

2. FISCAL BACKGROUND AND FISCAL SUSTAINABILITY

A. INTRODUCTION

2.1. BH's fiscal position has improved significantly since the end of the war, but substantial issues remain unresolved with the potential to seriously undermine fiscal sustainability and prospects for improving living standards. These issues include inefficient duplication and fragmentation of government functions, poor quality of government services and an inefficient structure of government spending. Coordination mechanisms among the state and the entities, crucial for setting, executing and monitoring fiscal policy, remain underdeveloped. Over the medium term, the authorities would be well advised to redouble efforts to deal with these problems and build effective government institutions that should help consolidate the single economic space and advance EU integration. These efforts will be complicated by the need to tackle large fiscal pressures, including these related to the costs of building state institutions, settling domestic claims and handling property restitution.

2.2. This chapter examines fiscal policy developments in BH over the last several years and analyzes the level, composition and outcomes of government spending. Government revenues are also reviewed and recommendations are made on ways to reduce the government burden on the economy. The chapter proceeds with an analysis of fiscal sustainability, taking into account imminent pressures on fiscal resources and the key quantifiable recommendations made in the remainder of the report. The chapter concludes with additional recommendations on fiscal policy, government spending and institutional capacity.

B. RECENT FISCAL DEVELOPMENTS

2.3. The authorities deserve credit for the substantial fiscal adjustment since the general government deficit peaked in 1999. The commitment-basis general government deficit narrowed from 6¼ percent of GDP adjusted for the size of the NOE (8.1 percent of official GDP) in 1999 to broad balance in 2004 and 2005, as a large reduction in outlays more than offset a drop in revenues (Table 2.1). General government expenditures on a commitment basis fell from 52.6 percent of adjusted GDP in 1999 to 40½ percent in 2004. (As a share of official GDP, general government spending fell from 68 percent in 1999 to 52.6 percent in 2004.) Preliminary data suggest that expenditures rose again as a share of GDP in 2005, however, and are likely to increase further in 2006. General government revenues declined through 2004 almost entirely in line with a contraction in grants, mainly for foreign-funded investment projects, before rebounding in 2005 and further in 2006, as economic activity and tax collection strengthened.

2.4. A sharp decline in foreign-funded investment projects and a shift from accumulation of arrears to their repayment accounted for the bulk of the decrease in commitment-basis spending from 1999 through 2004. The remainder reflected cuts in outlays on wages, interest and other current spending. The gradual reduction in international assistance, both in grants and loans,

followed disbursements from official donors for post-war reconstruction that totaled \$5.1 billion during 1995-2000.¹ The shift to arrear repayment was largely due to the cessation of unauthorized spending by the different armies operating in the country in the late 1990s and the introduction of treasuries at the different levels of government.

Table 2.1. BH: General Government Fiscal Developments, 1999-2005
(In percent of officially-estimated GDP unless indicated otherwise)

	1999	2000	2001	2002	2003	2004	2005
Revenues	60.3	56.2	52.0	50.6	53.0	52.1	53.1
Tax revenues	42.5	42.6	40.2	38.5	40.3	40.4	41.7
Indirect taxes	17.1	16.2	14.0	16.2	17.4	18.1	20.6
Trade taxes	5.7	6.2	8.0	5.7	5.2	4.1	4.7
Direct taxes	3.9	4.3	3.5	3.2	3.4	3.4	3.8
Social security contributions	15.8	15.9	14.7	13.5	14.4	13.2	15.7
Nontax revenues	5.5	3.7	4.3	4.8	7.6	8.1	9.4
Grants	12.2	9.9	7.6	7.3	5.1	3.6	2.5
Expenditures on a commitment basis	68.4	63.5	55.5	56.4	54.3	52.6	53.1
Non-interest current spending	56.4	54.1	47.5	49.1	47.1	46.0	46.2
Capital spending	10.8	8.0	6.8	6.3	6.2	6.0	6.2
Foreign-funded capital projects	10.0	6.7	5.4	2.7	3.9	3.2	1.7
Other	0.8	1.3	1.4	3.6	2.3	2.8	4.5
Interest	1.2	1.4	1.2	1.0	0.9	0.7	0.7
Balance on a commitment basis	-8.1	-7.3	-3.5	-5.8	-1.3	-0.5	0.0
Memoranda:							
Expenditures relative to adjusted GDP	52.6	48.8	42.7	43.4	41.8	40.5	40.9
Balance relative to adjusted GDP	-6.3	-5.6	-2.7	-4.5	-1.0	-0.4	0.0

Sources: BH authorities, IMF (various publications) and World Bank staff estimates.

2.5. Wage outlays have fallen primarily because of army demobilization and a reduction in the size of the police, reforms that have been politically difficult and for which the authorities deserve substantial credit. Outlays on defense and security fell from 12 percent in 1999 to a still outsized 7 percent of officially measured GDP in 2004. *Ad hoc* reductions in spending on maintenance and operations, mostly on roads and other infrastructure reconstructed with donor funds in the aftermath of the war, also contributed to the decline in spending. Lower international interest rates and the restructuring of BH's external obligations to the Paris and London Clubs helped reduce interest outlays by two-thirds to ¾ percent of GDP by 2004.

2.6. Increased social expenditure caused general government spending to rise as a share of GDP in 2005. The pre-election 2006 entity budgets provide for double-digit increases in spending largely on the authorities' view that revenues from the VAT will be substantially larger than predicted

¹ Disbursements of foreign aid, grants and loans are not recorded in the state or the entity budgets. Similarly, budgets do not record outlays on government investment projects funded by foreign donors. Tackling this issue emerges as one of the top priorities for the authorities to help improve fiscal transparency and facilitate the targeting and execution of fiscal policy.

earlier and that the broad budget balance achieved in previous years is an overly restrictive fiscal stance (Table 2.2). Spending as a share of GDP will rise in both the FBH and the RS, as a result. Most of the planned increase in spending in the FBH reflects a jump in largely untargeted social transfers, reflecting increased veterans' benefits, the creation of new entitlements and the provision

Table 2.2. BH: Entity Budgets, 2005-2006 1/
(In millions of KM unless specified otherwise)

	RS		FBH	
	2005	2006	2005	2006
Spending	942	1,091	1,033	1,140
(In percent of GDP)	21.0	21.9	10.6	11.1
Adjustments:				
Debt repayment	...	71	2	138
Defense	66	...	180	...
Interest	...	38	2	62
Adjusted spending	876	981	853	940
(In percent of GDP)	20.4	20.5	8.8	9.8
(Percent change year-on-year)	...	12.0	...	10.2
Nominal Entity GDP	4,502	4,830	9,500	10,191

Sources: Ministries of finance and World Bank staff calculations.

1/ Adjustments made to put 2005 and 2006 on the same basis.

for a poorly targeted program for VAT mitigation. Higher salaries for teachers and the police, together with outlays on similarly poorly targeted program of VAT mitigation, account for the bulk of the increase in spending in the RS. **All told, the likely increase in spending relative to GDP in 2005 and 2006 would offset progress made in the last couple of years and make it difficult for the authorities to achieve the goal of reducing the burden of the government on the economy and cut tax rates.**

C. GOVERNMENT REVENUES

2.7. The high level of government spending remains supported by a larger than optimal tax burden, primarily reflecting onerous social security contributions (Table 2.3). Levied on a narrow base due to pervasive legal exemptions and rampant evasion, high social security contribution rates are a key cause of the high and rising informalization of economic activity.

Table 2.3. Tax Revenues in a Comparative Perspective, 2004

	Tax revenues and social security contributions 1/						PIT, CIT, SSC	Taxes on G&S
	Total	PIT	CIT	SSC	G&S	Other		
	(In percent of GDP)						(In percent of total)	
BiH								
official GDP	41.7	2.4	1.2	14.6	19.2	4.3	43.6	46.0
adjusted GDP	32.1	1.8	0.9	11.2	14.8	3.2	43.6	46.1
EU-15	40.6	10.5	3.5	10.3	12.5	3.8	59.7	30.8
OECD average	36.3	9.4	3.4	8.3	11.6	3.6	58.2	31.9
Ireland	28.4	7.4	3.7	4.0	11.2	2.0	53.4	39.5
Korea	24.4	3.1	3.1	4.6	9.5	4.1	44.4	38.8
Slovak Republic	30.2	2.6	2.4	12.4	11.4	1.4	57.6	37.7
Chile	18.2	...	...	1.4	...	...	...	...

Sources: The OECD, the IMF and World Bank staff calculations.

1/ PIT - personal income tax; CIT - corporate income tax; SSC - social security contributions; G&S - goods and services, includes VAT.

2.8. Social security contribution rates are higher than in most OECD and EU countries, and are substantially higher than the rates in fast growing economies such as Ireland, Chile, Estonia and Lithuania (Table 2.4). The authorities would be well advised to seize the opportunity afforded by potentially stronger than assumed revenues from the value-added tax (VAT) to reduce the social security contribution burden, should the pickup in these revenues prove to be permanent. Priority should be given to cutting the employment contribution rates. Other reductions could be made only in tandem with decisions on funding a portion of some social security benefits from general government revenues rather than payroll taxes. For example, if the obligation to pay health insurance contributions for pensioners were transferred from the pension funds to the entity governments, some reduction in pension contributions could be sustainable. The RS government should also reconsider financing child protection from general revenues and eliminating the child protection payroll contribution (see Chapter 6 for details).

Table 2.4. Social Security Contribution Rates
(In percent of gross wages)

	Insured	Employer	Total
BiH	29.9	5.8	35.6
RS	27.7	0	27.7
FBH	32.0	11.5	43.5
OECD average	11.4	18.1	29.5
of which:			
Ireland	8.0	10.8	18.8
Korea	7.1	8.8	15.8
New Zealand 1/	0.0	0.0	0.0
EU-8 average	12.8	27.3	38.1
of which:			
Lithuania	3.0	28.0	31.0
Poland	27.0	19.7	46.6
Slovakia	9.4	25.6	35.0
Chile	17.6	2.4	20.0

Source: US Social Security Administration.

1/ Paid out of general revenues.

