

Fiscal Background and Fiscal Sustainability

Ivailo Izvorski

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Overview

- Substantial progress in reconstruction and nation building.
- More needs to be done to create a more efficient and fairer government, advance transition to a market economy and limit fiscal risks.
- The PEIR presents specific recommendations on how to achieve this broad agenda.

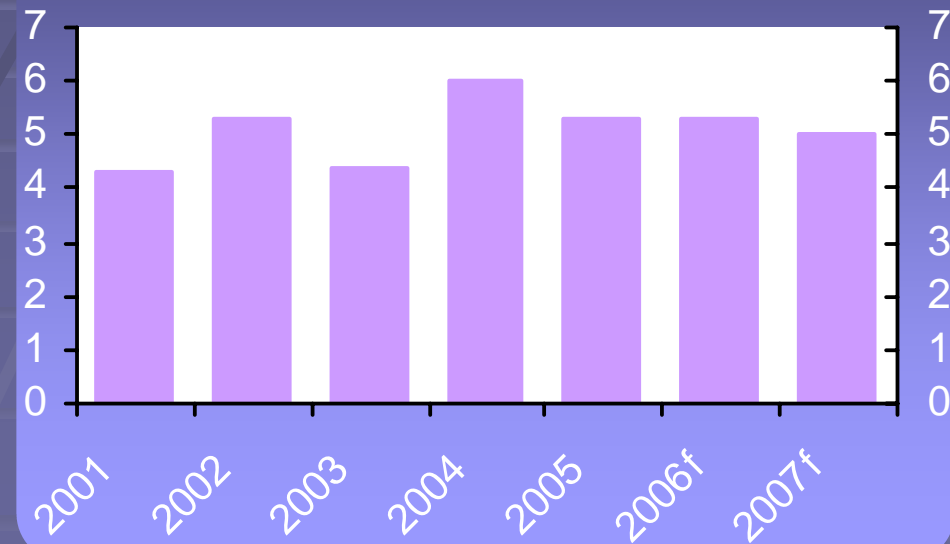
Contents of the Report

- The Strategic Setting
- Fiscal Background and Fiscal Sustainability
- State Building
- Managing the Public Administration
- Education
- Social Insurance and Protection
- Transport

Real GDP growth has been strong and inflation moderate.

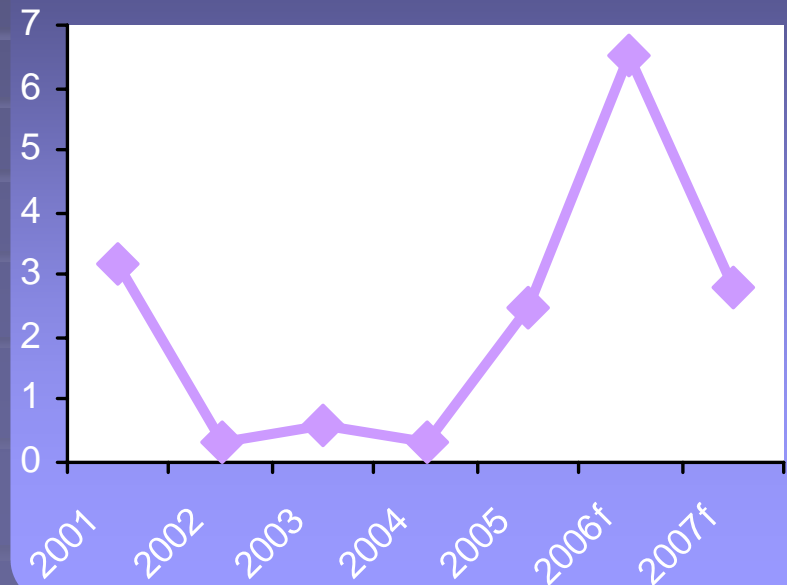
Real GDP

(In percent, year-on-year)



