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Joint Staff Assessment of the Poverty Reduction Strategy Paper

Prepared by the Staffs of the International Development Association
and the International Monetary Fund

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I. INTRODUCTION AND BACKGROUND

1. **The Medium-Term Development Strategy of BH (MTDS) for 2004-2007 represents a poverty reduction strategy aimed at restoring growth based on strong private sector development.** It builds on the Interim PRSP (I-PRSP) which was submitted to the Bank and the IMF in December 2001 for information, not linked to any Bank or IMF operation. Bank and Fund staff provided joint comments on Bosnia and Herzegovina's I-PRSP to help facilitate government's PRSP preparation process. The MTDS was adopted by both State and Entity governments¹ in early 2004. The State Parliament affirmed its support for the strategy on March 22, 2004, placing special emphasis on fulfilling conditions for the European Union (EU) stabilization and association process (SAp). At the outset of MTDS preparation the eventual integration of Bosnia and Herzegovina (BH) into the EU was seen by the authorities as providing the overall institutional and legal framework to economic development and the protection of the poor. The Strategy, therefore, seeks to provide the conditions for sustainable and equitable economic development while reducing poverty and accelerating the EU SAp.

2. **With the strong support of the international community, significant progress has been made since the late 1990's in building both a market economy and a single economic space.** This includes inter-Entity tax harmonization, the strengthening and modernization of public administration systems, the privatization and restructuring of the banking sector and the strengthening of State institutions necessary to BH's eventual accession to the EU. The BH authorities are working on establishing a single Indirect Taxation Authority (ITA), incorporating a unified customs structure, in anticipation of a single state-level VAT, and on centralizing defense command and control structures. In this context, real GDP has trebled since 1995, exports are up tenfold, the fiscal deficit

¹ Under the 1995 Dayton Agreements, four levels of government are provided for. At the highest level is the State of Bosnia and Herzegovina, hereafter denoted as the State. At the next level there are two constituent political Entities, the Federation of Bosnia and Herzegovina (FBH) and the Republika Srpska (RS) covering 51 percent and 49 percent of the land area of Bosnia and Herzegovina respectively. FBH is divided into ten cantons, which in turn are divided into municipalities. In the RS there are no cantons, with local government assumed directly by municipalities.

has strengthened 9 percentage points of GDP in the last four years and inflation, under a currency board system, has stabilized at industrial country rates. Growth was fueled by substantial donor aid--\$3.7 billion during 1996-99 from 48 countries and 14 international organizations--and by 2000, roads, power supply, telecommunications, water supplies, health and education infrastructure were back to near pre-war levels. In addition, the pension and to a lesser extent health financing systems have been put onto a more financially self-sustainable footing. Finally, ethnic tensions have declined - by November 2003 about half of the 2 million refugees and internally displaced persons (IDPs) had returned, many to areas where they are an ethnic minority.

3. **However, GDP growth has slowed recently following the post-conflict “bounce” and the current account deficit of 18 percent of GDP in 2003 is well above levels associated with external sustainability.** The slowdown in GDP growth has occurred even though GDP had not recovered to pre-war levels at the end of 2003. Moreover, the incidence of poverty remains higher than in most neighboring countries, though living standards have improved significantly since the cessation of hostilities in 1995.

II. COUNTRY OWNERSHIP AND PARTICIPATION

4. **The MTDS was discussed extensively with stakeholders suggesting that the strategy is broadly BH owned,** but it is unclear how these consultations influenced the design of the strategy. The process included forming a Coordination Board, chaired by the BH Prime Minister and comprising the State Council Ministers, Entity Prime Ministers and Ministers of Finance, to oversee the strategy’s preparation. This created for the first time a forum in which all three constituent governments of BH met on a regular basis. Within government a number of inter-ministerial MTDS working groups were set up, supported by local academics. A first round of participation and consultation was divided into local level consultation and consultation with the poor, as well as consultations along thematic lines. An NGO group managed local level consultations and consultations with the poor. Thematic consultations took place with a variety of interested parties in government, parliaments, civil society and the donor community. A general media campaign was also launched to increase public awareness of the PRSP process. Both the first and second drafts of the MTDS were discussed by a wide range of stakeholder groups, including representatives of NGOs, labor, youth, the BH private sector, foreign investors, parliaments, the international community and the media. For a country recently divided by conflict the formulation and initial implementation of a single countrywide developments strategy is one of the most important achievements of the PRSP process, and this process could have been better documented in the MTDS.