2.9. Aside from distortionary social security contributions, the bulk of revenues is generated through less distortionary indirect taxes. Revenues from indirect taxes account for a larger share of tax revenues than in most EU and OECD countries, while income tax receipts account for one of the lowest shares in the world. The low share of income taxes relative to GDP reflects low tax rates, numerous tax holidays and evasion. Entity governments intend to enact in late 2006 or early 2007 harmonized corporate and personal income tax laws, a welcome development. If enacted and enforced, these laws would go a long way toward establishing a more equitable revenue base. The elimination of exemptions and tax holidays is likely to result in higher effective statutory rates of personal and corporate taxes and will probably result in larger revenues. The authorities should use this opportunity to cut social security contribution rates. After a successful introduction of the laws, over the medium-term the authorities would be well advised to consider increasing the personal income tax rate to provide room for further reductions in social security contribution rates.

D. THE LEVEL OF PUBLIC SPENDING

2.10. Fiscal adjustment since 1999 notwithstanding, general government spending remains high at 40½ percent of adjusted GDP. Spending is a full 5 percent of GDP higher than in countries with similar levels of income per capita. Comparisons with other SEE countries are more difficult because SaM makes no adjustment for the NOE in its GDP, while other countries make substantially different adjustments. For illustrative purposes, a uniform cumulative 30 percent adjustment for the NOE in all SEE countries (taking into account the adjustments these countries make at present) results in an average spending to GDP ratio of 36.7 percent a full 4 percent of GDP lower than in BH (Table 2.5). Similarly, using estimates from a regression of average primary expenditures on GNI per capita, BH's predicted level of primary expenditures is 5 percent of GDP percent lower than observed (Figure 2.1). The predicted level of primary expenditures is even lower if transition economies, typically more highly taxed and with larger spending levels reflecting the legacy of transition, are excluded from the analysis.

2.11. More importantly, general government spending as a share of GDP in BH exceeds substantially the levels in several fast growing and typically higher-income countries. Estonia

Table 2.5. General Government Revenues and Spending for Selected Countries 1/
(In U.S. dollars, in percent of GDP and in percent)

Country	GNI per capita (US\$ PPP, 2004)	Revenues (In percent of 2004 GDP)	Spending	Real GDP growth per capita (1999-2004)
BH				
Official GDP	7,430	52.4	52.6	3.2
Adjusted GDP		40.3	40.5	3.2
SEE average				
With BH official GDP 2/	7,663	41.0	42.8	3.6
With all adjusted 3/		35.0	36.7	
NMS	14,926	38.2	40.8	4.4
Ireland	33,170	34.5	34.3	4.9
Spain	25,070	40.0	39.6	2.0
Greece	22,000	43.6	48.3	3.4
Slovenia	20,730	41.7	43.1	2.8
South Korea	20,400	31.1	20.8	3.7
Czech Republic	18,400	38.6	41.9	3.3
Hungary	15,620	43.0	49.3	3.3
Slovak Republic	14,370	35.0	38.9	3.3
Estonia	13,190	39.6	37.9	6.3
Poland	12,640	41.4	44.2	3.0
Lithuania	12,610	31.4	33.6	6.1
Latvia	11,850	34.8	35.9	7.0
Croatia	11,670	47.2	51.5	4.0
Chile	10,500	23.3	21.1	3.2
Malaysia	9,630	23.5	28.8	1.4
Russian Federation	9,620	32.0	34.1	5.8
Romania	8,190	29.6	30.7	4.4
Thailand	8,020	17.1	16.8	3.4
Bulgaria	7,870	41.7	40.0	5.0
Turkey	7,680	42.2	47.2	2.5
FYR Macedonia	6,480	36.6	37.1	0.7
Ukraine	6,250	34.9	39.4	7.3
Albania	5,070	23.7	28.5	4.7
SaM	...	45.3	44.3	5.2

Sources: World Bank ECA PREM database and national authorities.

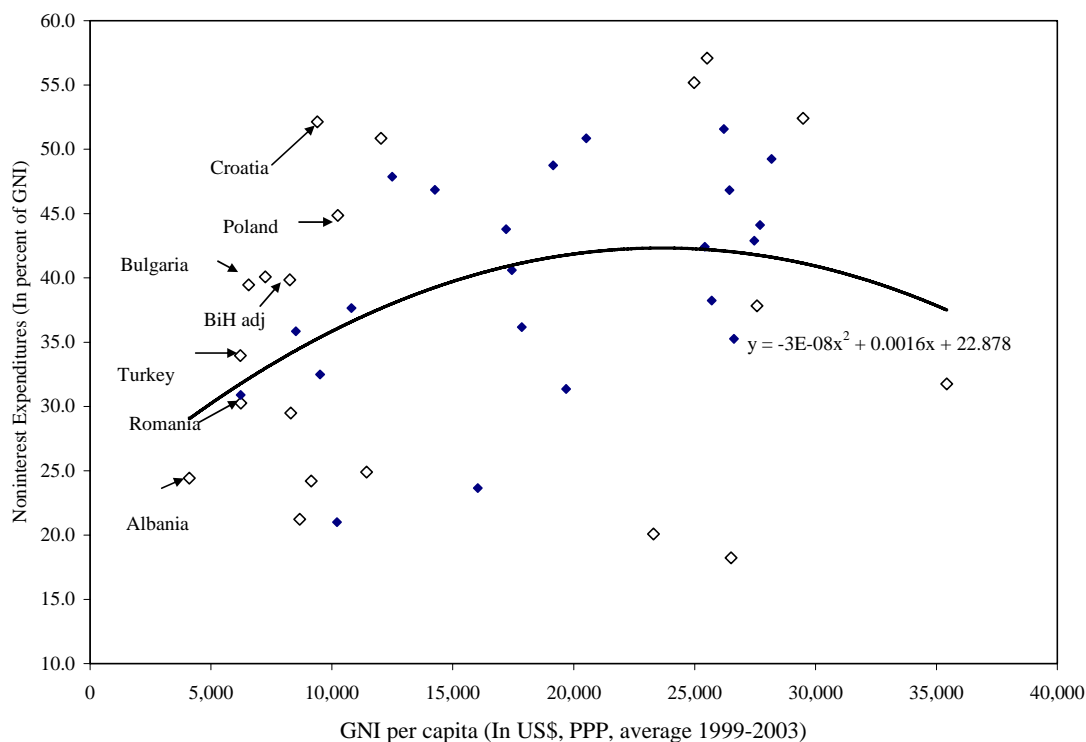
1/ Unless noted otherwise, ratios are relative to officially published GDP. Any adjustments made are working assumptions and do not reflect the official views of the governments or the World Bank. In this table, the SEE includes Albania, BH, Croatia, FYR Macedonia and SaM.

2/ All countries, including BH, relative to official GDP.

3/ For all countries, relative to GDP adjusted to include estimates of the NOE equivalent to 30 percent of the observed economy. This involves a 30 percent upward adjustment for BH and SaM and differential adjustment for the other countries, as their officially published estimates already include some adjustments for the NOE.

and Lithuania, for example, new EU member states with broadly similar population sizes and currency board arrangements, have general government spending roughly 5 percent of GDP lower than in BH, but incomes per capita that are 70 percent higher and real GDP growth rates that on average were twice as fast during 1999-2004. Government spending in Ireland, Chile and South

Figure 2.1. Noninterest Expenditures and Average GNI per Capita
(In percent of GNI and in US\$, PPP basis)



Korea is also lower, but incomes per capita and average real GDP growth rates are substantially higher. More generally, all countries in which real GDP growth averaged 6 percent or higher during 1999-2004 have much lower ratios of spending to GDP than BH.

E. THE COMPOSITION OF PUBLIC SPENDING AND THE QUALITY OF GOVERNMENT

2.12. The composition of spending reflects substantial duplication of functions across all governments and inefficiencies persisting ten years after the end of the war. The subsequent analysis and comparisons with other countries are based on the economic and functional classification of the consolidated general government prepared for this PEIR. In BH, the consolidated general government includes the state; the entities; the district of Brcko; the FBH cantons; the municipalities in both entities; the extrabudgetary pension, health, employment and child funds (the latter in the RS); and the road directorates at entity and cantonal levels (Table 2.6).² Outlays on foreign-funded investment projects are also included based on data from foreign donors.

2.13. The quality of government outcomes is lower than predicted by the level of overall spending or by spending in individual categories. The observed quality of outcomes in BH would be consistent with government spending of 30 percent relative to adjusted GDP, 10 percentage points lower than observed (Table 2.7). These results are only partial and need to be treated with caution, but they do indicate substantial inefficiencies in government spending. These inefficiencies need to be tackled before any new resources are committed to strengthening priority areas.

² The authorities do not produce consolidated general government accounts. The central bank has made progress in this direction, but data published on the central bank's web site as of early 2006 still do not include the municipalities, the road directorates and foreign-funded investment projects. The level of detail is also limited. See: http://www.cbbh.gov.ba/statistika/vladine_financije/vladina_statistika_metodologija_en.pdf.

Table 2.6. Bosnia and Herzegovina: General Government Spending, 2002-2005
(In percent of GDP)

	2002	2003	2004	2005b	2004	2005b
	(Official GDP)				(Adjusted GDP)	
Expenditures on a Cash Basis	56.4	54.3	52.6	53.1	40.5	40.9
Wages and contributions	16.4	14.6	14.2	13.5	10.9	10.4
Gross wages	11.8	11.1	10.9	10.4	8.4	8.0
Allowances	2.8	2.4	2.2	2.2	1.7	1.7
Contributions	0.9	1.1	0.9	0.8	0.7	0.6
Severance	0.8	0.0	0.1	0.0	0.1	0.0
Goods and services	10.7	12.6	11.5	10.4	8.8	8.0
Ousourced services	6.1	7.8	7.4	6.7	5.7	5.2
Utilities including energy	1.1	1.4	1.3	0.9	1.0	0.7
Procurement of materials	1.0	1.1	1.0	0.9	0.8	0.7
Current maintenance	1.3	1.5	1.0	1.0	0.8	0.7
Others 1/	0.8	0.9	0.8	0.8	0.6	0.6
Capital spending	6.3	6.2	6.0	6.2	4.6	4.8
Foreign-funded projects	2.7	3.9	3.2	1.7	2.4	1.3
Others	3.6	2.3	2.8	4.5	2.2	3.5
Subsidies and transfers	21.5	19.0	19.7	21.6	15.2	16.6
Subsidies	1.1	1.3	1.5	1.5	1.1	1.1
Transfers to individuals	13.7	13.7	14.4	15.2	11.1	11.7
Pensions	8.1	8.0	8.4	8.8	6.5	6.8
Veterans	3.6	3.5	3.3	3.1	2.5	2.4
Unemployment	0.2	0.1	0.1	0.1	0.1	0.0
Child protection	0.4	0.5	0.6	0.4	0.4	0.3
Social assistance	0.6	0.6	0.6	0.5	0.5	0.4
Refugees	0.7	0.7	0.5	0.4	0.4	0.3
Other individual transfers	0.2	0.3	0.7	0.9	0.5	0.7
Other transfers	6.7	4.1	3.9	4.9	3.0	3.8
Interest	1.0	0.9	0.7	0.7	0.5	0.5
Net lending	0.2	0.6	0.2	0.2	0.2	0.2
Arrears (+=cash outlays to settle)	0.3	0.3	0.4	0.4	0.3	0.3
Arrears (+=increase)	-0.3	-0.3	-0.4	-0.4	-0.3	-0.3
Expenditures on a commitment basis	56.1	54.0	52.2	52.7	40.2	40.5

Sources: World Bank staff estimates based on data from different levels of government.