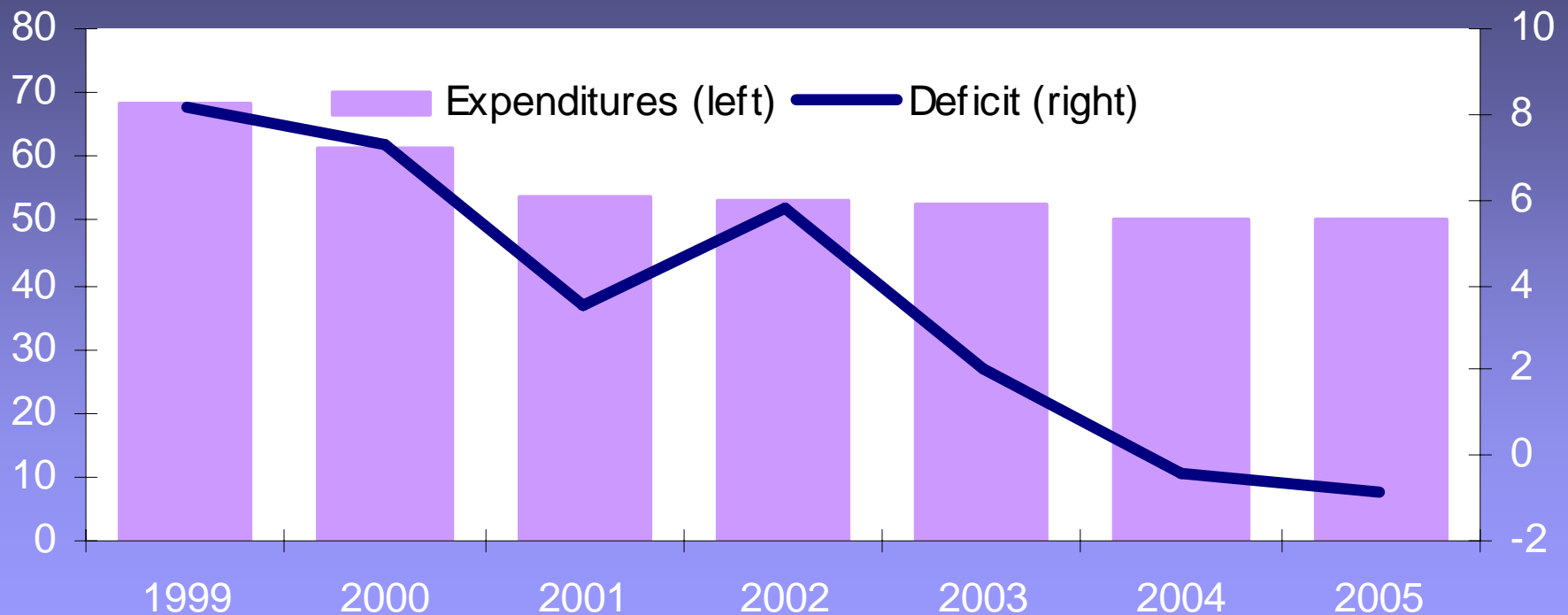
Consumer Price Index

(Annual average, in percent)