III. POVERTY DIAGNOSTICS

5. **The MTDS is anchored in survey-based poverty diagnostics and an in-depth analysis of poverty risks.** This represents a major step forward, particularly in comparison to the I-PRSP, which lacked solid numbers on the scope and magnitude of poverty. The poverty diagnostics show that 20 percent of the population is below the poverty line, the highest rate of poverty of any of the former Socialist Federal Republic of Yugoslavia (SFRY) republics. Furthermore, an additional 30 percent of the population are close to the poverty line and vulnerable to falling below the line with small declines in income. The poverty profile shows significant regional disparities in poverty largely centered on rural and semi-urban communities across the country, and while unemployment is an important determinant of poverty, 60 percent of the poor are living in families where someone is employed and as such are the working poor. The poverty line was established following best practice techniques using actual consumption patterns to arrive at the minimum cost of meeting basic needs.

The poverty diagnostic also places a commendable emphasis on non-income dimensions of poverty and attempts to integrate empowerment and human rights issues in the discussion of poverty. It also has a thorough and comprehensive discussion of the gender aspects of poverty. Due to data limitations, poverty diagnostics had to forego analysis of the distribution of income and assets and its link to poverty. Such a gap can be addressed with new Household Budget Survey data, and is recommended as an issue to be addressed in the first MTDS progress report.

6. **While the poverty diagnostic clearly identifies the causes of poverty, and proposes measures to address them, the analysis could have been applied more rigorously as a common organizing framework for policy recommendations and prioritization in the main body of the subsequent strategy.** The causes of poverty include the destruction from the war, slow implementation of reforms, low labor force participation and high formal sector unemployment, human rights violations, an inadequate social protection system, low quality education, corruption and the inability of the poor to influence institutions that matter to them. The policy measures include: fiscal reform, private sector development and employment growth, social protection, reduced corruption, reduction in the size of the informal economy, guaranteeing human rights, implementing the Law on Gender Equality, and reforming the education system. These priorities fit within overall strategy goals, which also include promoting sustainable growth and insuring EU accession, but are not explicitly treated throughout the subsequent strategy in poverty reduction framework, except when individual social sector strategies are presented at the end of the MTDS.

IV. THE POVERTY REDUCTION STRATEGY

7. **The MTDS has a clear set of overall goals.** These are to:

- create conditions for sustainable and balanced economic development;
- reduce poverty; and
- accelerate EU integration.

The main focus of the strategy, however, is on promoting private sector growth by reforming the public sector and establishing conditions conducive to private investment. This is appropriate, given the enormous challenge of developing a self-sustaining, less aid dependant, competitive economy which improves employment prospects (including for women and the young) while raising the skills of the working poor. The strategy would, however, be more balanced if this central strategic thrust was matched with a more coherent strategy of well prioritized fiscally sustainable poverty reduction measures, including through budget initiatives.

A. Macroeconomic framework

8. **The macroeconomic framework aims to achieve sustained higher growth while significantly reducing the external current account deficit.** The reform scenario assumes that growth will recover from 3.5 percent in 2003 to 5 percent in 2004, and reach 5.5 percent in 2007. This assumes an average investment rate of over 20 percent per year, financed by a significant increase in private domestic savings and by a continued fiscal effort to raise domestic public savings. The contribution of foreign savings, although reduced, will remain substantial, but its composition would shift as reduced aid flows would be partly offset by strong gains in foreign direct investment. Consequently, the MTDS framework foresees an adjustment in the current account deficit of more than 6 percentage points of GDP by the end of 2007. The projection assumes that export growth will

average 14 percent per year, while import growth will be restrained to around 6 percent per year, which represents a challenge in a high growth and investment framework. Moreover, the steep increase in domestic private savings and exports is conditional on the full and expeditious implementation of the structural reform program generating the expected supply response from the private sector, in itself an ambitious objective. The balance of payments projection also assumes that foreign direct investment will equal 9 percent of GDP by 2007, a figure which is ambitious, but achievable under a full reform scenario.

