

EXECUTIVE SUMMARY

Bosnia and Herzegovina (BH) has made substantial progress in economic reconstruction and nation building since the end of the 1992-1995 war, and fiscal consolidation has been strong through 2004. Recent progress has culminated in the start of negotiations in early 2006 with the European Commission on a Stabilization and Association Agreement (SAA). SAA negotiations have the potential of helping catalyze the pace of political and economic change needed to strengthen the single economic space, create an efficient government and boost living standards.

The authorities should be commended for the progress achieved, but more remains to be done to further strengthen government institutions, advance transition to a market economy and reduce risks to hard-won fiscal stability. Government institutions remain cumbersome, excessively decentralized and expensive. General government expenditures relative to GDP are still substantially larger than in countries with similar levels of income per capita and higher than in almost all countries in southeast Europe, while outcomes are in general poorer. The bulk of spending, moreover, seems inefficiently distributed across government functions, resulting in excess spending on wages and untargeted social transfers, and a dearth of funds for targeted social welfare and child protection and for maintenance of existing capital projects.

The governments of BH will be well advised to build on progress achieved and move forward with determination to address the key fiscal challenges. This Public Expenditure and Institutional Review (PEIR) presents specific recommendations on how to do this over both the near and medium term, as summarized in the following overview section and elaborated in greater detail in the main report. Recommended measures include broad-based efforts to strengthen state-level government institutions, ensure fiscal sustainability and reduce the government burden on the economy. The report also urges the authorities to take steps to settle the outstanding stock of domestic claims and resolve property restitution in a manner that balances the private and public interest. The proposed reforms of the public administration, education, social spending and transport will also allow BH to improve the quality of government spending and thereby contribute to boosting the economy's supply potential.

Successfully addressing the noted medium-term challenges will require up-front reforms in a range of areas discussed in the report. The following ten-point agenda highlights some of the most crucial areas for immediate action:

- (1) Establish a realistic target for reducing public employment by prioritizing key functions and activities of government institutions and implementing a partial hiring freeze.
- (2) Enhance performance incentives by decompressing the base salary structure, folding allowances into the base wage and reducing nominal salaries for positions with remuneration rates that most exceed those for private-sector comparators.

- (3) Implement per-student or capitation financing in education and reduce or moderate the growth of teacher salaries. Use part of the savings from these measures to help improve education outcomes.
- (4) Seize the opportunity offered by stronger than projected revenues from the value-added tax to reduce social security contribution rates, combined with broadening the contribution base and harmonizing the contribution rates across the entities. Reduce exemptions from contributions and shift to the entity budgets the responsibility for paying contributions for exempt individuals.
- (5) Help ensure the fiscal sustainability of the pension systems by legislating pension indexation based on the consumer price index (CPI). Abolish transitory arrangements allowing for retirement before the age of 65.
- (6) Rescind the recent changes to the Employment Law of the Federation of BH (FBH) and limit the maximum duration of unemployment benefits to 12 months. Discontinue unemployment insurance-financed soft loans to enterprises administered through the FBH Employment Institutes and the FBH Investment Bank.
- (7) Focus veterans' programs on the most vulnerable: limit disability benefits to categories I-VI and stop implementing the untargeted benefits system for holders of military decorations in the FBH. Reallocate resources in a targeted fashion to currently underfunded social welfare and child protection and centralize financing at the entity level.
- (8) Restructure and rationalize hospital care and limit high-cost procedures to a few hospitals. At the same time, strengthen primary healthcare providers as gatekeepers to hospital care and ensure efficient referrals.
- (9) Centralize drugs procurement to at least the entity level. Limit reimbursement for non-innovative drugs to the generic equivalent and for new drugs to the lowest cost therapeutic equivalent.
- (10) Ensure that priority in spending within the transport sector is placed on improving the condition of the current transport network, including on reducing the backlog maintenance. Develop a comprehensive strategy and policy for the transport sector to identify priorities and to ensure that all debt-financed public investments are consistent with the medium-term fiscal envelope available to the government. In particular, ensure that developing the road infrastructure along corridor Vc and procurement of rolling stock are consistent with this strategy and the fiscal envelope available.

OVERVIEW

1. Bosnia and Herzegovina (BH) has made substantial progress in economic reconstruction and nation building since the end of the 1992-1995 war, and fiscal consolidation has been strong from the late 1990s through 2004. A lot more needs to be done to help narrow the gap with the more advanced reformers in the region, however, and to resume fiscal consolidation that has stalled in 2005 and 2006. Recent progress has culminated in the start of negotiations in early 2006 with the European Commission on a Stabilization and Association Agreement (SAA). SAA negotiations, together with negotiations on constitutional change among the key political parties that commenced in late 2005 and that hopefully will be resumed after recent failings, have the potential of helping catalyze the pace of political and economic change needed to strengthen the single economic space, create an efficient government and boost living standards. Whether this potential is realized will depend on the authorities' will to press ahead with reforms.