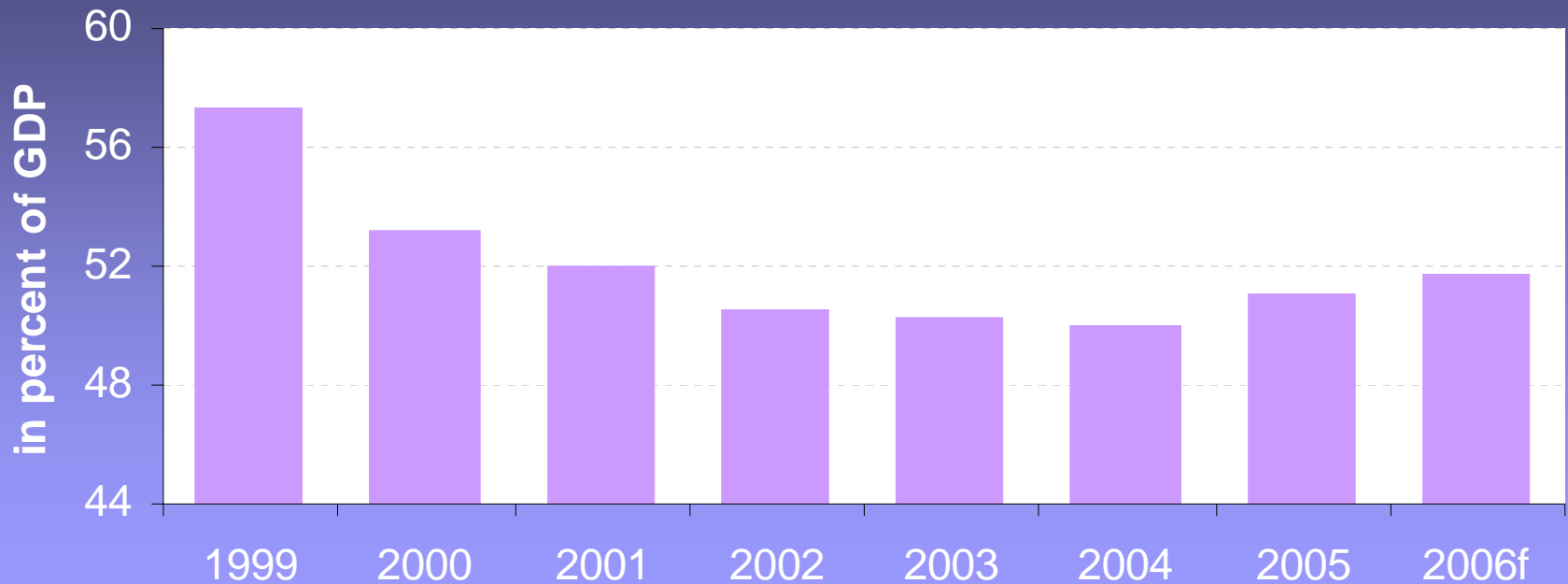
Fiscal consolidation has been substantial since 1999.

(In percent of GDP)



