

1. THE STRATEGIC SETTING

A. INTRODUCTION

1.1. Bosnia and Herzegovina (BH) has made substantial progress in economic reconstruction and nation building since the end of the 1992-95 war, but a lot more needs to be done to help narrow the gap with the more advanced reformers in the region. Recent progress has culminated in the start of negotiations in early 2006 with the European Commission on a Stabilization and Association Agreement (SAA). The SAA negotiations have the potential of helping catalyze the pace of political and economic reforms needed to strengthen the single economic space, create an efficient government and boost living standards. The ultimate success of SAA implementation and the further integration into the European Union (EU) will crucially depend on the authorities' determination to press ahead with reforms.

1.2. A lot more remains to be done to further strengthen government institutions, advance transition to a market economy and reduce risks to hard-won fiscal stability. Government institutions remain cumbersome, irrationally decentralized and expensive. General government expenditures relative to GDP are still substantially larger than in countries with similar levels of income per capita, while outcomes are in general poorer. The bulk of spending, moreover, seems inefficiently distributed across government functions, resulting in a dearth of funds for targeted social welfare and child protection and insufficient resources for maintenance of existing capital projects. The central government ("state government" thereafter) has been strengthened, but remains substantially weaker than the two constituent entities formed along ethno-religious lines: the Bosniak-Croat dominated Federation of Bosnia and Herzegovina (FBH) and the Serb-dominated Republika Sprska (RS).

1.3. Substantial fiscal pressures are emerging and are set to multiply over the coming years. These pressures reflect the need to strengthen the institutions of the state level of government (thereafter "institution building" or "state building") *en route* to EU integration, outlays needed to settle the large stock of domestic claims and the ultimate start of property restitution. Government intentions to embark on large infrastructure projects will also place substantial demands on fiscal resources. Coping with these challenges will require that governments make careful trade-offs among competing priorities while implementing bold measures to reduce or curb existing and new spending to lighten the government's burden on the economy. These policy challenges will need to be tackled while addressing the critical issues of efficiency and equity.

1.4. This Public Expenditure and Institutional Review (PEIR) analyzes the key issues and sectors that bear on the level and composition of public spending and the stance of fiscal policy. The overriding objective of the recommendations presented on the basis of the analysis, and the key motivation of the PEIR, is achieving stronger growth in output and employment, reducing poverty and ensuring fiscal sustainability. The remainder of Chapter 1 presents the strategic background for the analysis. The complex institutional structure emerging from the Dayton Peace Accords (DPA) and the institutionalized divisions along ethno-religious lines help explain the challenges to reform implementation in BH. Economic developments have been broadly favorable since the end of the war and fiscal adjustment has been substantial, but delays in advancing structural reforms have limited scope for growth in production, exports and employment. As measured by the EBRD's

structural reform indicators, BH is behind all other countries in central and eastern Europe (CEE) and southeast Europe (SEE). Macroeconomic challenges remain, notably the outsized current account. Poverty and unemployment are high, moreover, and broadly unchanged since 2001, creating social exclusion that needs to be addressed urgently.

1.5. Chapter 2 discusses the level and composition of public spending. Fiscal consolidation has been strong from 1999 through 2004, but general government spending relative to GDP is still high and the composition of expenditures does not appear to be growth-enhancing. Outcomes of government spending tend to be poorer than among countries at a similar stage of economic development, moreover, and spending itself is often ill-targeted. Using the recommendations in the remainder of the report and a detailed assessment of the forthcoming fiscal pressures, the chapter carries out a fiscal sustainability analysis. The forthcoming fiscal pressures can be effectively tackled and vulnerabilities to public finances contained if the authorities carry out an ambitious and determined reform program to curb or reduce existing spending. Such a program, as detailed in the rest of the report, would need to go beyond what is currently considered by the BH governments. The governments, moreover, need to accelerate building the capacity necessary for setting, coordinating and implementing fiscal policy to lend credibility to any government reform agenda. Changing the constitutional setup established as a result of the DPA may help reduce costs, but the PEIR is working within the confines of the existing arrangements.

1.6. State-building, a key input in the fiscal sustainability analysis, is discussed in Chapter 3. The chapter presents a medium- to long-term scenario of strengthening the institutions of the state-level of government and estimates the accompanying costs. The chapter recommends that shifting institutions from the subnational to the state level of government should be at least cost-neutral, while increased costs as a result of strengthening the capacity of new institutions need to be offset by expenditure reductions in other areas.

1.7. Chapter 4 discusses public employment and wages and concludes that high average wage rates, especially for the lower grade employees at the state and the FBH level, result in a large general government wage bill. By contrast, the overall size of the public administration relative to the country's population is not larger compared with other countries. Given substantial duplication and outsized employment in police, defense and education, this suggests that the core public administration is small, with adverse consequences for public service delivery.