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

3. This Public Expenditure and Institutional Review (PEIR) analyzes the key issues that bear on the level and composition of public spending and the stance of fiscal policy. Understanding these issues is all the more important given the substantial fiscal pressures that are emerging and are set to multiply over the coming years. These pressures include the need to strengthen the institutions of the state level of government, outlays needed to settle the large stock of domestic claims, and the ultimate start of property restitution. Government plans to embark on large infrastructure projects would also place substantial demands on fiscal resources. The analysis of the level and composition of spending and the stance of fiscal policy serves as the basis for the report's recommendations, with the overriding objective of helping achieve stronger growth in output and employment, reduce poverty and ensure fiscal sustainability.

4. The complex institutional structure emerging from the DPA and the institutionalized divisions along ethnic and religious lines, help create additional challenges to reform implementation in BH. Vested interests within the three constituent peoples, the Bosniaks, the Croats and the Serbs, have resisted changes to the DPA for longer than initially envisioned, hampering much-needed progress towards a modern and efficient government. The indirect costs to BH from failing to reform and modernize the DPA ten years after the war are probably large, but hard to quantify. The

report finds, however, that the direct costs of the DPA, as measured in terms of higher than optimal government spending, are rather small; it is inefficient and ineffective spending and not the DPA that is the key drain on public resources.

A. THE MACROECONOMIC SETTING

5. Economic activity has remained robust over the last several years despite a slowdown of structural reform implementation. Real GDP growth is likely to have eased modestly to 5.3 percent in 2005 from 6.2 percent in 2004. Inflation rose moderately in 2005 and is likely to increase to 5 percent or more in 2006, following the introduction of the VAT from the start of 2006. Unemployment and poverty have remained high and little changed over the last several years, as the share of employment in the informal economy has continued to rise. Companies in the informal sector pay substantially lower wages and do not make social security contributions, keeping poverty high despite robust real GDP growth. The rising informalization of economic activity, in turn, has been in response to rigid labor markets and a business environment that continues to be perceived as unfriendly.

6. The large current account deficit remains a key macroeconomic challenge. With the general government budget in rough balance, the deficit reflects a dearth of savings among companies and, of late, households. Corporate performance appears to have improved somewhat over the last few years, but probably one-half of all companies in BH are loss-making, paying little if any in taxes and social security contributions. As a result, renewed efforts on structural reforms are essential, especially in advancing privatization and corporate restructuring, improving the business and regulatory environment and carrying out labor market reforms. Growth in bank lending to households remains strong and, combined with increases in formal sector wages that consistently outstrip inflation and productivity gains, has contributed to boosting imports and the current account deficit.

B. FISCAL BACKGROUND AND FISCAL SUSTAINABILITY

7. BH's fiscal position has improved markedly since the end of the war, but many issues need to be resolved to limit risks to fiscal stability and growth. The commitment-basis general government deficit narrowed from 6.3 percent of GDP adjusted for the size of the non-observed economy in 1999 to near balance over the last several years, while general government expenditures decreased to 40.5 percent of adjusted GDP. However, expenditures rose again in 2005 as a share of GDP and are set to increase further in 2006 ahead of the parliamentary elections scheduled for October, reversing part of the earlier consolidation. At current levels, government expenditures are a full 5 percent of GDP higher than in countries with similar levels of income per capita and 4 percent higher than average of the countries in Southeast Europe (SEE). Government spending is significantly higher than in faster growing and wealthier economies including Ireland, South Korea and the Baltic states. Outcomes of government spending, meanwhile, tend to be substantially poorer. An important priority for the governments going forward would be to ease the government's burden on the economy and improve the delivery of public services.

8. The challenges to reducing government spending relative to GDP will be multiplied by the need to simultaneously tackle emerging new fiscal pressures. Doing so will require that the governments implement ambitious and wide ranging spending reforms, including curbing and reducing existing spending. Careful trade-offs among competing priorities need to be made to balance the private and the public interest. The capacity for settling, coordinating and implementing fiscal policy should be strengthened substantially to give credibility to the government reform agenda. All told, the measures to reduce or curb spending would need to go beyond those currently considered by the governments and their implementation would require significant political courage. The strong and

coordinated support from all members of the international community will also be vital for successful reform implementation.

