministry of Health and Social Welfare (MoHSW), which is responsible, inter alia, for establishing the policy framework for health, overseeing the regulation of the health sector, and managing the secondary and tertiary levels of the health care delivery system (the RS government owns all hospitals, as well as public health institutes); (ii) the Institute of Public Health (IPH), which is responsible for key public health tasks and reports to MoHSW;[175] and (iii) the Public Health Insurance Fund (PHIF), which is responsible for overseeing and implementing the statutory system of compulsory and voluntary health insurance. The key responsibilities concerning primary health care are assigned to local governments along with ownership of the primary health care facilities.

4.72 The resource base for the HIF comes from contributions by the insured, payments by other contributors, and other specified sources.[176] The insurance system covers all RS citizens and other specified people in relation to health protection, compensation for earnings lost by temporary employment incapacity, and certain other rights. The HIF administers the health financing system partly through eight regional offices.[177] At present, the respective policymaking responsibilities of MoHSW and HIF are unclear, often resulting in mixed and overlapping authority. In addition, policy decisions are often made on an ad hoc basis rather than on the basis of a clear strategy and full information.

4.73 In the ***Federation***, institutional and policy structure in the sector is much more complicated due to the somewhat unclear constitutional definition of the role that each government could play in the sector and to present extreme decentralization of responsibilities in the sector (see Box 4.3): The Federation is responsible for specified public health functions,[178] special care for Federation military and internal affairs personnel, and a unified health statistics system. Cantons are responsible, within their areas, for other public health measures, health care delivery systems, Federally legislated health insurance, and coroner's services. Thus, each canton is basically responsible for organizing, managing, financing, and providing health care.

Box 4.3 Constitutional Description of Functional Assignments in the Federation's Health Sector

The Federation's Constitution states: "Both the Federation Government and the Cantons have responsibilities for" (*inter alia*) health and social welfare policy. Article III.3 states that these responsibilities "may be exercised jointly or separately, or by the Cantons as coordinated by the Federation Government." Also, the Federation Government "has the right to make policy and enact laws concerning each of these responsibilities." However, "the Cantons shall act with respect for… coordinated approaches to inter-Cantonal matters…". Moreover, Article V.2 authorizes each Canton "to delegate or confer its responsibilities to Municipalities in its territory or to the Federation Government."

4.74 The Federation system functions through 10 cantonal ministries of health (MoH), which oversee the

[174] RS regulations require health care for children, pregnant women, and elderly people to be financed from public funds.

[175] These tasks include preventing and combating contagious disease epidemics, as well as uncovering and eliminating health problems arising from elemental and other occurrences and misfortunes; eradicating contagious diseases; monitoring the health of the population, hygienic and epidemiological conditions and undertaking measures for their improvement; detecting and eliminating factors detrimental to health in the environment; securing a sufficient quantity of blood for normal and emergency situations; and securing basic medicines.

[176] Insured categories include: employed, self-employed and agricultural workers; certain veterans, war invalids and their families; registered unemployed and formally redundant people; certain categories of students; those receiving pensions, training allowances, or regular financial assistance; institutionalized people; refugees and displaced persons; family members of many insured people; and certain others. People also derive health insurance rights if they are injured at work or contract work-related illnesses.

[177] Four of these offices are collection/distribution branches; with the other four are of a "satellite" nature.

[178] Specifically: reportable contagious diseases, quarantine, minimum living standards for good health, compulsory immunization against childhood diseases, prevention of malignancies and AIDS, health education and promotion; and treatment of uninsured people with tuberculosis.

organization and financing of health care services at the cantonal level. Similarly, each canton has public health institutes, implementing its assigned functions and health insurance institutes raising revenue, and financing expenditures.[179] The Federal MoH provides some coordination among cantons, but, practically, many decisions related to health care provision and finance are made at the cantonal level. Common policy/institutional measures to be adopted through the Federation Health Care Law requires joint decision making and the consent of cantons—which is responsible to the cantonal governments and cantonal parliaments—with a limited role for the Federation in full enforcement.

4.75 Recently, through such a consultative process, the Federation and the cantons have agreed on a very critical policy change, aimed at reducing the existing wide variations across cantons in access to tertiary health services. To this end, a Federation Heath Insurance Fund (FHIF) has been established and a portion[180] of the cantonal health insurance contributions, along with equivalent transfers from the Federal budget, have been assigned to the FHIF. The Fund will finance potentially catastrophic tertiary health services and selected expensive vertical services, such as hemodialysis. Both the coverage of FHIF services and the amount of cantonal contributions to the FHIF will be subject to annual review and revisions as necessary.

Delivery Systems and Policies

4.76 The main elements of the two Entities' health systems are similar. There are four types of hospitals: clinical centers (3 in the Federation and 2 in RS), general acute hospitals (14 in the Federation and 9 in RS), specialized hospitals (4 in the Federation and 3 in RS), and small district hospitals (12 in the Federation). BiH had 3.7 beds per 1,000 residents in 1999 (3.6 in the Federation and 3.8 in RS), lower than the pre-conflict rates, but broadly in line with the World Health Organization's (WHO) norm of 4 beds per 1,000 resident in the region, thanks to extensive donor-funded reconstruction/rehabilitation efforts. Hospital utilization rates are also somewhat below their pre-conflict levels. More important, owing to the fragmentation of the health system across the country, both the availability of hospital beds and their rate of use varies considerably, especially across the cantons of the Federation, with limited access to some services in certain localities.[181]

4.77 Primary health care has traditionally been provided through two kinds of institutions: health centers and health stations. Health centers are outpatient clinics providing not only basic care but also an array of specialized services. At present, the number of health centers in BiH is relatively large, and the extensive technology installed in them is often underutilized, leading to redundancy of structures and equipment.

4.78 Both Entities have invested significant efforts and made progress in developing strategic plans for reconstructing and reforming their delivery policies and systems.[182] In each case, these strategies are framed in terms of the language of WHO's "Health For All" program in a fairly harmonized manner across the Entities. These new strategies emphasize the need for rebuilding the health system with a much stronger emphasis on prevention, health promotion, and primary health care.[183] Given the public good nature of

---

[179] Cantonal health insurance funds were established starting in 2000, with assistance from the World Bank under the heath finance reform element of the PFSAC II. This system, by directing the payroll contributions for health from cantonal budgets to the health insurance funds, aimed at improving the transparency and accountability in the management of the heath care resources.

[180] Amounting to about 8 percent of the payroll-health tax revenues during the first year of implementation. This scheme was also one of the key elements of the health finance reforms supported under the World Bank's PFSAC II.

[181] E. Jakubowski and N. Jaganac. Restructuring Hospitals: Bosnia and Herzegovina, *Eurohealth*, Vol.&; Number 3; pp 51-53.

[182] These efforts are primarily assisted by the WHO, the World Bank, and the European Union PHARE project.

[183] Under the new system, the primary care will continue to be provided through health centers and their attached health stations. In a major change, however, teams of newly trained family doctors and family medicine nurses will constitute the primary level

many primary care services (e.g., positive externalities arising from disease control), this shift in emphasis will certainly improve the allocative efficiency of the public health care funds in both Entities. Within this framework, both Entities have begun developing a so-called basic benefits package to be provided under compulsory social insurance. In the case of RS, the emerging package provides benefits only for the insured, which puts the government under pressure to ensure funding for vulnerable groups. In the case of the Federation, the strategy is eventually to establish a uniform, Federation-wide package, with schemes in place to ensure equal access to the package across the Federation. An initial building block for this is being established, as described in para. 4.74 above. As part of their overall strategies, both Entities also envisage that hospital networks will be planned at the Entity level.[184]

Financing and Expenditures

4.79 The structural complexity of BiH's health sector is mirrored in the complexity of the flow and the use of funds within the sector (see Box 4.4). Understanding this complex structure is, in turn, the only means for answering the following critical questions: How much is BiH spending on health? Who ultimately pays for health care? What care is purchased? Who uses health services, and what characteristics of users correlate with health care use? What organizations are intermediaries in the process through which health care is provided and financed?

Box 4.4 Flow of Funds within the Health Sector in BiH[1]

The structure of flow of fund is fairly complex in BiH. The economic agents who represent sources of funds for the health system consist of households, public and private employers, the Pension and Disability Fund, the Employment Fund, the central Entity government, the cantonal governments in the Federation, municipalities, and local and international donor organizations. Households, in particular, provide funding for health services in several forms: taxes to various levels of government; taxes to the extra-budgetary Pension and Disability Fund and Employment Fund (which pay health insurance contributions to the Health Insurance Fund); health insurance contributions paid directly to the Health Insurance Fund; official co-payments; informal payments to providers; and payments to cover specific costs (like medicine or food).

The funds originating from these sources are used by several kinds of allocating agencies: households (which also purchase care directly); employers (which provide health services for employees); the Health Insurance Fund; government (through payments made directly or under the direction of Ministries of Health); Ministries of Health; municipalities; and donors. These funds are allocated to a variety of uses (and their providers): primary care services; secondary care services; tertiary care services; the Public Health Institute and other central-level provider agencies; administrative costs of the Health Insurance Fund and other agencies; and the cost of "other rights" funded by the Health Insurance Fund.

[1]For details, see *1999 Health Resource Accounts in BiH: Report of Methods and Results*, United Kingdom Department for International Development, Know How Fund and Health and Life Sciences Partnership, 2000.

4.80 An information system which is increasingly capable of answering these questions is being put in place by the health authorities in both Entities, with assistance from the United Kingdom Department for International Development. This system has provided the basis for the preparation of the "health resource accounts" (HRA) for 1997 through 1999, with increasingly complete coverage. Nevertheless, the initial HRA fell short of capturing private spending on health, which is quite significant in BiH, as noted in paras. 4.83-4.84. Starting in 1999, households were asked directly to report their private expenditures on health. Estimates based on these survey data are, however, not yet integrated into the HRA estimates. Similarly, the HRA accounts do not yet capture health activities occurring in private facilities, or the functions of ministries of health, public health institutes, and so on.

---

of public health care. Once the change is fully introduced, the health centers will then house only family medicine; and the specialists currently within health centers will be located at the secondary and tertiary levels of the health care system.

[184] Major privatization of hospitals is not foreseen on a major scale. Rather, the intention is to reduce hospital admissions and improve the quality of the services, including through closing some hospitals and upgrading others.

Table 4.17 Health Sector - Reveneus and Expenditure, BiH, 1997-99			
	1997	*1998*	*1999*
BiH			
Health Revenues/GDP (%)	6.5	7.8	7.7
Health Expenditures/GDP (%)	6.9	7.9	8.0
Per Capita Health Expenditure	116	156	175
Federation			
Health Revenues/GDP (%)	7.3	7.9	8.0
Health Expenditures/GDP (%)	7.6	7.8	8.5
Per Capita Health Expenditure	163	196	226
RS			
Health Revenues/GDP (%)	3.8	7.4	6.8
Health Expenditures/GDP (%)	4.4	8.0	6.7
Per Capita Health Expenditure	43	95	98
Memo Items			
"Recorded" donor assistance in % of health revenues			
Federation	16.0	9.0	5.8
RS	23.0	8.0	..
Health insurance revenues in % of health revenues			
Federation	84.0	78.0	76.2
RS	77.0	70.0	n.a.
Federation health spending in % of BiH health spend.	85.7	76.1	77.9
RS health spending in % of BiH health spending	14.3	23.9	22.1
Per Capita GDP:			
Federation	2,150	2,496	2,673
RS	977	1,197	1,455

Note: Figures reflect public spending.
Source : Know How Fund and Health and Life Sciences Partnership: 1997-1999 Health Resource Accounts in BiH: Report of Methods and Results. U.K. DFID (2000); and staff estimates.

4.81 The HRA accounts show that overall health revenues in BiH were about 7.7 percent of GDP in 1999. The main source of health revenues are payroll contributions, which accounted for 75-80 percent of the total revenues in 1997-99. Donor resources, which provided means for essential heath services, especially during and right after the end of the conflict, have increasingly been diminishing, accounting only for 6 percent of revenues in 1999.[185] (see Table 4.17)

4.82 Recorded health expenditures were at 8 percent of GDP, more than three times as high as the average for the developed European countries (2.2 percent of GDP) and close to twice as high as the transition CEE countries in the region (4.4 percent of GDP)[186]. At the Entity level, health expenditures absorb a higher share of GDP in the Federation (8 percent) than in RS[187] (6.7 percent). Our estimated functional composition of consolidated general government accounts—which shows health expenditures that are fairly consistent with this picture—indicates that these parameters remained fairly unchanged in 2000.[188] Nevertheless, per capita spending on health remains below its pre-conflict level; for instance, the Federation MoH estimates per capita spending to be about 60 percent of its pre-conflict level. Both high BiH health expenditures and higher Federation health expenditures represent the high costs of operating a multi-tiered structure as well as inherent inefficiencies in the system.

4.83 In both Entities, legislated entitlements to publicly financed health care are far above resources that can be collected at present. This results in implicit rationing, with many people failing to receive the level of publicly provided care envisaged in the legislation. Within this group, some can afford to buy similar care from private health care providers. The data suggest that this is one of the main instruments in which the gap between needed care and publicly financed care is currently bridged in BiH. Another way to bridge the gap is for people to do without care, whatever the consequences for their health. A third mechanism involves the use of bribes or unofficial payments to public employees in publicly owned health care facilities to "reorder the queue" by giving priority access to the services to those making these payments. One-quarter of those receiving health care services in 1999—or about three-eighths of those receiving publicly provided care—reported making such payments.

[185] This figure reflects only the identified donor assistance and mainly that in the Federation. There are no good records on donor funds channeled into the RS health sector, though humanitarian aid played a major role in maintaining essential health services in RS as well. In both Entities, the major part of the humanitarian financial aid funded the purchase of drugs in hospitals (covering about 50-70 percent of total drug expenditures), though such drug supply often mismatched the actual needs, which resulted also in the accumulation of as fairly sizable outdated stock of drugs in BiH.

[186] The share of spending on health in BiH is still among the highest, if the comparison is made in terms of share in total public spending for a broad range of transition economies. The message for policy makers remains that improvements in access to health care must come from rationalization of the service delivery systems with a focus on exploitation of economies of scale and improved revenue collection systems. The alternative is that many people will be unable to access needed care.

[187] The sharp growth in the recorded share for RS since 1997 (when it was 3.7 percent of GDP) might have resulted largely from improved reporting over time.

[188] See Table 2.6 in Chapter II.

4.84 Indeed, once private spending on health is considered, total health spending in BiH increases considerably. The 1999 survey data on households' private health spending, administered in five regions of BiH, suggest that, on average, private health spending accounts for about 4.7 percent of GDP. *The survey results indicate not only that the total health spending in BiH could in reality be as high as 13 percent of GDP but also that private, "informal" (or unofficial) payments are widespread, non-trivial, and more closely related to access to care than to its quality* (see Box 4.5) .

Box 4.5 Main Features of Private Payments for Health in BiH

- 80 percent of individuals contribute toward the cost of hospital and non-hospital services;
- insurance status does not influence level of payment for non-hospital consultations;
- patients that do pay for hospital services pay nearly KM200 for a hospital admission;
- average spending for individuals who pay for a non-hospital consultation is KM49;
- average spending for individuals who buy medicines for non-hospital consultations is KM38;
- increased hospital spending is linked to longer lengths of stay;
- increased hospital spending does not necessarily lead to higher levels of perceived quality.

Source: Health Expenditure and Perceptions Survey, 1999: Analysis and Reporting – one each for the Federation and RS, Know How Fund and Health and Life Sciences Partnership, June, 2000.

Table 4.18 Federation - Health Reveneus and Expenditures, 1999

	1999
In % of Health Revenues	
Insurance Fund	76.2
Households	4.0
Donors	5.8
Other	14.0
In % of Health Insurance Revenues	
Public	70.0
Private	25.1
Pension Fund	2.8
Unemployed	1.0
In % of Health Expenditures	
Primary Health Care	34.5
Secondary Health Care	26.8
Tertiary Health Care	14.3
Other	24.4

Note: Figures reflect public spending.
Source : Know How Fund and Health and Life Sciences Partnership: 1999 Health Resource Accounts in BiH: Report of Methods and Results. U.K. DFID (2000); and staff estimates.

4.85 ***Federation***. Within the Federation, the health sector's estimated total income in 1999 from all measured sources was KM491 million (8 percent of GDP). The Insurance Fund was the dominant allocating agency, receiving and allocating 76 percent of this total. Households directly contributed 4 percent to the sector's income—divided roughly equally between co-payments by the insured and payments by the uninsured. Donors contributed and allocated 5.8 percent. Other allocating agencies (namely, employers, government, ministries of health, and municipalities) allocated 14 percent (see Table 4.18). Of the sector's total income, 79 percent found its way to health facilities. Of this amount, 70 percent came from the Health Insurance Fund; and almost 7 percent from donors—with humanitarian drugs being the largest donor component.

4.86 The major portion of the income of the Health Insurance Fund (75 percent) came from public employers and the rest from private employers. The Pension Fund and Employment Fund were minor income sources, contributing 2.8 percent and 1 percent, respectively—far below the required contribution levels. Farmers' contributions were negligible (0.07 percent). This picture, when further supported by the following demographic and economic indicators, clearly suggests that the public health insurance system in the Federation is balanced precariously on a very narrow base of formal employment: of the total population in 1999: (i) only 27 percent were in the registered labor force, while 56 percent were at age 20-64; (ii) 22.4 percent were displaced persons and returnees; 44 percent were people under 20 or over 64; and 2.2 percent were invalids—i.e., groups (which may overlap) that in general do not pay insurance contributions directly; (iii) 25.6 percent were directly covered and contributing to insurance (they also contributed for dependents who represented a further 38 percent of the population); and (iv) 36 percent were, therefore, not directly covered and required another source of financing for their health care.[189]

[189] For a detailed discussion, see UK DFID, 2000.

4.87 The total recorded expenditures of the sector were KM519 million (8.5 percent of GDP). Of recorded expenditures, primary, secondary and tertiary care accounted for 35 percent, 27 percent, and 14 percent, respectively. Nevertheless, these figures should be interpreted with caution, because they principally reflect public spending through formal channels. It is highly plausible that the large informal private health payments are more heavily concentrated on financing secondary and tertiary care than public spending. This overall picture also fails to reflect the present wide differences in the financing capacity of the cantons, with the per capita health spending varying between KM427 in Sarajevo and KM98 in Posavina.

4.88 One of the reasons for high cost of service delivery in the Federation is the present complicated, input-based formula for payment to hospitals. The formula reflects the existing capacity—i.e., the existing supply of infrastructure and personnel—which encourages overspending in the cantons. Similarly, the formula does not provide an incentive for providers to reduce duplication of services. High expenditures resulting flow from these patterns are currently leading to arrears, albeit largely unrecorded, that simply cannot be paid within a system in which overall expenditures for health are already extremely high.[190]

Table 4.19 Actual and Required Health Insurance Contribution Revenues in the Federation, 2000-2001 (KM, mln)

CANTONS	*2000 plan*	*2000 execution*	*2001 plan*	*Expected Growth index*	*2001 projection*	*Required Growth index*
Una-Sana	35	34	37.9	110%	60.9	177%
Posavina	6	6	6.5	110%	9.8	166%
Tuzla	70	68	74.9	110%	139.5	205%
Zenica	54	63	69.7	110%	112.9	178%
Gorazde	6	6	6.1	110%	7.6	136%
Central Bosnia	38	36	39.2	110%	55.1	155%
Neretva	50	49	53.4	110%	92.4	190%
West Herzegovina	13	14	15.0	110%	21	147%
Saraievo	122	134	147.1	110%	193.4	148%
Herzeg-Bosnia	12	10	11.2	110%	14.6	143%
Total Federation	*405*	*419*	*461.0*	*110%*	*711.4*	*170%*

Source: Federation Health Insurance Fund Projections.

