

A Fiduciary Update on Public Financial Management

Bosnia and Herzegovina

EXECUTIVE SUMMARY

1. **Bosnia and Herzegovina (BH) hopes to successfully conclude the Stabilization and Association Agreement (SAA) with the European Union (EU), upgrading BH as a potential candidate for EU membership.** Entry into the EU will increasingly shape the future reform program of BH in several areas, including public financial management.
2. **Bosnia and Herzegovina has made good progress in establishing modern public financial management institutions and systems since the war ended in 1995.** Yet many challenges remain. BH inherited its institutions and systems from Yugoslav rule. Some were dysfunctional; and others simply did not exist and had to be created—for example, treasury and Supreme Audit Institutions. While international financial institutions, donors, and the Office of High Representative (OHR) played important roles in leading the reform process, the efforts and commitment of BH were critical to success.
3. **The State and both Entities—the Federation of Bosnia and Herzegovina and the Republika Srpska—have laid the foundation for sound public financial management, including independent external audits.** The reforms have been characterized by growing domestic ownership, particularly the finance ministries' efforts to improve the planning and execution of public finance. Recent amendments to budget laws have underscored this positive trend. Despite new or amended laws and improved institutional arrangements, however, technical assistance and training is still needed for the institutions to integrate new methods fully into practice.
4. **Fiscal policy remains fragmented among the State, the two Entities, and the Brcko District.** Fiscal policy in BH is still defined by the post-war outcome in the 1995 Dayton Peace accord, which gave overriding fiscal autonomy to the two Entities and the Brcko District. The establishment of an intergovernmental Fiscal Council is an important first step toward improving the level and quality of fiscal coordination among the governments. Going forward, the Fiscal Council must be vested with sufficient authority to make binding decisions.
5. **Enabling legislation for empowering the Fiscal Council is urgently needed.** The Fiscal Council should have sufficient authority to make timely fiscal policy decisions. The legislation should include a mechanism for resolving differences amongst the constituents. It should also include provisions for imposing penalties when agreements are breached.

6. **Strategic planning has improved, and ownership is more evident.** A key development was the country-wide Poverty Reduction Strategy Paper (PRSP), known as the Medium Term Development Strategy (MTDS), which was prepared jointly by the three governments. These efforts have helped to familiarize the governments with policy-based frameworks in a multiannual context, yet the link between policy and budget is still very weak. Externally financed technical assistance has helped to ameliorate the lack of capacity within the finance ministries. It is too early to say whether the medium-term expenditure framework (MTEF) will be sustained without continuing external support although there are indications that it is becoming the starting point for the preparation of annual budget rather than remaining as a standalone document.
7. **Some preliminary steps have been taken toward transforming the traditional line-item-based budgeting process to a program-based approach within a medium-term expenditure framework.** In addition, significant institutional reforms have been introduced by the State and two entity governments through enactment of new or amendment of the existing organic budget laws (OBL). Although not particularly well articulated, the amended Federation OBL now requires some program budgeting type information across the Federation and canton levels of government. Additionally, an intergovernmental Budget Coordination Board (BCB) has been formed for coordinating medium-term budget development among the governments including aligning macro-fiscal assumptions. These reforms in the budget preparation area are critically dependent upon government implementation capacity. Realistically, completion will require many years of technical assistance.
8. **The key to improved budget execution and cash management since 2002 has been the automated treasury system in the State and the two Entities.** This has improved controls, brought discipline to the budget execution system, and improved overall cash management across the State and Entities. It is, however, important that extrabudgetary funds (particularly health insurance and pension funds) and municipalities be brought into the system, because these bodies command significant resources. Budget discipline must be uniform and consistent across the entire system of public resource management.
9. **The treasury system has greatly improved the availability and quality of financial reporting in the public sector.** The State and two entity governments have adopted full accrual-based accounting though it is not yet fully implemented. The Republika Srpska (RS) has adopted the International Public Sector Accounting Standards. Instead of the State and the two Entities issuing their own guidelines and instructions on public sector accounting standards, a joint Government Accounting Standards Board should be created. This would ensure uniformity across the entire public sector in BH, in turn enabling preparation of national consolidated financial statements.
10. **Public procurement remains weak in practice despite a common Public Procurement Law based on international best practice.** The law is applicable across the State and two Entities but compliance has been weak thus far. In a few instances, provisions of the law have been contravened, resulting in noncompetitive

procurement. It is evident that knowledge and understanding of the law has not yet fully percolated down to the ministries and agencies. In addition, important institutions such as the Procurement Review Body have yet to be established, and the Public Procurement Agency is not yet fully functional. The challenge for BH is to fully implement the law, and for politicians and civil servants to then demonstrate sincere respect for its provisions.

11. **The unified indirect taxation system across the country presents a challenge.** The full effects of VAT are still uncertain. At the technical level of tax administration, early indications are encouraging. At the political level, however, it has been less easy to manage a state-level institution charged with sharing a major source of revenue between various governments. While the issue is resolved at the political level, it is important that donors continue their support to stabilize the technical systems.
12. **Compliance with internal controls needs to be improved.** Audit reports from the Supreme Audit Institution (SAI) point to several instances of noncompliance with the rules and procedures. Internal controls are only as strong as the attention paid to them and it is undermined by continuous noncompliance. For rules and regulations to be meaningful, everyone in the environment must understand them and work together toward compliance. Moreover, current internal financial controls would need revision to better align with the EU prescribed public internal financial control (PIFC) framework.
13. **The legislative and organizational framework for an internal audit system does not yet exist.** Internal audits tell management whether controls really work as specified and whether they are being followed in letter and spirit. There is a common observation in external audit reports that compliance with rules and procedures is weak. It therefore becomes all the more important to establish a mechanism of internal audit whereby management can continuously ascertain the status of internal controls.
14. **The newly enacted Supreme Audit Institution laws unify key principles, and they eliminate contradictions among the old laws.** The new laws ensure uniform standards. They protect the autonomy of the SAIs while introducing parliamentary oversight; and they clearly specify the mandate of the three SAIs. However, a clear declaration of the SAI role needs to be included in the constitution of the State and Entities. This is required to help shield the audit institution from outside interference.
15. **The SAI Coordination Committee should develop a shared vision and prepare a joint Strategic Development Plan.** The strategic plan will facilitate further adoption of common approaches. It will keep the SAIs focused on the objectives and tasks ahead; and it should help to reduce the abrupt appearance of unfunded mandates. The plan should highlight the need to prioritize financial audits, including a concrete strategy for audit of information technology environments, revenue audits, and audit of local governments.
16. **Corruption is reportedly widespread.** The fight against corruption has mostly been carried out on paper, with political commitment lagging. Instead of yet another set of

