June 2005
IMF Country Report No. 05/198

Bosnia and Herzegovina: Selected Economic Issues

This Selected Economic Issues paper for Bosnia and Herzegovina was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on May 11, 2005. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Bosnia and Herzegovina or the Executive Board of the IMF.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

BOSNIA AND HERZEGOVINA

Selected Economic Issues

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Approved by European Department

May 11, 2005

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I. INTRODUCTION AND OVERVIEW

1. **Since 1995, Bosnia and Herzegovina (BiH) has come a long way.** Output, exports, and incomes are much increased, inflation has stabilized, the budgets are now close to balance, and the currency board has become an established part of the environment.

2. **But a cursory glance at the major macroeconomic indicators suggests that much work still lies ahead.** Staff estimates put the external current account deficit at well over 15 percent of GDP, unemployment at over 20 percent, government spending at half of GDP, and, following recent court rulings, government domestic indebtedness at well above levels anticipated in the 2004 domestic claims settlement laws. And output is still well below pre-war levels and the IBRD assesses poverty at over 30 percent.

3. **This Selected Economic Issues paper addresses two sets of issues arising from this evidence.**

- The first, discussed in Chapters 2–6, is whether the bleak impression conveyed by these headline macroeconomic indicators is correct.
- The second, discussed in Chapters 7–10, concerns the implications for policies and policy-making frameworks in coming years.

4. **Chapter 2 discusses market indicators of confidence in banks and in the currency.** This provides immediate reassurance that with confidence in both strengthening, concerns which the headline macroeconomic data might arouse are not reflected in the behavior of the private sector in regard to their attitude to banks and the currency. Indeed, since 2000, the evidence suggests much increased confidence, with increased use of local currency and financial deepening. That said, the picture is not unqualified. Foreign currencies remain significant in bank deposits, banks continue to insist that loans longer than a year are indexed to foreign currencies, and bank intermediation is still well below comparator countries.

5. **Chapter 3 situates BiH's experience with a credit boom and a large external current account deficit in international experience.** On both accounts, Bosnia and Herzegovina is an international outlier, including among transition, post-conflict, and currency board cases. Given evidence—summarized in the chapter—that such patterns have been associated with instability internationally, concerns remain. But that international evidence is not straightforward. Credit booms have not always been linked to instability, or vice versa, and the same is true of large external imbalances. Taken with the evidence from Chapter 2 that, thus far, private confidence in banks and the currency is holding, this suggests that Bosnia and Herzegovina has time to address these two issues, but that it should not delay unduly in doing so.

6. **Chapter 4 turns to the domestic counterpart of the external deficit.** Bosnia and Herzegovina is unusual in that its external deficit seems associated with an unusually low level of domestic—notably corporate—savings. This chapter considers the company-level

evidence for this assertion, including providing a brief review of "how the corporate sector got to be this way." It also considers lessons for future initiatives to correct the problems from the rich set of largely failed initiatives undertaken since 1995 in Bosnia and Herzegovina to address corporate ailments. It summarizes a set of principles arising from this experience. More concrete proposals await the conclusion of work now underway by the authorities and the World Bank to determine, in concrete terms, the way forward.

7. **Chapter 5 sheds light on the extent to which the bleak impression given by the headline macroeconomic indicators reflects underestimation of nominal GDP.** It reviews work on Bosnia and Herzegovina, including by IMF statisticians, on this question, and it notes that BiH is unusual in not making any adjustments for the unrecorded economy in its official published data. Accordingly, the chapter summarizes ongoing staff analysis to use data on GDP internationally, and its correlation with various indicators, to "estimate" what Bosnia and Herzegovina's total—including unrecorded—GDP is. All this evidence suggests that, indeed, Bosnia and Herzegovina's GDP is underestimated, likely up to 50 percent. But because all economies have some unrecorded activity even after statistical adjustments aimed to reflect it, the implication that the headline indicators in BiH exaggerate problems does not necessarily follow. It is only to the extent that unrecorded activity in Bosnia and Herzegovina is proportionately more pronounced than elsewhere, and that the indicators expressed relative to GDP are themselves correctly measured that this implication follows. On both, the evidence is cautionary. Bosnia and Herzegovina may have a disproportionately large unrecorded economy compared with similar—post conflict, and low middle income—countries. But it seems to have similar propensities to unrecorded activity as the CIS countries. And key macroeconomic indicators, including the current account deficit, are measured with significant error. For example, the external deficit estimated by staff—used throughout these papers—makes no correction for unrecorded merchandise imports. If, instead, the Central Bank estimate of the deficit—which makes this correction—is used, and its estimate is expressed relative to GDP inflated by 50 percent for unrecorded activity, the deficit in 2004 is 16 percent of GDP, close to the staff estimate of 17 percent of GDP.