4.89 Moreover, as noted above, if the legislated financial obligations of the health insurance system in the Federation were to be fully implemented, then the actual expenditures would have been much higher than the resources that the system could generate today. For instance, the Federation HIF projected that fully meeting legislated obligations in 2001 would have required on average a 70 percent growth in revenues between 2000 and 2001 against an expected revenue growth of only 10 percent in the original 2001 cantonal financing plans (Table 4.19).

4.90 ***Republika Srpska.*** Total revenues of the Public Health Insurance Fund (PHIF) in RS were KM148 million in 1999 (6.8 percent of GDP)—5.8 percent above the planned level and one-third higher than the amount recorded in 1998. These revenues are mostly retained by the eight branch offices of the PHIF, which, together with their subordinate municipal offices, are responsible for collecting and distributing most of these funds. The revenues were received primarily from enterprises and individuals employed in the public sector (81.4 percent of income). The PHIF also received supplementary revenues from the central government budget (3.7 percent—down from 7.5 percent in 1998). Donor financing largely remained unrecorded in 1999 (see Table 4.20).

Table 4.20 RS - Health Revenues and Expenditures, 1999

	1999
In % of Health Revenues	
Public Sector	81.4
Private Sector	3.3
Pension Fund	3.1
Unemployment Fund	0.2
Farmers	1.7
RS Government Budget	3.7
Donations	n.a.
Other	6.7
In % of Health Expenditures	
Primary Health Care	36.9
Secondary Health Care	34.5
Tertiary Health Care	18.0
Other	10.6

Note: Figures reflect public spending.
Source: Know How Fund and Health and Life Sciences Partnership: 1999 Health Resource Accounts in BiH: Report of Methods and Results. U.K. DFID (2000); and staff estimates.

4.91 These patterns of income collection clearly indicate that, as in the Federation, public sector employees cross-subsidized

[190] For details, see E. Jakubowski and N. Jaganac. *Op.cit.*

other categories of insured workers or individuals. For instance, monthly contributions per insured private worker averaged KM17 against expenditures of KM 26. Insured farmers contributed, on average, KM40 per month against average expenditures of 99 KM.[191] The Pension Fund contributed an average of KM2 per pensioners per month (instead of the required KM6 or so), while expenditures per pensioner averaged KM17 per month.

4.92 Direct health care spending accounted for the majority of recorded health spending by all RS branch offices (about 90 percent). Primary, secondary, and tertiary health care accounted, respectively, for 37 percent, 35 percent, and 18 percent of all spending. There has been a notable increase in the share of primary health care spending in total between 1998 and 1999 (by 5.7 percentage points), reflecting the beginnings of the planned gradual shift in the mix of services away from secondary and tertiary care (see Table 4.20).

4.93 As with the Federation, the legislated obligations of the PHIF exceed its resources by a large margin, making their full implementation impossible. In an effort to increase revenue collection and contain expenditures, the PHIF and the government introduced a number of measures during 2000-01. Key among these measures were the adoption of a more aggressive approach to revenue collection, including legal action directed at non-compliant employers, and the placing of pressure on EBFs to pay health insurance contributions due on behalf of their beneficiaries. These revenue measures are complemented by a more stringent approach on the expenditure side concerning (i) the care that the PHIF will cover; (ii) more effective methods of scrutinizing whether invoices submitted to the PHIF for payment relate to care for eligible insurers for whom paid contributions are up to date; and (iii) the imposition of an effective cap on Fund expenditures through capitation-based payments for primary health care and population-based limits on PHIF expenditures for the recurrent costs of hospital care. Taken together, these measures could significantly improve the financial discipline and efficiency of resource allocations in the system if they are aggressively enforced, which the RS authorities intend to ensure.

Health Outcomes and Quality

4.94 Based on the above review, the present performance of the health sector in BiH has considerable scope for improving efficiency, equity and sustainability of public health spending along with quality of outcomes. This is further elaborated in the following paragraphs.

4.95 ***Does the system effectively promote good health and prevent avoidable illness?*** While most available health indicators in BiH are acceptable for low-income countries, BiH's health sector, like others in Eastern Europe, under-emphasizes health promotion and disease prevention. This feature, which is partly inherited from the former SFRY system, is exacerbated by the extreme fragmentation of the health delivery system in the current context. Clearly, having an efficient disease prevention system (covering food, water, disease control, etc.) in a small country in which public health functions and activities are divided among a dozen administrative agencies is a difficult task. One issue is the efficient coordination of these activities. Another is the fragmentation of the limited number of highly competent specialized skills among so many institutions. Moreover, public health institutes in both Entities are barely surviving on revenues that are mainly collected through charges for licensing restaurants and some imports. Their role in planning, analysis, and informed decision-making is relatively weak. Therefore, there is a need to review and reorganize the structure of essential public health functions.

[191] In most municipalities, farmers only participated in insurance if they were in the category of people with "risk" diseases entailing high treatment costs. In those areas, the tax base for other farmers' contributions—cadastred income—had not yet been determined. Farm families include an estimated 150,000 people, or one-seventh of the RS population.

4.96 ***When people need care, are there barriers to access?*** A number of barriers hinder access to care for some BiH residents. First, publicly promised health care is considerably un-funded, which results in rationing of services. Second, systematic arrears in the payment of insurance contributions for certain groups, such as pensioners, displaced persons, and returnees, and some groups of unemployed, render their access to insured care uncertain. Third, insurance coverage, in general, is not portable for people who need care while traveling or residing outside the geographic region of BiH. These problems will become more pronounced, to the extent that health insurance institutions balance their budgets partly by denying reimbursement to patients whose insurance contributions are not current. Fourth, while health survey data suggest that health care services are mostly physically available to those who need them across the Entities, coordination of cross-border care seems to be a problem for people near cantonal or Entity boundaries.

4.97 ***Is the care that is available financially affordable for all?*** As noted earlier, payments for health care in BiH are of three kinds: formal co-payments for insured care; unofficial and/or illegal payments to publicly employed providers of care; and payments to private providers of care. There is little evidence that formal co-payments represent a significant barrier to care. There is, however, evidence that people in the lowest income tier in BiH pay, to people in official capacities, an average of 7 percent of their incomes in bribes and other unofficial payments for all purposes, including, but not limited to, health care.[192] Payments for privately provided care can also be large: nearly KM200 (30-40 percent of average wages in the Entities) on average for a hospital admission; and nearly KM50 on average for a non-hospital consultation. Thus, people without effective health insurance coverage or significant private income are likely to experience financial barriers when seeking access to health care.

4.98 ***Is the quality of the available care satisfactory?*** Health surveys and technical assessments reveal mixed results. Surveys show considerable consumer satisfaction with the health care that users themselves have received—particularly when this care is provided by private doctors. However, there is gross public dissatisfaction with the overall functioning of the health care system as a whole in BiH (see Box 4.6). Technical assessments point to the potential for improving the quality of health care in many areas. They emphasize the following: the wrong mix of primary, secondary, and tertiary levels of care and facilities; unfamiliarity with Western-style primary care; shortages of materials and equipment; uneven knowledge of "evidence-based" medical protocols; and a physician-dominated health care system that does not utilize the potential for nurses and other health professionals to play larger quality-enhancing and cost-effective roles.

4.99 ***Do policy makers, facility managers, and clinical providers have available to them timely and accurate information that is essential for their efficient functioning and/or for adopting to changing circumstances that call for a policy response?*** Information systems that are needed for efficient functioning of the health system and for efficiency-enhancing improvements are under-developed. Health insurance funds are still developing systems to track individual contribution histories and the care for which providers seek insurance reimbursement. Hospitals lack effective management information systems needed for systematic monitoring of resource use and case outcomes—both are prerequisites for managing contracts that guarantee the delivery of specified levels of services within budget constraints. Most clinical and other record-keeping systems are manual. In both Entities, the technical capacities of the sector are severely stretched by the day-to-day pressures of keeping the system operational and at least minimally funded, which leaves little scope for the development of major reform initiatives.

---

[192] Within the health sector, those who received health services in 2000, 26 percent reported paying bribes (money, gifts, or reciprocal services). However, among those needing to use services frequently paid bribes each time and so could find bribes a serious burden on their finances. For those respondents at the lowest income levels, the mean share of income represented by bribes for all (health and non-health) reasons was over 7 percent. For details, see "Bosnia and Herzegovina: Diagnostic Surveys of Corruption," World Bank 2001.

Box 4.6 Perceived Quality of Care in BiH Health Care Systems

How do people in BiH view the quality of the health care they receive and of the systems that provide it? Two studies yield recent information from well-designed surveys:

A World Bank diagnostic study of patterns of corruption, which was requested by the governments of BiH, asked 700 public officials, 350 enterprise managers, and 1,200 individuals from the general public about their views on corruption and related matters in BiH. Among the general public, 64 percent indicated that they were very satisfied or fairly satisfied with health services, while 18 percent indicated that they were very dissatisfied or fairly dissatisfied. However, the customers of private health services reported higher rates of satisfaction with quality than the customers of the public services. The differential in reported rates of satisfaction was big in relation to waiting times and significantly big for the quality of medical care itself and for satisfaction with the facilities.

These data on satisfaction or dissatisfaction with care can be compared with those from sample surveys of health expenditures and perceptions conducted separately during 1999 for families in the Federation and RS. The proportion of respondents in RS who rated the care they personally had received as good or very good was 58 percent for GPs, 66 percent for specialists, and 79 percent for private doctors. In the Federation, the corresponding proportions were higher: 71 percent, 75 percent, and 85 percent. Overall satisfaction rates were quite high. Satisfaction with private doctors was clearly higher.

Yet the same respondents' satisfaction with the overall system of health care was much lower. In RS, only 7 percent of respondents in 2000 thought the system was functioning well, whereas 57 percent thought it required fundamental changes or complete restructuring. In the Federation, only 3 percent of respondents in 1999 thought the system was functioning well, whereas 67 percent thought it required fundamental changes or complete restructuring. As compared with respondents in RS, therefore, those in the Federation reported higher rates of satisfaction with the care they personally received, but were also more critical of the system as a whole.

Sources: World Bank; "Bosnia and Herzegovina: Diagnostic Surveys of Corruption". (2001); UK Department for International Development, Know How Fund: (i) "Health Expenditure and Perceptions Survey, 1999: Analysis and Reporting" – one each for Federation and for RS (2000); (ii) Report on "RS - survey on healthcare expenditures, perceptions of the population on health care and analysis of household pharmacies," 2000; Federation Ministry of Health; "Public Knowledge and Awareness of the Health Sector in the Federation: Part 1 – Analysis and Reporting of 1999 Perceptions Survey," 2000.

4.100 These problems are further exacerbated in the Federation by its highly fragmented and loosely coordinated system for delivering and financing health. The present system limits the ability to drive systematic reforms and increases the financial fragility of the system. New, more systematic coordination and information-sharing systems are essential to reforms. Equally important, cantons should consider, at a minimum, delegating Entity government with the responsibility for preparing technical options for achieving a better balanced and more effective health care system within the Federation. These options could then be presented to cantonal policymakers for discussion along the lines that have been piloted over the last year. Particular emphasis should be given to shifting the policy and financing responsibilities for primary heath care services to the Federal Government; improving the coordination of care and the efficiency of resource use near cantonal boundaries; and reducing unnecessary duplication of health facilities and services in adjoining cantons.

4.101 Broader geographic coordination of such sectoral functions as goal-setting, policymaking, regulation, and management across the Entities, and the transferring of particular organization and management functions to the State government could also significantly improve efficiency. This would require: (i) the development of greater parallelism on many fronts, including legislation, regulations, health insurance entitlements, clinical protocols, accreditation processes, curricula for medical education, approaches to provider payment, criteria for monitoring and evaluating health-sector performance, and data definitions within management information systems; (ii) increased portability and reciprocity in health insurance coverage so that residents who are traveling or who move can maintain access to insured health care; and (iii) joint planning of programs to rationalize facilities and undertake new capital investments in geographic areas that straddle political boundaries. Some of these policies should be developed specifically for the Brcko District, which will never achieve a financially sustainable health system unless its system is well coordinated with those of the Entities.

4.102 The thrust of reform processes designed to improve monitoring and evaluation should involve a shift in the emphasis from control of sectoral inputs to the monitoring of sectoral outputs in both Entities. This means that the health ministries must develop capacities and systems for routine monitoring and for more in-depth evaluation of the health system's performance and of the effects on reforms on health status, quality of care, and financial risk protection. The outputs of the monitoring and evaluation activities would then need to be closely linked to decision-making within the health sector. Such a link between information and decision-making is the hallmark of a sustainable health policy process.

4.103 ***Is the financing of care equitable and efficient?*** At present, the financing of health care scores poorly on equity and efficiency, despite the good intentions of the system's designers. As in many other countries, BiH has based its public health financing system on mandatory Bismarckian social insurance principles, whereby universal access to services is intended to result from universal contributory participation. This approach places a heavy burden on payroll taxation, which, in the BiH's current context, facilitates evasion and avoidance including through the informalization of the economy. Moreover, as noted in Chapter II, most formal employment in BiH is in the public sector, which effectively results in insurance revenues being underwritten by the general tax base. Another source of financial fragility lies in the intended sources of insurance contributions for socially and economically disadvantaged groups (e.g., intra-EBF and budgetary transfers), which have proved unreliable and inadequate. Finally, the extreme fragmentation of delivery systems makes the use of hard-won/and-to-collect health insurance revenues highly inefficient across BiH. The system generally fails to exploit economies of scale in health care delivery, financing, and administration.

4.104 The gap between what the public system promises and what can finance/deliver has increasingly been supplemented by privately delivered care—currently, at least one-third of all care delivered. While the latter is perceived to be more efficient, it is generally less equitable since it is available only to those with significant levels of income. Another equity issue is the lack of effective mechanisms for financing users in the poorest communities. Wide variations in economic and fiscal capacities of cantons further aggravate this problem in the Federation, though recent arrangements for the solidarity and redistribution of funds may help address this problem more deeply over time.

4.105 One option for improving the equity and efficiency of public health finance could be a new insurance approach whereby (i) insured people are subject to an annual deductible amount that they must pay before receiving any insurance benefits, a co-payment for each service used, and a ceiling (maximum) level of cumulative annual out-of-pocket payments; and (ii) the levels set for the deductible, the co-payment, and the ceiling are all *functions* of personal or household incomes and/or assets. These changes could be accompanied by measures that would gradually lower the payroll contributions and, hence broaden the tax base for health insurance, combined with direct budgetary financing from the center (Entities or ideally the State) for delivering health care to the socially disadvantaged. Nevertheless, whatever the final modality of medium-term health finance reforms, the latter must be one of the building blocks if basic primary care is to be accessible for all citizens of BiH from all locations and ethnic backgrounds.

4.106 ***Are the roles of the public and private sectors clearly and appropriately defined?*** The post-conflict health system has been designed predominantly around publicly financed, publicly delivered care. The scarce resource envelope, however, does not permit this role to be carried out as intended, and policy-makers are losing their influence over who gets access to services, equity of access to services and scope of services as formal and informal payments become growing sources of income for medical personnel.

4.107 In these circumstances, how can policymakers best structure public funding of health while taking account of private consumers' response? As a matter of principle, the public sector should avoid paying for health care products and services that people are able to, and likely to pay, for themselves. Instead, the public sector's role should focus on public health (support for health promotion and disease prevention);

access to essential care for those least able to afford it; regulatory action to maintain the quality of health services provided; and sectoral development strategies that create a flexible, equitable, well-coordinated, mixed health care delivery system within which public and private providers can function efficiently and transparently (see Box 4.7).

Box 4.7 Designing Health Care Policies for Competitive Market Economies

All established market economies find health policy a perplexing challenge. Often, the structure of public funding for health care will reflect circumstances (i) where private markets tend to fail (for example, because of information gaps and asymmetries, missing markets, "spillover" effects that one person's consumption or production choices can have for other people, and barriers to entering or leaving markets) or (ii) where poverty would lead to unacceptable inequities. For example, in the absence of efficient private financial markets that fund investments in healthy, skilled, and economically productive people— that is, in "human capital"— one could expect the costs of crucial preventive and curative care for poor families to be largely publicly funded, with the share that is contributed privately growing over time as real incomes rise.

Health care systems and their incentives must be carefully designed, managed, and regulated, because markets for health care services differ from a competitive market structure. For example:

- Modern health financing systems incorporate risk pooling because typically, in any given year, 70 percent of all expenditures are concentrated on about 10 percent of the population.
- Providers—not consumers—often decide what care is consumed, because patients frequently delegate complex medical decisions to physicians. Once demand is not independent of supply, the incentives facing providers become crucial, because providers are imperfect agents for the health care consumers who are their patients.
- In market-oriented countries with higher per capita incomes and more satisfactorily functioning health insurance systems than those in BiH, both consumers and providers are often insensitive to the cost of health services. Health insurance makes consumers insensitive, even though it is a rational policy response to high but uncertain medical costs. Medical training and professional standards make providers insensitive, by encouraging them to provide all care with positive expected medical or diagnostic benefits, regardless of its marginal cost.
- Private insurance options require demanding regulatory systems if people who are poor or sick are not to be excluded from their scope.
- Changes in medical technology place an escalator under medical costs.

Source. Verdon S. Staines, "A Health Sector Strategy for the Europe and Central Asia Region," World Bank, 1999.

4.108 ***Are the health care financing and delivery systems sustainable?*** Health spending is extremely high in BiH, yet public health revenues fall well short of financing all the legislated entitlements. Among the main problems are the extreme fragmentation of health care delivery, the inefficient allocation of expenditures, the clinically inefficient approaches to care, poor compliance in revenue collection, and weak systems of management for the sector as a whole. If they are not addressed, systematically, these weaknesses could further challenge the already fragile financial sustainability of the system. Diminishing donor flows to the sector place additional financial pressures that call for the timely design of adequate reforms. Moreover, reforms focusing on the restructuring of delivery systems to lower costs and improve service quality will take years to implement, which makes their timely implementation all the more important.

4.109 In the near term, policymakers could improve the transparency and enforcement of revenue collection from employers or others who are liable through creating strong disincentives for avoidance; establishing a workable base for contributions in rural areas; and converting intra-EBF flows for health contributions into direct payments (see Recommendations, below). These types of reforms have been explored by both Entities recently, with the RS introducing measures to encourage better compliance and the Federation replacing indirect flows from the pension fund to the health funds with direct flows from the pension contribution base.

4.110 Another area where new approaches are needed for more cost-effective care is the provider payment modality, as the current supply-based criteria do not provide incentives for effective resource use. Both Entities have begun addressing this issue as well. In RS, primary health care is moving toward capitation-

based financing, and the Federation intends to introduce a form of prospective payment for hospitals. A further shift toward payment methods that create good incentives would require more sophisticated information. These systems are expensive and involve significant economies of scale. Therefore, managing provider payment and related health information systems from the State, or at least the Entity level, should be considered, if the benefits of these reforms are to be fully capitalized in BiH.