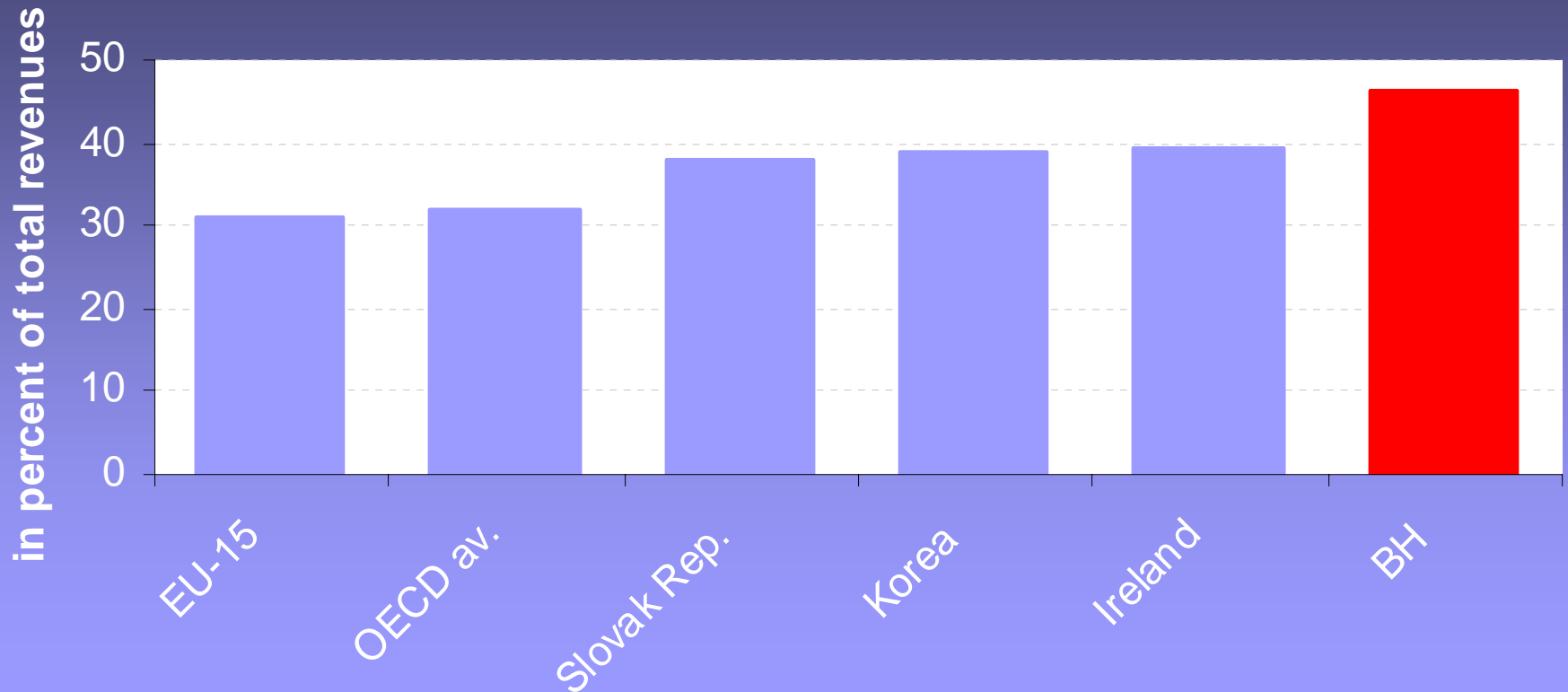
Revenues have picked up in 2006,
but so has spending.