8. **Chapter 6 assesses the implications of the court rejection of the 2004 domestic claims restructuring laws.** The various rulings issued recently by the constitutional court—the precise interpretation of which is still to be finally clarified—will certainly imply a much larger NPV of public debt than anticipated in those laws. This increases by a significant margin the primary fiscal balance associated with sustainability, and hence it sets the stage for need to rein in primary spending sharply. This chapter notes the background to these developments and illustrates with examples the possible extent of necessary adjustments in primary spending. The implication is that along with need to secure a strong fiscal stance through expenditure restraint so as to support efforts to rein in the external deficit, sharp reductions in primary spending may be needed within that envelope to provide room for interest payments on domestic debts. This priority contrasts, however, with aspirations to realize a variety of initiatives sponsored by the international community which will raise public spending. A balance between these two sets of imperatives will need to be found.

9. **Chapter 7, and those which follow, consider various policy responses starting with the revenue base.** With the external deficits and the domestic claims rulings calling for strong fiscal policies, an immediate implication is the necessity to secure the tax base for governments. Plans to introduce the VAT are key here, including as a measure to help to render the grey economy white. However, this task, already underway for some years, is unusually challenging in Bosnia and Herzegovina, and this chapter lays out the key steps already taken, as well as those which still lie ahead. It underscores that notwithstanding considerable efforts so far, the implementation risks remain significant and that, certainly for 2006, there is therefore no scope to anticipate a major revenue windfall.

10. **Chapter 8 turns to the spending side, focusing on "state building."** At issue is various initiatives to increase the role of the State, partly in order to prosecute ambitions to eventual accession to the EU. The chapter reviews past implementation of this agenda and finds much fault with it—including that state building is proceeding slowly and at too high a fiscal cost. But with major steps forward here imminent, including shifting security functions to State level, and given the imperative to find economies in primary spending due to the court rulings on domestic claims, the inadequacies in the past approach to state building are set to exact a high price in macroeconomic terms, unless corrected promptly. The chapter suggests that this requires prioritization among state building objectives, a clear link between such steps and corresponding contractions in spending at other levels of government, and a strengthening of the "fiscal architecture"—the set of rules governing budget preparation etc—to help ensure that these objectives are realized.

11. **Chapter 9 extends discussion of necessary policies to issues concerning control over Cantonal and Municipal budget balances.** With external and domestic debt considerations pressing for fiscal restraint, past ad hoc embargoes on cantonal and municipal borrowing have helped to secure fiscal consolidation in recent years. But these arrangements are, perhaps, excessively restrictive in so far as they impede even strong and creditworthy cantons and municipalities from borrowing to develop local infrastructure. This chapter considers how the current ad hoc framework could be strengthened so as to allow greater flexibility, notably for the stronger Cantons and municipalities, drawing on international experience. Consideration is given to how this can be done while securing effective monitoring and control of the aggregate fiscal impact, both in the transition to a new regime and when that transition has been completed. But, the chapter cautions that even with such control secured, the need to prevent a deterioration in the consolidated fiscal balance and to retrench and consolidate primary expenditure means that any new framework for cantonal and municipal borrowing should be implemented in close coordination with reductions in primary spending at other levels of government.

12. **Chapter 10 draws out the implications of all these issues for development of fiscal policymaking institutions.** There are a host of fiscal challenges in coming years:

- to maintain a strong consolidated balance,

- to secure a sizeable strengthening in the primary surplus and increases in public investment,
- to provide a “social plan” for large numbers of workers to be dismissed from bankrupt firms,
- to meet ongoing calls for increased pensions,
- to engineer multiple shifts in functions between different tiers of government and an expansion of State-level competencies in accord with EU-accession requirements, and
- to implement a host of tax reforms, starting with VAT at end-2005, and combat tax evasion.

All this has to be achieved in the context where the OHR’s coordinating role is receding sharply. Thus, strong fiscal policymaking institutions will plainly be essential.

13. **But the fiscal structure bequeathed by Dayton is fragmented and weak**. So much so that no institution is charged to determine, implement, or monitor the consolidated fiscal balance. Complicating matters further, there is no consensus on broader constitutional change within which efforts to address these institutional shortfalls could be embedded. Until that consensus is reached, progress is required within the current framework.

14. **In this challenging context, chapter 10 proposes a comprehensive approach to strengthening fiscal coordination.** It works within the spirit of the Dayton compromises, building on—but much extending and strengthening—the initiative of the Indirect Tax Authority and its notion of “pooled sovereignty.” A wide range of initiatives are suggested—encompassing coordination of budget calendars, development of devices to break fiscal negotiation deadlocks, controls on cantonal and municipal balances, the strengthening of macro analysis and statistics—all focused on establishment of a National Fiscal Council charged with fiscal coordination. This approach would need to be developed through “learning by doing.” But it heralds the prospect of creating mechanisms with which the authorities will be able to secure effective fiscal policy, and therefore the exercise of fiscal sovereignty, within the Dayton framework.