9. The PEIR carries out a fiscal sustainability analysis by quantifying the likely fiscal pressures and the potential savings from a subset of the recommendations informed by the analysis of specific issues and sectors. A ‘stronger reform’ scenario assumes ambitious spending reforms, in line with the measures proposed in the report, while a ‘slower reform’ scenario assumes a more modest implementation effort. Under the ‘stronger reform’ scenario, both government spending and debt are placed on a downward path, with a temporary financing gap emerging in the near term. Private creditors may be willing to fund the gap provided the governments’ agenda is credible. Alternatively, the authorities will need to implement either more ambitious spending reduction measures, stronger efforts to curb spending pressures or accept that state building may take longer than currently anticipated. Under the ‘slower reform’ scenario, government debt is set on an upward path, with a widening fiscal deficit that is unlikely to be financed. In summary, how much the authorities can accomplish in terms of state building and tackling the remaining fiscal pressures will ultimately be constrained by their political courage and ambition for reform.

C. STATE BUILDING

10. 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. To help ensure fiscal sustainability, the authorities would be well advised to advance institution building only within strict budget constraints. The recently adopted reforms of police and defense 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. **Furthermore, EU integration is not a reason *per se* to increase spending.** To the contrary, the experience of the new EU member states (NMS) shows that government spending relative to GDP was reduced in the ten or so years preceding accession, in some cases such as Estonia and the Slovak Republic quite substantially. BH should learn from this experience.

11. 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, other spending reductions would need to be found to help ensure fiscal sustainability. As with the other fiscal pressures the country faces, 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.

D. CHALLENGES IN MANAGING THE PUBLIC ADMINISTRATION

12. Strengthening the quality of public administration remains a key challenge for BH. Despite efforts over the past few years to reduce the burden of public employment, the wage bill relative to GDP is larger than in almost all countries in the broader region, while outcomes remain

substandard. The outsized share of wages in GDP primarily reflects wage rates that are out of line, especially for lower grade employees at the state and, to a lesser extent, at the FBH level. The size of overall public employment is not large relative to the country's population, but is excessive relative to total employment in the economy. However, given the substantial outsized employment in police, defense, the judiciary and education, as well as the duplication arising from the fragmented administrative structure, the size of the core public administration is very small, with negative consequences for the delivery of public services.

13. Reducing the cost of the public administration over the medium term will necessitate tight control, including a reduction in the salary levels of some categories of employees. Because the bulk of public employment is at the lower levels, excessive pay levels for these positions can have a significant impact on the overall wage bill. At the state level in particular, further assessment needs to be carried out as to whether the planned but as yet unrealized reduction in salary levels for 2006 by 10 percent should not be augmented to reduce public sector employment costs. Moreover, without good coordination between the levels of government, there is a risk that fiscal costs will rise even further, as employees are shifted to the state level as state building advances. Even within the current entity structures, there is a need to avoid over-paying for positions that are less essential to the core functions of government.

14. Difficult trade-offs need to be made to reduce the levels of employment at some levels of government. With wage outlays for defense, public order, the judiciary and education together accounting for about three-fourths of the overall wage bill, any serious attempt to reduce costs must include those sectors. Setting a realistic budgetary target for savings is one strategy to compel a prioritization of functions and activities across all levels of government. Incentives for performance must also be strengthened if there is to be any genuine improvement in the quality of public management. Though substantial progress has been made in introducing merit-based appointment in the civil service, the pay system remains largely unreformed.

Public Administration: Summary of Recommendations 1/

- Create a pay system that embodies transparency and accountability.
- Progressively decompress the salary structure, including through decreasing wages in nominal terms for some categories of public employees. Eliminate and/or consolidate most allowances into the base salary. Revise salary laws and ensure consistency across all levels.
- To help public administration management, develop consolidated personnel databases.
- Increase oversight for promotion and career advancement. Refine the criteria for entry into the civil service.
- Establish a realistic target for reducing public employment. Implement a partial hiring freeze.
- Follow through with significant reforms in defense, police and the judiciary.

1/ See Chapter 4, pp. 68-69 for the full list of recommendations.

E. EDUCATION

15. BH spends more on education than most countries in the broader region, including Croatia, SaM and Poland. Nonetheless, inefficient education spending within an institutionally complex structure has resulted in unacceptably poor education outcomes. Forty percent of students do not acquire basic skills and knowledge, while the large numbers of students enrolled in costly vocational schools graduate ill-equipped to meet the demands of BH's changing economy. Secondary and university enrollment remain low. Institutions of higher education, meanwhile, allow publicly-

funded students to take a long time to graduate, resulting in a waste of resources and in poorly-motivated graduates. Further, institutional fragmentation has enshrined significant regional differences in spending and educational achievements, making it hard for the single economic space to take firmer hold.