1.8. Chapter 5 analyzes government spending on education and proposes measures to improve both the efficiency of spending and the quality of education outcomes. While overall expenditures on education are larger than in other countries in the region, wage outlays dominate overall spending, crowding out outlays on capital improvements and operations and maintenance. Low secondary and university enrollment, together with the existence of costly but ineffective vocational secondary schools, leave graduates ill equipped for the challenges facing BH's economy.

1.9. Chapter 6 analyzes social spending funded both from social security contributions and from general revenues. Relative to GDP, BH's overall spending on social protection, including health, is similar to other CEE countries but the composition is different. Spending on pensions is substantially lower, while untargeted transfers to war veterans and surviving families are much larger. With the exception of the children fund in the RS, social welfare and child protection spending remains *ad hoc*, with payments in most cantons of the FBH below legally mandated benefits and even the latter too low to help the poorest members of society. The health sector is characterized by fragmented organization and financing, resulting in unequal access, inefficient spending and high arrears of health facilities. The chapter's key recommendations include measures to reduce social security contributions while improving prospects for the sustainability of the insurance schemes. For the programs funded from general revenues, the chapter proposes measures to improve targeting to help alleviate poverty and promote a more efficient use of resources.

1.10. The overall condition of the transport infrastructure remains poor and inadequate for a country of the size of BH despite considerable expenditures in the sector over the last decade. Chapter 7 analyzes public spending on transport and concludes that there are several reasons for the poor condition of infrastructure, including inadequate expenditures on both heavily traveled and local roads and an imbalance in allocations between capital outlays and expenditures on maintenance. Such an imbalance may be further exacerbated by proposed new investments. Improving the quality of infrastructure will require additional resources, but these need to be allocated within the overall budget envelope after a careful consideration of alternative demands for public money.

B. POLITICAL BACKGROUND

1.11. The DPA signed in December 1995 helped end the 1992-95 war and set the political framework for BH's development. The DPA (formally named the General Framework Agreement for Peace) was a necessary compromise to bring peace to BH and its three constituent peoples, the Bosniaks, the Croats and the Serbs, but at the cost of creating a complex, multi-layered and decentralized governance structure. Change to the DPA has been resisted for longer than initially envisioned, hampering much-needed progress toward a modern and efficient government. Under these challenging circumstances, BH has made substantial progress in rebuilding its war-torn economy, but the transition to a market economy has been uneven.

1.12. The governance structure established under the DPA is complex and expensive. In addition to the two entities, the internationally-supervised District of Brcko was created in 2000 following lack of agreement between the entities on how to govern the town with a population of 80,000. The FBH is further divided into ten cantons and 80 municipalities. The more ethnically homogenous RS is less decentralized, without cantons and with 62 municipalities. The DPA established the position of the High Representative (HR), supported by the Office of the HR (OHR) to oversee the implementation of the civilian aspects of the Peace Agreement.¹ The HR is directly overseen by the Peace Implementation Council (PIC), a body comprising 55 countries and international organizations. The powers of the HR were expanded in 1997 at the PIC meeting in Bonn, enabling the HR to remove from office public officials who violate legal commitments and the DPA, as well as to impose laws (the so-called Bonn Powers). It is intended that the role of the OHR diminish as administrative capacity is strengthened, with the Bonn powers of the HR, in particular, being scaled back fully perhaps in 2007.

1.13. Nationalist political parties have dominated the political process since the end of the war, with change often brought by pressure by the international community. Such an outcome has been supported by lack of willingness to move away from ethnic divisions, allow greater flexibility in the public administration and build a more efficient government. Decision making, as a result, has been driven to a substantial degree by the need to sustain the ethnic balance. This concern is enshrined, for example, in the following provisions:

- Two-thirds of the 42 members of the **state-level House of Representatives** (the parliament's lower chamber) are selected from the FBH and one-third from the RS. These percentages persist despite the lack of a population census since 1991.
- The 15 members of the **state-level House of Peoples** (the parliament's upper chamber) are selected in equal proportion by the three constituent peoples.
- The **state-level presidency** comprises three members rotating every 8 months, one from each of the three constituent peoples.