15. **Drafts of most of these chapters were discussed with the authorities during the Article IV consultation mission.** In that context, the drafts of Chapters 2, 3, 4, 8, 9, and 10 concluded with proposed “questions for discussion”. These questions are listed for the record in the annex to this Selected Economic Issues paper.

II. Market Indicators of Confidence in the KM and the Banking System Since 2000[1]

A. Introduction

1. **This chapter examines monetary and interest rate data to provide a perspective on the robustness of financial confidence in Bosnia and Herzegovina (BiH)**.

2. **The currency board is almost 8 years old**. International reserves stand at 6 months of merchandise imports. And after the 1998–2002 restructuring, banks are booming. These signal confidence in the KM and in the banking system and are major achievements.

3. **But confidence can shift quickly**. International experience shows a number of countries which enjoyed periods of confidence subsequently witnessed turbulence.[2]

B. Institutional Background

4. **Following the 1992-95 civil war there were a number of currencies circulating in Bosnia and Herzegovina, including the Bosnian dinar, Yugoslav dinar, Croatian Kuna, and the Deutsche Mark (DM).** The currency board was set up in 1997 and a new currency, the convertible mark (KM), was introduced, pegged at KM1= 1 Deutsche Mark. It was subsequently pegged at KM 1.9558=Euro 1, upon the abolition of the DM.

5. **Since then the KM has largely displaced the other currencies (though the Euro also circulates widely), and the currency board has delivered Euro area levels of inflation**. Gross international reserves and net free reserves (net reserves minus reserve money) have risen steadily to Euro 1,768 million and Euro 88 million, respectively, at end-2004. And confidence in the KM was strengthened by the smooth transfer to a new board for the Central Bank of Bosnia and Herzegovina (CBBH) in August 2003, and an uneventful transition from an expatriate to a Bosnian governor at end-2004.

6. **Meanwhile, the banking system was weak by war's end in 1995**. Most bank assets were state owned, over 90 percent of loans were nonperforming, and the confidence of depositors was very low.[3] Moreover, most of banks' foreign currency deposits had been seized by the National Bank of Yugoslavia prior to the civil war, thus forcing banks to freeze the foreign currency deposits of their clients. The war had also disrupted links to international financial markets, caused very high inflation, and extensively damaged the physical infrastructure of the country.

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[1] Prepared by Daniel Kanda.

[2] See Chapter 3.

[3] See IMF Country Report No. 98/69, September 4, 1998.

7. **Since then there has been much progress**. New modern banking laws were passed in both entities, and the banking sector has been almost completely privatized, with the majority of assets now under foreign ownership. In the process considerable consolidation has occurred—the number of banks has declined from 72 (55 in the Federation and 17 in the Republika Srpska (RS)) in 1998 to 33 (24 in the Federation and 9 in the RS) at end-2004.[4] Of the banks existing at end-2004, five were under provisional administration—four in the Federation and one in the RS.

8. **Banking supervision has been entrusted to two entity banking agencies—Federation Banking Agency and the Banking Agency of Republika Srpska, with a coordinating role for the central bank**. With some technical assistance as well as Fund program conditionality, supervisory quality has improved significantly in the past two years. Moreover, plans are underway to merge the two banking agencies into the CBBH in order to strengthen the independence of bank supervision. And a deposit insurance scheme has been successfully established—by end-December 2004, 21 banks were members.

9. **These reforms—to the central bank and to the banking system—were aimed to secure stability and to build an efficient financial system**. And both sets of reforms reinforce each other—a strong monetary arrangement builds confidence in banks, and vice versa. Has that confidence been secured?

C. Confidence in the KM

10. **Recent data suggests that confidence by Bosnian citizens in the KM has improved since 2000**.

- Following the introduction of Euro notes and coins, KM currency in circulation doubled between October 2001- December 2001 (Figure 1). This was the result of reverse currency substitution, as people converted their holdings of DM and other Euro area currencies into KM notes and coin in a show of confidence in the KM.

- Against this, how should the small decline in currency in circulation since then be interpreted? This appears to reflect increasing use of the banking system as a means of settlement and as a store of value; use of cash for these purposes has steadily declined. This interpretation is underscored by the rapid growth in bank deposits since 2001, and the associated increase in the money multiplier (Figure 1). This would suggest that financial deepening, rather than a reversal of confidence in the KM, accounts for trends in currency in circulation after the end-2001 surge. As is also clear from Figure 1, KM deposits in the banking sector have increased at a faster pace than foreign currency deposits until late 2004. This provides further evidence that increasing public confidence in the banking system, rather than a reversal of

[4] See World Bank, *Bosnia and Herzegovina Banking Sector Review*, June 2004.

confidence in the KM, accounts for the trends in currency in circulation since early 2002. The recent pickup in foreign currency deposits appears to be the result of banks' efforts to meet tighter forex exposure regulations, rather than a reduction in confidence in the KM (¶13).