1/ Per diems, transportation and fuel, rentals and insurance and banking services.

Economic Classification

2.14. Government spending does not appear to be growth-enhancing, with more than one-half of expenditures for categories of spending that are generally seen as only marginally conducive to economic growth. Such spending includes excessive outlays on wages compared with higher growth countries such as Slovakia, Chile or South Korea; small subsidies to state-owned companies; a large share of capital spending that ten year after the war tends to reflect projects carried out without proper overall sector strategies; and part of the substantial share of transfers to the health sector classified as “outsourced services” under operations and maintenance (Table 2.8).

Table 2.7. Measures of Quality of Government Outcomes

	Corruption Perception Index 1/	Infant Mortality per 1,000 2/	DTP Immun. 3/	Secondary Enrollment (Net) 4/
BH				
Actual	3.1	14.0	80	73
Predicted 5/	5.7	11.4	94	...
Albania	2.5	18.0	98	74
Croatia	3.5	6.0	95	87
FYR Macedonia	2.7	10.0	96	81
SaM	2.7	12.0	95	83
Estonia	6.0	8.0	97	87
Lithuania	4.6	8.0	95	93
Slovenia	6.0	4.0	92	93
Slovakia	4.0	7.0	99	87
Poland	3.5	6.0	99	91
Chile	7.4	...	...	79
Ireland	7.5	5.1	...	82
South Korea	4.5	5.0	97	...

Sources: Transparency International; WHO; and staff estimates.

1/ Transparency International. Higher score is better.

2/ WHO. Infant mortality per 1,000 live births. Lower is better.

3/ WHO. In percent of children 12-23 months. Higher is better.

4/ LSMS for BH and World Development Indicators for the rest.

5/ Regression of the indicator on government spending for 43 countries.

2.15. Outlays on public wages and capital spending are clear outliers relative to comparator countries, but other inefficiencies are also present.

- Relative to adjusted GDP, **spending on wages** is some 2½ percent larger than in the NMS on average and 5 percent larger than in Slovakia, Korea or Chile (Chapter 4). The larger wage outlays are in contrast to the poor performance of the public administration. BH scores below other SEE countries on some governance indicators.³ Moreover, the corruption perception index for BH from a regression on the level of government spending for 43 countries should be two times better than observed.

- **BH's level of capital spending is substantially higher than in other countries in the region.** While high capital spending is not unusual in countries recovering from war, observations from several projects throughout the country suggest that there is substantial inefficiency. Detailed work assessing efficiency in BH is needed for more definitive conclusions, but it is widely recognized that the public sectors in countries such as Chile and Ireland are highly efficient, indicating that even lower levels of capital spending in these countries can deliver equal or larger benefits than the much higher outlays in BH.⁴ Moreover, despite the large capital outlays, routine infrastructure maintenance does not appear to be carried out regularly and a large maintenance backlog has been accumulated (Chapter 7). Reducing the backlog and eliminating inefficiency in capital spending should be priorities.

- **Explicit subsidies are broadly in line with comparator countries, but implicit subsidies make the overall level of support to enterprises substantially larger.** Delays in advancing corporate restructuring and persistent losses of the railway companies have resulted in an increase in explicit subsidies from ¾ percent of adjusted GDP in 2002 to 1.1 percent in 2004. The latter is broadly in line with figures for the NMS, but subsidies among these countries tend to reflect to a larger extent support to agricultural producers. The cost of sustaining the substantial number of publicly owned or loss-making enterprises in BH is also certainly much higher. In addition, quasi-fiscal losses at the state-owned utilities have reappeared in recent years, as tariff rates have remained largely unchanged while the cost of inputs rose sharply. Quasi-fiscal losses probably amounted to ¼ percent of adjusted GDP in 2004. The size of the other implicit subsidies is difficult to quantify, however.

³ The World Bank, 2004, *Governance Matters*.

⁴ See Afonso et al., 2006, *Public Sector Efficiency: Evidence for New EU Member States and Emerging Markets*, European Central Bank, Working Paper No. 581.

Table 2.8. General Government Spending, Economic Classification, 2004 1/
(In percent of GDP)

	Spending		Goods and Services		Subsidies and Transfers		Capital	Interest
	Total	Primary	Total	Wages	Total	Subsidies		
BH								
Official GDP	52.6	51.9	25.7	13.0	19.7	1.5	6.0	0.7
Adjusted GDP	40.5	39.9	19.8	10.0	15.2	1.2	4.6	0.5
SEE average 2/								
With official BH GDP 3/	42.8	41.1	17.1	9.8	16.9	1.5	5.0	1.7
All adjusted 4/	36.7	35.1	14.5	8.4	14.4	...	4.4	1.6
Albania								
	28.5	24.9	9.4	6.3	10.6	...	4.9	3.6
Croatia								
	51.5	49.3	19.4	10.8	21.0	...	8.2	2.2
FYR Macedonia								
	37.1	36.2	13.1	8.5	11.2	...	3.2	0.9
SaM								
	44.3	43.1	17.7	10.4	22.1	...	2.5	1.2
NMS average								
	40.8	38.9	...	8.2	19.0	...	3.9	1.9
of which:								
Estonia								
	37.1	36.9	21.1	7.6	12.9	1.4	2.9	0.2
Lithuania								
	33.6	32.5	14.9	6.7	12.5	0.5	3.6	1.1
Slovenia								
	44.0	42.5	...	11.1	20.4	1.4	4.7	1.5
Slovakia								
	38.4	36.1	...	6.5	15.6	2.0	3.9	2.3
Poland								
	45.7	43.0	...	...	20.7	0.6	3.6	2.7
Others								
Chile								
	22.1	21.1	...	4.3	6.6	...	2.1	1.0
Ireland								
	32.7	31.5	14.8	8.7	12.2	0.7	3.6	1.2
South Korea								
	22.0	20.8	...	6.5	4.1	...	3.4	1.2

Sources: World Bank, IMF and World Bank staff calculations.

1/ Numbers may not add up to total because net lending and transfers to the EU budget are not included.

2/ In this table, SEE includes Albania, BH, Croatia, FYR Macedonia and SaM.

3/ Using spending relative to officially-estimated GDP in BH.

4/ For all countries, relative to GDP that includes a 30 percent cumulative adjustment for the NOE.

• **As discussed earlier, the difference between the levels of observed general government spending in BH and spending predicted based on the quality of outcomes amounts to 10 percent of GDP.** The analysis in this report suggests that the bulk of the difference is due to inefficient spending rather than the constraints imposed by the DPA. Wage outlays are as much as 6 percent of GDP higher than the outcomes of government services would suggest, and as Chapter 4 demonstrates, the larger wage bill primarily reflects high wage rates for lower grade employees, as well as excessive employment in the defense and police sectors, all of which are not greatly influenced by the DPA. Further, larger veterans' outlays reflect the legacy of the war and modest reform efforts rather than the DPA. Moreover, capital spending is higher than the average for the NMS without delivering the same quality of services, but again does not reflect costs imposed by the DPA. Therefore, the direct cost of the DPA appears limited to the relatively modest residual not to exceed 1-2 percent of GDP. The indirect costs of failing to reform and modernize the DPA ten years after the war, such as the lack of a single economic and political space, are probably larger and much harder to quantify.

Functional Classification

2.16. The legacy of the war still weighs heavily on the structure of public expenditures, with BH spending disproportionately more than the NMS on public order and veterans' benefits (Table 2.9). The key features of the analysis of the functional classification are as follows:

Table 2.9. General Government Spending, Functional Classification, 2004
(In percent of GDP)

	General Government		General Public Services	Defense and Public Order		Education	Health	Social Protection		Economic Affairs
	Overall	Primary		Total	Defense			Total	Pensions	
BH										
Official GDP	52.6	51.9	7.7	7.2	2.4	6.2	7.0	15.1	8.4	4.3
Adjusted GDP	40.5	40.0	5.9	5.5	1.8	4.8	5.4	11.6	6.5	3.3
NMS	40.8	38.9	6.1	3.5	1.7	5.1	4.7	15.9	8.8	4.5
Croatia	51.6	49.3	2.5	4.9	2.3	4.3	6.6	15.1	...	...
Estonia	38.9	36.9	...	...	2.0	5.7	...	14.3	6.1	3.8
Lithuania	32.9	32.5	4.6	3.6	1.6	5.9	3.8	15.2	6.2	4.4
Slovenia	44.0	42.5	8.5	3.4	1.4	5.9	6.8	18.3	11.6	3.5
Slovakia	38.4	36.1	5.0	3.8	1.8	1.8	4.4	8.4	7.6	4.7
Poland	45.7	43.0	7.0	2.2	1.8	5.6	4.1	22.1	11.6	3.2
Chile	22.1	21.1	0.3	2.7	...	3.8	3.0	7.5	2.9	2.7
Ireland	34.3	31.5	2.3	2.2	0.6	4.4	6.4	9.5	3.1	5.1

Sources: World Bank; IMF; World Bank: Bulgaria Public Finance Policy Review (2005); and World Bank staff calculations.

- Reflecting a substantially larger police force, **outlays on public order are substantially higher in BH than among the NMS**, or 5½ percent of adjusted GDP vs. 3½ percent. Ongoing demobilization has helped reduce spending on defense to the average for the NMS, the latter of which has risen to meet NATO commitments. The challenge for the BH authorities is to prepare for their objective of membership in the Partnership for Peace (PfP) and ultimately NATO, while keeping defense spending within prudent limits.