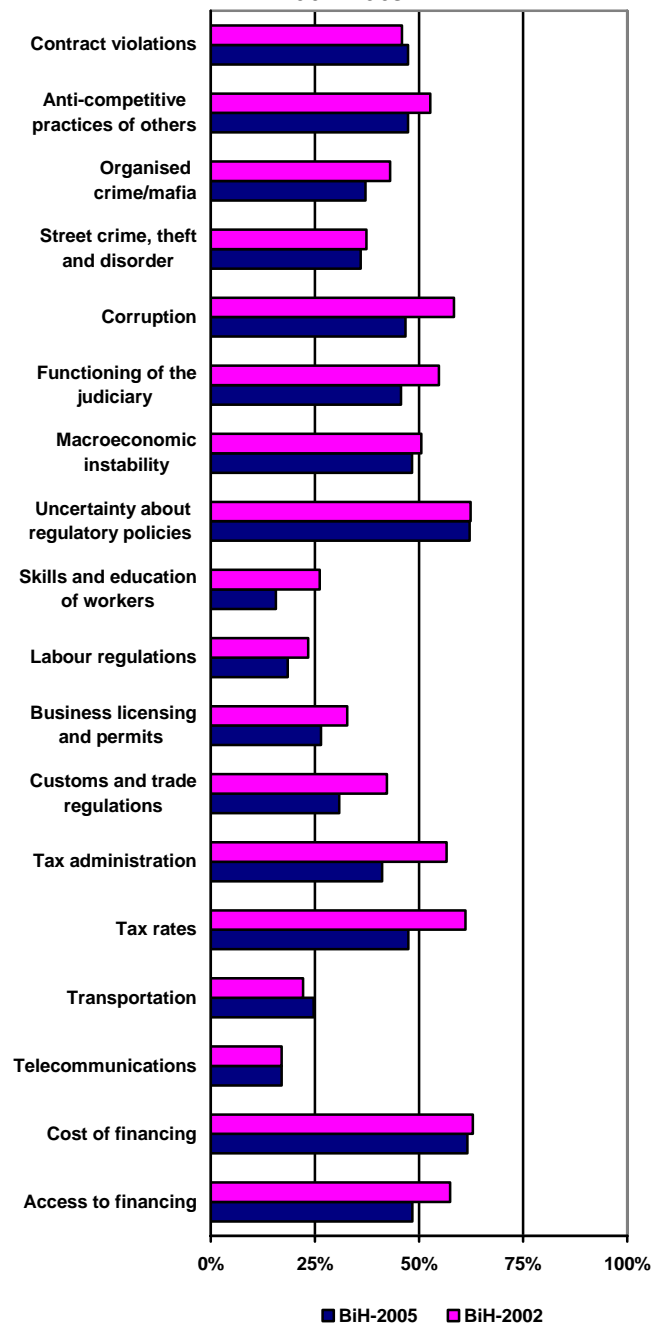
¹ Mr. Christian Schwarz-Schilling has been the current HR since February 1, 2006. Similarly to his predecessor, Mr. Paddy Ashdown, he is also the EU's Special Representative to BH.

- State and entity constitutions provide for protection of **Vital National Interests (VNI)**, thereby decisions regarding VNI, as listed in the constitutions, need a majority within the caucus of each of the constituent peoples.

1.14. BH has only recently shifted from focus on post-war reconstruction efforts to an emphasis on the transition to a market economy. Structural reform implementation, as a result, has been slow. As measured by the EBRD transition indicators, BH ranked only ahead of Belarus, Tajikistan, Turkmenistan and Uzbekistan in 2005. Negotiations on the SAA, together with negotiations on constitutional change among the key political parties that commenced in late 2005, hold promise that the transition to market economy will accelerate and the structure of governance will evolve towards a more rational model better suited to bring BH closer to the EU.

1.15. The complex institutional environment notwithstanding, governance appears to have improved over the last several years, as judged by surveys of BH companies (Figure 1.1). Nonetheless, BH remains among the countries in which poor governance and corruption is a substantial problem, with more than one-half of all firms in 2005 indicating that corruption is an obstruction to business.² Moreover, firms perceive state capture – corruption in the law-making process – to have increased over the last several years, making BH the country with the worst perception of state capture in eastern and central Europe.

Figure 1.1. BH: Percent of Firms Indicating a Problem to Doing Business, 2002-2005



Source: BEEPS, 2002 and 2005, The World Bank.

² BEEPS, 2002 and 2005, *EBRD-World Bank Business Environment and Enterprise Performance Survey*.

C. THE MACROECONOMIC SETTING

1.16. Economic activity has remained robust over the last several years despite slow reform implementation. Domestic demand has increased steadily, underpinned by strong wage and credit growth. Inflation picked up in 2005 and in early 2006 following the introduction of the single-rate Value Added Tax (VAT) set at 17 percent from the start of 2006, and reflecting higher energy import prices. Unemployment and poverty have remained high and little changed over the last several years, as informal employment continues to grow rapidly. Wages in the informal sector are lower and appear to grow more slowly than wages in the formal sector. The growing informalization of the economy has been in response to rigid labor markets and unfavorable business environment, underlining the importance of structural reforms.

Output, Employment and Inflation

1.17. Economic activity expanded strongly over the last several years, but at a slower pace than in the aftermath of the war. Real GDP growth is likely to have eased to 5¼ percent in 2005 after a robust increase in exports boosted growth to 6.2 percent in 2004 from 4 percent in 2003 (Table 1.1 and Figure 1.1). The decline in growth in 2005 reflected slow progress on structural reforms. Pre-emptive buying by companies and households surged, primarily of investment goods and durables. The strong increase in imports was also in response to continued rapid credit expansion, despite moves by the central bank to tighten the regulatory requirements for commercial banks.