4.111 There are number of other cost and allocation efficiency reasons for considering a State role (or at least an Entity level role) in health finance. One is that the consolidation or rationalization of facilities and service networks could reduce fixed costs—a substantial share of health sector resources at present. Another is that only the State allocation of at least a portion of health funds would offer a large enough population base for the satisfactory pooling of the financial risks associated with care for people who have complex medical conditions or who need expensive treatment. Finally, a national/aggregate perspective is a prerequisite for achieving optimal decisions about the most efficient structure for a coordinated countrywide network of health facilities and services.

Recommendations:

4.112 Improving the efficiency, equity, quality, and financial sustainability of public health services in BiH requires wide-ranging reforms in the short to medium term, as described below:

Financial Discipline and Equity

- Improve the enforcement of revenue collection from employers and others who are liable, through: (i) providing more compliance audits of employers for the number of employees and average level of wages reported for social insurance purposes; (ii) making full payment of social insurance contributions a prerequisite for businesses to obtain licenses to operate; (iii) establishing a workable base for contributions in rural areas and levying intended land taxes in areas that do not currently enforce collection of these taxes; and (iv) changing the health payroll contribution structure for EBFs to a "direct" basis by eliminating intra-EBF transfers and adjusting the contribution rate payable to each EBF accordingly.
- Create a framework for reconciling consolidated commitments and realistically achievable revenues in each Entity to introduce financial discipline into the health finance system and assess the necessary policy and administrative changes.
- Decide whether the publicly insured provision of "non-emergency" health care services will be limited to those people with current contribution payments. If so, implement the policy. If not, redefine public health commitments accordingly or else budget to fund these fully.
- Establish, in the Federation, a technical group, to be composed of Federal and cantonal experts under the Federation MOH chairmanship, and to be responsible for developing a consensual program of coordinated health care and efficient and cost-effective resource use. Among the priority tasks should be assigning functions with positive externalities, especially primary care, to the Federal government, as in the case of recent reforms in selected tertiary services.
- Introduce (in the Federation), and continue to implement (in RS) hard budget constraints for health facilities and providers that have contracts with HIFs, covering the nature volume, quality and monitoring of health services to be purchased. Support these efforts with technical assistance programs that will help these facilities and providers better manage their costs, expenditures, and associated financial risks.
- Expand, in the medium term, these provider payment systems into global budgets for health care facilities, preferably within the framework of a per capita funding approach for a local geographic system (rather than an individual facility or provider), for encouraging and facilitating moving toward a more appropriate mix of services.

Role and Scope of the Public Sector in Health Care Delivery

- Review and narrow the public sector's role within the health system, focusing particularly on: (i) disease prevention and support for health promotion; (ii) access to essential care for those least able to afford it; and (iii) regulatory action to maintain the quality of health services provided.
- Develop a more efficient, flexible, and equitable health care delivery system through:
  - Reviewing the number of staff/W&S levels in facilities delivering health care against lower-income OECD norms consistent with the efficient provision of care;
  - Establishing a new, higher level of co-payments for publicly insured health care services provided in publicly owned facilities by publicly employed medical staff, while wholly or partly waiving fees for the thoroughly needy, who are unable to afford the full co-payments for necessary care;
  - Prohibiting receipt of private payments by publicly employed doctors for care they provide in publicly owned facilities as part of their normal duties.
  - Allowing private payments to non-publicly-employed doctors if they are transparent and do not conflict with related public policies.
  - Levying charges set at cost-recovery levels for the use of publicly owned facilities by doctors who are practicing privately to provide health services to individuals for private payment.
  - Considering whether HIF should reimburse the costs of care provided by publicly employed and private doctors on a uniform basis and, if so, what that level should be.

Effective Delivery Systems

- Design and implement a significant rationalization and optimization of the network of health facilities that would help reduce the system's fixed costs and release additional much needed resources for financing actual care for patients.
- Pursue the coordination of care and the rationalization of facility capabilities across Entity borders, and, in the Federation, across cantonal borders.
- Develop effective planning processes and cycles for capital investment decisions about new facilities, coupled with improved processes for health technology assessment and business planning.
- Review the overall effectiveness and efficiency with which pharmaceuticals are used in BiH, and refine the use of essential drug lists and strengthen the rational use of drugs.
- Strengthen procurement processes for equipment and materials (see Chapter V).

V. PUBLIC EXPENDITURE FRAMEWORK: INSTITUTIONAL DIMENSIONS

This Chapter presents joint findings of PEIR, CFAA, and CPAR on BiH's public expenditure management and financial accountability systems. After an introductory discussion (Section A), it assesses the budget planning process (Section B), illuminates challenges faced in making the budget an effective policy tool (Section C) and in improving budget execution through Treasury system (Section D), and identifies necessary steps toward streamlining financial accountability (Section E) with a view to help authorities define the medium-term reform priorities (Section F) directed to improve aggregate fiscal discipline, forge a stronger link between the policy priorities and budget, and strengthen transparency and accountability of fiscal management.

A. INTRODUCTION

5.1 Previous chapters have emphasized that effective economic management and public service delivery requires, not only well-designed macroeconomic and fiscal policies, but also well functioning public institutions and procedures that will help policy-makers formulate strategic policy choices and achieve policy objectives. This chapter, therefore, focuses on institutional arrangements for public expenditure management (PEM) and financial accountability. It both takes stock of wide-ranging reforms to date and defines the overall objectives for a medium-term reform agenda that will help BiH broaden and deepen its ongoing reform efforts.

5.2 Bosnia and Herzegovina has made significant strides in developing key elements of its PEM systems over the last six years. At present, the system operates within an improved legal and institutional framework inter alia for budget management, foreign debt management and external audit. Beginning in 1999, both Entities and selected cantons in the Federation began creating necessary conditions for improving the linkages between their macro-fiscal planning and budgeting within a simplified version of a medium term expenditure framework (MTEF). In 2000, an external audit body began operating both at the State level and in each Entity, gradually improving the transparency of the operation of the budgetary institutions. The closure of the Payment Bureaus (PB) in January 2001 marked the beginning of movement toward a Treasury system, with each Entity having its computerized Treasury system in place as of January 2002, albeit covering only State and Entity level budget transactions at the initial phase.

5.3 Considering that these reforms have been implemented against a backdrop of a dual process of nation building and economic transformation in a war-torn economy, they become all the more impressive. Nevertheless, these very challenges have often become a factor in slowing down the realization of full benefits of reforms because they translated into both weak implementation and enforcement capacity in BiH's fragmented governance framework. The obvious examples of this are widespread public payment arrears, large off-budget public sector activities and poor outcomes in resource allocations and quality of public services, which are discussed in previous chapters.

5.4 In the period ahead, much remains to be developed and aggressively implemented, if BiH's PEM and financial accountability systems are to help authorities move toward fiscal sustainability in a self-governed fiscal management framework. Effective institutional arrangements could help authorities in this endeavor through four avenues. They will:

- Enable the authorities to determine a credible aggregate fiscal strategy and to maintain aggregate fiscal discipline. A credible fiscal strategy provides the basis for a more predictable resource framework in the formulation of the budget. It also enables the government to maintain aggregate fiscal discipline over time that will be demonstrated in stable and sound economic indicators, sustainable debt levels, and no payment arrears;

- Enable the authorities to link the policy planning with budgetary processes, and direct scarce resources to their strategic priorities defined in a coherent multi-year budget strategy. In achieving these goals, the budget process itself provides the authorities with an instrument for contestable policy formulation and analytical basis, so that informed decisions can be made;
- Enable the authorities to use the resources efficiently and to provide good quality services at least cost, by streamlining the role of government, and by defining and using different alternatives for provision of public services;
- Enable the authorities to use a system of checks and balances for more transparent and accountable fiscal management and service delivery, through monitoring, evaluation and audit of finances and performance of budget programs and activities.

5.5 This chapter will assess the performance of BiH's PEM systems against these standards and will present reform options for moving towards their institutionalization.

B. BUDGET PLANNING PROCESS AND LEGAL FRAMEWORK

5.6 If the budget is to become an effective policy tool then the budget planning process should include the following key elements: (i) a macro-fiscal framework that defines the available resource envelope in a given period; (ii) the economic and sector policy framework that defines the objectives, priorities, and outcomes for key sectors and the economy as a whole, and; (iii) budget expenditure allocations that translate authorities' policy priorities into expenditure decisions, which meet those priorities most cost-effectively. If carried out effectively, the budget planning process could be a very powerful instrument in facilitating the consensus needed both for policy trade-offs called for by hard-budget constraints and for concomitant expenditure decisions at the highest levels of the government and legislature.

5.7 Despite considerable progress to date, BiH's present budget planning process falls short of meeting these requirements. Four areas of weaknesses explain this:

- Absence of a comprehensive resource framework for the budget;
- Weak enabling framework for sound budget planning;
- Weak capacity for budget and sector policy planning in the MoFs and line ministries;
- Fragmentation in policy formulation and decision-making processes.

5.8 ***Preparing a more comprehensive resource framework.*** The preparation of an aggregate fiscal resource framework should be the starting point in the budget formulation process. The framework should be sufficiently comprehensive to define the overall resources that the government will have available for allocation in the annual budget; in other words, it should define the hard-budget constraints. At present, institutional and human capacity obstacles as well as systemic obstacles impede the preparation of a reasonably comprehensive resource framework across-BiH governments. Eliminating the former type of obstacles will, by their nature, be a gradual process; it will require, not only continued technical assistance from the donors, but also authorities' increased attention to adequately staff core fiscal analysis/planning functions and to create incentives for maintaining the continuity. Eliminating the latter type of obstacles, however, requires that the authorities play a more prominent role in ensuring smooth information flow particularly between MoF, aid management bodies and EBFs, and between Entity and Sub-Entity governments.

5.9 The previous chapters identified a number of major systemic obstacles for preparing a comprehensive resource framework. These include (i) separation between investment and recurrent budget planning; (ii) disconnect between the budgetary management and the management of the EBF resources; (iii) fragmented resource management with particularly poor emphasis on consolidating externally financed

expenditures and off-budget domestic resources, such as privatization receipts, off-budget earmarked resources etc. As discussed in Chapter II, the total amount of identified resources from these three sources that remain unaccounted for in the resource framework, be it at the Entity or sub-Entity level, are extremely large—equivalent to over 45 percent of total Federation resources and over 35 percent of total RS resources in 2000. Therefore, their integration into the overall resource framework is essential to the preparation of a realistic and effective budgets in BiH.

5.10 *Integration of investment and recurrent budgets.* Resources received under external assistance programs represent an important element of public expenditure in BiH (13 percent in the Federation, 12 percent in RS in 2000), requiring that they should be subject to the procedures of planning, authorization and accountability provided by the budget. Nevertheless, despite significant efforts for their integration into the budget since 1999,[193] progress to date has remained limited. Currently, only budgetary support financing is thoroughly included in the Entity budgets. The majority of external financing received as project assistance remains effectively outside the budgets, although both Entities have been making efforts to capture "credit- financed" portion of the project assistance in their budgets, albeit in an annex form.[194]

5.11 A number of factors played a role in constraining the authorities' ability to achieve more tangible progress to date. The first factor is the scattered management of external project assistance through Project Implementation Units (PIU) outside the governments' budgeting system. This, however, was unavoidable given the sheer lack of capacities and systems to handle large and wide ranging reconstruction efforts in the post-conflict era.[195] In many cases there are several PIUs in one sector or in one ministry working for different donors. There is very little communication between the PIUs and aid coordination units of the government, and there are no systematic reporting lines to the government ministries. The second factor is the management and coordination of donor assistance through various State and the Entity aid-coordination bodies outside the MoFs, which are the main repository of information, yet have limited co-ordination with the donors, MoFs, and PIUs[196] as well with each other. Despite improvements over the last three years, the coverage of the database varies across the Entities, with no systematic reporting on investment planning and implementation. One of the main reasons for this outcome is lack of systematic flow of disbursement information—both actual and planned—from the PIUs. And the third factor is, relative to the extent of donor involvement in financing public investments, a limited and irregular direct flow of information from donors to the public aid-coordination bodies.

5.12 Given their largely public investment nature, the present treatment of external project assistance translates into separation of investment and recurrent budgets at all levels of government.[197] This practice,

---

[193] These efforts were assisted by the World Bank under the PFSAC II, which has envisaged initiation of a process toward a more comprehensive, multi-year budget planning process as one of its key structural budgetary reform elements.

[194] In both Entities, the central/Federal Budgets for 2000 included spending both on domestically financed capital projects and aggregate information on externally financed projects (with RS being better able to expand the coverage of external financing then the Federation due to availability of adequate data). This was expanded in the 2001-2002 budgets with the help of deeper analysis that was carried out through 2000-01 to update information on project commitments and expenditures.

[195] The intentions of both donors and the authorities is to incorporate PIUs into the line ministries pending the implementation of projects they manage, allowing, in the meantime, some capacity building in the public administration.

[196] They include the Ministry of Foreign Trade and Economic Relations and Ministry of Treasury at the State level, the Office of the Reconstruction Co-ordination Committee in the Prime Minister's office in the Federation, and the Aid Co-ordination and Development Unit in the Ministry of Foreign Economic Relations in RS. They undertake various functions, ranging from participation in project negotiation and preparation of legal documents, follow up of project implementation, maintenance of a project database etc. to the involvement in formulation of sector strategies and programming of investment needs. Despite their broad range of functions, in practice their role in investment planning and programming is limited due to lack of capacity. However, they remain the main repository of information on foreign financed investments, although received unsystematically by asking donors and PIUs.

[197] In the case of credit-financed projects, while Parliament is being asked to approve the servicing of the debt incurred on these projects, project financing during a particular year and associated expenditures are missing from the budgets. In the case of grant-

coupled with incremental budgeting on the recurrent expenditures, greatly impedes the authorities' ability to formulate a coherent budget strategy, which would subject investment decisions to the same decision-making and policy formulation rules as the recurrent expenditures. Therefore, integration of external assistance programs into the budget is necessary, both for the authorities to establish an appropriate balance between capital spending and recurrent spending, and to meet operations and maintenance costs as donor assistance phases out. This is becoming increasingly important given that the present on-budget expenditures are largely non-discretionary, thereby significantly reducing the role of the budget as a policy instrument.

5.13 **Recommendations:**

- In line with each Entity Government's recent decision, re-organize the aid-management function in each Entity for ensuring direct information flow to the MOF consistent with the budget process. The objective should be to eventually integrate the aid-management function with the MOF structure, transferring the management of foreign financed project databases to the newly established Treasuries;
- Define core project specific information that PIUs will be required to report periodically to the MOF through the aid–coordination bodies;
- Improve the consistency of the existing structure of project information with the budget classification structure;
- Systematize the timing of information collection from donors to make it compatible with the timing of the budget cycle;
- Initiate a process for inclusion of projects financed by external credits as capital expenditure in the relevant line ministry budgets (where there is no clear ministerial responsibility for the project, the expenditure could be included under the budget of the MoF); and clear identification of such expenditures as being externally financed (since they will be subject to different financial management procedures);
- Establish a requirement for estimating future recurrent cost implications of ongoing and new investment projects.

5.14 *Improving Extra-budgetary Funds' Financial Planning/Reporting.* Social Security Funds are the major extra-budgetary funds (EBFs) in BiH, comprising one-third of consolidated on-budget revenues in both Entities. They are administered off-budget and at central level in RS, and at both Federal and cantonal levels in the Federation, with cantons playing a larger role on balance. As discussed earlier, they are all underfunded and receive budgetary transfers of varying amounts, though transfers are of a systematic nature only in RS. Although the Entities' Organic Budget Laws require that EBFs present their financial plan for approval to the Ministry of Finance before the budget is submitted to the Parliament, and that their financial plan should subsequently be presented to the Parliament along with the annual budget law, in practice, these requirements are not being enforced. The financial troubles of the EBFs play a role in this outcome, delaying institutionalization of much needed transparent and sound financial planning and reporting rules for EBFs. This, in turn, further complicates administration of the EBFs by exposing them to rather ad-hoc crisis management all the time. Given their nature, the EBFs do not lend themselves for integration into the budgetary framework. Nonetheless, reporting on the EBFs should be greatly improved by enforcing the requirements of the Organic Budget Law for better scrutiny.

financed projects, their exclusion from the Budget makes it more difficult to plan and manage sector expenditure programs, and to ensure that adequate resources are available to meet the downstream recurrent costs of externally financed public investment.

5.15 **Recommendations:**

- Enforce provisions of the Organic Budget Law concerning the actions EBFs need to take for financial planning and reporting;
- Systematically define budgetary support that each EBF will receive during a fiscal year based on sound financial planning and reporting by the EBFs;
- Subject EBFs to the same annual auditing requirements as those of other fiscal accounts.

5.16 *Integrating Off-budget Resources Into the Budget.* The Entities have a number of other off-budget resources, including privatization receipts, and earmarked fees/surcharges and rental income, mainly at sub-Entity level, for discretionary financing of local activities. While it is possible to obtain information on the former (see Box 5.1), it is difficult to understand the latter group of off-budget resources, which are not included in the fiscal accounts and some are not reported at all. As in the case of EBFs, Entities Organic Budget Laws includes provisions defining, in general, which resources should be considered as "fiscal resources" and, hence, incorporated into the budget, notwithstanding their final use. Nevertheless, these provisions have not been systematically enforced. If the budgets are to provide a unified measure of public fiscal activity, the off-budget fiscal resources need to be incorporated into the budgets by all levels of governments. In the case of privatization resources, proper accounting practices, however, would require their recording as a financing item and their use to be included as a spending item of the final user.

Box 5.1 Off-budget Resources: The Case of Privatization Receipts

The bulk of privatization activities are carried out by (12) privatization agencies, one per Entity and each of the cantons of the Federation. These agencies channel privatization receipts across public administrative units as dictated by the Privatization Law.[1] Receipts are allocated to final users, and, in general, their use has been treated as off-budget spending by the final beneficiaries. Proper privatization accounting requires all these transactions to be recorded under the budget of their final beneficiary—more specifically, they should be recorded as a financing item and their use to be included as an spending item of the final user. The practice, in BiH, has been *ad-hoc*; with some agencies—such as the Federation Pension Fund—recording its revenues from privatization and their respective use, and most (Cantonal governments) keeping the spending financed with these funds completely outside the budget.

[1]In the Federation, some privatization receipts, equivalent to some 35 percent of total cash privatization receipts, accrued directly to sellers. This is the case of *enterprises* when they sold company assets without privatizing the company and of *municipalities* when they sold office space. The latter is now a discontinued practice as now the proceeds from sales of municipal office space is to be channeled through Privatization Agencies as the rest of privatizations, which made Municipalities favor renting their excess office space.

5.17 **Recommendations:**

- Set the rule of incorporating privatization receipts under the budget of their final beneficiary;
- Prepare an inventory of off-budget resources with a view to rationalize (so that cost of collection and administration will be reduced) and incorporate them into budget, starting with the 2003-fiscal year. These resources could still be directed to their original use, but they must be included in the budget submissions and subject to the same budget controls as other public fiscal resources.