9. **To ensure a greater likelihood that full reform scenario targets are achieved, the authorities should develop a framework to prioritize proposals to ensure consistency with their MTEFs, implementation capacity, political commitment and ownership.** The rapid growth scenario is predicated on the implementation of the reform measures of the MTDS. The General Action Plan provides in matrix form the necessary policy steps. There are 390 actions mentioned in the plan, of which a significant number would have to be implemented in 2004. In addition, the social protection chapter lists a further 81 measures just for this area. Since many of these actions include passage of new legislation, keeping to the timetable envisaged will prove a significant challenge to the authorities. Whereas the particular measures in the action plans may have considerable merit, the question still remains if BH has the fiscal and institutional capacity to realize these actions in the time frame proposed. The actions are not prioritized either by: (a) the feasibility of implementation; or, (b) their likely impact. The authorities should take further steps to ensure a costed strategy, in the context of the MTEF, is completed by the time of the first progress report. The MTDS also outlines a “slower implementation” scenario, which assumes a real growth rate of 1.9% per annum through 2007.

10. **The MTDS makes a clear commitment to continue the existing monetary policy, including the continuation of the currency board.** This arrangement has provided monetary and price stability since it was started in 1997. The strategy also proposes to amend the Central Bank law to permit the Central Bank to function as a lender of last resort (LOLR), largely to handle short-term liquidity requirements of the financial sector. The MTDS also seems to suggest that establishing the LOLR function would adequately respond to the mismatch in the banking sectors balance sheet, which is believed to constrain medium and long term credit to the corporate sector, and that it would further ease what are perceived to be excessively high interest rates. Staffs do not share the strategy’s diagnosis, as the LOLR function is only to be used during a bank liquidity crisis and not as a liquidity supplement for banks’ normal operations, and recently there has been an increase in the share of credit going to the corporate sector as well as a decline in lending rates and the interest rate spread. The increase in corporate credit has been moderate, but even so we welcome the caution of the banking sector in its lending practices, in an environment that is still characterized by weak corporate governance, and note that this suggests that emphasis should rather be placed on improving corporate sector operations. Finally, the introduction of a limited LOLR role in the Central Bank should be reviewed with great care, given that the maximum size of any such facility would be limited to a prudent proportion of the country’s free reserves under the currency board arrangement. Staffs also caution against the proposals to permit the Central Bank to issue short term bonds for various reasons, including that this is not essential to improving commercial bank operations and could risk jeopardizing the profitability of the Central Bank.

B. - Investment climate

11. The core of the MTDS is encouraging private sector development, focusing on three areas: promoting entrepreneurship and private sector development, making the privatization process more

efficient, and attracting more private foreign investment. Major steps in this area include: reducing barriers to starting new businesses, creating a single “economic space” by removing internal barriers to trade and commerce, simplifying the tax system, improving the judicial system, reducing corruption, and improving infrastructure. While these interventions make sense, the list of initiatives is very long and will likely overstretch the limited capacity to implement them. The staffs again suggest that the authorities make an effort to prioritize their actions.

12. **Privatization.** Staffs welcome the MTDS’s emphasis on accelerating privatization. Privatization in BH has been disappointing. Government adopted, with donor advice, a voucher program which resulted in a dilution of ownership of previously publicly owned enterprises without introducing new management or new capital investments. A second stage of privatizations based on tenders has gone slowly. As a result, the state enterprises (SOE’s) constitute much of the economy (60 percent as reported in the MTDS) and this remains a major obstacle to enhancing competitiveness. Many privatized firms and SOE’s do not seek profits, loss-making is widespread and workers tolerate wage arrears so that many firms are unsustainably indebted both to the tax authorities and the workers. The MTDS proposes an accelerated program of privatization, focusing on a reclassification of enterprises by their readiness for privatization and developing a comprehensive strategy for debt resolution of these enterprises to facilitate and accelerate privatization. However, the strategy overlooks the need to improve the operations of the voucher privatized firms, and staffs encourage the authorities to create concrete proposals in this area as part of the MTDS implementation. As mentioned in the strategy, a major issue also to be resolved is how to handle the social costs of enterprise restructuring. Staffs welcome the strategy’s emphasis on developing instruments and systems to accelerate privatization, and note that the early definition of pragmatic, fiscally and financially sustainable reforms of the privatization, liquidation and social insurance systems, with appropriate respect for creditor and property rights, are essential if privatization efforts are to proceed. The Bank is preparing new programs to assist the authorities in the structural and macroeconomic aspects associated with accelerated privatization and improved corporate governance, which will include measures to mitigate poverty and the social aspects of such reform.

