

## 3. STATE BUILDING – A KEY CHALLENGE AND AN OPPORTUNITY

### A. INTRODUCTION

**3.1. Strengthening the institutions of the central level of government, which were left deliberately diminutive under the DPA, is both a key challenge and an opportunity for the BH authorities.** Consolidating key functions that have heretofore been fragmented across different levels of government would also improve BH's capacity to engage effectively with the EC and other partners.

**3.2. Future institution-building will follow the progress made in strengthening the state level of government since the end of the armed conflict and recent agreements to reform and centralize defence and police.** Conceptually, it is helpful to think of future institution building as consisting of two phases. The first phase includes the establishment of institutions, functions and capacities needed to strengthen the single economic and political space in BH and enable the government to take on the key obligations under the SAA. This first phase will include the creation of new institutions, the shifting of institutions from the sub-national levels of government, or expanding capacities/functions of existing institutions. In the second phase, which could run in parallel to the first in the later years, the BH government will move to implement the EU *acquis communautaire*. This process should be similar to developments among the CEE countries during the ten or so years before accession. This chapter concentrates on the first phase of institution building.

**3.3. Building on recent developments and the EC Partnership document, the baseline scenario developed in this chapter assumes that further state building proceeds within the existing constitutional structure via only modest centralization and expansion of existing institutions.** It is anticipated that the entity, canton and municipal governments in BH will realign their expenditure priorities to better meet the EU requirements, and that the role of the state will continue to be mainly policy coordination and international relations. If BH were to be restructured from its present federal structure to a structure more like other transition countries, the gross cost of institution building would indeed be substantially higher, and would require large offsetting reductions in functions at the sub-national level. Such a scenario would involve substantial constitutional change, a development that appears unlikely at present.

**3.4. To help ensure fiscal sustainability, the authorities would be well advised to advance institution building only within the context of the overall budget envelope.** The recently adopted reforms of police and defence are welcome achievements but present potential fiscal risks. As the authorities finalize these reforms, the prospect of a substantial and permanent increase in wage outlays would need to be carefully weighed against alternative priority spending and the broader macroeconomic effects of such decisions. Principles to guide institution building could include, first, the restriction that when institutions of the sub-national level of government are shifted to the national level without adding functions, the shift must be cost-neutral. Further, if adding functions or capacities within existing institutions results in costs, there should be an offsetting saving elsewhere.

**3.5. Furthermore, EU integration is not a reason *per se* for increased spending.** To the contrary, the experience of the NMS demonstrates that general government spending relative to GDP was reduced in the ten or so years preceding accession. For example, general government spending in Estonia fell from 40.8 percent of GDP in 1994 to 37.1 percent by 2004. In Slovakia, spending was cut from 47.8 percent of GDP in 1994 to 38.4 percent by 2004. BH should learn from this experience.

**3.6. The link between institution building and fiscal sustainability is often not acknowledged and sometimes state building is portrayed as a *sine qua non* that needs to be pursued regardless of fiscal costs.** Such an approach will ultimately have detrimental consequences for BH's hard-won fiscal and financial stability and the authorities are strongly urged not to pursue it. Were the authorities to decide to advance institution building at a more rapid pace than envisaged in this study, for example, additional spending reductions need to be found to ensure that fiscal sustainability is guaranteed. As with the other fiscal pressures discussed in Chapter 2, state building is largely about establishing a process of agreeing and setting government priorities, along with the ability to muster the consensus needed to bring forth change.

**3.7. Advancing state-building and the implementation of the ambitious reform agenda needed to make this a success would require the strong and coordinated support from all members of the international community.** The authorities are encouraged to work hard to set up their own priorities given the challenges they face and work to take the lead in coordinating international assistance, especially now that such assistance is on the decline. The international community should fully support the governments' efforts to build more effective state institutions in a coordinated fashion.

**3.8. This chapter assumes that the current decentralized structure of governance will remain unchanged over the medium term.** Ongoing discussions among political parties on constitutional reform may ultimately lead to a change in the structure, but it is currently unclear what these changes may be. The baseline scenario of the chapter assumes that institution building will result in lighter centralization of government than found in most other EU countries.