1.18. Over the last decade, the pace of economic activity has been slower than among the CEE countries. Growth, moreover, has been insufficient to make a dent in the persistently high poverty and unemployment, leaving BH as one of the poorest European countries. A fifth of the population is jobless and a similar percentage is poor, with both ratios little changed since 2001. Moreover, an additional one-third of the population lives just above the poverty line, leaving them vulnerable to even modest adverse shocks to income.

1.19. Unemployment remained unchanged from 2001 through 2004. Moreover, four-fifths of the increase in employment has been in the informal sector, including in subsistence agriculture. Further, a large part of the increase in formal employment reflected the building up of the state level of government without offsetting reductions at the subnational level, and was accompanied by a substantial labor shedding among the state-owned enterprises. Employment in the informal economy rose to 42 percent of the total by 2004 from 37 percent in 2001, a remarkable widening of informality driven by inflexible labor markets, poor business environment and burdensome social security contribution rates.

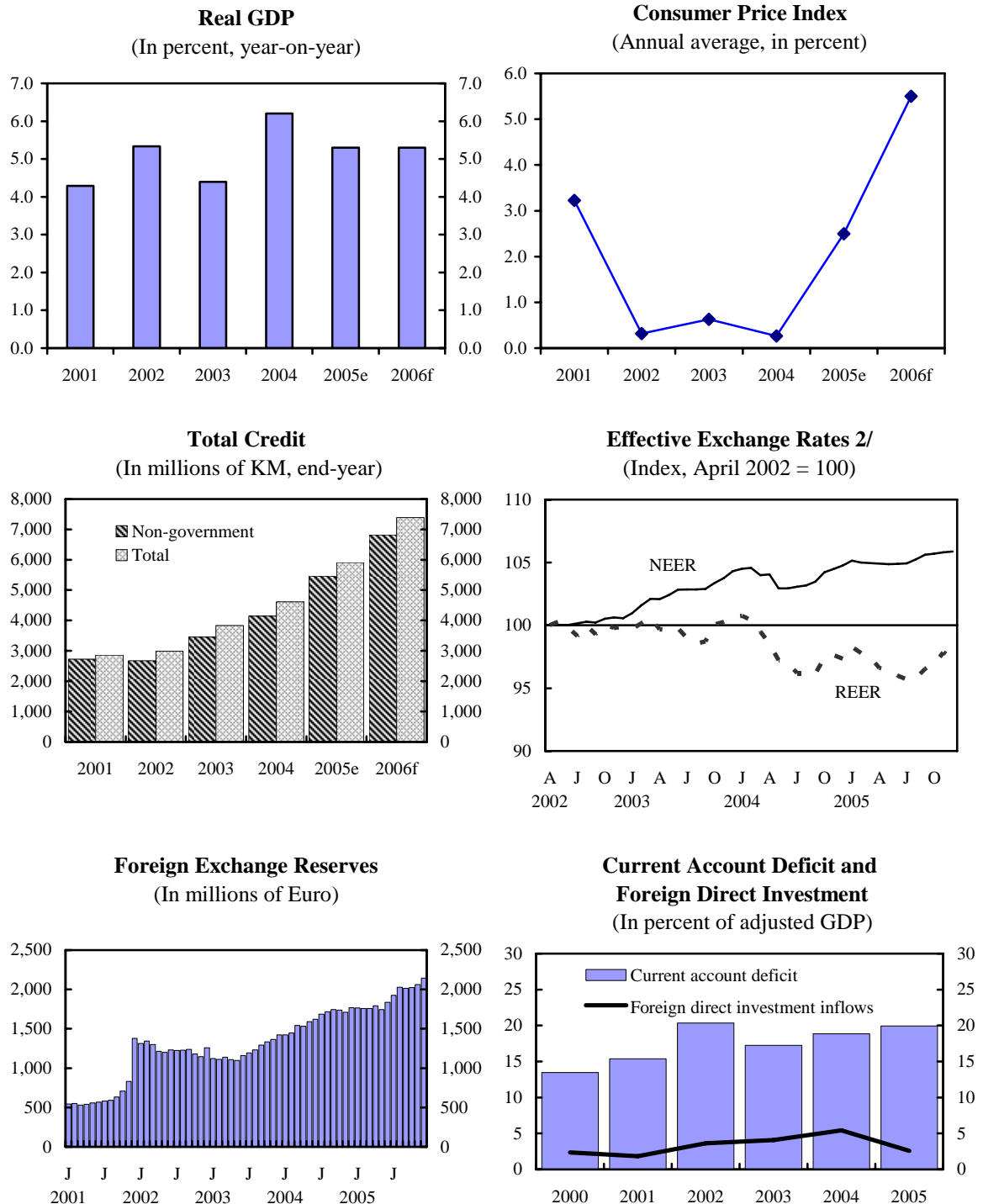
Table 1.1. Bosnia and Herzegovina: Selected Indicators, 2001-2006