- On the credit side, households and companies have also been willing to accept banks demands that the bulk (over 50 percent) of their KM denominated borrowing should be indexed to the Euro, and have not demanded a lower interest rate to compensate them for the currency risk they take on as a result of this indexation. On one interpretation, this suggests that they have strong confidence in the KM and the currency board. However, it is also likely that borrowers are unaware of these technical indexation clauses in their credit contracts. If so, the high degree of indexation signals consumer non-sophistication, rather than confidence in the KM. The truth may reflect some combination of both interpretations.

- There is also recent anecdotal evidence that some merchants are beginning to be less willing to accept Euro notes and coin for small transactions. This is in contrast with previous years when, for some time and in some places, the KM was not accepted for these purposes, and more recently, when Euro and KM notes and coins were freely interchangeable for all kinds of transactions.

11. **Confidence in the KM is also signaled in the spread between Euro and KM interest rates (Figure 2)**. Because there is no money market rate for Bosnia and Herzegovina, we proxy this spread using the mid-points of bank demand deposit and short term lending rates in BiH and the Euro area.[5] Thus the results should be interpreted with caution, since the spread could reflect a variety of factors influencing the Euro area and Bosnian banking systems, rather than a pure risk premium between the two currencies. Nonetheless, the trend decline in the spread observed in the data since January 2003 is suggestive of increased confidence. This spread is still around 2 percentage points, but it has fallen by ¾ percentage point since January 2003. And—the same issue measured a different way—the spread between Bosnian central rates and 3-month EURIBOR also declined through 2004 and early 2005, after being stable since mid-2002.

12. **However, domestic banks do not appear to be as persuaded as the Bosnian public about the KM**.

[5] Central Euro area interest rate is calculated as the average of the Monetary Financial Institution (MFI) rate on overnight household deposits and the MFI rate on household consumption loans (with floating rates or with rates fixed for one year or less). The central Bosnian interest rate is calculated as the average of BiH demand deposit rate and BiH short term lending rate.

- Banks have often required that their KM loans are indexed to foreign currencies, typically the Euro (Figure 3). The share of indexed loans is typically higher the longer the maturity of the loan. This behavior by banks suggests some caution on their part about exchange rate risk. Moreover, this behavior has remained firm in the face of several regulatory and other steps taken which have implicitly raised its costs to the banks, suggesting that it is not just an administrative habit, but is a strongly held view (¶13).

- But, interestingly, banks' apparent doubts about the KM are not evidently symptomatic of broader doubts on their part about the prospects for the BiH economy. Rather, the strength and persistence of the credit boom since 2002 suggests a significant degree of confidence in broader economic prospects (Figure 4). Banks have responded to the surge in deposits after 2001 by increasing credit, as a result of which credit to the private sector has increased by over 20 percentage points of GDP in the past three years, amidst keen competition by banks for market share. The key qualification to this interpretation is the degree to which bank behavior is dominated by their desire to establish market share, rather than concerns they may have about broader economic prospects.

13. **Importantly, however, the increase in international reserves of the CBBH and reserve money from mid-2003 is not evidence of strengthening confidence in the KM.** Instead, it almost entirely reflects banks' adjustments to tighter prudential regulations. In the context of a currency board and free capital mobility, traditional monetary policy instruments, such as open market operations or changes in policy interest rates, have limited effectiveness. Thus, the authorities have sometimes used supervisory measures to secure prudential and broader monetary goals. In particular, in response to concerns about the credit boom—and the fact that many banks had run foreign exchange exposure positions outside international norms—the authorities took appropriate measures from June 2003 to tighten the regulatory framework:

- Banks were required to phase in progressively tighter limits on their forex exposure positions, from about 120 percent of capital in mid 2003 to 30 percent of capital, by mid-2004. And from mid-2003, the forex exposure regulations were appropriately amended to include KM assets and liabilities indexed to foreign currencies, in line with international practice.

- Banks were also required to take steps to come into full compliance with the prudential regulations on liquidity by June 2004. These require that liabilities of maturity up to 90 days should be matched 100 percent by assets of similar maturity. Since previous forbearance in the application of these rules had led to substantial nonobservance of them, most banks were given up to June 2004 to secure compliance, with some allowed to comply by September 2004.

14. **These two reforms required banks to increase their deposits at the central bank**. Banks steadily increased their borrowing from abroad (largely from their parents),

converting the borrowed funds into short term KM deposits held with the CBBH. The currency conversion in this operation helped them to meet the steadily tightening forex exposure rules. And the short term assets created in this operation—the deposits with the CBBH—helped them to meet the liquidity rules. As a result, banks' reserves at the central bank increased steadily, month-end by month-end, as the forex and liquidity regulations were steadily phased in. And, pari pasu, their NFA declined (Figure 5, lower LHS panel).