13. The strategy also calls for accelerated privatization in key sectors including assets in power, telecommunications, railway, water management, forestry and media sectors, which staffs welcome. Nonetheless, staffs wish to reiterate that successful privatization will require creating a favorable investment environment in these sectors. This is predicated on putting in place an appropriate legal and regulatory framework, addressing issues of corporate governance, tariff/price reforms and restructuring these enterprises prior to privatization.

14. **Labor Markets.** The strategy acknowledges that taxes on wages (social security, health care) raise the cost of labor by 69 percent in FBH and 52 percent in RS. These taxes, plus the lack of formal sector employment growth, have resulted in a substantial growth of the informal economy, now estimated to be as much as 36 percent of GDP, which the strategy clearly recognizes as a big employer of labor. A recurring theme of the strategy is the elimination of this “unfair” competition for the formal economy by the informal. Staffs recommend that caution be used here, since the informal economy is also a significant employer of the poor and provides a useful safety net. Moreover, the MTDS recognizes that the costs of future shedding of employees in the public sector may be overstated, since these “wait listed” employees already may be working in the informal economy. The staffs view, therefore, is that this section of the strategy should be more strongly linked with initiatives to improve demand for labor through a strengthened business environment. Staffs suggest that the labor focus should be on reducing: (i) taxes on wages, as a function of an

improving fiscal situation, and (ii) administrative barriers that discourage private sector development and formal sector participation by firms.

15. With regard to the formal sector, the MTDS does not go into detail in terms of “wage setting” and collective agreements, which is key to enhancing competitiveness. Staffs encourage the BH authorities in the near term to fundamentally reform the collective bargaining system in a manner which emphasizes decentralization to firm level bargaining. The MTDS notes that the employment institutes of the Entities are supposed to administer both active and passive labor market policies, including unemployment insurance. However, these institutes have suffered from poor business processes and lax financial management. The level of employment services, furthermore, varies widely between cantons. In the context of devising new active labor market interventions, staffs underline the need to discontinue the practice of issuing soft credits to companies as a means to support employment creation.

16. **Financial Sector Reform.** The MTDS has a substantial analysis of the problems in the financial sector. Significant strengthening of this sector, particularly banking, has already occurred over the past five years, including restructuring, privatization, improved supervision and improvements in deposit insurance. The staffs welcome the envisaged role for foreign banks in the sector. Also useful is the proposed strengthening of the Entity Bankers Associations, and greater collaboration between them. However, regarding calls for more lending to firms, staffs believe that with recent trends of falling interest rates and growing deposits competition is increasing in the banking sector and the sector is behaving rationally in terms of its lending profile. Staffs caution that a fundamental shift in lending from the household to the corporate sector is predicated on the achievement of significant business environment and judicial reforms, a central thrust of the MTDS. In this regard the BH authorities should be wary of promoting high risk interventions, such as non-export oriented guarantee funds for the SME sector, which would be an inappropriate use of scarce public resources.

17. **Public Administration/ Anti-Corruption Efforts.** Government employees are 4.5 percent of total employment, but reportedly receive 14 percent of GDP in wages. While the MTDS notes that wage increases will be held in check (between 2-5 percent, nominal), it does not offer concrete solutions for reducing the heavy burden of the wage bill into the medium term. The discussion in the MTDS focuses largely on the plan to establish a modern civil service on the EU model, which is welcomed. Notably absent, however, is any strategy for pay reform. Staffs understand that this issue will be taken up in an upcoming public administration review, and strongly recommend that this important issue be treated as a top priority in the first MTDS progress report, in the context of the wider reform of the overall collective bargaining system. The strategy does highlight the need to reduce corruption in the public sector, through a combination of actions to increase transparency and accountability. It also notes the link between poverty and corruption, and the high level of bribery in such sectors as health care, education and the police. The staffs welcome the steps proposed in the strategy to reactivate and aggressively implement an integrated anticorruption action plan, including reform of the judiciary, tax administration reform, public procurement reform and improved public and State administration.

18. **Foreign Trade.** Trade liberalization, including tariff reduction, is a major and welcome goal of the BH authorities and a necessary step to WTO accession. In fact, BH already has one of the most liberal trade regimes in the region. While the strategy notes that trade liberalization helps the poor through lowering of food prices, it simultaneously argues for increasing protection of agricultural products. This is a contradiction which leaves the authorities’ future policy stance uncertain.