5.18 ***Strengthening the Enabling Framework for Sound Budget Planning.*** Key elements of the budget planning process, especially an adequate budget formulation timetable and systems for facilitating the analysis, planning, review, and monitoring of the budget programs, remain weak or are in their infancy across BiH (see paras 5.5-5.62). The budget preparation timetable is the same across all governments, with the process being carried out during June-November of the current budget year. Box

5.2 presents the steps that are taken within this timetable.[198] Based on the time required for preparation and adoption of the budgets over the last few years, the timetable for the preparation of the budgets appears unrealistically short. The adoption of the budgets usually experiences delays, though they are gradually getting shorter. Delays are partly attributable to the often difficult process of preparing realistic budgets—i.e. consistent with the macro-fiscal programs agreed with the IMF/IFIs. Delays are also attributable to the difficulty of gaining legislative approval, especially in the Federation. This is largely explained by the lack of prior consultations and coordination with the various players in both Entities, which cause delays in the approval process. Unfortunately, the timetable itself is also too short for appropriate consultations and coordinated budget preparation across BiH's multi-tired governments.

Box 5.2 Main Steps in Budget Process

June 30	MoF submits a report on macro-fiscal.
July 22	MoF sends budget circular.
September 15	Line ministries prepare their submissions.
October 15	MoF prepares the budget and sends it to the Government.
November 15	Government reviews, approves and sends it to legislator.
December	House of Representatives discusses and approves.
December	House of People discusses and approves
December	MoF and line ministries send detailed allocations to the budget institutions for implementation.
	Budget is audited by Supreme Audit Institution at the end of the budget year.

5.19 The existing legal framework for budget management in both Entities involves key elements for budget formulation and fiscal discipline. They provide for MoFs to present a report on the macro-fiscal policies in the beginning of the budget formulation process and include provisions for maintaining fiscal balance in all instances during the formulation, approval and execution of the budget. As noted above, they also provide for comprehensive coverage of the budget, including extra-budgetary funds. However, as the BiH moves toward a more advanced phase in its economic recovery and transition process, a number of issues need to be addressed for improving the effectiveness of the legal framework, especially concerning the strategic focus and coverage of the budget, and coordination both between and within BiH's government tiers (see the next section). Equally important is the full enforcement of the existing legislative framework, especially those provisions concerning the coverage of the budget and the financial planning and reporting, which are least observed at present.

5.20 Similarly, there is a need for a greater reliance on by-laws, implementing regulations and operational guidelines both for more adequately defining the "principle budgetary laws," which are more or less in place now, and for providing a more flexible operational framework that can respond more quickly to a changing environment. For instance, the recent adoption of Sub-Entity borrowing guidelines in each Entity constitutes a good example for such a process. In the future, aid-management, roles and responsibilities regarding consolidation of fiscal accounts, multi-year budget plans etc. could be considered good candidates for further definition through by-laws and implementing regulations.

5.21 **Recommendations:**

- Amend the legislation to extend the timetable for the preparation of the annual budget to a full calendar year, beginning with the preparation of the multi-year budget planning process (see paras. 5.29-5.38).
- Include, among the rules and provisions of the Organic Budget Laws, provisions for (i) how, when and on what issues consultations and information exchange will be conducted between government levels in each government; (ii) for systematic bottom-up reporting; and (iii) for consolidation of the fiscal data at the center (i.e. State; RS; Federation);

[198] As of 2001, the annual budget in both Entities and the State has been subject to audit from the Supreme Audit Institutes.

- Strengthen the linkage between the macro-fiscal framework and the budget by providing for medium term forecasts and a statement on the budget's main policy objectives in the Organic Budget Laws. The Entity governments (and over time the State) should assume a principle role in defining the overall macro-fiscal parameters that will guide preparation of sub-Entity (and over-time sub-national) budgets;
- Strengthen the requirements for the justification of budget proposals from Budget Institutions, both by improving the specificity of the required information and by broadening the economic categories on which information is requested.[199]

5.22 ***Strengthening Capacities for Budget and Sectoral Planning – Adjusting the Role of MoFs to the Changing Needs of the Budget Process.*** In the context of initial MTEF phase, both Entities have made efforts to establish capacities for macro-fiscal management in MoFs and, to a lesser extent, for policy and programming in line ministries (see paras 5.32-5.35). A macro-fiscal department is established in the MOF within each Entity.[200] Nevertheless, they remain understaffed and lack expertise for effectively undertaking analytical functions. Moreover, the present fragmented fiscal management and reporting lines does not provide adequate fiscal data for a reasonably comprehensive fiscal analysis/monitoring work to be carried out. If the State and the Entities are to take a more prominent role in developing macro-fiscal program in BiH and improve predictability of their respective overall resource framework—hence, performance of their budgets—then capacity building in fiscal management will need to be made one of the priority tasks in the medium-term. In time, this will improve MoF's ability to assume a greater role in guiding the process of strategic fiscal policy choices and monitoring/informing role in the budget management process. It will also allow line ministries to make trade-offs within their overall budget and to direct their resources more efficiently towards sectoral priorities.[201]

5.23 **Recommendations:**

- In the short-run, continue to use international technical assistance (particularly, on-the-job training) to develop analytical capacity, with an objective to aggressively practice the new skills;
- Develop a strategy for knowledge/skill transfer from PIUs to the respective line ministries, which PIUs work with. Establish policy programming units in few key line ministries in the near term and gradually expand this to other sectors;
- Assign the macro-fiscal department in Entity MoFs with the role of fiscal consolidation analysis. As a first step in this direction, this assignment should envisage extension of the PEIR consolidation framework to 2001;
- Improve economic forecasting ability in MoFs by collecting direct information and economic forecasts from prominent public and private sector agencies and by closer coordination with key public sector institutions (such as tax and customs administrations, key line ministries, Central Bank, EBFs etc.);
- Assign macro-fiscal department in MoFs for specific sectors and the line ministry staff in the policy programming departments (as they are developed) for overall fiscal monitoring to help build joint synergies and policy/planning expertise;
- Establish a fiscal assessment capacity in the MoFs with respect to various delivery options for programs, where more than one government is involved;

[199] Present provisions of the Law are overly general, such as "Budget institutions' requests should contain the following: (a) a brief description and structure of employees and officials for which the budget funds are being requested; (b) an explanation of the foreseen needs; (c) proposed requests that refer to future liabilities including investments".
[200] In 2000 for the Federation and 2001 for RS.
[201] For more on this topic, see Allan Schick, "The Changing Role of the Budget Office," OECD, No. GD(97)109, Paris 1997.

- Assign lead role to policy programming departments, both in MoFs and the line ministries, in the MTEF process.

5.24 ***Improving Budget Policy Coherence and Decision Making.*** Fiscal management framework is a key factor in effective and coherent budget policy and decision making since it defines the way executive and legislative powers are exercised and decisions are taken with regard to economic/sector policies and resource allocations. As noted previously, in BiH, fiscal management is conducted separately in fourteen political structures, with independent executive and legislative powers. This makes achieving consensus and policy coherence more challenging, not only because of numerous, often ethnically based checks and balances that the system embodies (especially at the State and Federation levels), but also because of weak centers of government, with limited capacity in promoting binding and sustainable budget decisions and policy outcomes across-BiH. An obvious example of the latter is the present limited arrangements for securing adequate administrative, analytical, and to a lesser extent, legal guidance to the Cabinet of Ministers in both Entities and the State.[202]

5.25 The institutional fragmentation and weak centers of government challenges the budget policy formulation in two main dimensions; (i) it creates conditions for *policy paralysis* as a result of numerous players involved in policy formulation, and numerous veto points that can bloc the development and implementation of coherent policies, and; (ii) it creates conditions for *policy asymmetry* demonstrated in the formulation and implementation of incompatible policies by different levels of governments. The latter is more pronounced at the Federation level given the need for coordination with the ten cantons. It is also present at the State level with regard to policy coordination between the two Entities. Nevertheless, there is much scope to improve coordination even within RS.

5.26 Addressing these challenges requires a two-pronged strategy. First, as previously discussed, it requires establishing formal policy harmonization and coordination channels between the State and the Entities, between the Federation and its cantons and within the cantons themselves. In turn, an effective consultation process would require facilitating tools, e.g. a consolidated fiscal framework, joint sector strategy plans/implementation outcome reviews etc. Second, it requires effective organizational arrangements, operating rules, and high quality support that will improve policy formulation and review capacity at the center of government. While meeting these requirements is a long-term process, which will partly be driven with the evolving political structure in the country, there are measures that are within the reach of the authorities in the near term, especially in each Entity (see below para).

5.27 **Recommendations:**

- Establish a formal mechanism for fiscal coordination as described in Chapter III;[203]
- Review, in each government, the effectiveness of the center of government against the following benchmarks and develop a reform strategy; (i) the council of ministers serves as the ultimate decision making body; (ii) the head of government is able to influence decision making outcomes; (iii) ministers perceive the rules of the collective decision making process to be credible and enforceable; (iv) the decision-making dynamics within the council of

[202] The 2001-draft operating procedures of the RS Government provided a good example of solid basis on which to build institutional procedures and capacity to strengthen the government's decision-making system. They included features such as (i) establishment of three standing policy committees (economy and finance, social affairs, internal policy) to vet legislation and policy initiatives prior to review at the government meeting; (ii) material that proceeds to the government is preferably to be accompanied by research, analysis and impact assessments; (iii) alternatives to the preferred policy option are encouraged; (iv) executive summaries (no more than five pages) of lengthy analyses are required; (v) ministries are required to provide a "thematic" or strategic analysis to accompany their proposed work (legislative) program. The success of actual implementation of these procedures requires a detailed assessment, which is beyond the focus of this Report.

[203] See para. 3.46.

ministers forces policy trade-offs among competing priorities; and (v) high quality support is provided to the council of ministers;

- Establish, under the leadership of the center of the government, formal and more rigorous internal, intergovernmental, and public consultation requirements, and make it compulsory to undertake a policy analysis addressing the major issues arising from these consultations;
- Integrate the policy review and coordination functions with the budget process through the MTEF (see the following section);
- Establish a legal review and policy coordination function (working with the cantonal MoF) at the Cantonal PM offices in the Federation.

C. TOWARDS MAKING THE BUDGET AN EFFECTIVE POLICY TOOL

5.28 The effectiveness of the budget as a policy tool is determined by the ability of the budget process to discipline policy choices and to direct expenditure decisions toward policy priorities. Clearly, the extent to which the budget process will have such ability is determined by whether it has a time frame consistent with those of the overall policy objectives, which have their full budgetary impact over time. This is all the more important in BiH, given that structural reforms are gaining increasing importance in BiH's economic development as the reconstruction phase comes to an end. Credibly defining the reform priorities requires that the authorities increase attention to understanding both their medium-term fiscal stance and fiscal implications of policy choices, given the unavoidable decline in donor assistance. Developing a medium-term fiscal perspective is also essential to the realism of the poverty reduction strategy, which the authorities have well-recognized in their initial strategy (I-PRSP). Similarly, although it is a longer-term objective, moving towards meeting EU accession criteria, requires the ability to develop and to maintain a sound medium term fiscal framework.

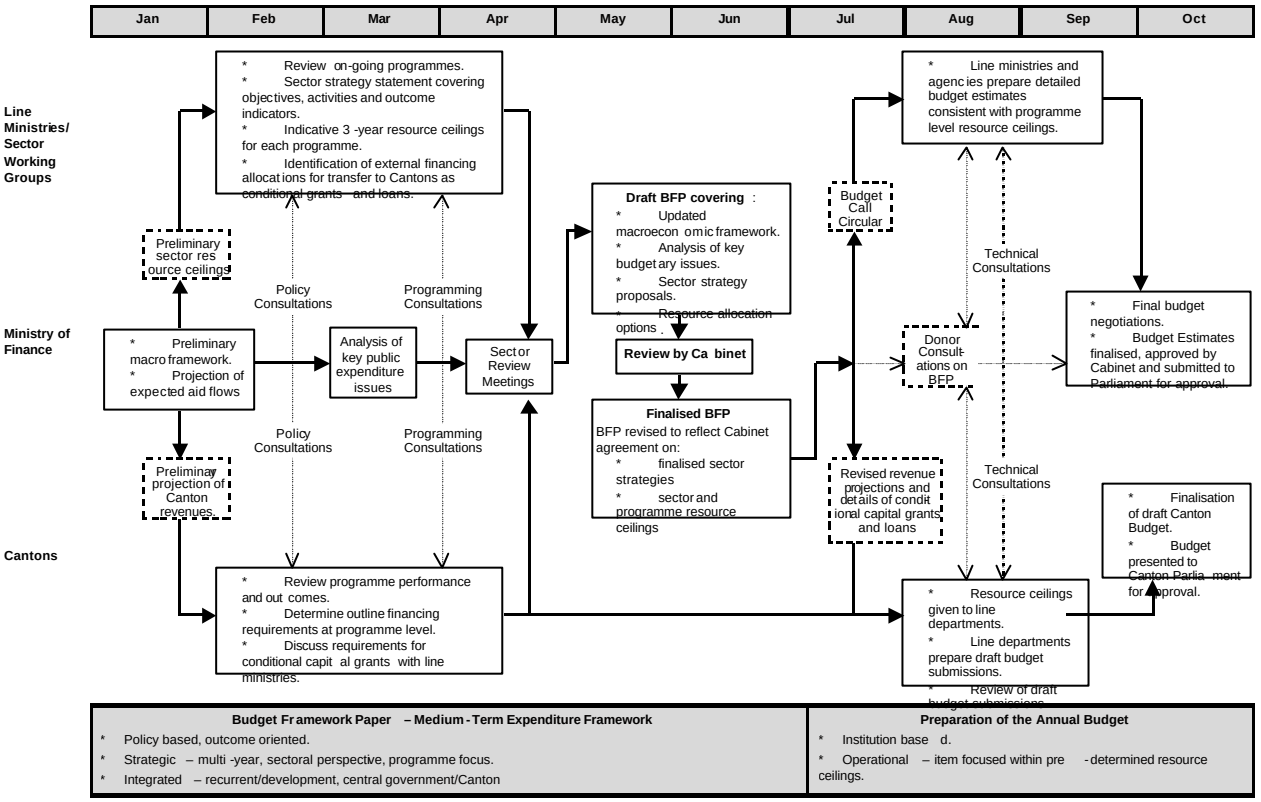
5.29 Although their budget process and institutions were at early stages of development, both Entities embarked in early 1999 on a challenging reform program towards improving the effectiveness of their budget process. The following objectives drove this initiative: (i) improving the budget coverage by integrating the donor financed investment programs into the budget; (ii) improving the linkage between the policy planning process and resource allocation; (iii) introducing a medium term perspective in the planning of government expenditures; and (iv) strengthening the economic policy and forecasting functions in the MoFs and programming capacities within line ministries; (v) coordinating between the MoF and line ministries within the Entities, and between the Federal and cantonal governments in the Federation.

5.30 Achieving these objectives required developing a two-pronged strategy: The first part focused on establishing an integrated approach to budget preparation in the form of a medium-term expenditure framework (MTEF), which culminated in the preparation of the main MTEF document—the Budget Framework Paper (BFP). It also aimed at consolidating the foreign financed investments into the budget. Both Entities initially prepared a one-year BFP in 1999, on time for the preparation of the 2000 budget. These initial documents were followed by a three-year BFP for 2001-2003, which was used to guide the preparation of the 2001 annual budget.[204] The second part focused on strengthening the institutional capacity and establishing a cooperative approach for budget planning/programming. The entire process was guided through external technical assistance.

[204] The time horizon for the MTEF was to be three years within which the MTEF would be revised and "rolled forward" each year.

5.31 ***Experience with the Introduction of the MTEF:*** As shown in Box 5.3, the MTEF was integrated with the budget cycle and prepared prior to the annual budget for guiding the preparation of the budget.[205] Institutional and capacity constraint meant that the preparation of the MTEF has adopted a limited and sequenced approach. The MTEF process involved three main elements. The first element was the preparation of the macroeconomic framework that provides the basis for projecting the resource base and the expenditure allocations, as well as the context against which key budget issues could be

Box. 5.3: MEDIUM-TERM EXPENDITURE FRAMEWORK AND BUDGETING CYCLE



analyzed. Efforts were focused on developing domestic capacities for macroeconomic forecast and analysis that would gradually be able reduce the reliance on IMF/WB for these purposes. In the course of two years, both Entity governments established their macroeconomic functions within the MoFs. These functions, however, are in their infancies and require further support for capacity building.

5.32 The second element was the sector strategy framework, which establishes the overall policy objectives for the sector as well as strategic program areas. The aim was to demonstrate credible formulation of the strategic shifts in inter-sectoral resource allocations and to develop a tool for monitoring and evaluating sector program outcomes. The sector analysis was limited to a few pilot, yet important, sectors in terms of their share in public spending—health, education and transport in the Federation, and education and transport in RS, which were expanded to include social sectors in both Entities in the second MTEF cycle. Nevertheless, limited analysis of the other sectors was included in the framework to ensure consistency. The sectoral strategy frameworks was developed by Sector Working Groups, which comprised the technical experts in each sector along with the MOF representatives.

[205] In both MTEF cycles, the respective BFPs were approved by each Entity's Cabinet prior to the approval of the budgets. In RS, the BFP was also presented to Parliament together with budget for 2000.

5.33 Complementing this process, the third element was the sectoral expenditure plans—covering both recurrent and investment allocations—developed against overall resource constraints. This involved major efforts to incorporate externally financed projects, both within the sectoral and the overall Entity budgets. Success was limited since the classification and coverage of the data was not suitable for budget preparation purposes (see para 5.10-5.14). Assistance and guidelines were provided to both Entities to deal with these issues, which helped in introducing the domestically and externally financed capital expenditures into budgets, albeit limited in coverage.

5.34 Finally, in the Federation, the MTEF process was extended in the second round to include pilot cantons (Sarajevo and Central Bosnia), of which MoFs and line ministries participated in the overall Federation exercise and prepared their own BFPs for 2001-2003.[206] This broader process has clearly revealed the benefits of coordinated sectoral analysis given the major role that cantons play in delivering social services. In addition, interactions with the cantons highlighted several weaknesses in their budget management systems to be addressed through the MTEF approach. These included (i) a tendency to increase the wage bill allocations and to crowd out the operations and maintenance expenditures resulting in a less effective use of available resources; (ii) the need for increased policy coordination between Federal and cantonal governments prior to changes in tax and spending policies of importance to the cantons as well as the need for increased attention to analyzing implication of policy decisions; (iii) the need for a transparent and equitable mechanism for on-lending from the Federal Government of external financing for canton-level projects; (iv) varying experience with modes of local consultations on the budget issues; and (v) the need for coordination of sector policy reforms with significant budgeting implications for cantons. Overall, cantons found the exercise very useful for improving contacts with the Federal Government and for receiving more information on the fiscal aggregates that helped them prepare their own budget plans.

5.35 ***Looking Back – Benefits of the initial MTEF phase.*** The MTEF exercise met a number of its objectives. It helped Entity Governments improve their analytical focus for budget formulation by designing/using the analysis undertaken under the MTEF as a basis for the preparation of their annual budgets. The reform process helped the Governments and the MoFs identify the kind of data, information, and analyses needed to achieve a better policy focus in allocating budget resources. More importantly, it raised governments' awareness about the need to improve information on foreign financed investment projects, to adopt an integrated approach to budgeting and to link aid-management function with the budget process. The MTEF process also improved the cooperation between the MoFs, line ministries and aid coordination units. All the participating institutions appreciated the increased level of consultations in the process and the benefits this brought in own-budget preparation. The pilot cantons, in particular, found the process useful to their own budgetary process, especially in bringing their own perspectives about fiscal and sectoral policies to the fore, and in understanding the broader fiscal picture in the Federation.