16. The education system needs substantial improvement, but more resources would not necessarily help improve education outcomes. A priority for the governments should be to implement measures to improve the efficiency of spending and streamline the organization and financing of education. Provided that they materialize, part of the savings from improved efficiency should be used to help improve education outcomes. A plan to improve outcomes could include measures to improve the classroom environment through increased availability of textbooks and other materials, to strengthen teachers' effectiveness through training, and to provide additional incentives and penalties to encourage school attendance by children from the poorest households. The agenda considered in the PEIR is undoubtedly ambitious and would require substantial political will to implement. It is, however, central to the future welfare of the country. Whether it could be implemented in the current fragmented institutional framework is a question that deserves careful consideration.

Education: Summary of Recommendations 1/

- Adopt policies to decrease teacher numbers in line with the decline in enrollments.
- Move to the recommended average class size for primary education in both entities.
- Implement per-student or capitation financing.
- Reduce or moderate the growth of teacher salaries.
- Restructure secondary education to reduce costs and improve its relevance.
- Move toward unified higher education management as a tool for major savings.
- In higher education, increase fees for repeating students and raise fees for foreign students.
- Use a part of these savings to help improve education outcomes.

1/ See Chapter 5, pp. 76-80 for the full list of recommendations.

F. SOCIAL PROTECTION

17. BH's overall spending on social protection is somewhat larger relative to GDP than in the faster growing European countries but broadly similar to the average for the NMS. The composition of spending is different, however. Smaller pension outlays have kept overall outlays for social insurance (pensions, unemployment benefits, health insurance and, in the RS, child benefits) relatively low despite higher health expenditures. By contrast, expenditures on social protection financed from general revenues are larger, thanks to sizable categorical benefits, mostly for those affected by the war.

18. The social insurance system suffers from persistent noncompliance, reflecting evasion, poor collection and low formal sector employment. With revenues falling short of legal entitlements, social insurance schemes regularly require general revenue transfers. Nonetheless, social security contribution rates tend to be higher than in most NMS and the OECD countries, underpinning the substantial informalization of the economy. Reducing social security contribution rates, while broadening and harmonizing the tax base across the entities should be a priority for the governments.

Social Security Contributions: Summary of Recommendations 1/

- Reduce social security contribution rates, while broadening the contribution base and harmonizing the contribution rates across the entities.
- Reduce exemptions from paying contributions. Shift to the entity budgets the responsibility for paying contributions for exempt individuals.
- Improve administration to increase collection efficiency and contribute to a transparent system.
- Unify the base and the administration for personal income taxation and social security contributions.

1/ See Chapter 6, p. 84 for the full list of recommendations.

19. High dependency ratios and low coverage rates in both entity pension systems are a threat to their financial sustainability, so far ensured by application of the coefficient rule. Long-term reform is needed, but further parametric changes in the system need to be implemented sooner.

Pensions: Summary of Recommendations 1/

- Abolish transitory arrangements allowing for retirement before the age of 65.
- Introduce CPI-based, legally anchored pension indexation.
- Limit recognition of pension rights to those whose contribution history has been fully covered.
- Modify the accrual schedule to give more weight to the later years of contribution.

1/ See Chapter 6, p. 90 for the full list of recommendations.

20. Generous unemployment benefits, especially in the FBH, tend to discourage the unemployed from searching for work. It is not so much cash unemployment benefits as free health insurance coverage for all registered unemployed that has been a major incentive to register with the employment services, draining public resources and confusing policy choices. Reducing generous unemployment benefits and inefficient spending on active labor market programs should facilitate a substantial reduction in unemployment contribution rates in the FBH and, in turn, support efforts to reduce the informalization of the economy.

Unemployment Insurance: Summary of Recommendations 1/

- Rescind the recent changes to the FBH Employment law and limit the maximum duration of unemployment benefits to 12 months.
- Reduce expenditure on untargeted and unevaluated active labor market programs in the FBH.
- Fully discontinue enterprise credit programs.
- Reduce the FBH unemployment contribution rate.

1/ See Chapter 6, p. 95 for the full list of recommendations.

21. The health system is fragmented and burdened with substantial duplication, excess employment and inefficient use of available resources. Access to healthcare, moreover, is inequitable, with informal payments larger than legally-mandated co-payments, implicit rationing and limited portability of insurance being the main causes. Substantial differences in resources and small risk pools in the FBH are also a factor. Preventable and high-cost diseases rank highly in the burden of disease. Inadequacies in the organization and delivery of care further contribute to concerns about equity in access. Inefficiencies in healthcare spending are further illustrated by the fragmented process of drug procurement.