strategies and action plans, the right tone must come from the top. Basically, those in high places must completely eschew *any* activity that can even remotely be considered “corrupt.” Barring this standard and example from the top, it is unlikely that any strategy or action plan will make any real difference. It is equally important that the governance in State Owned Enterprises (SOEs) be strengthened while simultaneously adopting transparent procurement practices, because most large-value procurement takes place in SOEs.

17. **Parliament has established specialized committees to review the budget, but its influence is extremely limited.** Its input on budget proposals and its oversight of budget execution are hampered: by inadequate qualitative budget execution data, lack of resources to recruit economic and sectoral experts who can provide research inputs, and the practice of adopting annual budget execution reports even before the SAI has submitted its audit report.
18. **It is important to calibrate reform measures in the light of the many lessons that have been learned in the implementation of reforms thus far.** Experience has taught, in particular, the importance of proper sequencing of reforms. Given the specific governance structure in BH, harmonizing policy decisions and reaching a consensus necessarily takes time. Building institutional capacity and strengthening coordination across governments will be critical to the sustainability of reforms in BH. Some reforms require good technical assistance. Some reforms require a proper legal framework. Some reforms have succeeded because a uniform, harmonized approach was applied across BH. However, without committed leadership, real progress is impossible.
19. **Despite these shortcomings, this Country Fiduciary Update found a good foundation for strong public financial management in Bosnia Herzegovina.** The treasury accounting system now provides reliable information; systems are in place to record, report, and track receipt and use of funds; and there is independent audit of the budget execution reports. However, weak compliance with the existing internal control rules and procedures is further compounded by the absence of a modern internal audit system thus weakening the internal control framework. Moreover, current public procurement practices are weak and fail to comply with the Public Procurement Law. This report therefore recommends that the use of country financial management systems in BH should begin with a pilot project subject to a separate project fiduciary assessment after progress has been made in setting up an effective internal audit function in the State and two Entities.
20. **The overall financial management risk to Bank development policy lending (DPL) funds is moderate.** Ample safeguards exist in the central bank to record and track foreign currency funds received under the Bank’s DPL program. However, future DPL operations should include measures to develop public financial management capacity and to address the weaknesses and risks, particularly in the management of budgetary resources identified in this report. In doing so, it is important that conditions and triggers focus on results rather than inputs/processes while clearly stating the expected outcomes.

21. **The financial management risk to Bank funds in investment projects implemented in BH is moderate.** Until now, investment projects financed by the Bank have been implemented by standalone Project Implementation Units (PIUs). PIUs have been regular in submitting quarterly financial management and annual audit reports. Recent audit reports and management letters by auditors do not reveal serious internal control issues within the PIUs. In recent years, no procurement contract has been found to be misprocured in recent years.
22. **An overarching theme in this report is the need to build government capacity to implement laws and regulations.** All recommendations to address the issues identified in this report are summarized in Annex 1. The highest priority recommendations are as follows.
- Integrate government policy priorities into annual budget preparation. Fiscal Council members must be actively involved in the process. The Fiscal Council should establish a medium-term macroeconomic and fiscal strategy that sets out macroeconomic assumptions, the aggregate resource envelope, indirect revenue allocations, and size of the State and entity budgets, fiscal balance objectives, and sector expenditure policy priorities.
 - Build capacity within the finance and line ministries in the area of fiscal management. The strengthening of technical skills is essential for improving upstream budgeting.
 - Harmonize fully fiscal reporting systems and formats and introduce comprehensive and timely reporting for general government.
 - Extend the treasury system to local government level and to extrabudgetary funds. In addition, online access to the treasury system should be extended to those line ministries and spending units that currently lack access to the system.
 - Establish a procurement review body and make the public procurement agency functional. Focus on implementing the Procurement Law and train the line ministry and agency staffs in understanding its requirements.
 - Establish a joint Government Accounting Standards Board and issue national public sector accounting standards.
 - Continue to build capacity in tax audit and enforcement.
 - Stipulate within the law explicit accountability that includes ministers, heads of departments, and managers.
 - Adopt a legislative and organizational framework for a sound internal audit system.
 - Develop a strategic development plan by the SAI Coordination Committee, focusing on financial audits. It should define a strategy for revenue audits, audit of local governments, and auditing within a modern information technology environment.
 - Form a joint parliamentary research service providing analytical and research inputs for all the three parliaments in the State and two Entities.

Monitoring the reforms. The Economic Management Structural Adjustment Credit (EMSAC) was the Bank's major vehicle for monitoring ongoing reforms in public

financial management. Donors such as EU, DfID, USAID, SIDA, and the Dutch bilateral programs were all expected to increase their technical assistance. They therefore have a continuing stake in monitoring public financial management improvements. This Fiduciary Update will contribute to the Country Assistance Strategy in 2007 and to the preparation of new development policy loans.