Furthermore, while a number of strategic industries have been identified for which tariff reduction on imports is suggested, staffs suggest that the authorities would be better placed reducing tariffs on all imports, rather than trying to pick industries for continued, let alone increased, protection. In this vein, the strategy's call for selective tariffs on new imported machinery and equipment runs counter to the principle of effective trade liberalization. An appropriate supply response will be generated by measures related to improving business environment rather than by protection. On the export side, the strategy suggests steps to further develop IGA in its role as an export credit agency to assist in the revitalization and expansion of the capital goods industry in BH. This may be possible but does not require a further infusion of capital into IGA, as suggested by the strategy.

C. Fiscal policies

19. **Fiscal reform is key to supporting efforts to strengthen the private sector.** The fiscal reform program laid out in the MTDS is generally adequate and reflects the Medium Term Expenditure Framework (MTEF) for 2004-2006 adopted by each Entity government.² Staffs believe that the fiscal stance should remain very strong as support for efforts to contain the current account deficit. We welcome the authorities' broad intention to meet this goal. However, the burden of taxation is an impediment to growth, as it has distorted private sector behavior by increasing tax evasion and the grey economy, and on available indicators the ratio of total government revenue to GDP is too high. To address evasion, the VAT should be introduced in a timely fashion and the tax burden reduced. Thus, staffs welcome the strategy's prioritization of continued progress in indirect taxation reform and the introduction of VAT. Staffs encourage the authorities to make all necessary efforts to ensure that the timetable for VAT be respected, if not accelerated, taking full advantage of further envisaged technical assistance in this area. The aspiration to reduce labor taxation (including contributions) is also welcomed, but should be converted into a concrete plan soon, given the high effective tax on labor and the need to encourage formal employment. Given the strong fiscal stance and the need to reduce the tax burden, staffs agree that expenditure needs to be reduced. Indeed, staffs believe that the envisaged adjustment in the ratio of public spending to GDP could have been more pronounced.

20. **Staffs concur that improving the composition and the management of public expenditures, while reducing its overall level as a percentage of GDP, is a key ingredient to carrying out the MTDS reform agenda and promoting growth.** On the expenditure side, the program is developed on three tracks: first, it calls for a reduction in spending, recognizing that the level of public expenditure, at above 50 percent of GDP (2003, including municipal spending) is still too high. Second, the strategy focuses on the needed reallocation of spending within that envelope, in order to achieve greater allocative efficiency. Finally, the fiscal reform program emphasizes the need to improve management over public resources with a view to improve technical efficiency, accountability and transparency. A major problem clearly recognized in the strategy continues to be the weight of public sector wages in total spending, which crowds out necessary spending on maintenance and investment. In addition, the wage determination system for government employees does have adverse signaling effects on wages in the rest of the economy, potentially affecting the country's competitiveness.

21. **A significant reorientation of expenditures is foreseen along with efficiency improvements.** The MTDS calls for expenditure reorientation, including decreasing the size of

² It should be noted, however, that with the estimated 4.4 percent increase in the wage bill in the RS in 2004, the Entity is already in violation of its previously adopted MTEF.

military spending, holding the line on spending for public wages, and more efficient public procurement and revenue collection. All these policy recommendations are to be welcomed, including the strategy's goal of ensuring that a greater proportion of public expenditures goes to operations and maintenance and public investment, although the programmed increases in the shares of these two spending categories could have been more ambitious. Both Entities have approved Public Investment Programs (PIPs) but they have not been incorporated into annual Entity budgets. Moreover the linkages between the MTDS, the MTEFs and the annual budgets needs to be further strengthened. Education sector reform aimed at addressing major inefficiencies within the sector, will reduce spending from 6.4 percent of GDP in 2002 to 5.4 percent by 2006. Similar efficiency savings are expected in the health sector. A substantial retargeting of priorities within social protection system (including war veterans) is envisaged, which staffs strongly welcome. Additional revenues and savings will be directed toward social protection, to strengthen and establish more equitable core social safety net programs to cover the social costs of privatization, restructuring and public administration reforms, as well as subsidies in agriculture. However, the magnitude of these shifts is not indicated.

22. **The strategy is silent on macro fiscal architectural problems which have resulted from the highly decentralized constitution and its discussion of micro level issues does not lead to clear recommendations.** In particular, there are no institutions tasked with deciding on the appropriate overall fiscal target for the country, apportioning this target amongst the various governments, and enforcing and monitoring progress towards the target. These gaps ultimately compromise fiscal support for the currency board. Thus, staffs welcome the authorities' efforts since the preparation of the MTDS to come up with proposals in this area. An effective solution will require adequate analysis of current macroeconomic trends, based on good quality data. Given the poor quality of statistics, and the slow pace of improvements in this area, staffs urge the authorities to place much higher priority on improving macroeconomic statistics. At the micro level the MTDS correctly highlights the mismatch between expenditure and revenue assignments and the substantial regional variations in per capita spending across the country. It further states an objective of ensuring an adequate allocation of revenues to different levels of government, but remains unclear about how to address this.