- **Social Protection:** Overall outlays on social protection are broadly similar to the levels in other countries in the region, but they are poorly balanced (See Chapter 6). Untargeted veterans' benefits consume a disproportionate share of public resources, with outlays as a share of GDP six times larger than in neighboring Croatia. Social welfare and child assistance programs, by contrast, appear underfunded.

- **Healthcare:** Overcapacity in the health care sector, combined with large duplication of the health care administration, results in larger but inefficient health outlays (see Chapter 6).

- **Education:** Net enrollment in secondary schools is substantially lower in BH than in the CEE countries, with negative consequences for growth prospects (see Chapter 5).

F. FISCAL SUSTAINABILITY

2.17. With the general government in near balance over the last several years, and with debt restructuring carried out with the Paris and London Clubs, government debt fell to 31½ percent of official GDP by 2005. All of government debt is owed to external creditors. Government debt is set to increase substantially, however, after the likely formalization in 2007 and 2008 of claims on the government for war damages, frozen foreign currency deposits ("frozen currency deposits" hereafter), unpaid liabilities and others (domestic claims). Current estimates suggest that the stock of domestic claims has a face value of about 25 percent of GDP, which, together with the existing stock of external government debt, would cause government debt to rise to about 56 percent of official GDP (see below for a discussion and calculations of the stock of domestic claims) (Table 2.10).

2.18. Calculations of the debt-stabilizing primary balances are useful, but they are an incomplete tool for fiscal sustainability analysis in the case of BH. (See Annex A for a brief description of the methodology for calculating the debt-stabilizing primary balance). Assuming the real interest rate (the nominal interest rate less inflation) is **lower** than real GDP growth by 1 percentage point, the stabilizing primary **deficit** is estimated to be roughly 0.6 percent of GDP (Table 2.11).⁵ Including interest outlays of 3.3 percent of GDP a year, this will imply a fiscal deficit of 3.9 percent, a magnitude lenders will be unlikely to finance. It is more informative, as a result, to assume a limit on government borrowing of 1½ percent of GDP a year. The required primary **surplus**, as a result, amounts to 1.8 percent. Fiscal policy would be guided by factors other than

Table 2.10. General Government Debt
(In percent of GDP, 2005)

	Total	Of which: External
BH 1/		
Official	56.3	31.7
Adjusted	43.3	24.4
SaM	60.2	52.9
Croatia	44.2	24.4
Albania	55.6	17.8
FYR Macedonia	37.6	26.9
Bulgaria	32.0	20.0
Romania	38.6	18.8

Sources: IMF and World Bank staff estimates.

1/ Includes domestic claims with face value of 29.6 percent of GDP.

Table 2.11. Debt Stabilizing Primary Balance 1/
(In percent and percent of GDP)

Real interest rate less real GDP growth 2/ (In percent)	Primary Balance (In percent of GDP)	Fiscal Balance
Fiscal outcome for 2005	0.7	0.0
1. No borrowing constraint		
-2.0	-1.1	-3.9
-1.0	-0.6	-3.9
2. Borrowing constraint: Max 1.5 percent of GDP a year		
-2.0	1.3	-1.5
-1.0	1.8	-1.5

1/ Real GDP growth of 5 percent; debt stock, including domestic claims, equal to 56.3 percent of GDP.

2/ Negative if the real interest rate is **lower** than growth.

those taken into account in this analysis, however. The large external deficit, uncertainties regarding both the policy variables and the stock of domestic claims, *inter alia*, are likely to imply a need for even tighter fiscal policy. Even abstracting from these factors, however, the simple model in this paragraph would require a tightening of about 1 percent of GDP relative to the 2005 outcome. The authorities' 2006 budgets are out of line with this calculation, however, making it necessary to carry out a larger adjustment in the following years.

2.19. A more complete picture of fiscal sustainability would require that the analysis take into account future fiscal pressures, and the need to reduce government spending and debt relative to GDP. Looming fiscal pressures include the need to formalize and settle the large stock of domestic claims, strengthen the institutions of the state government and handle property restitution. Moreover, the governments have expressed desires to engage in large infrastructure projects and have moved forward with purchases of rolling stock without a clear strategy for the railroad sector. Raising tax rates to cope with these challenges will be counterproductive, given the already large government burden on the economy. Neither is deficit spending an option because of the adverse consequences this will have on fiscal sustainability.

⁵ Reflecting the concessional nature of the existing stock of government debt and favorable international interest rates, the average nominal interest rate equaled 2.3 percent in 2005 (dividing interest payments by the average stock of debt during 2005). This rate is projected to rise to 5½ percent over the medium term. The average nominal rate on the bonds to be issued to settle domestic claims is assumed equal to 2½ percent, and the rate on new debt is assumed to rise to 7 percent, resulting in a nominal average rate of 5 percent on government debt.

2.20. Tackling the fiscal pressures would require that governments make careful trade-offs among competing priorities to limit new spending, while implementing bold measures to reduce or curb existing expenditures. Carrying out agreed reforms of defense and police, for example, would require that the authorities set wage rates for the new forces (see below). The authorities should seize the opportunity to set wage rates in a manner that would balance concerns about attracting and retaining a professional force and reducing the potential for corruption, with the need to ensure fiscal sustainability. Reforms that bring down employment in the police and the military and centralize command structures should reduce and not increase costs. By contrast, the governments will have substantially more room for maneuver in advancing property restitution, implementing a social program in support of corporate restructuring and limiting infrastructure spending.

2.21. Curbing new fiscal pressures will need to be supplemented by bold measures to cut existing spending. As the analysis below demonstrates, these measures **would need to go beyond what is currently considered by the governments.** Agreement on such measures should be supplemented by building the capacity for setting, coordinating and implementing fiscal policy. Only with such a capacity could the governments identify continuously areas that could be rationalized.

2.22. The rest of the chapter assesses fiscal sustainability by combining the effects of the fiscal pressures and savings measures using a ‘stronger reform’ and a ‘slower reform’ scenarios. The former assumes a bolder and determined reform effort, contributing to a more favorable macroeconomic environment and stronger growth prospects. The latter, by contrast, assumes a much more moderate reform effort. Given that the government will be constrained in financing a large fiscal deficit, the latter scenario illustrates the limits to modest reforms combined with large fiscal pressures and ambitious plans to boost spending. All told, these scenarios are illustrative and the authorities will face more intermediate choices. Intermediate choices will produce intermediate results and constraints on what can be accomplished, including in terms of state building.

Table 2.12. Fiscal Sustainability Scenarios: Key Assumptions

	2005	2006	2007	2008	2009	2010
A1. Revenues excluding grants remain constant as a share of GDP.						
A2. Grants decline in line with IMF assumptions (SM/05/164), the same under both scenarios.						
A3. Spending to GDP remains constant excluding interest and the categories with pressures and savings.						
A4. Interest rates on government debt are the same under both scenarios.						
A5. Principal repayments due on the external debt as of end-2005 are from the BiH MTEF 2006-08.						
A6. The change in the GDP deflator is constant at 2 percent a year.						
	(In percent of official GDP)					
Grants	3.3	2.3	1.8	1.2	0.8	0.7
	(In millions of KM)					
Principal repayments due on the end-2005 stock of external debt	157	194	168	146	183	183
	(In percent)					
Interest rate on the external debt as of end-2005	2.3	5.0	5.5	5.5	5.5	5.5
Interest rate on new loans						
Stronger reform		6.0	6.5	7.0	7.0	7.0
Slower reform		7.5	8.0	8.5	8.5	8.5
Real GDP growth						
Stronger reform		5.3	5.3	5.3	5.3	5.3
Slower reform		5.0	4.8	4.5	4.0	4.0

2.23. The savings measures considered under the ‘stronger reform’ scenario summarize the key quantifiable recommendations of the remaining chapters of the PEIR. Both scenarios assume the same levels of inflation and principal repayments due on the existing government debt (Table 2.12). Interest rates on new loans are assumed to be different, reflecting divergent perceptions among creditors about the country’s medium-term prospects. Interest payments are calculated based on the stock of government debt at the end of the preceding year. Also common to both scenarios is the assumption that revenues excluding grants remain unchanged relative to GDP, while grants decline as a share of GDP over the medium term. Real GDP growth, by contrast, is different across the scenarios, as are the magnitudes of the fiscal pressures and spending measures.

G. THE ‘STRONGER REFORM’ SCENARIO

Quantifying the Fiscal Pressures

2.24. The ‘stronger reform’ scenario assumes a substantial political will and effort to tackle the forthcoming fiscal pressures, reduce the government burden on the economy and lower government debt. The fiscal pressures BH faces are substantial. For reasons detailed below, in the absence of measures to reduce or curb spending, tackling these fiscal pressures would boost general government noninterest expenditures by 1.3 percent of GDP by 2010 relative to 2005, excluding principal repayments on domestic debt. Including the principal repayments, outlays are projected to increase by 2.3 percent of GDP by 2010 (Table 2.13). The key spending pressures are detailed in the following paragraphs.

Table 2.13. BH: Quantifying Fiscal Pressures, ‘Stronger Reform’ Scenario, 2005-2010
(In millions of KM unless specified otherwise)

	2005	2006	2007	2008	2009	2010
Spending in categories with pressures (In percent of official GDP)	1697 11.9	2094 13.7	2471 15.0	2616 14.8	2717 14.3	2889 14.2
Spending in cat's with pressures excl. principal (In percent of official GDP)	1697 11.9	2014 13.2	2259 13.7	2372 13.4	2519 13.3	2686 13.2
Defense (In KM relative to 2005)	274	283 9	290 16	267 -7	267 -7	267 -7
Police (In KM relative to 2005)	610	610	610	627 17	632 22	641 31
Corporate restructuring (In KM relative to 2005)		19 19	19 19	19 19	19 19	19 19
Domestic claims		80	256	313	261	261
Interest			63	88	83	78
Principal		80	193	224	178	183
Restitution			29	29	29	29
Interest			10	10	9	9
Principal			18	19	19	20
Capital outlays (In percent of GDP)	813 5.7	1026 6.7	1102 6.7	1184 6.7	1271 6.7	1366 6.7
Institution building (In percent of GDP)		77 0.5	164 1.0	177 1.0	237 1.3	306 1.5

Sources: World Bank staff estimates.