## B. THE CURRENT STATE OF INSTITUTION BUILDING

**3.9. State building has been advanced over the last decade, but a lot more remains to be done for BH's state government to become truly effective and efficient.** At the onset, the DPA provided for a three-member rotating presidency, a small bicameral state parliament with tightly defined requirements for eligibility, and a small state government. The presidents, one from each of the constituent peoples, rotate every eight months. Members of both houses of parliament, the 15 delegates of the upper House of Peoples and the 42 of the House of Representatives, must be elected in equal shares from the three constituent peoples. The state government established as a result of the DPA consisted of three ministries: Ministry of Foreign Affairs, Ministry of Foreign Trade and Ministry of Economic Relations and of Civil Affairs and communications, coordinated under the auspices of the Council of Ministers chaired by one of the three ministers on a rotating basis. Administrative spending by the state institutions amounted to  $\frac{3}{4}$  percent of GDP in 1998, or 1 percent of consolidated general government spending.

**3.10. State building picked up in 2000 with the creation of three new ministries:** Ministry of Treasury, Ministry for Human Rights and Ministry for European Integration, with the latter transformed into a department soon thereafter. A State Border Service was also created. The process continued in 2002 when a Ministry of Security and a Ministry of Justice were created and the Ministry of Civil Affairs and Communications was split into a Ministry of Traffic and Communications, and a Ministry of Civil Affairs (Table 3.1). Expenditures by the 28 state institutions in existence in 2002 amounted to  $\frac{1}{4}$  percent of GDP. Further progress strengthening the state-level institutions has

continued since then, increasing the number of institutions to 49 by 2005 and their administrative expenditures to the equivalent of 1.8 percent of GDP.

**3.11. State building has also reflected the creation of institutions carrying out central government functions but performing outside the state level of government, such as the ITA and the NFC.** The ITA was set up as an intergovernmental agency through the merger of the state and entity customs administrations to help comply with provisions in the state constitution (Annex IV of the DPA). Under these provisions, all functions and powers not expressly assigned to the state government are assigned to the entities. The entities can agree to delegate additional functions to the State, and additional institutions to carry out these functions can be established. Similarly, in response to the lack of a capacity to set and monitor the aggregate stance of fiscal policy, the authorities set up the NFC. The challenges in establishing the NFC have been multiple, however, and the NFC is yet to become fully operational. Substantial progress in state building was achieved in late 2005, thanks to agreements to transfer competencies for defense and police to the state level. As discussed in Chapter 2, the authorities merged the entity armies and the MoDs in a single state-level armed forces and a ministry from the start of 2006. Agreement in principle on police reform proved politically difficult to reach and will probably remain challenging to implement.

**3.12. Thus far, however, state building has been carried out without sufficient regard for fiscal constraints.** The creation of the ITA, for example, saw 1,500 employees shifted to the state level, together with a substantial increase in salaries because of the persistently large differentials between the state- and entity-level public wages. Similarly, the establishment of the State Intelligence and Security Agency resulted in the shift of roughly 1,000 employees at similarly inflated pay levels.

**3.13. Unresolved issues at the state level of government need to be addressed to improve effectiveness.** Many institutions of the central government exist, but their administrative capacities are weak and subject to the veto-like hold of the need for consensus among the three constituent peoples. Policy coordination mechanisms, even if established at the state level, are neither efficiently operating within the Council of Ministers, nor do they allow for resolving conflicts between the entity- and state-level officials during the policy making process. Persistent understaffing in key institutions, notably

Table 3.1. BH: State Building, 2002-2005

	Number of Institutions	Budget (In millions of KM)	Employees	
			Number	% change year-on-year
2002	28	146	3,449	...
2003	37	157	3,895	12.9
2004	41	215	6,982	79.3
2005	49	308	8,224	17.8

Sources: State Ministry of Finance and Treasury and World bank staff calculations.

the state Ministry of Finance and Treasury, is a key problem. Building an effective state government would require not only strengthening of staffing and technical capacities, but also creating the mechanisms for reaching decisions and breaking deadlocks between the three constituent peoples. Further, strengthening of fiscal control and accountability at the state

level is a key ingredient for more successful institution building. Adopting the state-level supreme audit law and drafting and adopting internal audit laws will go a long way towards meeting this goal.