	2001	2002	2003	2004	2005	2006
(Percent change unless indicated otherwise)						
Nominal GDP (In millions of KM)	10,480	11,651	12,303	13,440	14,490	15,622
Real GDP growth	4.3	5.3	4.4	6.2	5.3	5.3
Consumer price inflation (Annual average)	3.2	0.3	0.6	0.3	2.5	6.1
Gross wages (Annual average)	10.9	10.4	8.6	4.4	5.9	...
(In percent of official GDP)						
Consumption	111.0	114.1	114.2	117.2	116.3	113.2
Gross national savings	3.2	-0.8	-3.0	-2.8	-3.4	-2.3
Gross investment	18.9	20.4	21.5	19.7	20.5	21.0
Foreign savings	15.7	21.2	24.5	22.5	23.9	23.3
(In millions of U.S. dollars)						
Merchandise exports	1,135	1,101	1,470	2,082	2,592	3,209
(Percent change year-on-year)	0.3	-3.0	33.6	41.6	24.5	23.8
Merchandise imports	4,095	4,419	5,612	6,647	7,648	8,767
(Percent change year-on-year)	5.0	7.9	27.0	18.4	15.1	14.6
Current account balance	-739	-1178	-1629	-1784	-2108	-1570
(In percent of GDP)	-15.4	-21.0	-23.0	-20.9	-22.9	-15.0
(In percent of adjusted GDP)	-11.8	-16.2	-17.7	-16.1	-17.6	-11.5
Gross official reserves	1234	1187	1604	2195	2668	...
(In months of imports goods and services)	3.4	3.0	3.2	3.7	4.0	...
Broad money (End of period, percent change)	89.3	8.6	8.4	24.3	18.2	...
Domestic credit (In KM million) 1/	3339	4281	5122	5464	7491	...
(Percent change year-on-year)	10.7	28.2	19.6	15.7	26.4	...
Credit to households	682	1456	1966	2628	3402	...
(Percent change year-on-year)	77.5	113.6	35.0	33.6	29.5	...
External debt (In millions of US dollars)	3010	3579	4436	5118	5556	...
(In percent of official GDP)	62.8	63.8	62.5	60.0	60.3	...
(In percent of adjusted GDP)	48.3	49.1	48.1	46.2	46.4	...
External public debt (In millions of US dollars)	2311	2250	2519	2755	2820	...
(In percent of GDP)	48.2	40.1	35.5	32.3	30.6	...
(In percent of adjusted GDP)	37.1	30.8	27.3	24.8	23.5	...
Exchange rate (KM per U.S. dollar, period average)	2.19	2.08	1.73	1.58	1.57	1.55

Sources: Statistics agencies; Central bank of BH; IMF; and World Bank staff estimates.

1/ Adjusted for debt assumption in 2004 of KM463 million of enterprise debt by the RS government.

Figure 1.2. Bosnia and Herzegovina: Selected Economic Indicators



Sources: Statistics agencies; Central bank of BiH; World staff estimates (e) and forecasts (f).

1/ Net of government deposits and corrected for debt assumption in 2004 of KM463 million of enterprise debt by the Republic Srpska (RS) government.

2/ An increase denotes appreciation.

1.20. With due allowance for poor data, nominal wages appear to have increased substantially faster than inflation and productivity over the last five years despite high unemployment. Average nominal wages rose by 8 percent a year from 2000 through 2005 compared with a 2.2 percent average annual inflation (Table 1.2). The increases reflect in large part rigid wage-setting and lack of qualified labor. Increases in average nominal wages have been substantially larger in the RS, but these have been accompanied by a strong growth in productivity. More moderate wage increases in the FBH, by contrast, coincided with a drop in productivity reflecting in part delayed reform implementation.

Table 1.2. BH: Wages, Employment and Unit Labor Costs, 2000-2004

	2000	2001	2002	2003	2004
FBH - Manufacturing					
Paid employment	41,607	46,359	51,922	52,057	60,858
Wages (In KM per month)	302	316	360	409	412
Unit Labor Costs (Index, 2000=100)	100.0	101.9	114.7	124.3	128.0
(Percent change year-on-year)	24.2	1.9	12.5	8.4	2.9
RS - Manufacturing					
Paid employment	30,391	24,761	26,816	23,043	22,399
Wages (In KM per month)	192	210	235	259	303
Unit Labor Costs (Index, 2000=100)	100.0	109.0	116.1	111.0	110.5
(Percent change year-on-year)	4.9	9.0	6.6	-4.4	-0.4
BH – Overall					
Unemployment rate 1/			21.6		22.2
Employment rate 2/			41.8		45.9
Employment in informal sector 3/			39.0		42.3

Sources: Statistical offices of the FBH and RS, IMF and World Bank staff estimates.

1/ In percent of the labor force.

2/ In percent of working age population.

3/ In percent of total employment.