2.25. There are risks that the size of the fiscal pressures identified in this section could increase and additional pressures could emerge. Such developments would need to be addressed by identifying additional spending reductions and further tightening of fiscal policy if institution building and the rest of the government agenda are to proceed as outlined. Within the identified

categories, key risks could result from larger costs of property restitution, corporate restructuring or settling domestic claims. Further, efforts to strengthen the municipal levels of government by allowing municipalities a higher borrowing ceiling, and thus larger outlays, may need to be offset by spending reductions at other levels of government.

State Building

2.26. Strengthening the central level of government is both a key challenge and an opportunity to improve efficiency and help advance EU integration. As detailed in Chapter 3, state-building includes consolidating at the state level of key institutions or functions that have heretofore been fragmented across the different levels of government, creating new institutions and strengthening the capacity of existing institutions. As estimated in Chapter 3, a modest pace of state-building will result in costs of $\frac{3}{4}$ percent of GDP a year. A modestly more ambitious agenda would boost costs to $1\frac{1}{2}$ percent of GDP a year. The 'stronger reform' scenario assumes that costs amount to $\frac{1}{2}$ percent of GDP in 2006 but rise to $1\frac{1}{2}$ percent by 2010.

Domestic Claims

2.27. Substantial domestic claims were accumulated in BH as a result of the 1992-1995 war and the fiscal pressures in its wake (Table 2.14). In response to a surge of court filing by individual claimants and vastly different court awards for similar claims, both entities enacted laws specifying the type and size of valid claims. The laws were also enacted in response to earlier judgments of the Human Rights Commission (HRC) of the Constitutional Court (CC), which invalidated portions of the then existing settlement mechanisms enacted under the privatization laws. With minor exceptions, the laws divided the claims into three large groups: government spending arrears

Table 2.14. The Stock of Domestic Claims, 'Stronger Reform' Scenario
(In millions of KM unless specified otherwise)

	Laws 1/	Current	Planned Settlement	
		Est 2/	Cash	Bonds
Total face value	4,731	3,308	211	3,097
Face value (In percent of 2004 GDP)	35.3	24.6	1.6	23.0
NPV (In percent of 2004 GDP)				17.8
FBH	2,969	1,654	100	1,561
General liabilities	948	93	93	
Liabilities for commercial bank loans	11	11		11
Liabilities for frozen currency deposits	1,110	1,150		1,150
War claims	900	400		400
RS	1,762	1,654	111	1,543
General liabilities	387	224	56	168
Liabilities for frozen currency deposits	775	830	55	775
War claims	600	600		600

Sources: BH authorities and World Bank staff estimates.

1/ Law on the Specification and Settlement of the Internal Debt of the FBH (2004) and Law on the Specification and Settlement of the Internal Debt of the RS (2004).

2/ Entity ministries of finance, OHR, IMF and World Bank staff estimates.

Table 2.15. BH: Payments to Settle Domestic Claims, 'Stronger Reform' Scenario
(In millions of KM unless specified otherwise)

	2006	2007	2008	2009	2010	NPV 1/
Total outlays	80	256	313	261	261	
(In percent of GDP)	0.5	1.6	1.8	1.4	1.3	17.8
Interest		63	88	83	78	
Principal	80	193	224	178	183	
General liabilities cash	52	52	52			
General liabilities bonds 2/		15	15	15	15	1.0
Bank credit FBH 2/		1	1	1	1	0.1
Frozen currency deposits 2/ 3/		161	161	161	161	11.3
Frozen currency deposits cash	28	28				
War claims 2/			84	84	84	5.4
Memo: Restitution 3/		29	29	29	29	
of which: interest		11	10	9	9	

Sources: BH authorities and World Bank staff estimates.

1/ NPV as percent of 2004 nominal GDP.

2/ Fully amortized 15-year bonds with a 3 percent coupon.

3/ Assuming settlement with bonds with NPV of 2 percent of GDP.

(incurred from June 30, 1996 through December 31, 2002), liabilities for frozen currency deposits and liabilities for war damages (Table 2.15). The NPV of the bonds to be issued to settle domestic claims under the laws was limited to 10 percent of GDP.

2.28. The laws were challenged in the CC and the HRC. Regarding frozen currency deposits, the HRC ruled that settlement must be via bonds issued by the state government, carrying an explicit state guarantee, with maturity no longer than 15 years and with an interest rate that would adequately compensate bondholders for inflation. The current state framework law on settling frozen currency deposits provides for bonds with maturity of 13 years and a fixed interest rate of 2.5 percent.

2.29. War claims are potentially smaller in size than frozen currency deposits, but have been accompanied by equally substantial challenges. The CC ruled in December 2004 and the HRC reiterated afterwards that 50-year, zero-coupon bonds were incompatible with citizens' rights protected by the constitution. The HRC decision, however, provided no further guidance as to appropriate bond maturity consistent with the constitution and the European Convention on Human Rights. The analysis assumes bonds with maturity of 15 years and an interest rate of 2.5 percent, but the actual settlement may turn out more favorable, with longer maturity and a grace period.

2.30. With entity governments repaying domestic arrears, the stock of domestic claims has been reduced since late 2004. Together with further write-offs as a result of verification, the overall size of domestic arrears has been reduced substantially. Moreover, an upward revision of the size of domestic arrears is unlikely and the existing stock is taken as the basis for both the 'stronger reform' and the 'slower reform' scenarios. The authorities began verifying frozen currency accounts on August 11, 2005 in the RS and on September 11, 2005 in the FBH and expect to complete the process by the end of 2006. Both scenarios are based on the legally mandated limit, although experience from the neighboring countries suggests that the final amount is likely to be smaller.

2.31. A substantial reduction of the size of war claims in the FBH is likely. Exhaustive work by the OHR, including reviews of all claims submitted at cantonal and entity levels, suggests that the war claims that were estimated at KM 900 million in the FBH law are likely to amount to at most KM400 million. This is the figure used under the ‘stronger reform’ scenario. In contrast to the FBH claims, a further reduction of the RS war claims relative to the KM 600 million cap provided under the RS law is unlikely. The ‘stronger reform’ scenario uses the figure provided under the law and the ‘slower reform’ scenario assumes a much larger figure.

2.32. Under the ‘stronger reform’ scenario, the face value of domestic claims amounts to 24.6 percent of 2004 nominal GDP, with a NPV of 17.8 percent.⁶ Only a portion of the claims is assumed to be settled with cash and the rest with bonds. Bonds for settling the claims for frozen currency deposits are assumed to be issued in 2007 and for war claims in 2008. The bonds are assumed to be fully amortized during their lifetime, a conservative assumption.

Defense Reform

2.33. The authorities have embarked on an ambitious defense reform. A single command structure and a single budget were established at the state level from the start of 2006. The entity armed forces and ministries of defense (MoD) were unified at the same time, but staff levels and wage rates will remain unchanged through the end of September 2006. The authorities are committed to agree by the middle of 2006 on the staff levels and wages that will be in effect starting in October 2006. These wage rates will be provided under the state-level public wage law. The ‘stronger reform’ scenario assumes a substantially smaller increase in wage rates than implied by the 2006 budget. Achieving such a smaller increase would require substantial political will, especially ahead of the 2006 elections. The following assumptions are made:

- From October 2006, the armed forces will be reduced to 10,000 from 11,766 at present and the administrative staff to 1,000 from 1,364. Average wage rates for the army are assumed to increase to KM 1,137 per month (a 5 percent increase for the FBH armed forces, resulting in a 34 percent increase for the RS armed forces) and to KM 1,717 for the MoD staff. Such wage rates are still very high. For comparison, the average gross wage in the formal sector in BH amounted to KM 713 a month in 2004, while average wages in the growing informal sector are much lower.

- Reductions are accompanied by a severance package, under which the redundant soldiers and civil servants draw their current salaries for 12 months, from October 2006 until September 2007 (equivalent to KM 12,400 per person in the FBH army and KM 11,300 in the RS army).

2.34. Relative to a scenario of preserving the status quo and no changes in defense employment and wage rates, the ‘stronger reform’ scenario results in modest costs of 0.1 percent of GDP in 2006 and 2007. There are negligible savings thereafter, an achievement that reflects the assumed modest wage increases (Table 2.16). These results underline the importance of fiscal prudence when setting wage rates and severance packages for the army and the MoD.

⁶ To calculate the NPV of the claims, the analysis uses a discount rate which is the sum of the average yield on 10-year German bunds since 2001 (about 4 percent) and the spread on the recently-issued Eurobond by Ukraine relative to German bunds (250 basis points). The discount rate used, therefore, is 6½ percent. Under the ‘stronger reform’ scenario, the NPV of all domestic claims amounts to 17.8 percent of 2004 nominal GDP or 18.9 percent of 2003 nominal GDP. The latter figure is to be compared with the 10 percent of GDP NPV that the 2004 laws targeted to achieve.

Table 2.16. Bosnia and Herzegovina: Defense Reform, 'Stronger Reform' Scenario
(Employment in actuals, gross average monthly wages in KM)

	2005		2006				2007		2008		2009		
	empl	wage	Jan-Sept		Oct-Dec		Total wage	empl	wage	empl	wage	empl	wage
			empl	wage	empl	wage							
State													
Army					10,000	1,384		10,000	1,384	10,000	1,384	10,000	1,384
Administration	158	1,717	158	1,717	1,000	1,717		1,000	1,717	1,000	1,717	1,000	1,717
FBH													
Army	7,937	1,034	7,937	1,034									
Administration	791	1,348	791	1,348									
RS													
Army	3,829	813	3,829	813									
Administration	415	941	415	941									

(In millions of KM)

Total wage bill	156.6	117.4	46.7	164.1	186.7	186.7	186.7
Allowances	31.3	23.5	9.3	32.8	37.3	37.3	37.3
Severance 1/			7.0	7.0	17.5	0.0	0.0
Other costs of transition 2/				3.3	5.0		
Overall cost of reform 3/ (in percent of GDP)				19.4	58.7	36.1	36.1
				0.1	0.4	0.2	0.2

Sources: Ministries of Defense, Defense Reform Commission and World Bank staff estimates.

1/ Starting in October 2006, all redundant staff will receive for an extra 12 months the gross wage they received until September 2006.

2/ Ministry of defense.

3/ Relative to a non-reform scenario under which wages are kept unchanged in nominal terms.