5.36 ***Looking Forward – Institutionalizing the MTEF.*** While the MTEF exercise continues to be well-received and recognized as an important element of the annual budget cycle, a number of factors imposed challenges in sustaining and further developing the exercise, once the external technical assistance was scaled back in 2001. These include organizational and staffing constraints in the Entities; underdeveloped planning and programming capacities in line ministries; and difficulties in ensuring a regular flow of consistent external financing information to the MoFs. Challenges in maintaining a reasonable coordination between MoF and line ministries, even at the same level of government, have also been considerable—e.g. the MoFs in both Entities were concerned that the sector expenditure

[206] Discussions were open to cantons, in general, and some attended number of working group meetings.

strategy exercise fell outside the MoFs' mandated responsibilities, while the evaluation of line ministry expenditure plans against the delivery of government policies is, in fact, a core function of any MoF. As noted above, without internalizing the MTEF process, at a depth most practical, it will be difficult for the authorities to define and to meet their longer-term strategic development priorities within a fiscally viable framework in an environment of diminishing concessional assistance. This will have to be a gradual process, as budget supporting systems are also evolving over time. The steps recommended below will help in ensuring that, even if gradual, progress will be made.

5.37 **Recommendations:**

- Extend the budget preparation timetable to cover the entire fiscal year, particularly, with a view to analyzing, during the first half of the year, the multi-year implications of the current and coming years' spending through a consultative process, as an input to the preparation of the annual budgets. The legislative framework should also provide for consultative consolidation of the MTEF at the State level;
- Initiate the use of functional classification in budget preparation consistent across governments and with GFS;
- Increase the leadership role of the MoFs to provide adequate guidance to the line Ministries in the MTEF process through preparation of detailed guidelines;
- Analyze selected expenditure policy and management issues of strategic importance for the budget and/or for the macro-fiscal framework for the next round of the MTEF, drawing on the analysis of this PEIR and with a view to support expenditure policy reform options;
- Improve the annual budget guidelines sent to the line ministries to include a statement of objectives for the sector and better justification of their proposed activities;
- Seek agreement from donors (and PIUs) for timely reports on commitments and disbursements that are structured for smooth integration into the budget;
- Improve budget supporting systems through measures recommended in this chapter in general, which is critical to institutionalizing the MTEF process in the period ahead.

D. IMPROVING BUDGET EXECUTION THROUGH TREASURY SYSTEM

5.38 If the aggregate fiscal discipline is to be maintained throughout the implementation of the budget, then adequate procedures must exist to monitor budget institutions spending limits in the purchase of goods and services. Equally important is the availability of accurate data and information on actual costs of activities and budget programs to allow for adequate costing of sector policies in the medium term. Similarly, ensuring that spending is directed towards policy priorities requires timely and reliable management reports that will enable monitoring the use of resources and budget outcomes. All such features are usually provided by a well functioning treasury system.

5.39 ***Towards Establishment of Treasury Systems.*** The beginnings of preparatory work for the establishment of the Treasury systems in BiH dates back to 1999, when, in parallel with the work towards abolishing the Payment Bureaus, the Treasury system was first designed (see Box 5.4). To date, substantial progress has been made in establishing both the legal and institutional frameworks for the development of the Treasury Systems at the State and the Entity levels.[207] This has paved the way for

[207] RS has adopted a sound Treasury Law. A Treasury law was also adopted for the State. The Federation has, for the time being, a government regulation in place which is undergoing a significant revision in the process of being converted into a Law. Both Entities have also established a Treasury Department in their MOFs in the last two years. They include important functions of budget execution, accounting, information technology and audit. The State has created the Ministry of Treasury, which includes all the functions of budget and debt management.

operationalisation of a computerized Treasury General Ledger (TGL)[208] system in each Entity in January 2002, which manages all the budget transactions at the Federal budget and the central RS-budget. The State government has started operating with a similar computerized system, since June, 2002.[209] Both Entities and the State are currently operating according to the principles of the Treasury Single Accounts (TSA) system while finalizing the formal establishment of a TSA system, which will operate through Treasury Transit Accounts in commercial banks. In the cash-short environment of BiH, the effective operation of the TSA system is critical in ensuring that all governments efficiently use all idle cash balances and improve the management of arrears.

Box 5.4 Budget Execution Prior to the Closure of the Payment Bureaus

Until their closure in January 2001, the Payments Bureaus (PB) and Ministry of Finance (MoF) carried out limited budget execution functions, in both Entities and the State. After the budget was approved in the Parliament, the MoF's Budget Department prepared monthly allocation plans for budget institutions, which were sent to the PB for execution. The PB authorized payments against this limit, simply performing a banking service for the budget against a fairly high fee. A transaction slip was sent to the Budget Institutions (BI) and the MoF for every transaction that occurred. The PBs also sent banking statements to the M oF and BIs regularly, as they did for any other client using their services.

The process involved some rudimentary financial planning and cash management that were carried out by the BIs and the MoFs. Nevertheless, although the MoF prepared monthly allocation plans, spending authorizations were, in practice, given for much shorter periods, such as a week, based on the revenues that were coming into the governments' accounts. This was mainly due to the cash limitations and the need to limit expenditure arrears, which were rather common feature of the budget execution.

All in all, the system was inadequate for supporting a sound budget execution. While the MoFs monitored total allocations from the budget, they did not monitor actual spending, since there was no single account to consolidate governments' resources, although the information could have been found in the PB accounts. The predictability of funds for carrying out budget activities and prioritization were weak due to frequent changes in allocation plans during the month and the year. As a result, the budget ended up authorizing mostly non-discretionary payments such as wages and especially veteran benefits. Moreover, the lack of sufficient information and delays in the reporting of budget accounts, made it impossible to discover any inefficiency or abuse and take preventive actions.

5.40 These TGL systems are able to monitor budget institutions spending limits and budget allocations, and record transactions automatically according to a new and improved chart of accounts. If implemented properly, they will significantly increase the transparency and accountability in the execution of the budget. They will also provide timely and accurate information to be used in the budget planning and decision making process. As authorities move forward, a number of issues will, however, need to be addressed for reaping the full benefits of a sound Treasury system. They are discussed below.

5.41 ***Extending the Treasury System to Sub-Entity Level.*** As noted above, the newly established computerized TGLs operate only at the Entity level. This means that transitional treasury arrangements, which were in place through 2001, will continue to operate at the sub-Entity level. These arrangements, while ensuring an un-interrupted transactions and financing from the budget, do not allow adequate oversight for preventing abuse and mismanagement of the public funds (see Box 5.5)

[208] These efforts assisted by the USAID and the US Treasury.

[209] These systems were established through extensive external technical assistance with the USAID taking the lead in establishment of the computerized TGL system.

Box 5.5 Transitory Arrangements for the Treasury System

The closure of the PBs required the establishment of several systems to replace the functions that PBs use to perform, including transitory arrangement for budget execution functions at all government levels. These arrangements, however, focused almost entirely on the revenue side of the budget with little attention to expenditures.

Under these systems , banking arrangements for the budget execution were taken over by the commercial banks. Two main accounts, a Depository Account (DA), where collected revenues are consolidated, and a Transaction Account (TA), from where budget allocations are paid out, were established in selected banks in the name of the MoFs at each government. The BIs were, on the other hand, instructed to open individual accounts anywhere in the commercial banking system, which posed serious risks for the effective and transparent use of budgetary resources. Monthly budget allocations are transferred from the MoFs TA to the BIs accounts, which is the last point in a transaction that can be traced by the MoF. From this point on, any spending authorized from BIs can not be traced by the MoF, unless it is recorded and reported form the BI itself.

5.42 The design of a broader Treasury system ought to account for the Entities' unique governing structures while help to develop an integrated fiscal monitoring systems and unified standards for accounting and reporting. In this endeavor, while design of the broader Treasury system in the RS can follow a more classical model of a unitary entity with a relatively centralized budget, the design of the system in the Federation requires special attention to its 10 fiscally autonomous cantons.

5.43 Options in addressing these special design challenges are being discussed by the authorities and donors at present. Two options are worth noting, which are also emphasized in the joint IMF and World Bank treasury study.[210] One envisages the creation of a unified service for payment and accounting of government transactions (PAO), with offices in each canton and independent management of the Treasury Accounts at each level of government. Under this system, each canton has full authority for its budget preparation and execution. Cantonal treasuries remain responsible for allocating resources, authorizing spending and managing their TGL, while payment processing and day to day posting of the transactions into the TGL is done by the PAOs. The alternative to this system is the establishment of eleven independent Treasuries—one each in the Federation and the cantons. While the experience with the newly established TGL systems will help in the final design, it ought to be able to offer the following benefits of a PAO network:

- Enhancing much needed inter-government cooperation in the Federation, thereby fostering symmetric professional excellence in treasury management in all regions;
- Ensuring that standardized government financial regulations and treasury procedures conforming to international norms of efficiency, transparence and accountability are applied at all levels of government;
- Enabling the use of commonly shared computing and data communication resources;
- Enabling the use of uniform accounting and reporting format across the Federation;
- Eliminating the use of imprest accounts, ensuring adequate cash management and the use of TSA;
- Allowing for the use of professionally qualified and specially trained staff in TGL accounting, IT and other required disciplines;
- Ensuring economies of scale and elimination of redundancies/duplications in daily transaction management routines.

[210] For details, see "A strategy for the Development of Entity Treasury Systems," Joint World Bank-IMF Report, November 2000.

5.44 ***Handling the Cash Transactions Adequately.*** The newly established computerized treasuries will continue to rely on individual BI accounts—so called imprest accounts[211]—placed in the commercial banks, for part of their cash transactions (see Box 5.5). In order to limit the problems this creates, both Entities have made considerable progress in limiting cash transactions prior to the launch of the new system—they both reported less than 15% of cash transactions in early 2002. In the Federation, the MoF has prepared a new computerized payroll system under which all employees will be paid through bank accounts. The payroll system is treated as an accounting subsystem using a transit account specifically for wages, which also ensures that the commitment and payment phases are correctly accounted in the computerized TGL. The remaining cash transactions would, however, all need to be placed under Treasury control. In RS this will be achieved through the branch treasury offices. In the Federation however, the Treasury will only be present in Sarajevo and Mostar, and an interim solution of a limited number of impressed accounts (where replenishment is strictly connected to justification) may be needed for a small number of local units of Federal government operating in other cantons. At the State level, the only institutions that are located outside Sarajevo and might require a similar arrangement are the institutions of State Border Services. The need for all these individual BI accounts will be eliminated if the PAOs are to be added into the system in the period ahead.

5.45 ***Treatment of EBFs under the Treasury System.*** The legal framework in both Entities envisages that EBFs will be included in the Treasury system. As previously noted, the EBFs have their own management systems, budget and accounting rules and undertake a large volume of small-scale payments throughout each Entity. In the case of the Health Fund they also operate many subordinate medical facilities. Their inclusion in the Treasury system will necessarily involve a large increase in the volume of treasury work.

5.46 While eventual coverage of the EBFs in the Treasury system is desirable, a phased approach to this end will smooth out the increase in the coverage of the treasury systems. It should be possible initially for the Treasury to handle the EBFs Treasury Single Accounts. The commingling of such EBF and general budgetary resources, however, should be avoided, since in no way should the general budgets be automatically required to fund any EBF deficits. It may be possible to come to some agreement on short-term liquidity arrangements between the EBF-TSAs in the interests of an efficient cash management, but the terms and conditions of all such arrangements should be explicitly stated. As to the processing EBF transactions, it is recommended that they remain outside the treasury system at present and only when the treasury system has demonstrated capacity to handle this workload should there be any attempt to execute these operations through the treasury system.

5.47 This stepwise approach implies that EBFs, though they are institutions of general government, will remain excluded from immediate coverage in the treasury system. Therefore, an adequate reporting system will need to be urgently developed from the EBFs to the Entity treasuries, which will allow monitoring of their activities and consolidation of the general government accounts in both Entities. Achieving the latter objective requires that a similar reporting system be also developed for the municipal governments, which will also remain outside the coverage of the Entity treasuries, even when a cantonal treasury system be put in place.

5.48 **Recommendations:**

- Design the sub-Entity Treasury systems with a view to ensure uniformity in standards for accounting and reporting and to facilitate consolidated fiscal management and monitoring;

[211] Imprest Accounts are accounts outside the TSA system that work as a non-zero deposit account. They are constantly replenished through budget allocations in order to allow access to cash resources to remote budget users located far from the treasury office.

- Eliminate the use of individual BI accounts (i.e. imprest accounts) ensuring adequate cash management and the use of TSA;
- Adopt a phased approach to the inclusion of the EBFs in the Treasury;
- Establish a reporting system for EBFs and sub-Entity governments that will allow a full fledged monitoring of their activities and consolidation of their accounts with the rest of general government accounts in both Entities.

E. STREAMLINING PUBLIC FINANCIAL ACCOUNTABILITY

5.49 The strength of the public expenditure management systems in maintaining aggregate fiscal discipline and in allocating resources efficiently depends, to an important extent, on how well the institutions for financial accountability function. A well functioning system of financial accountability encompasses the following processes and mechanisms:

- Financial management processes—i.e. budgeting, accounting, reporting and auditing—that can provide a system of adequate controls and generate adequate information on government's transactions that allow review and analysis from concerned parties;
- An adequate institutional framework that is able to verify these controls and certify government's reporting and financial transactions, providing the necessary checks and balances to improve government performance and avoid mismanagement and abuse;
- Mechanisms for ensuring that essential information reaches those who need it, including disclosure of information in the public domain;

5.50 These key elements of an effective financial accountability are either being developed or being introduced in BiH. As noted earlier, the CFAA and CPAR studies reviewed, jointly with the PEIR, the strength of present legal and institutional frameworks in financial management and accountability, which complements the discussions on budget management so far in this chapter. In what follows, we will present the findings of this joint assessment concerning budgetary processes, public sector accounting, public sector internal and external auditing and public procurement.[212]

Financial Controls in the Budget Processes

5.51 ***Budget Execution.*** Until their closure in January 2001, the Payment Bureaus performed quasi financial control and reporting functions on the budget transactions. As noted earlier, the transitory treasury arrangements that were put in place after their closure, however, have provided only a very weak system of controls concerning expenditure management (see Box 5.5). While this situation has changed with the establishment, in January 2002, of computerized TGLs at the Federal Government level in the Federation and central government level in RS, the weak systems of financial controls are still present at the sub-Entity governments as well as concerning the EBFs. This is particular risky for the Federation finances, where cantons along with their municipalities account over 45 percent of general government spending.

5.52 At the Entity level, the new computerized TGL system will clearly bring more transparency and better management of budget expenditures because it provide a full system of controls and accountability, including (i) ex-ante controls on the legitimacy of the expenditures; (ii) posting of every transaction

[212] In addition, the CFAA provides a review of financial accountability frameworks in BiH for the private sector and provides an indication of the level of financial accountability risk in BiH. The CPAR undertakes an in depth review of public procurement system, including a risk assessment.

according to a newly adopted chart of accounts; (iii) automatic generation of periodic, comprehensive reports and information on budget execution; (iv) and systematic reconciliation with the banks on the BIs account balance. In the period ahead, their full scale implementation and their expansion to the sub-Entity level within a Treasury framework that will avoid institutionalizing fragmentation in fiscal management will go a long way to improving overall financial controls and accountability in BiH.

5.53 ***Budget Monitoring, Evaluation and Reporting.*** Despite progress, budget monitoring in BiH is currently limited to monitoring fiscal aggregates and ensuring, broadly, that the fiscal discipline is being maintained. It takes place in different forms during the course of budget implementation, starting with the monitoring of expenditure limits while monthly allocations are issued from the Treasury Departments in MoFs at the Entity level and cantonal budget departments in MoFs in the Federation. MoFs also try to monitor fiscal aggregates during the year through the quarterly data that is being reported from the BIs. A particular emphasis has been given to monitoring tax and customs revenue performance, which is very effectively assisted by EC's Customs and Fiscal Assistance Office to BiH and, hence, provides a broader monitoring possibility across each Entity. Nevertheless, there is no monitoring of consolidated fiscal aggregates for the Entities and for BiH as a whole, except for the monitoring provided by the IFIs. Particularly absent is any monitoring of municipal fiscal aggregates.

5.54 While monitoring fiscal performance is essential and should be rigorously advanced, more attention will also need to be paid to monitoring and analysis of other dimensions of budget management in BiH, such as budget policies and programs. For instance, very little is being done, both during the year and after the budget is closed, on how budget allocations are being spent, whether they are used for the purposes intended and whether they are achieving the intended results. Expanding the monitoring function to include these dimensions of budget management requires, in turn, a well functioning evaluation system, which allows managers to (i) determine how their resources are being used and whether spending on budget programs are contributing to the achievement of the original plan-objectives; and (ii) assess ongoing programs and policies and take corrective actions as necessary.[213]

5.55 These functions are not yet adequately developed in BiH, where, currently MoFs and line ministries perform no significant budget evaluation function. Planning of budget programs is mainly incremental, and the budget submissions process does not require for budget proposals to be accompanied by cost effectiveness or cost benefit analysis, including domestic investment proposals. Evaluation tools, such as client surveys, for internal use of the executive or for publication, are also largely absent at present. Obviously, effective and broad monitoring and evaluation of this sort requires good quality fiscal data and regular and systematic reporting from authorized departments. As noted earlier, establishing computerized treasuries constitutes a major step toward improving the completeness of the information base as well as timeliness and relevance of reporting on fiscal aggregates and implementation of budget programs, though as yet only at the Entity level.

5.56 Establishing an enabling environment for proper parliamentary budget oversight is another area, which requires attention in BiH. Public Accounts Committees (or Parliamentary Budget/Finance Committees) of the Parliament constitute a mechanism for administering accountability of the executive to the legislature. But in BiH, this mechanism has not yet been broadly established, except at the State

[213] Evaluation can take place ex-ante, during the implementation or ex-post, after the budget has been closed. During the budget preparation process the Budget Department, central agencies and budget institutions evaluate their policies and programs, in order to determine their performance and whether they should continue in the next budget year, be expanded or suspended and replaced with more efficient programs. During the course of implementation, evaluation enables that corrective actions are taken as needed for non-performing programs to restructure them and ensure better outcomes. Ex-post evaluations are often used to improve the design of future programs and contribute to the strategic policy decisions.

level, where the Committee has not yet been sufficiently empowered to function.[214] This perpetuates the vacuum of legislative scrutiny over the executive. Therefore, it is important to create a strong budget oversight function at all levels of government and to separate it from other legislative oversight functions while ensuring that an effective coordination and collaboration be established between Public Accounts Committees and Supreme Audit Institution (see para. 5.78)

Public Sector Accounting and Reporting

5.57 ***Budget Classification and Accounting Function.*** Improving systems of accounting and expenditure controls in the execution of budgetary transactions have been one of the primary reform elements, supported through extensive external technical assistance in BiH. Both Entities have developed a new budget classification and chart of accounts along with detailed procedures for their use at all levels of government. Nevertheless, actual implementation of these new systems to date has remained limited and asymmetric[215] with budget management mainly based on economic and administrative categories for planning, execution and monitoring purposes. The introduction of the new TGLs in each Entity, albeit only at the higher governments, will be the first tangible step towards change in this practice, since TGLs embodied the new chart of accounts. With the ongoing work towards introduction of the State TGL in mid-year, the State will also be using the new chart of accounts, compatible with these in the Entities.