## C. THE BASELINE SCENARIO: METHODOLOGY

**3.14. The chapter's baseline scenario assumes that the authorities will advance reforms at a moderate pace within the existing constitutional arrangements.** Entity competencies, therefore, are assumed to remain as provided under the DPA, with state institutions and functions established to

provide a coordinating function. This assumption is clearly conservative. The recently agreed defense and police reform involve the full transfer of entity competencies from the entities to the state. There is no indication that political support for state building to proceed in such a fashion will continue going forward, however. Were consensus to emerge for such a change, it will enable the authorities to strengthen state institutions in a more efficient way.

**3.15. The methodology of the baseline scenario has several components:** (i) identification of the requirements for new or strengthened state institutions or functions; (ii) estimation of the costs of carrying out institution building; and (iii) projecting the timing of the process. The text below discusses the general thrust of the assumptions and the factors that may affect the assumptions. Annex B presents the specific assumptions for individual institutions and detailed calculations.

## **New or Strengthened Institutions or Functions**

**3.16. Institution building may entail creation of new institutions at the state level, the shift of existing sub-national institutions or strengthening of existing state institutions.** Important reforms are being carried out within existing institutions, but many of these do not appear to have measurable fiscal implications. Reform or capacity building within existing institutions is included where the additional fiscal implications may be significant. The following are some of the key assumptions: (i) the analysis does not include the costs of expanding institutions at the sub-national level; (ii) the study looks beyond already agreed reforms of police and defense; (iii) the chapter's list of new or strengthened institutions/functions is based largely on the Proposed European Council Decision of November 9, 2005,<sup>1</sup> supplemented with other sources,<sup>2</sup> including the governments' 2006-08 Budget Framework Papers (BFP). Some institutions or functions considered below are not directly envisioned in the EU Partnership, but are considered as needed to facilitate a more efficient functioning of the state government; (iv) the State BFP for 2006-08 is used as a reference to the potential needs of existing ministries, but is not a reliable estimate of future costs. The above-quoted COM (2005) proposes that "*all state-level ministries and institutions [be] adequately financed, operational and properly equipped, namely in terms of premises and staff.*" The BFP compares current staffing levels with rule book staffing levels, and calculates that full staffing would cost approximately KM80 million a year, or 0.6 percent of 2004 nominal GDP. The BFP notes that rule book staffing levels are unrealistically high, however, as they are based on claims on public resources without thinking of budget constraints. The BFP also compiles a list of additional priorities sought for current and new institutions, in terms of both capital and current expenditures.

## **Timing**

**3.17. Judgments about the timing of future reforms take into account the EU functional reviews, discussions with the authorities and observations in other countries.** The timing and the structure of institution building will ultimately be directly affected by the speed and nature of legal and constitutional reform. The current scenario assumes that the status quo will not be changed. Estimates are presented under the assumption of EU membership by 2020. This projection reflects the time it took the countries that joined the EU in 2004.

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<sup>1</sup> Council of the European Union, "On the Principles, Priorities and Conditions Contained in the European Partnership with Bosnia and Herzegovina," COM (2005) 555.

<sup>2</sup> These included meetings with government officials and with representatives of international organizations. Documents consulted include the Functional Reviews recently produced by the Public Administration Review Program; the EC "Feasibility Study" of November 2003 (COM 2003, 692 final); the Council of Ministers Report of May 2005 on progress in priority areas; the MTDS.