15. **The increase in bank reserves with the central bank led to corresponding increases in reserve money and international reserves**. It was also reflected in the composition of reserve money, with commercial bank reserves rising relative to currency in circulation and cash in vaults (Figure 5, top LHS panel, and Figure 6). And given the currency board structure, which tightly links reserve money to international reserves, these movements in reserve money were matched by increases in international reserves at each month-end from mid-2003 to mid-2004 while the forex and liquidity regulations were phased in. Thereafter, the pace of growth of reserve money began to decline.

16. **Three further aspects of monetary developments confirm this interpretation of the regulatory—rather than a KM confidence—motive for the increased commercial bank reserves with the CBBH, and therefore in international reserves, from mid-2003.**

- First, in early 2004 the commercial banks began to exploit the fact that the forex and liquidity regulations being phased in from mid-2003 applied only on a month-end basis, not daily. So banks only observed them at end month—borrowing in foreign currencies from external parents at month end, placing these with the CBBH, and reversing these transactions a few days later. This caused substantial intra-month swings in bank and international reserves from January 2004 (Figure 5, top RHS panel), suggesting that in the absence of the new regulations banks would have preferred a significantly lower level of reserves with the CBBH. These swings increased in size, month by month, as banks borrowed more from their parents in order to meet the progressively tighter limits. The within-month swings reached as much as KM 400 million from peak to trough by mid-2004. But their amplitude declined significantly from July 2004, after banks were informed that the banking agencies would be requiring daily reporting of forex exposure positions. The swings have been virtually eliminated since daily forex exposure reporting was implemented in October 2004.

- Second, this within month behavior suggests that the steady increase in bank reserves with the CBBH at each month end did not reflect the attractiveness of the remuneration offered by the CBBH on those deposits. From 1998 through mid-2003, required reserves were remunerated at market rates, while excess reserves received no remuneration. However, starting in June 2003 all bank reserves with the CBBH (not just required reserves) were remunerated at market rates—the rate earned by the CBBH on its overnight deposits of foreign exchange reserves. This, however, continued only up to December 2003. After that, required reserves continued to be remunerated at market rates, while remuneration of excess reserves was cut from the market rate (2 percent at the time) to a fixed one percent (which happened to be the European Central Bank deposit rate at the time). Despite the cut in remuneration, excess (and total) reserves continued to grow strongly through most of 2004, from month-end to month-end (Figure 5, top LHS panel). But the within month swings in reserves began precisely at this point. This appears to suggest that the reduction in remuneration of excess reserves induced banks to seek a better return on these assets elsewhere, within each month, than was available from the CBBH.

- Finally, although the reserve requirements were raised, this did not cause the rise in commercial bank reserves with the CBBH either. The base for required reserves was widened in June 2003 to include foreign currency denominated liabilities—which more than doubled the base—and the rate of required reserves was reduced from 10 percent to 5 percent, the net effect of which was to raise required reserves modestly. But the stock of required reserves remained well below the actual level of reserves throughout (Figure 5, top LHS panel).

17. **This combined evidence suggests that confidence in the KM has increased significantly since 2000, but that the rise in international reserves after mid-2003 reflected the regulatory reforms, rather than mandated reserve requirement levels or further KM-confidence factors**.

D. Confidence in the Banking System

18. **Recent trends indicate that confidence by the Bosnian public in the banking system has also increased since 2000**.

- There are clear signs of financial deepening (Figure 7). The share of KM currency in circulation in M1 and broad money has declined as Bosnians use bank deposits for an increasing share of their transactions. However the money multiplier remains on the low side (around 2) and a cross country comparison suggests that there is still room for more financial deepening (Table 1).

- Correspondingly, the velocity of bank deposits declined significantly in December 2001 and continued to drop thereafter, albeit more gradually, as confidence in the financial system has led to continued strong growth in deposits alongside a steady decline in currency in circulation (Figure 7).[6]

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[6] The true velocity is likely higher than presented in Figure 7, since official estimates of nominal GDP exclude the large non-observed economy (see chapter 5 and IMF Country Report No. 04/54, March 9, 2004). However, the gradual decline in reported velocity suggests that the official estimate of the *rate of growth* of GDP may not be too far off, implying that the grey economy may be growing at a similar rate as the recorded economy.

- And time and savings deposits have grown faster than demand deposits since December 2001 (Figure 8). However, a pickup in growth of time and savings deposits in late 2004 may in part reflect banks efforts to meet prudential regulations on maturity matching—since they need to lengthen the maturity profile of their liabilities in order to provide longer term loans (¶13, ¶14). Enforcement of these regulations appears to have caused an increase in spreads of time and savings deposit rates over demand deposit rates in 2004. But depositor's willingness—even if so encouraged—to extend the maturity of their deposits signals confidence in the banking system, even if at a price.