BH: Consolidated Government Revenues



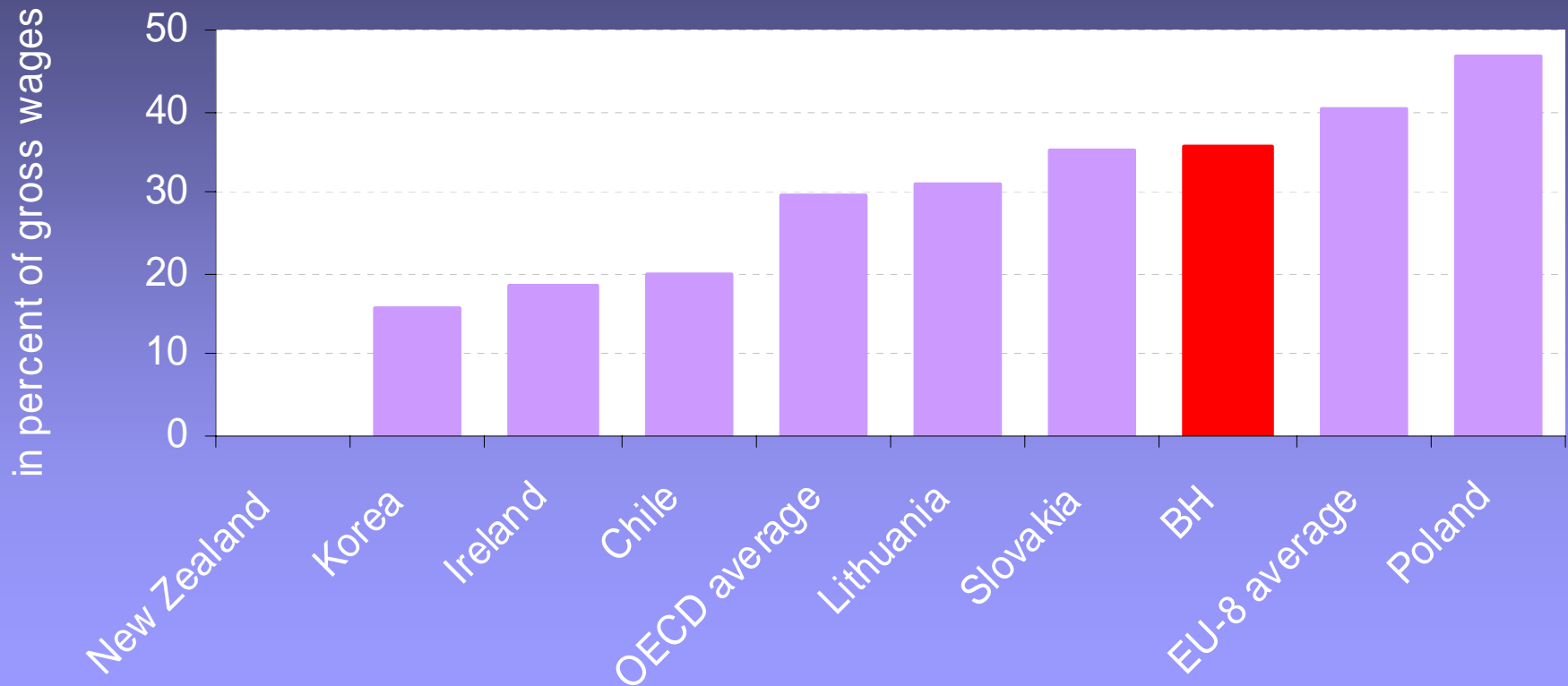
Positively, less distortionary taxes
account for a sizable share of
revenues.

Share of Indirect Taxes in Overall Revenues



But social security contribution rates are very high.

Social Security Contribution Rates



Where is BH Today?

- Government spending to GDP is high, inefficient, often unfair
- Financed with high (payroll) taxes
- Outcomes are often inadequate
- And yet: substantial fiscal pressures exist and set to multiply.