23. **Public debt issues are addressed comprehensively and a pragmatic external borrowing strategy is being pursued.** The MTDS squarely addresses resolution of the large internal debt problem, and both Entities have adopted fiscally sound plans for the reduction of the debt over time. Staffs welcome the initial resolution of this issue and emphasize the importance of pursuing the effective implementation of these plans. The description of the country's external debt situation and the analysis of its medium term sustainability is generally adequate. However, it is unclear how the estimate of the need for international aid for 2004-2007 (US\$1.5 billion) has been derived. And while the staffs support the otherwise prudent external borrowing policies called for in the strategy, we urge the authorities to intensify the cooperation with the EBRD and the EIB which have committed substantial funds for major infrastructure projects (e.g. power, road and railway rehabilitation), but have found it hard to disburse these funds, especially in 2003.

24. **In summary, while the MTDS's fiscal reform program is generally adequate, more work is needed to ensure consistency between the macroeconomic and fiscal frameworks, the Public Investment Plans and the sectoral priority spending programs described in the body of the strategy, and to strengthen the fiscal architecture.** There are no details given of the proposed public investment program, and a description on how the planned incremental expenditures will address poverty is lacking. There is no sense of where limited public revenues will be directed either

to promote growth or to reduce poverty directly. Yet many of the programs subsequently discussed in the strategy have fiscal implications. While recognizing that establishing these links is extremely complex, especially in a country having such a complicated administrative and fiscal architecture, staffs perceive this as **an important shortcoming of the MTDS**.

D. Sector strategies

25. **Social Protection.** The chapter on social protection focuses on pension reform and assistance to certain critical groups: individuals with disabilities, children, war victims, refugees and displaced persons, the elderly, and veterans. The MTDS is ambiguous between the fiscal and social sector reform priorities in its overall message on social protection spending levels and does not fully differentiate between the various elements of the social protection system. This somewhat dilutes the message on the fiscal requirements and impact of the reforms. Social welfare and child protection spending in BH is low, and below average for transition economies, at about one percent of GDP, but this does not take into account the high spending on war veterans which is estimated at around 5 percent of GDP. Staffs see the reform challenge as one of rationalizing spending on veterans benefits and ensuring adequate spending for well targeted social welfare and child protection policies. Staffs welcome the strategy's emphasis on ensuring war veterans benefits are rationalized within Entity budget funding capacities, while promoting equity in the provision of benefits, but would have welcomed greater detail on how the program is to be reformed to ensure benefits are retargeted to the most vulnerable. Furthermore, while the MTDS proposes increased spending for child allowances, civilian victims of the war and social assistance, it is not clear how much these will cost and how they will be financed. There is no discussion of unemployment insurance, or a pension reform strategy, which the staffs feel are a high priority given high unemployment and prospective corporate restructuring. The 81 measures proposed in the action plan suggest that limited thought has been given to the development of a prioritized approach to the sector that is in keeping with administrative and fiscal resources, and focused on the most critical problems.

26. **Education and Health.** The MTDS clearly acknowledges that despite relatively high levels of expenditure relative to GDP both the education and health sectors are characterized by inequitable access to quality services, which is a particular problem for the poor. The strategy's poverty profile equally highlights the link between education and poverty, with about 60 percent of the poor living in households in which the head of the family has primary education only; and, that inequalities in the health care system - in terms of both access to services and funding - presents a significant problem for a variety of vulnerable groups. The strategy's emphasis, therefore, on increasing the efficiency of public sector expenditures across the various levels of government (particularly in the higher education and primary health care sectors), while focusing on the adequate funding of a basic health care package, in tandem with efforts to promote greater solidarity in health care funding between the richer and poorer areas of the country (cantons in FBH), is welcomed. Staffs also welcome the MTDS' corresponding efforts to improve the coverage and quality of education and health services. Efforts to expand access to secondary education, especially for those from underprivileged backgrounds while modernizing the tertiary and vocational training system are priorities of the MTDS which staffs support, as is the strategy's emphasis on the promotion of primary health care, particularly through the expansion of the family medicine delivery system. Continued analysis and consensus building is still, however required in the identification and sequencing of reforms, predicated on efficiency gains, and a greater willingness of the various BH authorities to pool financial resources.