5.58 As noted earlier, the new chart of accounts will improve the transparency and accountability in the execution and reporting of the budgetary transactions. Nevertheless, the categories of the accounting chart are too detailed for being useful for budget policy management purposes. Therefore, they need to be consolidated in a structured budget classification that, preferably, uses GFS compatible functional, economic and administrative categories.[216] This will not only help significantly improve policy analysis, but it will also allow close monitoring of actual implementation of policy priorities—both are critical, inter alia, for effectiveness of fiscal management as well as for ongoing work towards the preparation of the Poverty Reduction Strategy.

5.59 ***Accounting Standards.*** In both Entities accounting standards are issued by the respective standard-setting bodies.[217] Currently, while there is a fairly clear and detailed framework for financial reporting—based on International Accounting Standards (IAS)—existing accounting practices do not actually follow the applicable accounting policies and procedures, and actual practices are not well documented. This partly reflects the weak enforcement powers of standard-setting bodies, which lack authority, means, and resources to have the mandatory accounting standards correctly implemented or to sanction cases of non-observance.[218]

5.60 The poor application of existing standards is also partly explained by the unnecessarily complex IAS on which the Entity Accounting Standards are based on. Given the current capacity of BiH's public institutions, they are clearly too demanding. It might, therefore, be more appropriate to phase in their implementation based on real needs. A different standard-setting body, the Public Sector Committee

[214] At the State level, the Public Accounts Committee (PAC) is required to provide the government with its opinion before the annual budget is presented to the Assembly for discussion. However, the Committee is not working due to lack of proper structure, resources (staff, adequate office space, equipment), and a clear mandate.

[215] Only a few of the simpler elements of the new chart of accounts and classifications are being used at the Federal government level, Sarajevo Canton, and Central Sarajevo municipality.

[216] The new chart of accounts allows for such consolidation since the codification is compatible with the GFS classification.

[217] Institute for Accounting and Auditing (IAA) in the Federation and Association of Accountants and Auditors (AAA) in the RS.

[218] For instance, the RS MoF Accounting Department is staffed with four people, in charge of compiling all general budget organizations' accounts. In each Ministry, there is a person in charge of bookkeeping, but not always full-time or qualified for the job. For instance, in the Ministry of Sp ort, a secretary performs this function.

(PSC) of the International Federation of Accountants (IFAC), is actually in charge of issuing standards for the preparation of financial statements of budgetary institutions and other government agencies, i.e. International Public Sector Accounting Standards (IPSAS), which are more directly applicable to governments and other users in public sector's organizations.[219]

5.61 ***Accounting Systems.*** Despite the adoption of a subset of IAS by both Entities,[220] requiring a shift to accrual accounting, pure cash bookkeeping was in place (and is most likely to stay in place at the sub-Entity level in the near-term) prior to the introduction of the TGL—supplemented by a fragmented, rudimentary commitment tracking system, not integrated with the overall accounting system. Under this system, locally developed software packages were customized, in both Entities, to take into account the new budget classifications and to provide basic routines to compile classified reports, but many accounting functions remained semi-manual and paper-based.[221]

5.62 In the period ahead, computerized TGLs, which will be systematically applying commitment accounting, would allow optimization of cash management and tracking of arrears, a major break with the past, concerning especially the latter aspect. Over the medium term, a switch to modified accrual accounting system could be considered for a better commitment recording, an area where tangible improvement are yet to be achieved.[222] This would help public sector institutions to better understand their financial and economic position and would support decision-making. However, it is a shift which is well beyond BiH's current capabilities.

5.63 The full-scale implementation of TGLs could facilitate both Entities to draw up the necessary financial information, such as the existence, ownership and value of their assets and liabilities.[223] This will require maintaining adequate records for external inflows. The integration of sovereign debt management within the overall government accounting systems is another step that will need to be taken in the near term.[224]

---

[219] The PSC recognizes that many governments may not yet be in a position to adopt the accrual-based IPSASs. To assist them, the PSC has also developed an exposure draft ED 9 Financial Reporting under the Cash Basis of Accounting. ED 9 sets out the requirements for the presentation of the primary financial statement under the cash basis of accounting, as well as the statement's structure and minimum content requirements. The PSC is conducting field testing of this document before final release.

[220] A Rule Book, issued in 1999, indicates which IAS apply to the public sector and which do not, stating how each relevant standard applies, with a brief description of its content.

[221] These software were also reported to allow recording of purchase commitments at invoice stage, and their linkage when payment becomes due. This was the only element of commitment accounting being implemented. It must be noted that recording of commitments and monitoring their liquidation was based on reports received by the MOF from the line ministries and was performed as a parallel activity to conventional bookkeeping.

[222] Under the modified accrual basis, revenues (similar to receipts under the cash basis system) are recognized only when cash is received, while expenses and related liabilities (as differentiated from payments under the cash basis system) are recorded when incurred, irrespective of the time of cash disbursements. The modified accrual basis can sometimes be a more prudent, conservative approach to financial statements presentation and it is generally followed in cases where revenues cannot be measured until they are actually received (e.g. taxes, fines and fees), or where the timing and amounts to be collected on accounts receivable may be highly uncertain.

[223] As emphasized in earlier chapters, there are off-budget public liabilities, besides difficulties of quantifying contingent liabilities (for instance, guarantees issued by all levels of governments). Economic transactions with various counterparts within the public sector at large (especially implicit subsidies to public enterprises and utilities, publicly-owned banks, and other quasi-governmental organizations) are also not reflected in the accounting books.

[224] Presently, debt service is managed using a partial tracking database (single-entry, not linked to an accounting system and, thus, not allowing to record liabilities).

5.64 **Recommendations:**

- Enforce periodic budget execution reports by sub-Entity governments (not less than quarterly) and EBFs (monthly), with a specified content, which will allow analysis of important fiscal parameters;
- Initiate design of basic output measures to expand budget evaluation to cover outcomes of key budget policies and programs and integrate this into the annual budget process;
- Establish/empower parliamentary Public Accounts Committees (or Parliamentary Budget/Finance Committees) assigned with legislative budget oversight function at all key levels of government;
- Mobilize external assistance for consolidating the categories of the accounting chart in a structured budget classification that uses GFS compatible functional, economic and administrative categories;
- Consider measures that would make sure that those elements of IAS-based accounting standards that apply to BiH's current needs and systems will be given priority in enforcement, while the rest is phased in over time.

Public Sector Audit

5.65 Auditing, together with management controls and evaluation, are essential processes of the financial management systems in ensuring that planning, budgeting and the reported use of public resources conform to the laws and pursue the objectives defined by the Parliament and government. Audits in the public sector also have an important function in giving the ultimate responsible decision-makers (Parliament and government) and/or citizens a regular assurance on the quality of reports of how the taxpayer money has been spent.

5.66 There is a fundamental distinction between the two forms of audit: internal audit and external audit. The distinction concerns the scope and objectives of the auditor's remit as well as the degree of independence the auditor or the organization responsible for the audit has in relation to the entity and to whom the results of the audit are addressed. In a well developed system of checks and balances, internal audit is essentially a form of internal management control of the government agency, while external audit (both financial and performance audit) is totally independent from the executive and usually its findings are reported to the legislature.

5.67 These two forms of audit functions, structured along the described-lines in OECD countries, are at the early stages development in BiH, with technical assistance from donors. Progress to date has been mixed, with modern internal audit functions remaining largely absent, while independent, external audit functions have been largely institutionalized, with the setup of the Supreme Audit Institutions (SAIs) in late 2000.

5.68 ***Internal Audit.*** Until their dismantlement, Payment Bureaus were the key element of the internal controls system for public sector in BiH, a function inherited from the former SFRY system. They were in charge of the administration and quasi-audit functions of financial transactions broadly, including those of the various economic subjects—such as budgetary transactions, business entities and individual taxpayers. Under this system, MOF internal control functions were limited to basic, documentary controls over accounting and reporting of spending units, and custodial-type oversight. These functions were not conducted systematically or as part of any overall managerial control within an organization, but rather focused on investigations, relating to uncovering abuses of public officials in the use of property and economic resources, rather than preventing and/or minimizing their occurrence. In other words, they were "control activities" which fall somewhere between the internal control and internal audit.

5.69 At present, this surrogate of audit functions is still exercised by the MOF Inspection Units in both Entities and the Financial Police, with the latter particularly active in investigating financial frauds. Nevertheless, the Inspection Units have inadequate mandates, are insufficiently staffed, poorly equipped and scarcely trained to carry out their duties efficiently and effectively. In general, the present financial controls are characterized by on–site inspections, putting the emphasis on individual cases rather than on the establishment of comprehensive internal audit systems—with management responsible for ensuring the operation of appropriate controls for the ministry/agency—that are well-coordinated with the newly established external audit functions. As a result, auditing and related inspection activities are broadly fragmented and either overlap or fail to have adequate coverage. The present environment also makes it easy to circumvent the financial controls because (i) decisions to release funds in line ministries are often communicated vaguely, with cases of violation of statutes (for instance involving amounts for which no delegated authorizations exist); (ii) there are very little follow-up controls to ensure that funds have been spent as intended; (iii) accounting records and supporting documentation are incomplete, allowing for appropriate audit trail; and (iv) procurement methods are inappropriate and not properly enforced[225] (see paras 5-82-5.90).

5.70 With the development of the computerized Treasury systems, many basic internal financial control functions would be performed off-site as an integral element of the system by a unit within the Treasury. The Treasuries hold exclusive authority for transfer of funds, and this will substantially improve budget execution control and cash management functions. In particular, the operationalization of the TSAs will provide the necessary integrity of the overall flow of funds. Furthermore, the introduction of ex-ante controls over the legality of expenditure types and amounts (based on the budget appropriations approved by the Parliament and recorded in the TGL) and the introduction of financial controls over accounting and reporting will contribute to a more orderly and disciplined management of public finances. Among others, these controls will make it possible to perform selective checks on spending units or budgetary items that show significant and unexpected deviations from norms or desired patterns, contributing to the overall budget management monitoring and evaluation, and allowing corrective actions as necessary.

5.71 In a parallel track, adequate internal audit functions will need to be systematically introduced across government institutions in BiH for strengthening managerial accountability and controls, especially at the sub-Entity level, where the establishment of a Treasury system will take time. For capacity-building and cost-effectiveness reasons, this task should be seen as a sequenced, medium-term process. The most efficient approach in initiating the process will be to setup of a small, independent (from the various departments and agencies, i.e. solely answerable to the Minister), centralized and highly professional internal audit department within the MoFs at each Entity and cantons, working across the various governmental institutions, and gradually expanding it to municipalities and other public institutions.

5.72 The objective should be the implementation of a strong internal control framework, in accordance with internationally recognized standards.[226] That would not only allow audit functions to graduate from

[225] The results of the Special Audits (in the form of a limited scope review without audit assurance) undertaken, under the initiative of OHR/OSCE, in both the Federation (including in some cantons) and RS during February-May 2001, provide ample evidence about the absence of mechanisms that would protect public expenditures from corruption and incompetence. The Reviews emphasized that, in the transition from Payment Bureaux quasi-audit functions to a full-functioning treasury system (which would systematize financial controls over budget execution), the existing internal controls practices are inadequate for the protection of public assets of BiH against losses from fraud and negligence, and suggest that the establishment of a sound control environment is key to the improvement of financial accountability in BiH.

[226] The Integrated Framework for Internal Control published by the Committee of Sponsoring Organizations (COSO) can provide guidance in this critical area.

investigations conducted at the single transaction level to a system-audit approach, but also allow external audit system to rely upon internal audit system. An internal audit modality that could perform these functions has, in fact, been developed in 2000, with external assistance and in consultation with the Entities and cantons.[227] The model envisaged a gradual approach with priority given to compliance audit (i.e. adherence of administrative procedures to prescribed legal/regularity framework and published guidelines) at the initial phase, so that control and management of budgetary revenues and expenditures can be improved. Over time, internal audit function is to be broadened to include the operational efficiency of non-financial systems (organization, information technology, logistics etc.) and, eventually, the overall effectiveness with which the whole range of services are delivered, particularly in key line ministries. So far, three cantons (including Sarajevo, Tuzla and Bihac) have adopted this methodology and introduced internal audit functions.[228] Broadening these efforts requires Entity governments to take the lead, especially through transforming present inspection units in the Entity MoFs to strong internal audit units and to seek further external technical assistance for capacity building.

5.73 **Recommendations:**

- Building on the external technical assistance provided to date, adopt a legislative and organizational framework for a sound internal audit system both at the Entity and State levels;
- Develop a gradual implementation timetable for these frameworks starting with their implementation at each Entity and canton MoFs, working across the various governmental institutions, and gradually expanding it to municipalities and other public institutions.

5.74 ***External Audit***. An external audit function has been introduced in late 2000, with the operationalization of the Supreme Audit Institutions (SAI)—one each at the State and Entity level, with co-ordination arrangements under the State SAI, and a uniform legislative framework (see Box 5.6). The objective was to effectively address chronic weaknesses in financial transparency and accountability of the public administration in BiH. Although SAIs are still at their infancy, their operation to date has already verified how critical the external audit function to the transparency and reliability of public sector financial management systems is, as well as the credibility of government financial statements in BiH.

5.75 Since their establishment, all three SAIs have invested substantial efforts in capacity building[229] simultaneously with undertaking a significant audit of the public administration institutions—comprising large portion of sub-Entity governments in the case of the Entities. During this initial phase, poor accounting and financial reporting in the public sector has, however, been a major obstacle to the proper and timely audit of government finances—several budget beneficiaries and institutions were simply unable to provide the SAIs with their financial reports. Therefore, strict enforcement of existing rules and regulations on public sector financial accounting/reporting as well as ensuring SAIs' full access to auditable accounting records and other necessary financial information should become one of the urgent priorities for the State and the Entity governments in the near term.

---

[227] The assistance was provided under the audit reform component of the World Bank's PFSAC II. For details, see PFSAC II supervision reports (February 25, 2000-June 1, 2001 mission reports). The Model has been presented to the budget inspection staff through comprehensive training seminars held in both Entities.

[228] In particular, the Tuzla canton was the first to develop, based on the above-mentioned model and with the assistance from the WB PFSAC II team, an internal audit legislation which was adopted by its parliament in 2000. This legislation provides for an independent internal audit function within the canton, reporting to the Audit Committee of the Tuzla canton parliament. If implemented properly, the legislation will significantly improve the transparency of government financial operations in the Tuzla canton. This legislation, and the regulations made under it, could form a model for use throughout other cantons in the Federation as well as for the development of internal auditing of the Federation and Republika Sprska central governments.

[229] Thee efforts have been assisted by the Swedish International Development Agency (SIDA), which operated as institutional advisor to the SAIs during their start up phase.

Box. 5.6 The Structure of the Supreme Audit Institutions in BiH

The most critical aspect in designing an external audit system in BiH was to determine a feasible organizational structure that would enable several layers of largely autonomous governments to undertake sound audit functions within their jurisdictions while at the same time ensuring consistency of standards, methodology and quality across all levels of government. To achieve this, SAIs have been established in each Entity and at the State level for carrying out external audit functions of respective Entity and sub-Entity government activities and organizations.

In addition, by law, a Coordination Board of the Supreme Audit Institutions was instituted on the Auditing of the Financial Operations of the Institutions of Bosnia and Herzegovina (the State-level Audit Office). The Board, is the technical body of BiH SAIs, consisting of a Committee and a Secretariat. The three AGs and their deputies are members of the Coordination Committee, which is chaired by the Auditor General of the State Audit Office. The main functions of the Committee are to establish audit standards (to be consistently applied by the three SAIs); to ensure consistent audit quality; to assign responsibilities for joint audit activities; and to determine representation in international bodies. The members of the Coordination Board meet according to a fixed schedule on at least a quarterly basis. In April 2001 the Board adopted the INTOSAI Code of Ethics for public sector auditors.

The legislative framework unambiguously assigns ex-post, external audit functions to the three SAIs. The mandate of the SAIs is very broad, encompassing the verification of all public revenues and expenditures (i.e. their proper collection, legality and safeguard), as well as the proper custody of assets; the annual audit of accounts of ministries, courts and government bodies, municipalities, public funds and other public institutions. The mandate also extends to enterprises, companies or organizations partially or wholly owned, controlled or funded by the budget or other funds controlled or guaranteed by the parliament and/or the municipalities; as well as organizations or activities receiving government funds, loan or grants from the central government budgets and/or municipalities.

According to the law, the audit standards issued by the International Organization of Supreme Audit Institutions (INTOSAI) are to be applied by the three SAIs with regards to the fundamental aspect of the audit work (audit organization, documentation, reporting, and quality control). In addition, the SAIs are empowered to carry out ad hoc (special) audits at the request of the relevant parliament or at the legitimate request of a governmental organization. The BIH's SAIs were recognized by and have gained a membership in the INTOSAI in 2001.

5.76 At present, SAI's work is, necessarily, primarily focused on compliance audits, though they aim at developing the necessary skills to perform financial, or "certification," audits, which are among their mandates (see Box 5.6). To this effect, an activity with the most value-added for the SAIs is the preparation of good management reports, an important building block for a new, stronger control environment. Nevertheless, it is also an activity that requires further significant skills enhancements in all three SAIs, through continued external technical assistance.

5.77 Looking forward, beyond the continued need for capacity building in the SAIs, there are a number of issues, which will need to be addressed by the State and the Entity governments for facilitating a strong enabling environment for the SAIs. First and foremost, there is an immediate need to increase awareness, within public sector and broadly in BiH, about the role and mandate of the SAIs. Similarly, there is a need to institutionalize working relations and collaboration both between SAIs and respective Parliamentary Public Accounts Committees (PAC)—as the latter is established in time—and between SAIs and bodies in charge of governmental internal audit functions. The appreciation of the linkage and complementarities of sound government internal auditing functions and external audit activities is particularly important for creating synergies while avoiding duplication of efforts. There is also a need for creating a legal basis for permanent legislative oversight over the SAIs, through the establishment of dedicated Parliamentary Audit Committees.[230] At the same time, clear mechanisms and procedures should be established regulating the resolution of conflicts between auditors and auditees—currently the only requirement is that disagreement be simply recorded in the audit report.

[230] *Quis custodiet ipsos custodes?* or "Who shall oversee the overseers?" Juvenal, from the Satires.