## Cost Assumptions

**3.18. The basis for each cost estimate is typically a product of the number of staff and a factor for some broadly similar body to incorporate non-staff costs.** This factor is taken from the draft 2006 state BFP and other 2005 state budget documentation. Individual ministry budgets have also been reviewed to check overhead rates. The quantitative assumptions for each case are presented in Annex B. One-time costs, i.e. the cost of initial purchase of furniture, equipment and supplies, have been estimated as a share of total salary and other ongoing administrative costs, using data from BH-specific studies where available (e.g., EU Public Administration Reform reports), government sources, or subjective assessment. Finally, where BH-specific data is not available, as is the case of the establishment and operation of an Environment Ministry in line with EU standards, a simple percentage of GDP is used, derived from other CEE countries. The cost estimates do not take fully into account the cost of office space for the new institutions under the assumption that space needs will be resolved with the donor-financed reconstruction of the government tower in Sarajevo. A state-level law on public wages is currently under preparation and could alter the cost assumptions made under this chapter. Some institutional changes should not result in substantial costs, including the intended mergers of entity bank supervision and insurance supervision agencies, the competition councils, the utility regulators and the stock exchange regulators.

### D. THE BASELINE SCENARIO: RESULTS

**3.19. Based on the sources discussed above, the chapter identifies the institutions the authorities will need to establish over the medium to longer term, as well as additional funding needed to strengthen existing state-level institutions. It is estimated that setting up all state-level institutions described in this section will result in a setup cost of 0.4 percent of GDP and a running cost of 0.5-0.8 percent of GDP a year.** These estimates form the basis of the assumptions used in the fiscal sustainability analysis in Chapter 2. The estimates assume that sub-national governments continue to perform their current functions, with the state essentially providing a coordination role where there is an overlap.

**3.20. The analysis distinguishes between institutions to be set up over the next two-three years and over the longer term.** Table 3.2 lists the institutions to be set up over the near- to medium-term (next two-three years). The one-off setup cost is estimated at KM8 million and the ongoing costs of their operation at KM21 million a year. Table 3.3 presents projections for longer-term developments, largely incorporating institutions that should be set up under the Stabilization and Association process. This is a minimal set of institutions and functions believed to be necessary. The associated additional ongoing costs, when fully operational, are estimated at KM40 million a year, with one-time set-up cost of about KM14 million.

**3.21. As the government has advanced EU integration, many agencies have already been created.** The effect of the changes listed in Tables 3.2 and 3.3, therefore, is often only to consolidate these coordinating functions and provide adequate funding for their implementation. As a consequence, one-time costs tend to be low, principally reflecting recruitment of additional staff.

Table 3.2. BH: New Institutions and Functions Needed in the Near to Medium Term

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Expanded Agricultural Coordinating Agency  
 Food Safety Agency  
 Banking Supervision Consolidation  
 Unified Stock Exchange Regulatory Body  
 Standardized Statistical Agency  
 Strengthened Central Public Expenditure Management  
 Education Coordinating Agency  
 Higher Education Coordinating Agency  
 Environment Coordinating Agency  
 Expanded Consumer Protection Agencies including  
 Competition Council and Market Surveillance Agency  
 Expanded Regulatory Bodies including an Institute for  
 Intellectual Property  
 Coordinating Health Agency  
 Labour Coordinating Function  
 Advisory Commission on Intergovernmental Relations  
 Council of National Minorities  
 Information Society and Data Protection Agencies  
 Insurance Supervision Inspectorate  
 Office for Narcotics

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Sources: As quoted in the text.

**3.22. In addition to the new institutions discussed above, Table 3.4 lists institutions for which additional funding is needed to help strengthen capacity, as per the state BFP for 2006-2008.** One-time costs are estimated to amount to about KM28 million and the associated extra ongoing costs, when these institutions become fully operational, are estimated to be approximately KM57 million a year. Table 3.5 summarizes the costs presented in Tables 3.2-3.4.

**3.23. Most of the new or enhanced institutions assumed to be established are relatively modest in size and not accompanied by substantial administrative costs** (Annex B, Tables B3 and B4). Only the agencies/ministries of agriculture, environment and transport are relatively large. Together, these three agencies account for about two-thirds of all new costs. Should there be any major

restructuring of service provision in other areas, such as state funding of pensions, transfer payments, or higher education, total state spending may need to grow far beyond that of spending on administrative costs alone, albeit with potential for largely or wholly offsetting savings at other levels of government.