27. **Infrastructure, Energy, and Water Management.** The MTDS presents a good analysis of the key issues facing the strengthening and maintenance of infrastructure in an environment where post-conflict aid flows for reconstruction and rehabilitation are rapidly declining. Furthermore, the strategy makes a sound effort at linking infrastructure development to the growth agenda, particularly as it regards the strengthening of the transport network and trade facilitation. The strategy is silent, however, on the impact that either infrastructure provision or utility reform will have on the poor. (Expansion of housing infrastructure for displaced persons is a notable exception.) An ambitious strategy for the restructuring of the water management is outlined without any analysis of the how the longer-term investment and operating costs will impact on the ability of consumers to pay. The major shortcoming in MTDS's ambitious plans for infrastructure development is the absence of any link to the financing capacity of the country, either in fiscal terms through the MTEF or in terms of cost recovery and the ability of the consumer to pay. While Staffs commend the authorities for scaling back the list of investments outlined in earlier drafts, there is still no sense of priority in the proposed actions and investments both within discrete sectors (such as energy) and between the different sub-sectors in the finalized MTDS. Bold plans for the construction of a road corridor, for example, have to be independently assessed as to their economic and financial sustainability before they are embarked upon. Staffs welcome, the MTDS's clear policies for restructuring and regulating the power sector, aimed at attracting private investment into the sector, as well as the strategy's recognition of the macroeconomic importance of restructuring the coal sector which accounts for 93 percent of energy potential in BH. The critical problems of fragmentation in the provision and regulation of infrastructure inherent in BH's government structure is clearly recognized in the gas sector. Staffs believe this theme could be developed further to other sectors such as railways and telecommunications.

28. **Agriculture, Forestry, Environment.** With a sizeable proportion of the poor living in rural and semi-urban areas where small-scale agriculture is the predominant economic activity; and, with 52 percent of the territory of BH occupied by forests and forestry land the MTDS rightly focuses on the effective development and management of these sectors. The thrust of the strategy to ensure that the legal and regulatory framework governing the agricultural and agri-food sectors are in line with EU regulations is key to attainment of trade (notably export) and EU stabilization and association objectives, while improving the overall quality and productivity of local production. Staffs welcome this approach along with the strategy's objective of increasing the competitiveness of domestic agriculture. The competitiveness goal does, however, appear to be contrary to other proposed measures to develop long-term subsidies to the sector and for the reduction of imports through increased tariff protection. Staffs recommend that such issues be sensitively handled within the evolving processes of EU stabilization and association, WTO membership and regional trade agreements; where BH's policy focus should be on resolving unfair trading practices and structural problems in underdeveloped rural areas. After significant legal and regulatory reform in the forestry sector, the strategy's emphasis on strengthening institutional capacities for the implementation of effective forestry management and the protection of natural habitats is appropriate and welcomed by staffs. A complete ban on the exports of unprocessed timber should, however, be treated with caution as it could undermine the general development of the forestry industry. An approach focused on improving the business environment should rather be pursued in expanding the wood-processing industries. In terms of laying the ground for the better management of the environment, BH has made significant progress with the adoption of National Environment Action Plan (NEAP) in 2003, associated environmental legislation and international conventions that entitle BH assistance to the Global Environmental Fund. The challenge facing BH now is to develop the necessary institutional capacities to significantly improve environmental management, notably in the area of solid waste.

V. Targets, Monitoring and Evaluation

29. **The MTDS lays out a strategy for monitoring and evaluation of PRSP implementation, and indicates a role for civil society in this process.** It involves the setting up of an Economic Policy and Planning Unit (EPPU) in the office of the State Prime Minister which strikes an appropriate balance between program monitoring and strengthened research capacities to facilitate further policy development. Staffs welcome the establishment of this unit, which will initially be supported by a Bank supervised PRSP Trust Fund, along with other donor funding. Staffs do, however, wish to underscore the need for a clear time-line for the integration of the EPPU into State/Entity budgets and the phase out of donor funds. New surveys, including a Household Budget Survey and Labor Market Survey, are planned. A list of indicators are given, that are suitable both for monitoring progress on the MTDS as well as the Millennium Development Goals (MDGs). The government also lays out a program for strengthening of its statistical system, and harmonization with international standards. The driving force behind this program is clearly the drive for EU accession, and standardization with other European countries. The staffs welcome these initiatives, but note that the agreed agenda for reforms in the statistical system has been lagging. Further delays would be extremely harmful to economic and social policy formulation.