- The financial deepening has been boosted by increased bank efficiency generated by intense competition for market share, which has led to a substantial decline in spreads between deposit and lending interest rates. Spreads have declined by over two percentage points since January 2002 (Figure 9).

- It is also noteworthy that despite the substantial changes and consolidation there have been no bank runs. Bank closures have generally occurred as a result of banks being put under provisional administration by the banking agencies, rather than by runs. It is not entirely clear why this is so. One explanation could be that depositors were generally well aware of the weak banks, and avoided them completely. Alternatively, or in addition, the Bosnian public may have believed that there was an implicit government guarantee on deposits, particularly if the banks were state owned. Formal deposit insurance is not likely to have been the cause of the lack of bank runs, because coverage of banks began only in 2001, and has been limited to sound banks, none of which have had any difficulty meeting their obligations to their depositors.

E. Prospects

19. **Looking forward, there are a number of signals to monitor which could indicate further increases in the confidence in the KM, but these will need to be interpreted with care**.

- If citizens continue to shift out of Euro currency in circulation into KM currency in circulation as a means of settlement and store of value, KM currency will rise and this will be reflected in increased international reserves of the CBBH.

- If banks reduce indexed lending of their own volition, this would signal a welcome change in their perception of exchange rate risk. It would be reflected in less foreign currency external borrowing and less foreign currency deposit-taking. Note, however, that this aspect of increased confidence in the KM could *lower* CBBH international reserves. In this favorable context, banks' need for KM deposits with the CBBH to meet prudential regulations would drop, lowering international reserves. The decline in the pace of growth of CBBH reserves in early 2005 could reflect this, though confirmation of this interpretation of these most recent trends will have to await collection of more data on loan indexation in 2005.

- If an interbank market develops, this will provide an alternative short-term KM asset for banks, and reduce reserves with the CBBH. However, given that banks already have an excess of short term assets, the market need for interbank transactions is low so one may be unlikely to develop soon.

- With the European economy continuing to show weakness and the current strength of the Euro against the US dollar, there is a possibility that ECB rates will decline, which will make the rate of remuneration of excess reserves with the CBBH (one percent) more attractive, thus encouraging banks to increase their reserves. This would not reflect a “confidence” effect, but an interest rate differential effect.

20. **In the case of banks, the main indicators of confidence will be the money multiplier, velocity, and the maturity of deposits**. These have been trending in the right direction, but all have further to go by international standards. The main risks are indirect—through the malaise of the corporate sector. With over 60 percent of state-owned companies lossmaking, and requiring deep restructuring and many others only marginally profitable, banks run the risk of being caught up indirectly in these corporate difficulties.[7]

21. **Moreover, the framework for banks to monitor borrower quality and recover nonperforming loans needs improvement**. There have been efforts to set up a collateral and pledge registry, but these have not yet borne fruit. In this situation, banks have improvised by requiring borrowers (for consumer loans) to have personal guarantors who would be liable in case of default. However, many guarantors have guaranteed loans for multiple borrowers, and there is no satisfactory way for banks to track this, thus raising the risk that guarantors cannot meet these multiple contingent liabilities. And the court system is not yet in a position to swiftly adjudicate bank suits against recalcitrant debtors.

F. Concluding Remarks

22. **While confidence in the KM is generally much strengthened since 2000 further efforts should be made, notably because banks’ skepticism remains**. Such efforts encompass a wide array of policy areas, and include the early implementation of structural reforms to promote private sector growth and competitiveness, particularly corporate restructuring. But as indicated, a drop in international reserves will not necessarily signal a loss of confidence—indeed, if it reflects changes in bank behavior, it could reflect increasing confidence in the KM.

23. **Banking system restructuring has progressed at a much faster pace than corporate reforms**. As a result, a relatively modern and dynamic banking sector coexists with a weak corporate sector, and it is not clear that the health of the banks can be maintained indefinitely alongside the malaise in the corporate sector. To sustain and strengthen further

[7] See Chapter 4.