Police Reform

2.35. The authorities reached an agreement to embark on police reform in late 2005. Current proposals are for the process to be completed over five years, starting with administrative and legal preparations from 2006 through the end of 2007, to be followed by the unification and reduction of existing police forces from 2008 through 2010. There is substantial uncertainty as to the speed of the process, however. The following assumptions are used under the ‘stronger reform’ scenario (Table 2.17):

- From 2008 through 2010, the overall number of police will be reduced by 3,500 relative to 2005 levels (20 percent in 2008, 30 percent in 2009 and the rest in 2010) and the administrative staff by 2,000 (50 percent in 2008, 30 percent in 2009 and 20 percent in 2010), in line with the recommendations contained in the Report of the Police Restructuring Commission of BH from December 2004. The pace of shifting of the police and the administration to the new police regions is assumed to proceed in line with the above assumptions on the pace of staff reductions.

- In the absence of an official decision, the average wage of the new police force is assumed to increase 5 percent relative to the current average wage in the FBH. This is an ambitious assumption whose realization would require political will. Policemen will begin receiving the new salaries when they are shifted to the new force; until then, they are assumed to receive their existing salaries. Absent any other guidance from the authorities, redundant police are assumed to receive severance packages of KM 7,000 per person.

2.36. Under the ‘stronger reform’ scenario, the cost of police reform is projected to be modest and would amount to 0.1-0.2 percent a year from 2008 through 2010. The authorities would be well advised to set wage rates and employment level to generate savings over the medium term, rather than to increase costs.

Property Restitution

2.37. Property restitution is yet to begin. The state-level Restitution Commission established in 2004 has invited citizens and companies to present claims for property to be restituted, but there is no decision on what the next steps should be. The submitted claims thus far cover one-half of BH’s territory, with most of these for arable land and forests. Even with due allowance for overlapping or inflated claims, these numbers suggest that the potential costs of the process could escalate if not managed properly. With this in mind, the authorities would be well advised to agree to provide only monetary compensation and to devise mechanisms for settling restitution claims that balances private demands with the public interest. The analysis assumes that the NPV of debt issued to deal with restitution will amount to only 2 percent of 2004 nominal GDP and settlement is assumed to begin in 2007 via bonds with the same characteristics as those used to settle domestic claims. Risks are substantial, however, that the actual settlement may well be much larger than assumed. Uncertainty as to when the process will actually begin is also substantial.

Table 2.17. Bosnia and Herzegovina: Police Reform, 'Stronger Reform' Scenario 1/
(Actual employment; gross average monthly wages in KM)

		2005	2006	2007	2008	2009	2010
Ministry of Security 2/ of which:							
Administration	Avg wage	1,900	1,900	1,900	1,900	1,900	1,900
	Empl	51	51	51	2,001	3,171	3,951
Police	Avg wage				1,622	1,622	1,622
	Empl				2,161	5,403	10,805
RS							
Administration	Avg wage	750	750	750	750	750	750
	Empl	2,196	2,196	2,196	1,098	439	0
Police	Avg wage	850	850	850	850	850	850
	Empl	5,458	5,458	5,458	4,366	2,729	0
FBH							
Administration	Avg wage	1,545	1,545	1,545	1,545	1,545	1,545
	Empl	404	404	404	202	81	0
Police	Avg wage	1,545	1,545	1,545	1,545	1,545	1,545
	Empl	847	847	847	678	424	0
Cantons							
Administration	Avg wage	1,360	1,360	1,360	1,360	1,360	1,360
	Empl	3,300	3,300	3,300	1,650	660	0
Police	Avg wage	1,360	1,360	1,360	1,360	1,360	1,360
	Empl	8,000	8,000	8,000	6,400	4,000	0
Total							
Administration	Avg wage	1,152	1,152	1,152	1,451	1,695	1,900
	Empl	5,951	5,951	5,951	4,951	4,351	3,951
Police	Avg wage	1,176	1,176	1,176	1,247	1,368	1,622
	Empl	14,305	14,305	14,305	13,605	12,555	10,805
(In millions of KM)							
Wage bill without reform		284	284	284	284	284	284
Reform scenario summary							
Wage bill 2/		284	284	284	290	295	300
Severance			0	0	12	12	15
Total wage cost		284	284	284	302	306	315
Net cost					17	22	31
(In percent of GDP)					0.1	0.1	0.2

Sources: EUPM, Ministries of Interior, Ministry of Security, IMF and World Bank staff estimates.

1/ Average wage is in KM per month.

2/ Excluding SIPA, SBS and Interpol.

Table 2.18. BH: Quantifying Spending Measures, ‘Stronger Reform’ Scenario, 2005-2010
(In millions of KM unless specified otherwise)

	2005	2006	2007	2008	2009	2010
Spending in categories with measures (percent of GDP)	4134 29.0	4204 27.5	4209 25.6	4300 24.3	4417 23.3	4544 22.3
Narrow wage bill 1/ (In percent of GDP)	822	812 5.3	803 4.9	793 4.5	790 4.2	790 3.9
Education 2/ (In percent of GDP)	745	732 4.8	764 4.6	801 4.5	843 4.4	889 4.4
Subsidies (In percent of GDP)	210	205 1.3	200 1.2	195 1.1	195 1.0	195 1.0
Transfers to non-profits (In percent of GDP)	285 2.0	278 1.8	271 1.6	264 1.5	264 1.4	264 1.3
Social welfare 3/ (In percent of GDP)	623	697 4.5	630 3.8	641 3.6	653 3.4	665 3.3
Pensions (In percent of GDP)		1316 8.6	1369 8.3	1425 8.1	1482 7.8	1542 7.6
Pharmaceutical procurement (In percent of GDP)	184	164 1.1	172 1.0	181 1.0	190 1.0	199 1.0

Sources: BH authorities and World Bank staff estimates.

1/ Excludes public employees in defense, police and education.

2/ Includes all outlays on education, including wages.

3/ Includes social welfare, child protection and veterans benefits.

Capital outlays

2.38. To reflect increased prospects that the governments will engage in large-scale infrastructure investment, and to reflect the likelihood that spending will be increased to upgrade infrastructure at the sub-national level, the ‘stronger reform’ scenario assumes that capital outlays by the general government will rise from 5.7 percent of GDP in 2005 to 6.7 percent by 2010.

Quantifying the Spending Reduction Measures

2.39. To offset the spending pressures and allow for an overall spending retrenchment from 53 percent of official GDP to 49 percent, the proposed spending measures alone would reduce outlays by an estimated 6.7 percent of GDP by 2010 relative to 2005. These measures are a subset of the recommendations contained in the remainder of the report and represent a substantial reform effort (Table 2.18). While bold, the proposed spending reductions are certainly not unrealistic. These reductions could be compared with a reduction of general government spending equivalent to 6.2 percent from 1998 through 2002 in Lithuania and a cut of 4 percent of GDP in Serbia and Montenegro from 2002 through 2005. The identified spending measures, moreover, work within the existing constitutional arrangements. The authorities may decide to alter the existing system of governance over the longer term to reduce duplication and generate further savings, however.

- **Public wages and employment (see Chapter 4 for details).** The measures in the following paragraphs refer only to the existing government institutions, excluding defense, police, and

education (Table 2.19). The wage bill for defense, police and new institutions is discussed in the section on fiscal pressures. The wage bill for education is handled in the following section on education.

Table 2.19. Bosnia and Herzegovina: Wage Bill, ‘Stronger Reform’ Scenario
(In millions of KM unless specified otherwise)

	2005	2006	2007	2008	2009	2010
Total	1953					
(In percent of GDP)	14					
Defense	234					
Police	284					
Education	613					
Narrow wage bill 1/	822	812	803	793	790	790
(In percent of GDP)	5.8	5.3	4.9	4.5	4.2	3.9
Judiciary	116	113	113	113	113	113
Health excl. medical professionals	42	42	39	36	33	33
All others	664	657	651	644	644	644

Sources: BH authorities and World Bank staff estimates.

1/ Excluding public employees in defense, police and education.

Measure 1: Reduce wage rates in the judiciary in line with proposals from the High Judicial and Prosecutorial Council. After a cut of 4.4 percent at the start of 2006 (KM2.9 million), nominal wage rates are assumed to remain frozen through 2010. In addition, benefits that were abolished and then partially reinstated are assumed to be permanently abolished.

Measure 2: Reduce employment in the health ministries, health insurance funds and public health institutes in line with the recommendations of the EU functional reviews. The wage bill among these institutions will decline by KM9.3 million over the next several years as a result. However, there is substantially more scope for reduction.

Measure 3: Reduce the wage bill for the remaining categories of public employees by 1 percent in nominal terms a year for three years, and then keep the wage bill frozen in nominal terms. This would be achieved by implementing measures to help prioritize functions and to reduce total employment gradually by 2-2½ percent a year. Savings would be offset by setting aside a modest amount (1-1½ percent) for wage decompression for priority posts.

- **Education:** All measures related to education are detailed in Chapter 5. Enacting all the measures proposed in this section will help reduce outlays by 0.9 percent of GDP by 2010 relative to 2005 (Table 2.20).

Measure 4: Move to per capita financing of primary and secondary schools.

Measure 5: Reorient students to general secondary education from technical and vocational education to help reduce outlays on education and improve the job market prospects of students.

Measure 6: Raise fees for university students that repeat years.

Measure 7: Raise fees for foreign students to cover fully the cost of their tuition.

Table 2.20. BH: Education Outlays, ‘Stronger Reform’ Scenario, 2005-2010
(In millions of KM unless specified otherwise)

	2005	2006	2007	2008	2009	2010
Proposed measures 1/ (In percent of GDP)		65 0.4	92 0.6	119 0.7	143 0.8	168 0.9
Move to per capita financing		17	30	40	44	46
Reorient from technical to general sec. educ.		8	20	35	53	73
Raise fees for repetition		25	27	29	31	34
Integrate universities		15	15	15	15	15

Sources: BH authorities and World Bank staff estimates.

1/ Differences relative to 2005.

Measure 8: Integrate fully each university’s separately managed faculties to reduce the widespread duplication of staff, facilities and programs.

- **Subsidies and transfers to non-profit organizations**

Measure 9: Reduce subsidies to railroads and freeze agriculture subsidies in nominal terms, resulting in a reduction of ½ percent of GDP in 2010 relative to 2005. Achieving cuts in subsidies to the railroads will require hard decisions to trim labor, services and the network. In addition, improved cost recovery from freight flows on the network will also improve the financial position of the railway companies, reducing the need for subsidies. Keeping agriculture subsidies unchanged will also require strong political commitment.