1.21. The currency board arrangement introduced in 1997 has helped anchor price stability. After increasing strongly in the aftermath of the war, consumer price inflation slowed to industrial country levels by 2003. After remaining little changed at near 1 percent in 2003 and 2004, inflation picked up to 2½ percent in 2005. Consumer price inflation is set to rise further in 2006, reflecting mainly higher indirect tax rates and increases in regulated prices. Preliminary estimates suggest a substantially larger impact from the VAT than earlier believed, above levels seen in other countries in the region. While some of these effects may dissipate, consumer price inflation is likely to average about 5 percent in 2006.

Balance of Payments and External Debt

1.22. The large current account deficit remains a key macroeconomic challenge. With the general government budget in rough balance and nongovernment investment moderate, the deficit reflects a dearth of savings among companies and, of late, households. Corporate performance appears to have improved somewhat over the last few years, but one-half of all companies in BH

remain loss-making and a large share of the rest make little in profit, paying little if any in taxes and social security contributions. Households have also reduced savings and increased borrowing from domestic banks to fund purchases of real estate and consumer durables, the latter supporting the increase in imports.

1.23. Higher prices for imported petroleum and natural gas, together with pre-emptive imports ahead of the VAT introduction, widened the current account deficit further in 2005.

The current account deficit is likely to have increased to 19 percent of adjusted GDP in 2005 from 17¼ percent in 2004. Terms-of-trade losses related to higher prices for imported energy appear to have worsened the external deficit by some 2 percent of adjusted GDP in 2005. Moreover, the surge of imports of capital and consumer goods in late 2005, ahead of the introduction of the VAT, probably added an additional 1 percent of adjusted GDP to the deficit.

1.24. Net capital inflows have consistently exceeded the current account deficit, boosting foreign exchange reserves.

Reserves rose to \$2.7 billion by the end of 2005, equivalent to 4 months' imports of goods and services. The pace of reserve accumulation slowed in 2005, as the current account deficit widened, while capital inflows fell slightly. The decrease in capital inflows in 2005 reflected a reduction in foreign direct investment to 3 percent of GDP, after the privatization of BH Steel boosted inflows of foreign direct investment to about 7 percent of GDP in 2004. Another factor contributing to slowing down reserve accumulation was a slight reduction in bank borrowing from abroad.

Monetary and Exchange Rate Developments

1.25. Adherence to the currency board arrangement, tighter fiscal policy through 2005 and determined efforts to advance banking privatization to strategic foreign investors have underpinned financial stability. Deposits denominated in local currency have grown strongly, rising from 15 percent of the total deposits in 1997 to one-half by 2005.

1.26. Reserve requirements were tightened in 2004 and again in 2005 to help slow the pace of credit expansion. The central bank doubled reserve requirements on bank deposits to 10 percent in late 2004 and boosted them further to 15 percent in late 2005. These measures helped moderate twelve-month credit growth to 25 percent by December 2005 from 31 percent in December 2004. Lending to nongovernment borrowers slowed by less, to 25 percent from 28 percent over the same period. Lending to households remained buoyant amid further reductions in bank lending rates and strong demand for mortgages and consumer credit.

1.27. With the SaM dinar depreciating vis-à-vis the euro-pegged KM and the Croatian kuna remaining little changed, the nominal effective exchange rate (NEER) has appreciated modestly over the last several years. The NEER appreciated 6 percent from 2002 through 2005 at a broadly similar pace each year. With inflation in BH lower than in SaM and in Croatia over the last several years, however, the real effective exchange rate (REER) depreciated. The REER weakened 3 percent from 2002 through 2005. In contrast to real exchange rate depreciation, unit labor costs (ULC) in manufacturing have risen steadily. The increase has been moderate in the RS, with ULC in manufacturing rising 3 percent a year on average from 2000 through 2005, as strong productivity growth combined with labor shedding. In the FBH, by contrast, ULC in manufacturing rose by an outsized 9 percent a year on average over the same period, reflecting in large part reform delays.

Structural Reforms

1.28. Progress on structural reforms has been uneven. Reforms of the financial sector, trade policy and public finance have been advanced with determination. By contrast, progress has been slow in non-bank privatization and corporate restructuring, improvements of the business environment and labor market reforms. Overall, structural reform implementation has lagged substantially the pace among other countries in transition.

1.29. Bank privatization and other financial sector reforms have been well-advanced. Only 6 out of 33 banks, accounting for about 10 percent of banking system capital, are still government-owned. Banking supervision remains vested in two entity supervision agencies, however, an anomaly for a country with a population of 3.8 million. Efforts to merge the banking supervision agencies under the umbrella of the central bank have been ongoing.