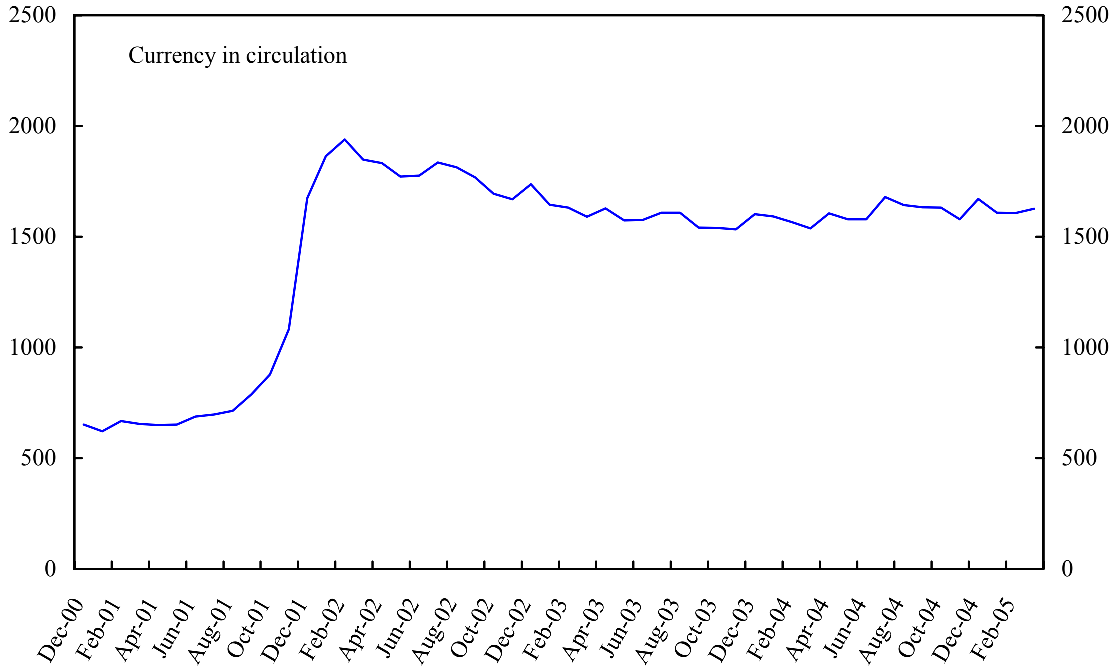
depositor confidence in banks, continued improvements in the quality of bank supervision, the regulatory environment, and the analytical capacity of the CBBH, alongside a determined effort to strengthen companies, will all be required. Finally, supervisors and the central bank will have to keep a watchful eye on the credit boom and stand ready to act decisively to maintain financial system stability.

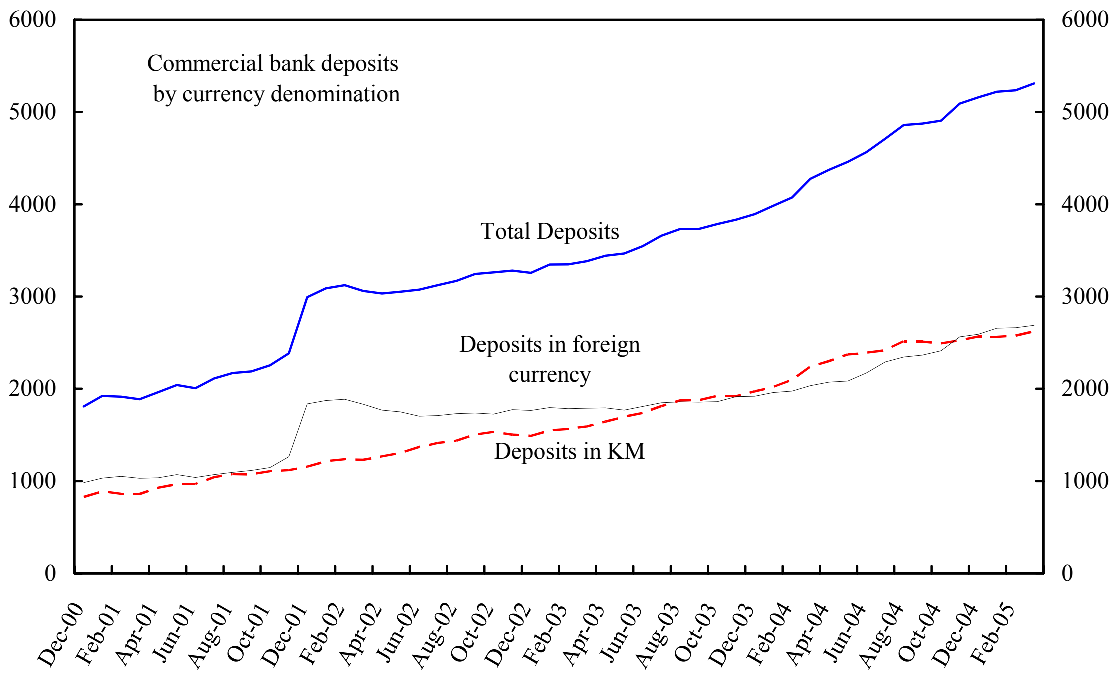
Table 1. Cross-Country Indicators of Financial Depth, 2003 1/

	BiH	Croatia	Czech Rep.	Estonia	Hungary	Romania	Slovenia	Serbia and Montenegro	Macedonia
Broad money velocity	2.2	1.5	1.4	2.5	2.1	4.1	1.6	4.6	3.2
Broad Money/GDP	44.8	66.8	72.3	40.0	47.3	24.2	60.9	21.6	31.7
Currency outside banks/M1	51.4	31.2	23.0	23.2	33.4	49.0	19.6	43.8	52.0
Money multiplier	2.1	3.5	6.6	3.7	4.8	4.7	13.0	3.4	3.8

Sources: Data from country authorities and IMF staff calculations
1/ Broad money used is M3, except for Czech Republic and Serbia and Montenegro which are M2.