Measure 10: Reduce transfers to non-profit organizations. Entity and sub-entity governments transferred the equivalent of 1½ percent of GDP to veterans’ associations, citizens’ organizations and other non-profit entities in 2004.⁷ The authorities should consider reducing transfers to non-profit organizations by at least ½ percent of GDP by 2008 relative to 2005 to help improve transparency and reduce the inefficient use of public resources.

- **Veterans’ benefits, social welfare and child protection (See Chapter 6 for details):** The measures proposed in the following paragraphs would more than offset the modest costs related to the enactment of laws on social welfare in the RS and child protection in the FBH and help reduce overall spending on veterans’ benefits, social welfare and child protection by 1.1 percent of GDP by 2010 relative to 2005 (Table 2.21). Such savings could only be generated with substantially bolder reforms of the veterans’ benefits systems than those supported in the last round of legislative changes. Reforms would require decisive action to improve targeting of benefits to the most disabled veterans and the neediest survivors and thus call for a reduction in the number of beneficiaries by over 40 percent. Reforms of this level of ambition would reach well beyond the nominal freeze of veterans’ benefits spending that has been targeted with little success so far.

Measure 11: Tighten eligibility requirements for veterans and survivor families.

Measure 12: In the FBH, reduce the allocation for people with non-war-induced disabilities through cash rationing.

⁷ Transfers to non-profit organizations often include *bona fide* subsidies, such as the payments to Air Bosna by the FBH budget in 2004 and 2005. The PEIR adjusts for this misclassification.

Table 2.21. BH: Outlays on Social Welfare, Child Protection and Veterans Benefits, 'Stronger Reform' Scenario, 2005-2010 1/ (In millions of KM unless specified otherwise)

	2005	2006	2007	2008	2009	2010
Total	623	697	630	641	653	665
(In percent of GDP)	4.4	4.5	3.8	3.6	3.4	3.3
Social welfare 2/	93	133	136	139	141	144
Child protection 3/	76	110	113	116	119	122
Veterans' benefits	455	453	381	387	392	398
(In percent of GDP)	3.2	3.0	2.3	2.2	2.1	2.0

Sources: BH authorities and World Bank staff estimates.

1/ General government.

2/ Includes outlays on social welfare, civilian victims of war and disability. Assumes enactment of a social protection law in the RS from the start of 2006.

3/ Assumes enactment of a child welfare law in the FBH in 2006.

- **Pensions (See Chapter 6 for additional details)**

Measure 13: Limit pension increases in both entities to the change in consumer prices. The shift to inflation indexation from implicit average wage indexation will help slow the increase in pension outlays in nominal terms and reduce them by 1¼ percent of GDP by 2010 compared with 2005 (Table 2.22).

Table 2.22. BH: General Government Pension Outlays, 2005-2010 (In millions of KM unless specified otherwise)

	2005	2006	2007	2008	2009	2010
Total	1265	1316	1369	1425	1482	1542
(In percent of GDP)	8.9	8.6	8.3	8.1	7.8	7.6
FBH 1/	831	865	900	936	974	1013
(In percent of GDP)	5.8	5.6	5.5	5.3	5.1	5.0
RS 1/	434	452	470	489	509	529
(In percent of GDP)	3.0	2.9	2.9	2.8	2.7	2.6

Sources: World Bank staff estimates.

1/ From 2006 onwards, the analysis assumes an increase in the number of beneficiaries by 2 percent a year. Average annual pensions are also assumed to increase by 2 percent a year.

- **Pharmaceutical procurement (See Chapter 6 for additional details)**

Measure 14: Centralize pharmaceutical procurement, at least at the entity level; and convert the new system of procurement to a tender-basis. Centralized procurement of drugs through competitive tendering should help reduce total drug expenditures by up to 20 percent in the FBH, or a quarter percent of GDP by 2010 relative to 2005. Savings would be smaller in the RS because the system is already more centralized. Centralized and tender-based procurement, combined with measures to limit expansion of the positive drug list and encourage generic substitution, is assumed to help keep the increase in the overall pharmaceutical outlays covered by the health funds to 5 percent a year over the medium term after the initial decrease, which would require tight controls over drug expenditures.

Fiscal Sustainability: Putting Pressures and Measures Together

2.40. The ‘stronger reform’ scenario assumes that all of the above spending measures are implemented. Such a bold reform effort would enable the governments to meet the fiscal challenges identified in this chapter while reducing government spending and debt (Table 2.23). Government spending, as a result, is projected to decline from 41 percent of adjusted GDP to 38 percent by 2010. **This is a substantial reduction given the magnitude of the fiscal pressures assumed to be tackled under this scenario, but spending would still be higher relative to GDP than in countries with similar incomes per capita and higher than the SEE countries on average.** General government debt, including domestic claims, is projected to fall to 33 percent of adjusted GDP after rising to 41 percent in 2007. As a share of officially estimated GDP, government debt is projected to decline from 53 percent of GDP in 2006 to 43 percent by 2010.

2.41. Commitment to ambitious spending reductions along the lines of the ‘stronger reform’ scenario should strengthen investor confidence and contribute to improving BH’s creditworthiness. This should enable the governments to finance the temporary deficits over the next several years and the principal repayments due. Principal repayments due on the current stock of external debt are assumed to amount to 1-1¼ percent of GDP in 2006 and 2007 and decline thereafter, while principal repayments due on domestic claims and restitution are set to jump to 1.4 percent by 2008. The governments’ gross borrowing requirements are projected to increase from 3.5 percent of GDP in 2006 to 3.9 percent in 2007 before easing to 0.8 percent in 2010.

2.42. Part of the borrowing requirements could be funded via drawdowns of the governments’ deposits held with domestic banks. Provided the authorities agree to a credible medium-term program along the lines of this scenario, it is assumed that multilateral creditors will extend about \$80 million a year during 2006-2010.⁸

2.43. All told, even with the ambitious reforms considered thus far, a substantial funding need would remain. Assuming deposit drawdowns amount to \$100 million during 2006-2010 and gross multilateral disbursements to \$400 million, the remaining cumulative financing gap is projected to amount to \$850 million, with heavier concentration in the earlier years. Whether private foreign creditors would finance such a gap is unclear, but prospects would certainly improve were the authorities to agree and begin implementing an ambitious agenda of spending and structural reforms. Alternatively, the gap can be narrowed substantially if the authorities were to accept that the pace of institution building at the state level has to be slower than assumed and that capital outlays were to remain broadly unchanged rather than increase as projected.

⁸ This assumes disbursements in roughly equal proportions under the existing and new policy-based lending from the World Bank and under new stand-by arrangements with the IMF.

Table 2.23. BH: Summary of the 'Stronger Reform' Scenario, 2005-2010
(In percent of GDP unless specified otherwise)

	2005	2006	2007	2008	2009	2010	
General government revenues and grants	53.5	52.5	52.0	51.4	51.0	50.9	
Revenues	50.2	50.2	50.2	50.2	50.2	50.2	
Grants	3.3	2.3	1.8	1.2	0.8	0.7	
General government spending	53.5	54.0	53.6	52.3	51.0	49.8	
In categories with fiscal pressures	11.9	13.2	13.7	13.4	13.3	13.2	
In categories with savings	29.0	27.5	25.6	24.3	23.3	22.3	
Other noninterest outlays	11.9	11.9	11.9	11.9	11.9	11.9	
Interest	0.7	1.5	2.4	2.7	2.6	2.5	
(In millions of KM)	100	224	388	469	492	500	
General government balance	0.0	-1.5	-1.6	-0.9	-0.1	1.1	
(In millions of KM)	0	-225	-261	-164	-10	217	
Primary balance	0.7	0.0	0.8	1.7	2.5	3.5	
Financing		1.5	1.6	0.9	0.1	-1.1	
Principal repayments due on ext. debt as of end-2005		-1.3	-1.0	-0.8	-1.0	-0.9	
Principal repayments due on dom. debt as of end-2005		-0.3					
Principal repayments due on dom. claims and restitution		-0.5	-1.3	-1.4	-1.0	-1.0	
New borrowing		3.5	3.9	3.1	2.1	0.8	
Government debt	31.7	48.9	53.2	50.4	47.0	42.7	
External debt as of the end-2005	31.4	28.0	25.0	22.5	20.0	17.7	
Domestic debt as of the end-2005	0.3						
Domestic claims and restitution		17.4	21.0	18.1	15.8	13.7	
New loans		3.5	7.2	9.8	11.2	11.3	
		(In percent of adjusted GDP)					
General government spending	41.2	41.5	41.2	40.2	39.3	38.3	
General government debt	24.4	37.6	40.9	38.8	36.2	32.8	

Sources: BH authorities and World Bank staff estimates.

H. THE 'SLOWER REFORM' SCENARIO

2.44. The 'slower reform' scenario assumes that weaker will for reform would result in larger costs of tackling the fiscal pressures and smaller savings from the implementation of a subset of the spending measures discussed under the 'stronger reform' scenario. These factors, combined with slower real GDP growth, are projected to result in a persistently large general government deficit that will leave government debt on an upward and unsustainable trend.

2.45. The differences in fiscal pressures under the ‘slower reform’ and the ‘stronger reform’ scenarios are detailed in the following paragraphs (Table 2.24). The ‘slower reform’ scenario assumes that the stock of domestic claims will amount to KM900 million in the FBH, in line with the FBH law, and to KM3 billion in the RS, or half as much as under the RS law (Tables 2.25 and 2.26). The larger amounts compared with the ‘stronger reform’ scenario reflect the risks that additional claims for war damages will appear, but the figures are certainly at the outer limits of what is possible. Under these assumptions, the face value of domestic debt would amount to 45 percent of GDP with NPV of 33.5 percent. Settlement of domestic claims is assumed to be carried out via bonds with the same parameters as under the ‘stronger reform’ scenario.

Table 2.24. BH: Quantifying Fiscal Pressures, 'Slower Reform' Scenario, 2005-2010
(In millions of KM unless specified otherwise)

	2005	2006	2007	2008	2009	2010
Spending in categories with pressures (In percent of official GDP)	1697 11.9	2132 14.0	2675 16.4	3116 17.9	3219 17.4	3400 17.4
Spending in cat's with pressures excl. principal (In percent of official GDP)	1697 11.9	2053 13.4	2428 14.9	2670 15.3	2813 15.2	2982 15.2
Defense (In KM relative to 2005)	274	305 31	381 107	358 84	358 84	358 84
Police (In KM relative to 2005)	610	610 0	610 0	638 28	662 52	701 91
Corporate restructuring (In KM relative to 2005)		38 38	38 38	38 38	38 38	39 39
Domestic claims		80	311	660	608	608
Interest			83	206	194	182
Principal		80	228	427	386	397
Restitution			29	29	29	29
Interest			10	10	9	9
Principal			18	19	19	20
Capital outlays (In percent of GDP)	813 5.7	1023 6.7	1143 7.0	1218 7.0	1292 7.0	1371 7.0
Institution building (In percent of GDP)		76 0.5	163 1.0	174 1.0	231 1.3	294 1.5

Sources: BH authorities and World Bank staff estimates.