Fiscal Pressures

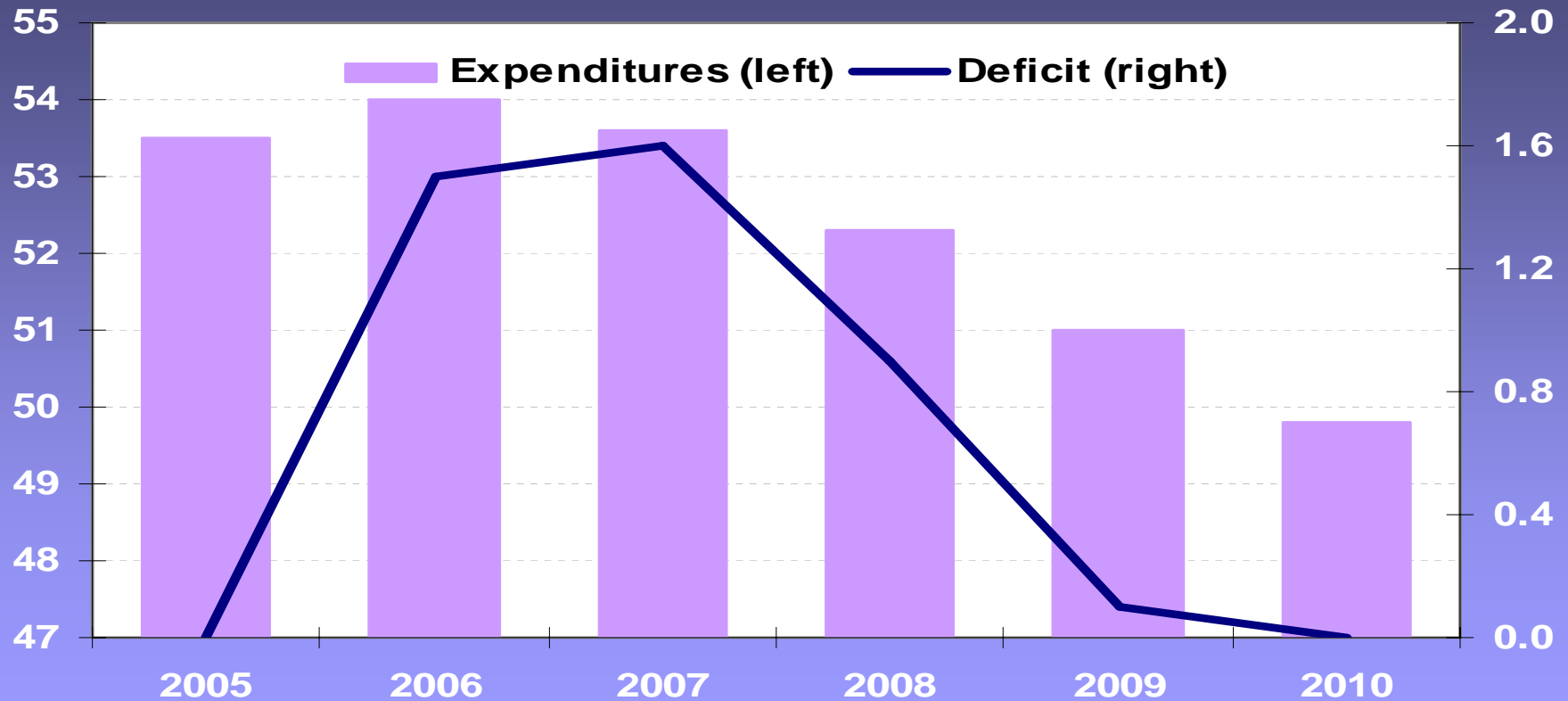
- State building
- Domestic claims
- Defense and police reform
- Corridor Vc
- Electricity generation
- Other infrastructure
- Restitution

Fiscal Sustainability Analysis

- “Stronger reform” and “weaker reform scenario”, 2005-2010
- “Stronger reform”
 - Substantial will to tackle fiscal pressures
 - Will to enact spending cuts and restructuring
 - Will to advance structural reforms, i.e., faster growth

“Stronger reform” scenario

(In percent of GDP)