1.30. Trade liberalization was pursued with determination earlier, but several restrictions were introduced in 2005. BH has concluded bilateral free trade agreements with all SEE countries and is negotiating to join the WTO. The average unweighted tariff rate amounts to 6 percent, among the lowest in the region, with the rate on agriculture products the lowest among the SEE countries. Under pressure from domestic agricultural producers unhappy with rising imports from Croatia, and in response to a decision by the SaM government to subsidize exports of meat and dairy products, the BH government suspended parts of the Free Trade Agreements (FTA) with these countries in early 2005. Although SaM revoked the export subsidies in May 2005, the counter-measures by BH are still in force. *Ad hoc* responses of this kind, in violation of the spirit of the bilateral FTAs, raise questions about the commitment of the authorities to free trade despite the start of SAA negotiations, especially as the core measures under the SAA cover free trade.

1.31. Significant progress has been made in the area of public finance, but much more remains to be done. Major achievements to date include successful harmonization of indirect taxation, culminating in the establishment of the Indirect Tax Authority (ITA) at the beginning of 2004 and the introduction of a state-wide single-rate VAT from the start of 2006. Draft laws on modernizing and harmonizing across the entities corporate and personal income taxation have been prepared and are in parliamentary procedures, with implementation of the laws planned for late 2006 or early 2007. The draft laws introduce a single-rate corporate income tax at 10 percent and a personal income tax with rates of 10 percent and 15 percent.

1.32. Efforts to improve public expenditure management are ongoing, with increasing local ownership over the preparation of the medium-term expenditure frameworks and enhanced coordination arrangements, including the establishment of the National Fiscal Council (NFC) in 2005.³ Introduction of public sector audit has led to increased transparency and accountability in public sector spending. Responsiveness to the audit reports and follow-ups to the recommended measures remain insufficient, however.

1.33. Non-bank privatization has been slow and the private sector generates only about one-half of GDP, a substantially smaller share than in most other countries in the broader region. Privatization has been well-advanced among smaller enterprises, while a substantial share of the larger or most indebted companies remain state-owned. Reflecting the extensive use of privatization certificates and other non-cash payment methods, together with the poor state of most companies that were privatized, cumulative cash receipts from privatization were modest and amounted to €230 million by the end of 2005.

³ As constituted at present, the NFC is composed of the state and entity prime ministers and finance ministers.

1.34. Corporate performance has been mixed and remains a key policy challenge. Reflecting lack of effective ownership, in part due to the reliance on mass and voucher privatization, and amid continued delays in corporate restructuring, loss-making companies abound, representing a significant drag on the economy. Efforts by the governments to grant unconditional debt write-offs have not produced results, as expected, but willingness to resort to bankruptcy has been weak, in particular in the FBH. After delays, the RS authorities made substantial progress in advancing privatization and other corporate restructuring in 2004 and 2005. Overall, the business environment is not perceived as investor-friendly, despite recent improvements in the areas of business registration, bankruptcy and business inspection.⁴ A large number of companies still see obtaining licenses, dealing with the governments, economic policy uncertainty and corruption as the most burdensome constraints to development and operations.

1.35. High unemployment, high and strongly rising wages in the formal sector and the increasing share of the informal economy are the key labor market challenges facing BH. Wage setting remains rigid within comprehensive collective agreements dominated by powerful trade unions. Labor laws, moreover, remain inflexible and steeped in labor practices reminiscent of those in former Yugoslavia. Rigidities and gaps in the regulatory framework contribute to persistent overstaffing combined with skills mismatches, but yet generous wage increases. All this underpins the urgency of advancing labor market reforms.

D. THE NON-OBSERVED ECONOMY

1.36. BH national accounts data are not adjusted for the size of the non-observed economy (NOE). By contrast, most countries in Europe and central Asia (ECA) make such adjustments. Ratios to GDP, therefore, would appear less accurate for BH if GDP without at least some adjustment for the NOE is used. This PEIR attempts to correct officially estimated GDP to help address this issue and make more accurate comparisons across countries.

1.37. Adjustments for the NOE are large and range from 12 percent of the observed economy on average for the new EU member states (NMS)⁵ to 30 percent for the countries of the Commonwealth of Independent States (CIS) (Table 1.3). Albania's officially published national accounts include a sizable adjustment, while the adjustments made in FYR Macedonia and Croatia are substantially smaller. The national accounts for SaM, by contrast, do not include an adjustment.

1.38. According to what is by now well-established OECD methodology for measuring the NOE, the NOE comprises of underground, informal and illegal production.⁶ Underground production includes activities that are not observed either because of underreporting, lack of registration or various statistical reasons. Informal production includes unregistered production, while illegal activities cover corruption, prostitution and some others.

1.39. Several studies have estimated that the NOE in BH is large. An OECD report estimated that the NOE fluctuated from 57.7 percent of officially estimated GDP to 52.6 percent during 2001-2003.⁷ Excluding corruption and prostitution, the NOE is estimated to have amounted to 48.2 percent of officially estimated GDP in 2003. Further, an IMF statistical advisor to the central bank of BH

⁴ BEEPS, 2005.

⁵ The eight central and east European countries that joined the EU in 2004: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

⁶ OECD, 2004, *Handbook for Measurement of the Non-Observed Economy*, www.oecd.org.