Table 2.25. BH: Stock of Domestic Claims, 'Slower Reform' Scenario
(In millions of KM unless specified otherwise)

	Laws 1/	Current Est 2/	Planned Settlement	
			cash	bonds
Total face value	4,731	6,208	196	6,012
(In percent of 2004 nominal GDP)	35.3	46.4	1.5	44.9
NPV (In percent of 2004 nominal GDP)				33.5
FBH	2,969	2,154	93	2,061
General liabilities	948	93	93	
Liabilities for commercial bank loans	11	11		11
Liabilities for frozen currency deposits	1,110	1,150		1,150
War claims	900	900		900
RS	1,762	4,054	103	3,951
General liabilities	387	224	48	176
Liabilities for frozen currency deposits	775	830	55	775
War claims	600	3,000		3,000

Source: BH authorities, OHR, and World Bank staff estimates.

1/ Law on the Specification and Manner of Settlement of the Internal Debt of the FBH (2004)

Law on the Specification and Manner of Settlement of the Internal Debt of the RS (2004).

2/ Entity ministries of finance, OHR, IMF and staff estimates.

Table 2.26. BH: Payments to Settle Domestic Claims, 'Slower Reform' Scenario
(In millions of KM unless specified otherwise)

	2006	2007	2008	2009	2010	NPV 1/
Total outlays	80	256	556	504	504	
(In percent of GDP)	0.5	1.6	3.1	2.7	2.5	33.5
Interest		63	171	161	150	
Principal	80	193	385	343	353	
General liabilities cash	52	52	52			
General liabilities bonds 2/		15	15	15	15	1.0
Bank credit FBH 2/		1	1	1	1	0.1
Frozen currency deposits 2/ 3/		161	161	161	161	11.3
Frozen currency deposits cash	28	28				
War claims 2/			327	327	327	21.2
Memo: Restitution 3/		29	29	29	29	
of which: interest		11	10	9	9	

Source: BH authorities and World Bank staff estimates.

1/ NPV as percent of 2004 nominal GDP.

2/ Fully amortized 15-year bonds with a 3 percent coupon.

3/ Assuming settlement with bonds with NPV of 2 percent of GDP.

2.46. For defense, under the 'slower reform' scenario average army wage rates are assumed to be increased to the level of the average wages for the state MoD, or to KM1,717 a month. The

costs of defense reform will be roughly double than under the ‘stronger reform’ scenario, or 0.2 percent of GDP in 2006, 0.7 percent in 2007 and ½ percent through 2010.

2.47. For police, the ‘slower reform’ scenario also assumes large increases in average wages. The average wage is assumed to increase by 20 percent for the operational police staff relative to the current level in the FBH and by 10 percent for the administrative staff relative to current state wage levels. Under these assumptions, the cost of police reform would increase to 0.4 percent of GDP by 2010 from 0.2 percent of GDP in 2008.

2.48. Outlays on the social program to facilitate corporate restructuring and capital expenditures are also assumed to be larger than under the ‘stronger reform’ scenario. On the social program, outlays are assumed to be three times as large as under the ‘stronger reform’ scenario but still modest at ¼ percent of GDP a year. Capital outlays are assumed to increase faster than under the ‘stronger reform’ scenario to 7 percent of GDP by 2007 and remain at that level through 2010. All remaining fiscal pressures are assumed to have similar magnitudes as under the ‘stronger reform’ scenario.

2.49. The ‘slower reform’ scenario assumes that a more limited set of spending measures will be implemented compared with the ‘stronger reform’ scenario. The three areas where reform implementation will be slower are public wages, subsidies and spending on social welfare, including on veterans’ benefits (Table 2.27). The analysis assumes that public wages, other than those for the military, police, judiciary, education, and health, would increase by 2 percent a year in nominal terms. The narrowly defined wage bill is therefore projected to decrease by 1¼ percent by 2010 relative to 2005 rather than the roughly 2 percent of GDP under the ‘stronger reform’ scenario. Subsidies are

Table 2.27. BH: Quantifying Spending Measures, 'Slower Reform' Scenario, 2005-2010
(In millions of KM unless specified otherwise)

	2005	2006	2007	2008	2009	2010
Spending in categories with measures (In percent of GDP)	3301 23.1	3326 21.8	3420 20.9	3524 20.3	3644 19.7	3774 19.3
Narrow wage bill 1/ (In percent of GDP)	822	835 5.5	843 5.2	854 4.9	865 4.7	879 4.5
Education 2/ (In percent of GDP)	745	732 4.8	764 4.7	801 4.6	843 4.6	889 4.5
Transfers to non-profits (In percent of GDP)	285 2.0	278 1.8	271 1.7	264 1.5	264 1.4	264 1.3
Pensions (In percent of GDP)	1265	1316 8.6	1369 8.4	1425 8.2	1482 8.0	1542 7.9
Pharmaceutical procurement (In percent of GDP)	184	164 1.1	172 1.1	181 1.0	190 1.0	199 1.0

Sources: BH authorities and World Bank staff estimates.

1/ Excludes public employees in defense, police and education.

2/ Includes all outlays on education, including wages.

2.51. The ‘stronger reform’ and ‘slower reform’ scenarios presented in this chapter illustrate the key choices faced by the BH governments. Even if all the bold measures proposed therein are implemented, however, there will remain a substantial financing gap. Whether and at what cost this gap can be financed is the key constraint that will ultimately guide the choices the authorities make. Part of the gap reflects the assumption made in the chapter that revenues net of grants would remain unchanged relative to GDP over the medium-term. An ambitious implementation of structural reforms, implied under the ‘stronger reform’ scenario, should help boost economic activity and result in stronger revenues. These would afford the opportunity to reduce social security contribution rates, with a further beneficial effect on real GDP growth and revenues.

2.52. Agreeing and implementing a bolder agenda of spending reforms than proposed in this chapter should help reduce the gap and improve the governments’ credibility. There should be no illusion that this will be very difficult politically. Should such an agenda be agreed, access to capital markets will improve, making it more likely than not that a substantial part of the remaining gap will be financed. More ambitious spending reductions are all the more important, given that the potential cost of state level institution building is unknown. Should the cost amount to more than is assumed in this chapter, the authorities would need to find additional savings. While some savings could result from *ad hoc* measures to curb outlays on operations and maintenance, as done in the recent past, such an approach would only hinder further economic expansion and add to fiscal woes. Savings need to come from the areas that are the most inefficient, and these are plenty.

2.53. Delays implementing spending or structural reforms would have serious negative consequences for the pace of EU integration. With foreign investors unlikely to finance large fiscal deficits if no credible medium-term program of fiscal restraint and adjustment is adopted, the authorities will be forced to slow the pace of institution building and cut spending in an unplanned manner. The slower pace of building or strengthening government institutions will delay EU integration and limit scope for creation of a single economic and political space. All told, the authorities will miss the opportunity to reduce the very high unemployment and poverty and improve living standards. Fiscal and financial consequences will also be substantial should investors’ worries about fiscal sustainability intensify.

I. RECOMMENDATIONS

2.54. This chapter concludes with a summary of recommendations derived from the analysis of the level and structure of government spending. The recommendations do not include those that are presented in the following chapters and quantified in the fiscal sustainability analysis.

Government Spending

- **Reduce the level of government spending relative to GDP closer to the levels among the faster growing economies and countries with broadly similar incomes per capita.** This should help lighten the government’s burden on the economy and help tackle forthcoming fiscal pressures. All told, consider enacting and implementing a medium-term plan of fiscal consolidation that will reduce existing spending by at least 7 percent of GDP.

- **As a general rule, eliminate inefficiencies in sectors or programs before committing new funds to these areas.**

- **Using the analysis in the remainder of the report, improve the structure of government spending to reduce the share of expenditures that are more often seen as not conducive to boosting economic growth and reducing poverty.**

Taxes and Social Security Contributions

- **Enact the harmonized entity laws on corporate and personal income taxes.** Consider ways to further eliminate exemptions to create an even playing field for all companies, domestic and foreign.

- **Reduce social security contribution rates.** As a first step, use the larger than projected VAT revenues, should these turn out to be permanent, to eliminate cross flows between the extrabudgetary funds and cut contribution rates (See Chapter 6 for details). As a second step, should the new personal and corporate income tax laws also prove to be revenue positive, reduce contribution rates further. Finally, consider modest increases in the personal income tax rate to reduce yet further social security contribution rates.

Defense and Police Reforms, State Building

- **Set the wage rates and employment levels for the army and the police in a fashion that would be fiscally sustainable while providing for incentives to retain and recruit capable personnel in line with the governments' longer-term priorities.**

- **Prioritized and carefully planned strengthening of state institutions should help limit costs.** As a principle, shifting institutions from the sub-national to the national level of government without adding functions should be at least cost-neutral. The authorities should work toward offsetting costs related to creating new or strengthening existing state-level institutions and functions through reductions in spending elsewhere.

Domestic Claims and Restitution

- **Settling the outstanding domestic claims and handling restitution should be done in a way that balances the public and the private interest.** The need to reduce government spending to boost economic activity and reduce poverty, together with the need to strengthen state-level institutions, put a limit on what the governments can pay to settle the outstanding claims. Violating these constraints will have adverse fiscal consequences.

Data and Capacity for Fiscal Policy

- **Data quality needs to be improved dramatically and capacity for consolidating fiscal data strengthened substantially to enable reliable analysis.** Preparing consolidated fiscal accounts at least at annual frequency should be a priority. Explicitly including foreign-financed investment projects in the entity and state budgets should also be carried out to help improve transparency and the ability to analyze fiscal developments.

- **The governments' capacity to analyze fiscal data, as well as set, execute and monitor fiscal policy needs to be strengthened.** Such capacity would be important in analyzing trade-offs among conflicting spending proposals and reaching agreement on how to accommodate forthcoming fiscal pressures.