5.78 In the near term, there is also a need to re-consider several provisions of the audit legislation, which are either diverted from the original uniform legal framework or defined vaguely during the process of final adoption of the State and Entity Laws on Supreme Audit. These provisions concern (i) the functions/responsibilities of the SAIs (e.g. in the State and the RS legislation, the present wording of the special audits oblige the SAIs to carry out all requested special audits, notwithstanding the established work program and priorities of the SAIs during a year, as opposed to the original provision allowing the SAIs to assess and determine the need for special audits); (ii) the mandate of the Federation SAI (e.g. the provision specifying cantonal and municipal audits as the responsibility of the Federation SAI is vague, and is, therefore, open to interpretation); and (iii) nomination of the Auditors General (AG) and the Deputies (in the Federation and RS, AG/Deputy AG are appointed by the Parliaments upon advice from the government; although subject to meeting a defined eligibility criteria, this creates room for politization of the process); and (iii) the removal of the Auditor General (AG) and Deputies from the office (present provisions leave room for discretion for the dismissal of the AG and Deputies on non-technical grounds and, therefore, poses risks to the AG's independence). Revisions to these provisions are necessary, not only for improving the strength of SAIs at all levels, but also for restoring the uniformity in the legislative framework. Currently, a list of amendments, incorporating the above noted changes have been drafted for all three SAIs, yet discussions, so far, have not gone beyond the level of relevant parliamentary committees[231] (see Box 5.7).

5.79 An equally important step towards strengthening the SAIs in the near term, is anchoring the institutional mandate of SAIs to the State and Entity Constitutions, as originally planned. This is a standard norm in countries with established traditions of public sector external audit. And, last but not the least, is the need for adequate financing for SAI activities, tied to the annual work plan. So far, despite the strength of the legislative framework in ensuring adequate and regular financing for the SAIs, in practice, financing arrangements, required difficult negotiations and fell short of meeting additional staff and capital expenditure needs (e.g. office and IT) for adequately equipping the SAIs' regional offices. Ensuring adequate funding and mobilization of the necessary external technical assistance for the SAIs should be an unconditional priority of the State and the Entity authorities if the SAIs are to rapidly assume the full range of activities assigned to them, all critical for effectively strengthening the public sector financial management.

5.80 **Recommendations:**

- Define needs and mobilize further external technical assistance for facilitating expansion of audit activities to cover all mandated areas;
- Enforce existing rules and regulations on public sector financial accounting/reporting and ensuring SAIs' full access to auditable accounting records and other necessary financial information;
- Adopt draft amendments to the legislative framework including recommendations in joint PEIR/CFFA recommendations outlined in Box 5.7;
- Anchor the institutional mandate of SAIs to the State and Entity Constitutions;
- Ensure adequate and regular financing for SAI activities, tied to the annual work plan;
- Create a legal basis for permanent legislative oversight over the SAIs, through the establishment of dedicated PAC;
- Institutionalize working relations and collaboration both between SAIs and respective PACs (as they are established) and between SAIs and bodies in charge of governmental internal audit functions;

[231] The PEIR/CFFA team has reviewed the draft amendments and made recommendations.

Box 5.7 External Audit Legislation - Provisions in Need of Strengthening

Federation SAI: The AG and the Deputy Auditor General are appointed by the President of the Federation in accordance with the advice of government, with prior approval from the Parliament. It is advisable that government involvement in the appointment process be eliminated. Both the AG and the Deputy AG are appointed for a fixed, non-renewable term of five years. Both the AG and the Deputy AG may be removed from office if both Houses pass a motion asking for their removal should they "for any reason, be unable to perform the duties of office" (Article 6). This provision leaves wide discretion for the dismissal of the AG on non-technical grounds and, therefore, is not considered adequate to ensure the AG's independence in the exercise of his mandate. Its elimination is necessary to remove opportunity for improperly influencing the AG to be removed.

The AG and the Deputy AG may be also removed from office if the quality of the audit work fails to meet the standards determined in the law, which must be certified by the Independent Quality Reviewer (IQR) who may be appointed under the modalities specified by the law (Article 27). The IQR must be an internationally recognized organization with expertise in assessing the work of SAIs. Although this provision goes in the right direction (in the attempt to establish means and clear procedures allowing for the legislative oversight over the SAI), the fact that the appointment of the IQR is an option, and not a prescribed parliamentary function, leaves the matter open to arbitrary action (or inaction). The independent quality review must be a mandated function.

The mandate of the SAI over external audits of cantons is open to interpretation and needs to be adequately clarified.

The current law directs the SAI to submit its reports on the audit of the financial accounts of the Budget Users in the Federation to the President and Parliament and to the responsible ministers. The latter is a provision, which compromises legislative oversight. It should be eliminated to establish an exclusive reporting lines to the legislature. All Audit Office reports should be discussed with the Ministries and their views should be recorded, but they should then be finalized and submitted only to Parliament.

RS SAI: The AG and the Deputy AG are appointed by the parliament on the recommendation of the government. It is advisable that government involvement in the appointment process be eliminated. Currently the Job Plan Rules are also approved by the government which needs to be changed to AG-approval only for preventing job plans from being limited by public service norms.

The SAI reports, and is solely accountable, to the Parliament. The AG reports brought before the Parliament but they simply recorded in the SAI-Bulletin. It will be necessary to have them published in the Official Gazette and made available for purchase from the SAI.

The AG ceases his functions when he submits a written resignation to the parliament and may be removed: (i) "when permanently disabled for audit work;" (ii) in case of criminal offences that make the AG unfit for the position; (iii) if the parliament passes a motion removing him from office on the basis of severe adverse criticism in the Independent Quality Reviewer's report (the provisions relating to the IQR are identical to those discussed for the Federation). As in the Federation, the ambiguity in the dismissal process needs to be eliminated.

The Law obliges the SAI to carry out all requested special audits, notwithstanding the approved work program and priorities of the SAIs during a year SAI. This provision obstructs the SAIs work and therefore needs to be replaced by a provision allowing the SAIs to assess and determine the need for special audits.

State SAI: The State AG is appointed by the Presidency, acting solely in accordance with the advice of both Houses of the Parliamentary Assembly of BiH. There are two Deputy Auditors General, nominated by following the same procedure, who must be appointed from different ethnic groups than that of the AG. The AG and the Deputies may be dismissed only if the parliament passes a motion asking for their removal on the grounds of misbehavior, or if the quality of audit work fails to meet the standards determined by the law, as certified by the IQR.

As in the case of RS, there is need for providing for a joint determination by the AG and the Deputies of the Rules of Service, which would not be limited by public service norms (currently agreed between the AG and the Council of Ministers of BiH).

In terms of reporting lines, the AG is required to "submit the report to the Presidency who shall cause it to be laid before Parliament" (Art. 14). The AG is therefore accountable to both the presidency and the parliament; however, the AG may be required not to disclose information in a public report, in cases where the Chief Legal Office has issued an act stating the sensitivity of the information to be disclosed (Article 28). This provision limits the autonomy and independence of the AG at the discretion of another public administration body and needs to be removed.

The Law oblige the SAI to carry out all requested special audits, notwithstanding the approved work program and priorities of the SAIs during a year SAI. This provision obstructs the SAIs work and therefore needs to be replaced by a provision allowing the SAIs to assess and determine the need for special audits.

- Establish clear mechanisms and procedures regulating the resolution of conflicts between auditors and auditees.

Public Procurement

Sound and transparent procurement rules play a critical role in increasing the efficiency of public expenditures and public service delivery. Despite a predominantly large role that donors play in the reconstruction process in BiH, domestic procurement spending is significant—for consolidated BiH general government, estimated to be at least 7 percent of GDP. Yet the public procurement system is underdeveloped, with weak legislative and institutional frameworks and enforcement regime. These weaknesses create considerable room, not only for low value for money in public contracting, but also for abusive procurement practices as confirmed by the findings of the BiH's anti-corruption survey (see Box 5.8). A comprehensive procurement reform is, therefore, one of the critical stepping-stones towards ensuring the prudent management of scarce public resources in BiH. Increasing transparency, accountability and competitiveness in public procurement is also an indispensable tool for combating corruption and for creating a level playing field for private sector development—both are increasingly near-term priorities of the authorities.

Box 5.8 Measures of Corruption in Public Procurement in BiH[1]

- Corruption is regarded as "widespread" by 60 percent of the general public, 54 percent of public officials, and 52 percent of entrepreneurs.
- Seventy-three percent of respondents believe that bidders sometimes have to make an unofficial payment to win a public sector contract and 25 percent think that such bribing is the usual practice.
- The standard bribe rate for government contracts is reported as being 4 percent of the contract price.
- Opportunities for corruption associated with public tenders increase due to several factors, primary among them being inaccessibility of information about the tender and complexity of the tendering process.
- State enterprises and firms with Foreign Direct Investment (FDI) are less vulnerable to changes in the legislative/regulatory framework than new firms, small firms and private firms, mainly because they have better access to advance information on planned changes in laws and regulations.
- There are important factors which deter bidders from participating in public tenders, notably:
  - their inability to obtain information on bidding opportunities in time to prepare a bid;
  - unfair competition;
  - non-transparent tender conditions;
  - excessive demands for prepayment;
- Twenty-two percent of respondents thought that corruption would deter foreign investors from investing in BiH, while 10 percent thought it would retard the development of the private sector.

[1/] BiH: Diagnostic Survey of Corruption, World Bank (2001).

5.81 There has been an increasing recognition of the benefits of procurement reforms in BiH, with both the State and the Entity governments defining legislative reforms as one of the key elements of their public finance reforms during 2002 in their recent Action Plan for Combating Corruption.[232] This will be a major step forward in improving the public procurement system since—though fairly harmonized across-Entities—present legislative framework[233] is a source of major weaknesses in the system. Its weaknesses include:

[232] "Action Plan for Combating Corruption," February, 2002 published by the Ministry of Foreign Trade and Economic Relations, Council of Ministers of BiH; Ministry of Justice, Government of FBIH; Ministry of Justice, Government of RS available at www.prsp.info/english/index2.htm

[233] The legislative framework in the Federation has a status of a decree which became effective on August 18, 1998, and which is based on the UNCITRAL Model Law on Procurement of Goods, Construction and Services, 1994. In May 2001, RS enacted a new Law On Procedures for Procurement of Goods, Services and Works that was drafted by the RS Ministry of Finance, and modeled closely on the Federation decree, with only a few differences in procedural detail.

- Excessive discretion allowed to public officials when making decisions about awarding government contracts;
- Inadequate prohibitions against breaking down procurement requirements into smaller-value lots in order to avoid the use of Open Bidding, the most competitive procurement method;
- The absence of a specific provision against using proprietary definitions, including brand names, to define procurement requirement;
- Opaque provisions on the evaluation of bids and ineffective arrangements for the review of bidders' complaints.

5.82 The new legislative framework is planned to be aligned with EU standards, under EU assistance, and introduced as a State legislation, which will be complemented by new, harmonized Entity legislation for ensuring uniformity—essential to the objectives of economic integration, free movement of goods and services across BiH as well as to enhancing both FDI flows and domestic investments.

5.83 Nevertheless, a sound legislative framework will not, by itself, solve the problem of weak enforcement, which is a broad problem in BiH. In fact, notwithstanding its weaknesses, the present scope of application of both Entity procurement legislation is reasonably comprehensive, both in terms of the sources of funding and of the categories of local governments and public institutions that they cover.[234] The supervisory authority over the application of the procurement rules is vested in the MoFs of the Entities—including those in each canton in the case of the Federation, which have authority over procurement financed by cantonal, city and municipal budgets. These functions include:

- Providing budget beneficiaries with instructions in accordance with the legislation;
- Issuing approvals, consents and making decisions regarding the application of the legislation, including giving prior approval for the use of the Limited Bidding and Direct Contracting procurement methods;
- Punishing breaches of the procurement legislation by budget beneficiaries by canceling an appropriate amount of their financing from the budget.

5.84 In practice, however, the level of compliance with the legislation remains low in both Entities and, in general, across public administration. This is largely explained by the chronic lack of dedicated resources for undertaking regulatory functions, where procurement is often handled improperly by untrained, non-specialist staff.[235] The present system is also weak in holding those public officials who breach the procurement rules accountable.

---

[234] The Federation decree applies to federal administration authorities and federal institutions and other bodies. It also applies to cantonal administration authorities and other cantonal bodies, to city and municipal administrations if funds are provided by cantonal, city or municipal budgets, unless cantons have put in place their own public procurement regulations, in which case, the latter would apply. Procurement by public enterprises is also governed by the decree, when they spend funds from the federal, cantonal, city or municipal budgets. The RS law applies to republican administrative bodies, republican institutions and other republican agencies using funds provided by the RS budget, and to municipalities and cities using funds provided by municipal or city budgets. Public enterprises are also covered. In addition, procurement funded by a loan obtained or guaranteed by a republican body, such as the Health Insurance Fund, comes within the scope of the law.

[235] In most procuring entities in BiH, responsibility and accountability for the conduct of procurement are not clearly assigned to a particular department, manager, or group of staff. In the majority of cases, it is an across-the-board function undertaken by many managers and staff as an adjunct to their main job functions. In a small number of larger public organizations which have significant procurement spends, procurement is either allocated to a specific department, which undertakes procurement in addition to other administrative tasks, or to a dedicated unit—e.g. in the FBiH Electroprivreda, the electrical utility, the Commercial Department undertakes procurement as one of a number of functions. The ability of such units to perform procurement satisfactorily is still undermined by a number of factors, primary among them the many weaknesses in the legislation and the absence of trained staff.

5.85 To facilitate uniform enforcement of the new legislative framework in the period ahead, it will be essential to put in place a comprehensive set of implementing regulations, with a view to making the provisions of the legislation as clear and specific as possible. As in the case of the principal legislation, the regulatory framework should be harmonized across-BiH's governments. Moreover, if these efforts are to effectively deal with present weaknesses, they should be guided by the actual practices that pose high risks to the principles of economy, efficiency, accountability and open competition in public procurement. The CPAR identifies a number of such practices and provides specific recommendations for addressing them (see Annex IV). Most egregious among them are:

- Public purchasers may easily break down procurement requirements into small value lots to avoid using Open Bidding;
- Procuring entities use restricted procurement methods (Limited Bidding etc.) excessively rather than Open Bidding;
- Procuring entities cut short the bidding period to favor preferred bidders;
- Information on tenders is not made available equally to all bidders;
- Foreign bidders have particular difficulty in accessing information on Open Bidding tenders;
- Public officials have excessive discretion in making decisions on the award of contracts;
- Bidders are unaware of, or unclear about, the rules governing how they should bid for public sector contracts;
- Reliance on the seller's form of contract weakens the procuring entity's contractual position;
- Payment of bribes to public officials;

5.86 All these methods clearly restrict competition and encourage inefficient use of resources by enabling the purchaser to pay a higher price and/or get less value for money. The achievement of greater efficiency in public procurement in the next few years will also rely on progress with the privatization efforts for creating a competitive supplier base to bid on public contracts. Indeed, this structural problem was one of the key findings of the BiH's Anti-corruption Diagnostic Survey, which highlighted that 50 percent of public firm's revenues comes from sales under government and public contracts. This is well exemplified by the 2001 budget of the RS-Road Directorate—one of the major public spenders in RS: 50 percent of the Directorate's total annual budget[236] was earmarked to be contracted directly to public-owned regional road maintenance utilities in the municipalities where the road works are planned to take place. While it is planned that these public utilities will be privatized in the near term, after which the Roads Directorate will be forced to put these contracts out to competitive tender, it is surely open to question whether the kind of cost-effectiveness use of scarce budgetary resources which the RS MOF has already identified it needs, can be achieved when half of a major spending body's expenditure is contracted without exposure to competition.

Table 5.1: Public Procurement Spending in BiH

% of Own-Budgeted Expenditures	**2000**
Total BiH	
State	10
Federation	11
Federal Government	5
Cantons	14
Municipalities	11
EBFs	19
RS	21
Central Governmet	28
Municipalities	17
EBFs	9
% of GDP	
BiH	7
Federation	6
RS	9

Note: Official procurement spending for canton capital inves. + 60%of goods&serv. for others.
Source: Official data and staff estimates

5.87 Equally important is the need to address organizational requirements at the Entity and sub-Entity levels. As shown in Table 5.1, the available data on procurement spending indicates that, as expected, sub-Entity governments in the Federation,

[236] Source: Republika Srpska Ministry of Transport and Communications, Roads Directorate.

central government in RS and EBFs in both Entities (mainly the health fund) account for a majority of public procurement expenditures in BiH, which at estimated 7 percent of GDP, is close to those in EU countries (on average 11-12 percent of GDP). However, both the share of the sub-Entity procurement spending in total, and overall BiH-spending will increase, if spending by off-budget public utilities—which the data does not cover—is taken into account. Clearly, the above-noted present modality of procurement supervision is far too weak for efficiently managing significant procurement spending, especially at the sub-Entity level. Establishment of a dedicated central unit mandated to perform essential oversight and regulatory procurement functions in the State ministry of Treasury and the Entity MoFs, and dedicated procurement units in all high-spending public administration units and companies should, therefore, be given an urgent priority along with legislative improvements. These efforts will need to be complemented by developing a countrywide training strategy for public procurement, with the objective of creating a system with longer term perspective that can adopt changing training needs over time. Finally, to enhance oversight by public bodies, it should also be made compulsory for these institutions that perform regulatory functions to submit an annual report on public procurement to the appropriate legislative body at their level.

5.88 If the procurement system, as it undergoes major reform, is to smoothly function, then the interface between budget planning and execution on the one hand, and the procurement planning and contracting on the other, will also need to be strengthened. Present budget management modalities make procurement planning very difficult, especially for those programs that have to continue beyond the budget year. On the other hand, as noted above, once the budget allocations have been decided by the authorized body, little or no control is applied to the packaging of contracts to maximize competition or to ensure effective implementation of the projects. Delays and perennial shortfalls in financing[237] also hinder procurement planning during the financial year. For instance, in the Federation, the ministers frequently cancel recurrent and investment expenditures on procurement in October or November in order to balance their budgets at year-end and attain the overarching requirement to meet the wage-bill costs before other discretionary expenditures. This causes problems with contracted payments and the performance of the existing contracts. One of the overarching recommendations of this report is, therefore, rationalizing and prioritizing expenditure policies along with strengthening the budget management and financial controls, which are altogether essential to eliminating ad-hoc budgetary practices and to bringing much needed predictability to the fiscal picture.

5.89 **Recommendations:**

- Adopt new, harmonized procurement laws at State and Entity levels, supported by a comprehensive set of harmonized implementing regulations to be adopted across the board including at the sub-Entity level;
- Develop, a comprehensive set of standard procurement documents for goods, civil works and services for mandatory use by all public procuring entities;
- Establish a Central Unit on Procurement within the State Ministry of Treasury and Entity MoFs and cantonal MoFs (especially in those cantons where most expenditure on public procurement takes place), with adequate enforcement powers, which should be defined in the new laws;
- Nominate an institution to carry out independent administrative review of bid protests and requiring the oversight bodies to submit an annual report on public procurement to the appropriate legislative body at their level;
- Establish a training system, within a clearly-defined countrywide training strategy for public procurement, covering all levels of administration, that is sustainable over the long term. A

[237] The budget uses a monthly spending authorization process.

number of educational institutions should be identified in key centers that can be set up and deliver an agreed curriculum for public procurement training.

F. MEDIUM-TERM REFORM PRIORITIES

5.90 A key message of this chapter is that better enforcement of public expenditure management reforms to date, in parallel with broader and deeper reforms in the period ahead, are essential for the effectiveness of medium-term fiscal adjustment and reform in BiH. The medium-term reform agenda should be centered around the following priorities: *first*, establishing a comprehensive and integrated fiscal resource framework, and effective reporting and monitoring channels, at both the Entity and the State level, are critical to managing a credible aggregate fiscal program; *second*, strengthening the capacities, in terms of both human resources and processes, for budget and sectoral planning with a medium-term vision and a performance-oriented approach, is essential to the success of BiH's structural reform efforts, as it moves to orient its economy to the market and to increased integration with the rest of the Europe; and *third*, strengthening financial accountability systems and facilitating their effective operation are critical to maintaining fiscal discipline and the efficient use of BiH's increasingly tight resources.