⁷ Dell'Anno, Roberto and Marje Piirisild, 2004, *Estimates of the Non-Observed Economy in Bosnia and Herzegovina*, OECD.

estimated that the gray economy amounted to 40 percent of GDP in 2002.⁸ Finally, an IMF report estimated via regression analysis that the nonobserved economy is equivalent to 30 percent of GDP.⁹

Table 1.3 Adjustments for the Non-Observed Economy in GDP Statistics
(In percent of published GDP and in percent of observed economy)

Country	Year	NOE included in GDP	
		In percent of GDP including NOE 1/	In percent of GDP excluding NOE 2/
SEE		20.8	27.6
Albania	2004	31.8	46.6
BH	...	This PEIR - 23.1	This PEIR - 30
Croatia	3/ 2002	14.2	16.6
SaM	...	none	none
FYR Macedonia	4/ 2003	16.3	19.5
NMS		13.8	16.4
Estonia	3/ 2002	9.6	10.6
Czech Republic	3/ 2000	4.6	4.8
Hungary	4/ 2000	11.9	13.5
Latvia	3/ 2000	13.6	15.7
Lithuania	3/ 2002	18.9	23.3
Poland	3/ 2002	15.7	18.6
Slovakia	4/ 1998	22.0	28.2
Accession countries		14.0	16.4
Bulgaria	3/ 2001	10.2	11.4
Romania	3/ 2002	17.7	21.5
CIS		23.2	29.8
Armenia	3/ 2003	28.9	40.6
Azerbaijan	3/ 2003	20.7	26.1
Belarus	3/ 2003	10.7	12.0
Georgia	3/ 2004	28.3	27.6
Kazakhstan	3/ 2003	21.6	27.6
Kyrgyzstan	3/ 2003	17.0	32.1
Moldova	3/ 2001	31.6	33.3
Russia	3/ 2003	24.3	32.1
Tajikistan	3/ ...	25.0	33.3
Ukraine	3/ 2003	17.2	20.8
Uzbekistan	3/ ...	29.5	41.8
Others			
Austria	3/ 2001	7.9	17.4
Italy	3/ 2003	14.8	17.4
Mexico	3/ 2003	12.1	13.8

Sources: UNECE (2003 and 2005) and IMF (05/158, 2005).

1/ $100 \times \text{NOE} / (\text{NOE} + \text{OE})$, with NOE (OE) the non-observed (observed) economy.

2/ $100 \times \text{NOE} / \text{OE}$, where NOE is the non-observed and OE the observed economy.

3/ UNECE, Non-Observed Economy in National Accounts, April 2006.

4/ UNECE, 2003 as quoted in IMF (05/158), 2005.

⁸ IMF, 2004, *Selected Economic Issues*, Report 05/54.

⁹ IMF, 2005, *Selected Issues*, Report 05/158.

1.40. While the ranges reported in these studies are large, this PEIR assumes conservatively that the NOE amounts to 30 percent of officially estimated GDP or 23 percent of the overall GDP including the NOE. Including an adjustment for the NOE would help improve the reliability of cross-country comparisons and fine-tune the analysis presented in the report. For fiscal sustainability issues, however, the adjustment is not relevant and the discussion tends to focus on unadjusted figures – adjusting the GDP affects only the level of spending or debt relative to GDP, but not the overall direction of change.

1.41. Comparisons of BH with other SEE countries need to be made with care, as this report does not carry out any explicit adjustment for other countries except where noted (Tables 2.5 and 2.8). In particular, were the GDP for SaM to include an adjustment for the NOE, or were the GDP for FYR Macedonia and Croatia to be adjusted upward by a larger amount than reported in the table below, ratios to GDP in SEE would be substantially lower. Foreshadowing the discussions in Chapter 2, general government spending relative to GDP adjusted for the NOE in BH was 40.5 percent in 2004, while the average for the SEE countries was 40.4 percent. Adjusting all countries' GDP to include estimates of the NOE equivalent to 30 percent of the observed economy, government spending among the SEE countries averaged 36.7 percent of GDP in 2004. (This involves an upward revision of 30 percent for BH and SaM and differential revisions for the other countries, as they already include estimates for the NOE in officially published GDP estimates.) **Thus, using a broadly comparable methodology, BH's spending to GDP is still very large compared to that of its neighbors, not to speak of the faster growing countries elsewhere in the world.**

E. CONCLUSION

1.42. This chapter presents the overall background against which the detailed fiscal discussion of the rest of the report is developed. The SAA negotiations with the EC hold the promise of helping accelerate the pace of reforms. Time will be needed, however, to take into account the interests of the three ethno-religious groups. Macroeconomic imbalances need to be tackled more speedily and structural reforms advanced with renewed rigor to create the conditions for stronger growth in output and help reduce poverty. The next chapter focuses on more in depth analysis of macro-fiscal developments and challenges.