Health: Summary of Recommendations 1/

- Restructure and rationalize hospital care. Limit high-cost procedures to a few hospitals.
- Strengthen primary healthcare providers as gatekeepers to hospital care. Ensure efficient referrals.
- Ensure insurance portability and a common benefit package at least at the entity level.
- Create a central drug agency in charge of quality control, positive list and pricing.
- Centralize drugs procurement to at least the entity level. Limit reimbursement for non-innovative drugs (new drugs) to the generic equivalent (lowest cost therapeutic equivalent).
- Target low income groups with services such as immunization and prevention of tuberculosis.

1/ See Chapter 6, pp. 105-106 for the full list of recommendations.

22. Transfers financed from general revenues are high by international standards as a share of GDP, but the share of these transfers that are means-tested with the explicit goal of reducing poverty is smaller than in any other country in the broader region. Crowded out by veterans' benefits, the system of social welfare and child protection is unfunded, with the exception of the children's fund in the RS. One in five individuals in BH benefits from some type of social transfer, but such transfers reach only one-fourth of the poor and have a smaller poverty alleviating effect than in Croatia or Bulgaria. Cash transfers to individuals are budgeted to increase further in 2006, notably in the FBH, due to a continued proliferation and expansion of largely untargeted benefits. Given overall fiscal pressures and considerations of fairness, BH should aim to reduce the overall share of resources allocated to social transfers, while restructuring the system to ensure that it provides an effective social safety net.

Transfers Financed from General Revenues: Summary of Recommendations 1/

- Focus veterans' programs on the most vulnerable. Adjust benefit levels downward in line with benefits to civilian victims of war and the disabled.
- Limit veterans' disability benefits to disability categories I-VI.
- Refrain from implementing the FBH system for holders of military decorations.
- Prevent "double dipping" by all beneficiaries.
- Discontinue additional cantonal and municipal veterans' benefits programs.
- Centralize financing for the core social welfare and child protection benefits at the entity level.
- Merge the benefits for social welfare, refugees and internally displaced persons.
- Improve targeting, including through greater reliance on means- and proxy means-testing.

1/ See Chapter 6, p. 109 and p. 112 for the full list of recommendations.

G. TRANSPORT

23. The overall condition of the transport infrastructure remains poor and inadequate for a country of the size of BH despite considerable expenditures in the sector over the last decade. The ungainly institutional structure of the sector, especially of the road sub-sector, has substantially raised transaction costs and blunted the efficiency of spending. Moreover, expenditures on transport have fallen over the last several years, especially on rehabilitation and maintenance, resulting in a large maintenance backlog. Going forward, demand for both road and railroad freight transport is projected to increase substantially. Passenger railroad traffic, by contrast, appears unlikely to recover to even pre-war levels. Since the return on investment in rehabilitation is currently considerably higher on average than the return on upgrading or new road construction, priority needs to be given to expenditures to clear the backlog maintenance and rehabilitate the network. The issues are similar for the railroad sub-sector.

24. Recent developments are cause for concern. The FBH government is in the process of procuring passenger rolling stock at a cost that does not appear to take fiscal constraints fully into account, with technical characteristics far in excess of the capacity of the railroad network. Other fiscal concerns are raised by the authorities' intentions to develop rapidly the road infrastructure of corridor Vc, an undertaking that is likely to cost a sum equivalent to one-half of BH's GDP. In light of these developments, the PEIR argues that any public investment should be advanced only within prioritized national and sector investment strategies, consistent with the available fiscal envelope. Involving the private sector is important, but a substantially improved institutional framework for public private partnerships (PPP) and open and transparent competitive bidding are pre-requisites to ensuring that best value is obtained for the public resources available.

Transport: Summary of Recommendations 1/

- Develop a comprehensive national strategy for the transport sector, with priorities and timing.
- Carefully weigh public investment plans against other alternatives within the overall fiscal envelope. Proceed with such plans only within national and sector strategies.
- Give priority to clearing the maintenance backlog and rehabilitating the existing road network.
- Strengthen the institutional framework for PPP.
- Work toward consolidating policy making and operational responsibilities at all levels.
- Revise the existing provision in the FBH law on roads to enable a shift of resources to the main road networks carrying the most traffic.
- Retrench railways services and lines to a viable core network to improve performance.

1/ See Chapter 7, p. 126 for the full list of recommendations.