Table 3.3. BH: New Institutions and Functions Needed in the Longer Term

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Ministry of Agriculture and Rural Development  
 State Ministry of Education

Ministry or Department of Higher Education  
 Ministry of Environment

Stronger Ministry of Transportation  
 Department or Ministry of Welfare  
 Department or Ministry of Health/Public Health Agency  
 Labor and Employment Department or Ministry  
 Occupational Health and Safety Department or Agency  
 Ministry of Economy  
 Financial Supervision Authority

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Sources: As quoted in the text.

Table 3.4. BH: Increased Funding for Existing Institutions, State BFP, 2006-2008

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Parliamentary Assembly  
 Electoral Commission  
 Secretariat of Council of Ministers and Public Administration Coordinator  
 Civil Service Agency  
 State Court, Prosecutor's Office and High Judicial and Prosecutorial Council  
 Ministry of Security  
 State Investigation and Protection Agency, including Financial Intelligence Unit  
 Ministry of Transport and Communications  
 State Border Service  
 Accreditation Institute  
 Department for European Integration

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Sources: As quoted in the text.

**3.24. Under a more centralized, but much less likely scenario based on a comparison of state-level institutions in Slovakia and BH, the cost of state-building would be capped at 1.8 percent of GDP a year.** The details of these calculations are available upon request.

Table 3.5. BH State Building: Cost Summary

	<u>One-time</u> KM million (2006 prices)	<u>Ongoing, p.a.</u> (2006 prices)	<u>One-time</u> Percent of 2006 GDP 1/	<u>Ongoing, p.a.</u>
Total	50	118	0.4	0.8
New Institutions, Medium-Term (Table 3.2)	8	21	0.1	0.1
New Institutions, Longer Term (Table 3.3)	14	40	0.1	0.2-0.3
Strengthening Existing Institutions (Table 3.4)	28	57	0.2	0.4

Sources: As quoted in the text and World Bank staff estimates.

1/ As a share of 2006 nominal GDP. Relative to current GDP, costs fall to 0.5 percent by 2010.

## E. CONCLUSION

**3.25. Under the chapter’s baseline scenario, the net additional costs of future institutional reform appear to stabilize at about 0.7-0.8 percent of GDP per year after 12 years or so.** More than half of these costs are already included in the state BFP for 2006-2008, albeit without explicit assumptions on what institutions these costs refer to. Under a more centralized model, the costs of state building would be larger but capped at 1.8 percent of GDP a year. These estimates form the basis of the assumptions for state building under the fiscal sustainability analysis in Chapter 2.

**3.26. The actual costs of state building could vary substantially from the those under the scenario presented in this chapter because of several factors.** First, pressures to boost staffing levels and wage rates are likely to persist. Second, the data available for estimating the costs of additional office space may well be optimistic and the actual outturn could well be larger. Third, substantial wage differentials persist among the different jurisdictions in BH, giving rise to substantial wage increases when responsibilities are transferred across jurisdictions. Fourth, on the positive side, the analysis has not taken into account possible savings at the subnational level that may offset costs of building the state government.

**3.27. The absence of a fully operational central fiscal authority makes it difficult to execute state building within a properly defined budget constraint.** The authorities will be well advised to accelerate the adoption of the law on the National Fiscal Council and move steadfastly in making both the Council and a properly staffed secretariat operational. Outlays on state building, as all other public expenditures, should be subject to the processes of budgetary planning and control. No reform will ultimately be viable unless executed with strict fiscal discipline.

**3.28. Ultimately, the real effectiveness of the institutions that are created at the state level goes beyond the staffing levels or the specific functions ascribed to it.** As Chapter 4 demonstrates, policies related to recruitment, promotion, pay, and incentives can all have a significant impact on the state’s ability to attract and motivate skilled staff. To assure that the resources expended on state building produce a tangible benefit to citizens, the authorities will want to assure that reform of public administration systems goes hand in hand with the creation of new and expanded institutions.