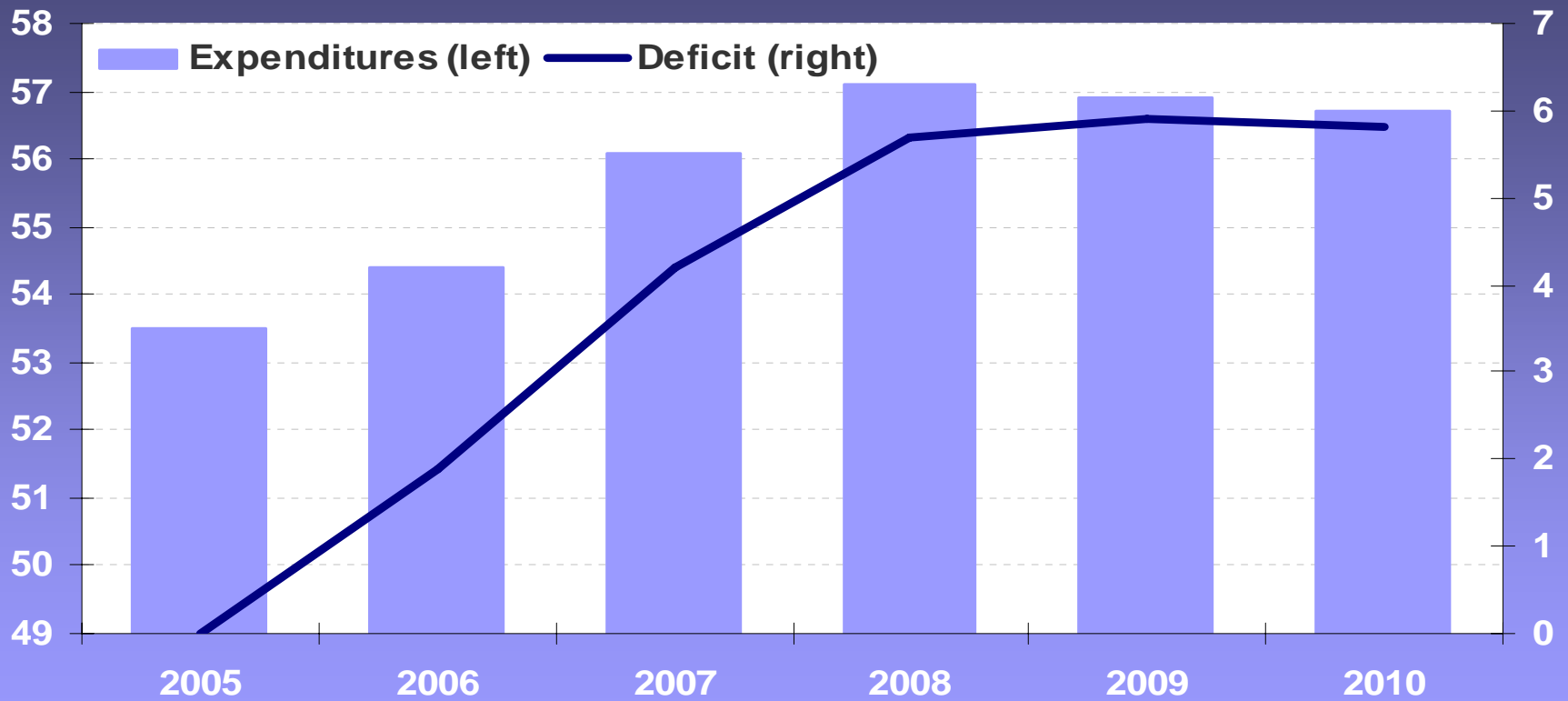
“Stronger Reform”

- Spending “with pressures” up 1%GDP
- Principal repayments up 1%GDP
- Interest outlays up 2%GDP
- Other spending cut 7%GDP

- Results:
 - Overall government spending down 4%GDP
 - Government debt contained to 42%GDP by 2010

“Weaker reform” scenario

(in percent of GDP)



“Weaker Reform”

- Spending “with pressures” up 3%GDP
- Principal repayments up 2%GDP
- Interest outlays up 4%GDP
- But other spending cut 4%GDP

- Results:
 - Overall government spending up 3%GDP
 - Government debt more than doubles, explosively

Lessons from the Scenarios

- Being cash constrained works for a while
 - Veterans; pensions; frozen currency deposits
- As access to borrowing improves, the cost of fiscal imprudence will rise
- Ambitious plans to boost spending require ambitious measures to find spending cuts. Half-hearted measures will not suffice.

Recommendations – Government Spending

- Reduce government spending by at least 7%GDP by 2010
- Eliminate inefficiencies before committing new funds to programs or sectors
- Using the PEIR, restructure spending to move to growth-oriented fiscal policy

Recommendations - Taxes

- Enact the laws on CIT and PIT in the FBH (RS completed)
- Do not amend the VAT law
- Reduce social security contribution rates
- Improve tax and contribution compliance

Recommendations - Other

- Be cautious in setting wages and employment levels for the army and the police
- Prioritize and carefully plan strengthening of state institutions to help limit costs
- Settle the outstanding domestic claims and handle restitution in a way that balances the public and the private interest
- Improve urgently data quality and capacity for consolidating fiscal data