ANNEXES

ANNEX I

A Standard Framework for Fiscal Sustainability

Although there are several criteria used for evaluating fiscal sustainability, the common ground centers around a theoretical framework that focuses on whether current fiscal policy can be continued into the distant future without threatening government solvency and resorting to default on public debt. Solvency is evaluated by taking into account all current and future assets and liabilities, estimating a comprehensive public sector balance sheet. If assets were sufficient to cover all liabilities, the current fiscal policy stance would be considered as sustainable. The informational requirements for such approach are enormous and certainly difficult to put together in the case of Bosnia and Herzegovina.

A less broad approach on fiscal sustainability uses the consolidated government's intertemporal budget constraint as the benchmark against which solvency is determined. Within this strand of literature, the most simple approach--the *accounting approach*--focuses on the consistency of fiscal policy with certain macroeconomic targets, while keeping the current ratio of public debt to GDP constant (or in certain cases, allowing this ratio to raise to a level deemed to be comfortable and stabilizes thereafter).[238] Sustainability is attained when the rate of growth of public debt does not exceed that of the nominal GDP, at least in the long run. While this approach does not deal with optimality of fiscal deficits, the evaluation of the consistency with other macroeconomic targets provides policymakers with an answer to the question: How large should the deficit be? This analytical tool is used to evaluate how far is the current fiscal policy from sustainability, defined as the primary deficit necessary to stabilize the debt ratio (See Blanchard 1990).

The analysis of fiscal sustainability starts with the one-period government intertemporal budget constraint and the three sources of financing public spending beyond the regular tax system:

$$(1) \qquad G_t - T_t = \Delta B_t + \Delta M_t = -S_t + i_t B_{t-1}$$

where B_t is the market value of the government debt in domestic currency (net of foreign exchange reserves), G_t and T_t are the non-interest government expenditures and tax revenues, respectively-- i_{t-1} is the ex-post interest rate on government debt and M_t is the nominal stock of high-powered money (monetary base). The primary budget surplus, S_t, is defined as the overall surplus excluding interest payments but including revenue from seignorage. Equation (1) represents the three different ways that the budget deficit can be financed: by issuing debt (domestic and foreign), by monetary expansion (seignorage revenue) and by using foreign exchange reserves. In practice, the third instrument can be used only at the margin and for short periods of time.

Re-writing equation (1) as ratio of GDP, then the change in the debt to GDP can be expressed as:

$$(2) \ \Delta b_t \equiv b_t - b_{t-1} = [i_t - (p_t + g_t + p_t g_t)]b_t - s_t + \frac{(p_t + g_t + p_t g_t)}{(1+g_t)(1+p_t)} m_t$$

[238] Among other methods for evaluating the sustainability of fiscal policy is the *present value approach*, which assumes that the sustainability of fiscal policy is accomplished when the present value of the government's debt in the indefinite future converges to zero. This is known as the no-Ponzi game restriction and requires that an excess of future primary surpluses over primary deficits match today's government's debt in present value terms. The infinite horizon approach, however, gives a long-term picture of fiscal policy but does not address the issue of the adjustment size needed to achieve fiscal sustainability. In the case of BiH, a more interesting approach is the one that allows assessing the scale of future adjustments need to place fiscal policy on an intertemporal consistent path. The *accounting approach* provides the finite framework that is more useful for the current study.

where lower cases, b, m and s, are the respective ratios of public debt, base money and primary surplus to GDP, while i is the ex-post interest rate on public debt, p is the inflation rate and g is the real economic growth rate. In the *accounting approach,* a primary surplus (or deficit) is defined as sustainable if it generates a constant debt to GDP ratio, given steady state macroeconomic targets and a constant interest rate. Thus, the sustainable primary surplus to GDP ratio is defined by setting Δb_t equal to zero and by dropping the time subscripts in equation (2):

$$(3)\quad s = [i - (p + g + pg)]b + \frac{(p + g + pg)}{(1+g)(1+p)} m$$

Bosnia and Herzegovina operates fiscal and monetary policy within the confines of a currency board arrangement (CBA). Under the CBA, the government cannot influence the steady state inflation rate, p, because this is determined by foreign inflation when the exchange rate is fixed. The government also has no influence over the monetary base, m, as it must satisfy money demand in order to keep the exchange rate fixed. Essentially there are two tools of policy: the primary surplus, s, and the real growth rate, g. Policy makers can improve fiscal sustainability by ensuring an adequate primary surplus and by following broader policies that are growth enhancing.

Equation (3) is the simplest framework for evaluating consistency of fiscal policy. However, the analysis of consistency using equation (3) has some limitations. For example, it ignores the fact that in addition to solvency constraints, countries may have borrowing limitations. Creditors may be unwilling/unable to roll over public debt. Second, there is an obvious element of circularity. Some of the variables used to calculate solvency indicators depend on the state of fiscal solvency at the same time. This is clearly seen with interest rates. The higher the interest rates, the higher the primary surplus needed to stabilize the debt. However, solvency indicators also affect interest rates to the extent that those reflect the risk of default. As a result, solvency indicators depend on spreads and spreads depend on solvency. This type of circularity usually leads to multiple equilibrium. A parallel analysis can be done with other variables, such as exchange, interest and growth rates. Unfortunately, there is no way to break up this circularity, and the numerical estimations should be viewed as rough approximations.

ANNEX II

Tax Structure and Assignment/Sharing System in Bosnia and Herzegovina

Tax[1]	Type and Rate	Levied on	Main Ex-emptions	Collection Basis	State	Entities				
						Federation			Republika Srpska	
						Federa-tion	Cantons	Munici-palities	Republic	Munici-palities
Customs duties	Ad-valorem (0.5%; 10%; 15%)	Imports	Exports	Point of entry	Regu-lates	100% Administers, and Collects			100% Administ.& collection	
Excise	Specific and Ad-Valorem (rates 3% to 30%)	Beverages cof-fee, tobacco, petroleum other materials	Mineral natural water and juices.	Deriv. basis—SR: retail level Federation:first sale point[8]	Regu-lates	100% Administers, and Collects			100% Administ.& collection	
PIT	Feder.: Flat 5%	Payroll Rate [2]		Derivation basis (place of work)		Regulates, Administers, and Collects	80%	20%	74% Regulation, Administ.& collection	26%
	Feder: Flat rate 10% RS:Regressive 25-15%	"citizens' income",[5] Schedular		Derivation basis (place of residence)		Administers, and Collects	20% Regulates	80%		
CIT	Fed.:Flat30% SR: Regressive 20-10%	Profits -Legal entities	Charitable & non-profit	Profits		100%(large enterprises)[6] Regul, Adm., and Collects	100%(other enterprises)		100% Regulation, Administ.& collection	
Sales Tax	(turnover tax) harmonized rates: 20% - 10%	Sales of goods and services [7]	8% on food (some items exempted)	Deriv.basis - Destination(collection point: retail)		Regulates, Administers, and Collects	70-80%	30-20%	Regulation, Administ.& collection 74%	26%
Property Tx[3] (Real Estate Tax)	Rent based, at a rate of 15%	Land, buildings, structures	Extensive list of exemptions			Administers and Collects	20% Regulate	80%	Regulation, Administ.& collection	100%
Prop.Trnsf. (Gifts and Inheritance)	Inheritance, gifts	Real state, inheritance and gifts	State org. &privatization			Administers and Collects	20% Regulate	80%	Regulation, Administ.& collection	100%
Road Taxes	Annual (specific)	Cantonal motor vhc.tax Fed. Road tax	Public transp. Road use			Administers and Collects (Road tax, 45%)	.Road tx. 55% .Reg.motor vhc. tx 55%	Motor Vhc. Tx .45%	100% Regul., Administ.& collection	
Levy,Fines Rents, Utility user charges	Miscella-neous	Utilities, housing, natural resources	Charitable org. disabled, children, seniors			Administer and Collects	Some, including Regulation	Some, including Regulation	Some, including regulation	Some, including regulation
Social Sec.Contr.[4]	Retirement Healthcare Unemploy-ment[7]	Wages and personal incomes		Derivation and ethnic basis		Regulates, Administer, and Collects	100% ear-markd extra-Bgt.Fnds (ethnic based		100% earmarked to Extra Bgt.Funds	
Privatiza-tion proceeds						80% (20% to pension funds)	80%(20% to pension funds			

Source: Ministry of Finance.

Remarks on the Table:

[1] With the exception of customs duties, which are regulated by the *State*, but administered by the Entities, all other taxes are regulated and administered at the Entity level. In the Federation, customs duties, excise taxes, and corporate income taxes on the largest corporations (post office, electricity, banking, and insurance companies) are assigned to the Entity government, and all other taxes are assigned to Cantons. The Cantons share some of their taxes (sales tax and payroll tax) with municipalities. In RS all taxes are assigned to the central government, and some (including sales tax and personal income tax) are shared with the municipalities. In each Entity, all tax proceeds are collected by the respective central tax administration and allocated (according to the derivation principle) to the government level to which the tax is statutorily assigned (federal, cantonal, republican, or municipal).

[2] In the Federation, the so-called "wage tax," a component of the PIT, is charged in advance at the payroll, and paid by employers on gross wages less social security contributions. This tax is paid by the employer—on the gross wage-bill minus contributions to social security. This tax is not deductible (or creditable) against the general "citizen income tax" when the latter is filed. Since August 2000, the flat 15% rate was reduced to 10%, and in 2001 again to 5%.

[3] On land and buildings, but tax enforcement is practically nonexistent. Property rights are blurry, and local authorities are hardly aware of the existence of this tax (even in Cantons where a property tax law exists—"on paper").

[4] Total Social Security Contributions rates on net wages are 47 percent in the Federation and 42% in RS. In the Federation, the contribution to pension fund is 25%, to health fund is 19% (the health insurance system basically operates at the Cantonal level) and to the employment fund (also largely cantonal) is 3%. In the RS, the contribution to the Pension Fund is 24%, to Health Insurance 15%, to the Unemployment Fund 1%, and to the Children Fund 2%. The basis of the Social Security Contribution is total income received and income paid (including wages and salaries).

[5] Individual and unincorporated income taxes (PIT)— schedular taxes in both Entities—including small businesses, properties, revenue from properties, inheritance and gifts, copyrights etc. In the RS, the allocation of the "citizens' tax differs according to the "schedule": income tax from agriculture and forestry is exclusively assigned to municipalities. Income tax from independent businesses is shared between the republican government and municipal governments at a ratio of 70/30; and other income taxes are assigned exclusively to the republican government. In the Federation, this tax is shared at 20% to Cantons and 80% to municipalities.

[6] In the Federation, the profit taxes on banking, insurance, telecommunication and postal enterprises, as well as on energy producing industries are, since 1999, assigned to the Entity government.

[7] This includes 2% railways tax, which is earmarked to a sub-budget Railways Fund.

[8] Entities and Brcko District have recently adopted a rebate-like mechanism for allocation of excise taxes on a destination basis.

ANNEX III

Expenditure Assignments in Bosnia and Herzegovina

Expenditure Assignments	State	Entities				
		Federation			Republika Srpska	
		Federation	Cantons	Municipalities	Republic	Municipalities
Immigration, refugees and asylum policies	Immigration, refugees and asylum policies	Refugees and displaced persons			Refugees and displaced persons	
Justice Internal Security and Police	Internat. & inter-Entity criminal law enforcement	Internal affairs /justice and police	Police		Internal affairs/ justice and police	Local police
Communications	Regul. inter-Entity telecom. system	Intra-Entity regulation	Reg. Radio TV intra-canton		Intra-Entity regulation	
Public Transportation	Regulates -Nat.transp.system -Inter-Ent.traff.cntl	Intra-Entity	Reg. Intra-canton		Intra-Entity	
Social Safety Net and Welfare	Soc.Ass.–joint (Refugee programs)	Federation Pension system Categorical S.Ass.	Soc.Ass.—joint	Soc.Ass.—joint	RS Pension system	Social assistance
Energy		Electricity transmission lines			Electricity transmission lines	
Roads		Highways Railroads	Local roads		Highways Railroads	Local roads
Defense (army)		100 percent			100 percent	
Economic and social policies		100 percent			100 percent	
Reconstruction programs		100 percent			100 percent	
Education			-Universities and research institute -Teachers' salaries -School bldg.Subs. -All levels educ.	-Pre-school -Primary school part.maintenance -School buses -Second.Schools [1]	-Universities and research institute -Teachers' salaries - School.bldg.Subs	-Pre-school -Primary school part. maintan. -School buses
Health care		Federation HIF-responsible for selected tertiary services	Primary healthcare Hospitals Medical research institutes HIF	Ambulance services Healthcare supplies	Primary healthcare Hospitals Medical research institutes RS HIF	Ambulance services Healthcare supplies
Sanitation (Garbage Collection)				100 percent		100 percent
Sewerage treatment				100 percent		100 percent
Water and Public Utilities				100 percent		100 percent
Housing and Spatial/City Planning			Housing policy	City planning	Housing policy	City planning
Culture, Sport, Recreation, Parks, Street Lighting			Museums Theaters	Culture, sports, parks, street lighting	Museums, Theaters	Culture, sports, parks, street lighting
Fire Protection			100 percent		100 percent	
Libraries				100 percent		100 percent
Environment and use of natural resources		Concurrent responsibility			Concurrent responsibility	

[1]To be transferred to Cities.

Note: major areas of joint responsibilities: between State and Entities: Justice, refugees, communications; between Entities and sub-Entity government.: health, environment policy, infra-structure for communication and transport, social welfare and interior affairs, education.

ANNEX IV

Summary of Procurement Risks Factors in Bosnia and Herzegovina and Recommended Actions

Risk	Factors Creating / Increasing Risk	Recommendations
Bidders are unaware of or unclear about the rules governing how they should bid for public sector contracts.	Not all firms have equal access to up-to-date information on procurement legislation and regulations.	1. FBiH and RS MOFs should re-publish relevant legislation and make it available to all bidders on request. 2. All levels of administration should move to Internet-based dissemination through the launch of a dedicated Public Procurement website. All current legislation and implementing regulations relating to public procurement should published on the website and kept up-to-date.
Public purchasers may easily break down procurement requirements into small value lots to avoid using Open Bidding.	Relevant provisions in current legislation are inadequately stated and not enforced.	1. The provisions in the new LPPs against disaggregation of procurement requirements should be clearly stated. 2. The new LPPs should clearly establish Open Bidding as the main and "default" procurement method. 3. Use of a procurement method other than Open Bidding for contracts estimated to cost above the defined threshold subject to prior waiver by applicable MOF. 4. The relevant MOFs should play a more proactive role in reviewing applications for waivers to the use of Open Bidding. 5. The new LPP should require that, in all cases where a procuring entity uses a method other than Open Bidding, it should include in the record of procurement proceedings a statement of the grounds and circumstances on which it relied to justify the use of that method.
Procuring entities use restricted procurement methods (Limited Bidding etc.) excessively rather than Open Bidding.	Absence of an upper financial limit in BiH decree and RS law on the use of Limited Bidding affords purchasers excessive discretion. Condition for use of restricted procurement methods are defined too laxly.	1. The new LPPs should introduce an upper threshold on the use of Limited Bidding. 2. The new LPPs should define the conditions for use of all procurement methods other than Open Bidding more clearly.
Procuring entities cut short bidding period to favor preferred bidders.	Weak provisions in legislation require only "a reasonable period"	1. The new LPPs should introduce increase the mandatory minimum bidding periods in line with EU law.
Information on tenders is not made available equally to all bidders. Foreign bidders have particular difficulty in accessing information on Open Bidding tenders.	Open Bidding tenders are not being advertised internationally, as procuring entities cannot afford advertising costs.	1. The new LPPs should introduce increase the mandatory minimum bidding periods in line with EU law. 2. The new LPPs should require that bidding opportunities should be advertised in national / entity newspapers of wide circulation and on the Public Procurement website, when it is launched. 3. Bidding opportunities for contracts estimated to cost above a given threshold should be advertised in English on a Public Procurement website.
Bidders find the tendering process too complicated	Current legislation lacks precision, clarity and affords too much leeway to procuring entities in defining procedures for individual tenders	1. The new LPPs and, particularly, the supporting implementing regulations, should define detailed procedures for all procurement methods.
Tenders conditions are not transparent	Current legislation lacks precision, clarity and affords too much leeway to procuring entities in defining procedures for individual tenders. Bidding documents and forms of contract currently in use are poor.	1. The new LPPs and, particularly, the supporting implementing regulations, should define detailed procedures for all procurement methods. 2. State, FBiH and RS should prepare and disseminate standard bidding documents (SBDs) for procurement of goods, works and services, consistent with new LPPs and regulations containing clear instructions to bidders on bid preparation, and make their use mandatory by all public purchasers.

Risk	Factors Creating / Increasing Risk	Recommendations
		3. The new LPPs should require that bid evaluation criteria should be expressed in objective, quantifiable terms and pre-disclosed to bidders in the bidding documents.
Reliance on seller's form of contract weakens procuring entity's contractual position.	Bidding documents and forms of contract currently in use are poor.	1. State, FBiH and RS should prepare and disseminate standard bidding documents (SBDs), consistent with new LPPs and regulations containing clear instructions to bidders on bid preparation, and make their use mandatory by all public purchasers.
Bids are rejected on frivolous grounds at bid opening	Current legal provisions prescribe rejection at bid opening as part of documentary check.	1. The new LPPs should require that no bid should be rejected at bid opening and that assessment of the compliance of bids with the bidding documents should be conducted only during detailed evaluation of bids. 2. The requirements in the new LPPs relating to the minimum mandatory contents of written records of procurement proceedings should require procuring entities to record the stage at which and the basis on which all bids are rejected.
Bidders and suppliers / contractors may withdraw from bids without penalty	Public purchasers' rights are unprotected, as legislation does not require bid and performance securities	1. The new LPPs should introduce requirements for bid and performance securities.
Public officials have excessive discretion in making decisions on the award of contracts	Bid evaluation provisions in current legislation are too subjective. Legislation does require procuring entities to pre-disclose to bidders how evaluation criteria will be applied during evaluation	1. The new LPPs should require that bid evaluation criteria should be expressed in objective, quantifiable terms and pre-disclosed to bidders in the bidding documents.
Inadequate record-keeping allows public officials to conceal procurement actions and obstruct audits	Legal requirements for compiling and retaining records of procurement proceedings are inadequate	1. The requirements in the new LPPs relating to the minimum mandatory contents of written records of procurement proceedings should be more stringent, should specify which information is to be recorded and which documents are to be retained.
Bidders' rights are inadequately protected against error, omission or illegal act by public officials	Bid protest mechanism fails to afford bidders appropriate protection	1. Strengthen provision in the new LPPs on bid protest. 2. New LPPS should nominate an institution which will carry out independent administrative review of bidders' complaints. 3. The independent review body should publish the results of its reviews.
Payment of bribes to public officials		1. Strengthen bid protest mechanism to make it easier for bidders to complain when a public official demands a bribe. 2. Increase internal and SAI auditing of procurement transactions. 3. Increase penalties for unethical or corrupt conduct by public officials or by bidders.