30. There is no discussion or evaluation, of the link between results indicators and inputs. While many indicators given seem plausible, it is difficult to judge the feasibility of all of them. They include targets of reducing overall poverty by about 20 percent, raising secondary school enrollment from 57 to 75 percent, and halving infant mortality, all by the year 2007. While it is clear these targets are consistent with overall MDG objectives by 2015, it is not clear how they are related to government efforts in carrying out the MTDS. In particular, the reforms in the health and education sectors do not clearly lay out how many of the goals, established by the indicators, can be achieved. For the purposes of monitoring Staffs recommend that indicators be refined further to more explicitly link them to MTDS priorities and measures defined in the strategy.

VI. RISKS TO THE STRATEGY

31. **There are many important risks faced by the Government which could inhibit the successful implementation of this strategy.** Some of the major ones are:

- **Political:** Government is significantly decentralized to the two Entities and 10 cantons. Inter-Entity coordination has greatly improved with the limited powers of the State government having been gradually strengthened to meet EU SAP requirements. Nevertheless, the ruling coalitions in both State and Entity governments are strained, with political tensions running high particularly in the face of a significant reform agenda. Successful implementation of the MTDS will depend both on a “willingness” to reform and the ability of State, Entity and canton governments to work together towards their common goals. While the BH authorities are striving to realign their institutions so as to enable EU and WTO accession, political and social pressures may make this a long and difficult process.
- **Institutional.** The existing public sector administration is fragmented, often engendering duplication or under provision of public services and large horizontal and vertical fiscal imbalances. This will continue to constrain the BH authorities’ capacity to implement a complicated and detailed agenda as laid out in the MTDS. While tremendous progress has been made to overcome the ravages of the relatively recent conflict, and the inheritance of the

socialist system, much institutional strengthening is still required to provide a comfortable framework for private sector investment and growth. It is recognized that institutional strengthening as it relates to budget management, public administration, and inter-ministerial coordination will take time and require sustained commitment and effort by the BH authorities.

- Economic: While there are a number of positive signs regarding reform performance, the economy remains burdened by a large and inefficient public enterprise sector, which includes much of the principal infrastructure. The economy remains vulnerable to external shocks, such as lower than expected foreign investment and slower than expected recovery of trading partners. Reform of the wage and benefit systems, particularly from veterans and other affected groups, could prove difficult to implement and as a result prevent resources from being reallocated to meet critical public investment requirements. In short, social and economic pressures may inhibit the government's progress on the reform agenda, particularly the goal of reducing the size of the public sector, accelerating privatization, and building a better climate for private investment.

VII. CONCLUSIONS

32. **Despite the many risks to the strategy, as outlined above, Bosnia-Herzegovina has made considerable progress since the Dayton Accords.** The new MTDS is a good first attempt to define an overall strategy, that can be improved and prioritized as it is implemented. The widespread consultation process used in the formulation of the strategy was a pioneering effort bringing together many of the disparate ethnic elements in the society for a discussion of common problems for the first time. The Government is clearly making an effort to align itself with the EU, and to promote the private sector as an engine of growth.

33. The Government needs to make certain improvements to the MTDS by the time of the first progress report and should mobilize technical resources now to ensure that they are realized. These improvements should cover:

- The development of a costed strategy integrated with the MTEF and the PIP, and consistent with the fiscal revenues and foreign assistance likely to be available.
- A more prioritized action plan of policy and legislative interventions, focusing on poverty reducing and growth enhancing steps, and a more realistic timeframe for their implementation.
- An improved set of monitoring indicators, related both to overall objectives and inputs that can be controlled by the Government.
- A strategy to improve the operations of voucher privatized firms, and strengthen the overall environment for corporate governance.
- Concrete proposals to address weaknesses in the fiscal architecture so as to ensure macro stability and an effective fiscal contribution to poverty reduction.

34. **The staffs of the World Bank and IMF consider that the MTDS is the basis for a credible poverty reduction strategy and recommend that the Executive Directors of the IMF and World Bank reach the same conclusion.** Bank staff further conclude that the PRSP represents an adequate basis for World Bank concessional assistance and recommend that the Executive Directors of the World Bank reach the same conclusion.