Figure 1. Bosnia and Herzegovina: Currency in Circulation and Commercial Bank Deposits
(in millions of KM)

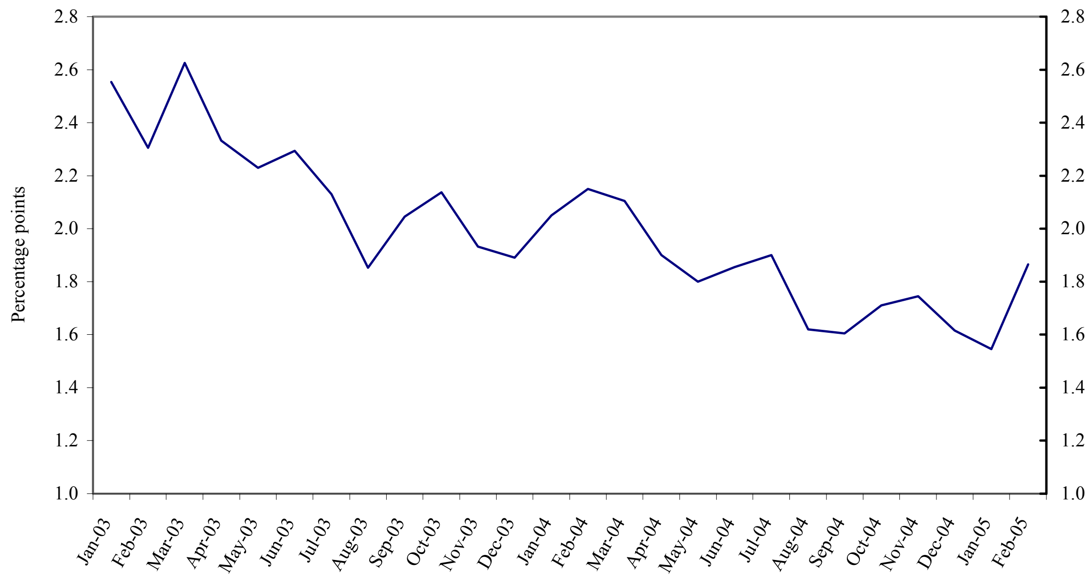




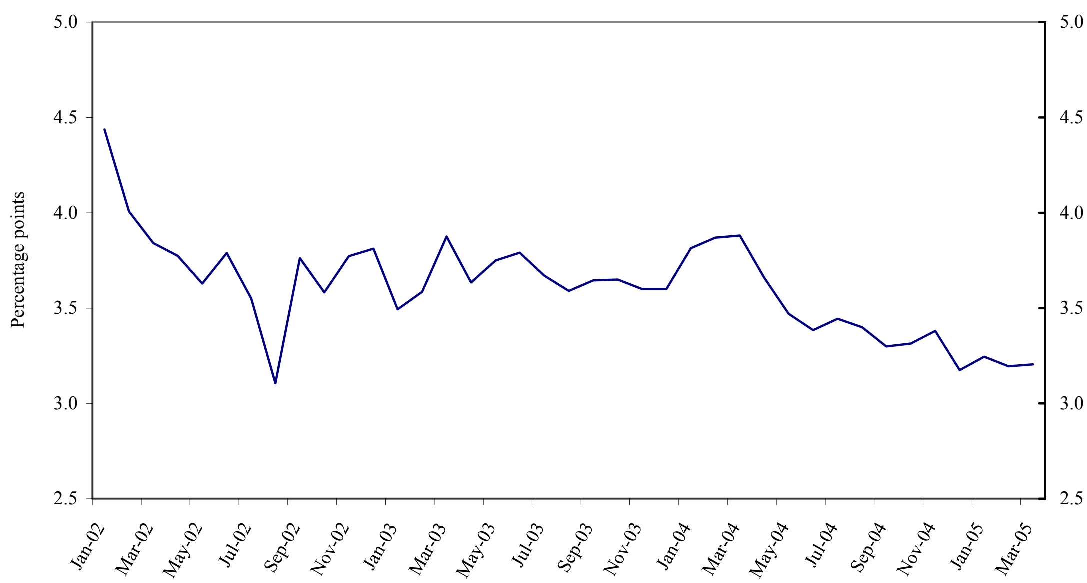
Source: Central Bank of Bosnia and Herzegovina, and staff calculations.

Figure 2. Spreads between Bosnian and Euro Area Interest Rates

KM-Euro central interest rate spread

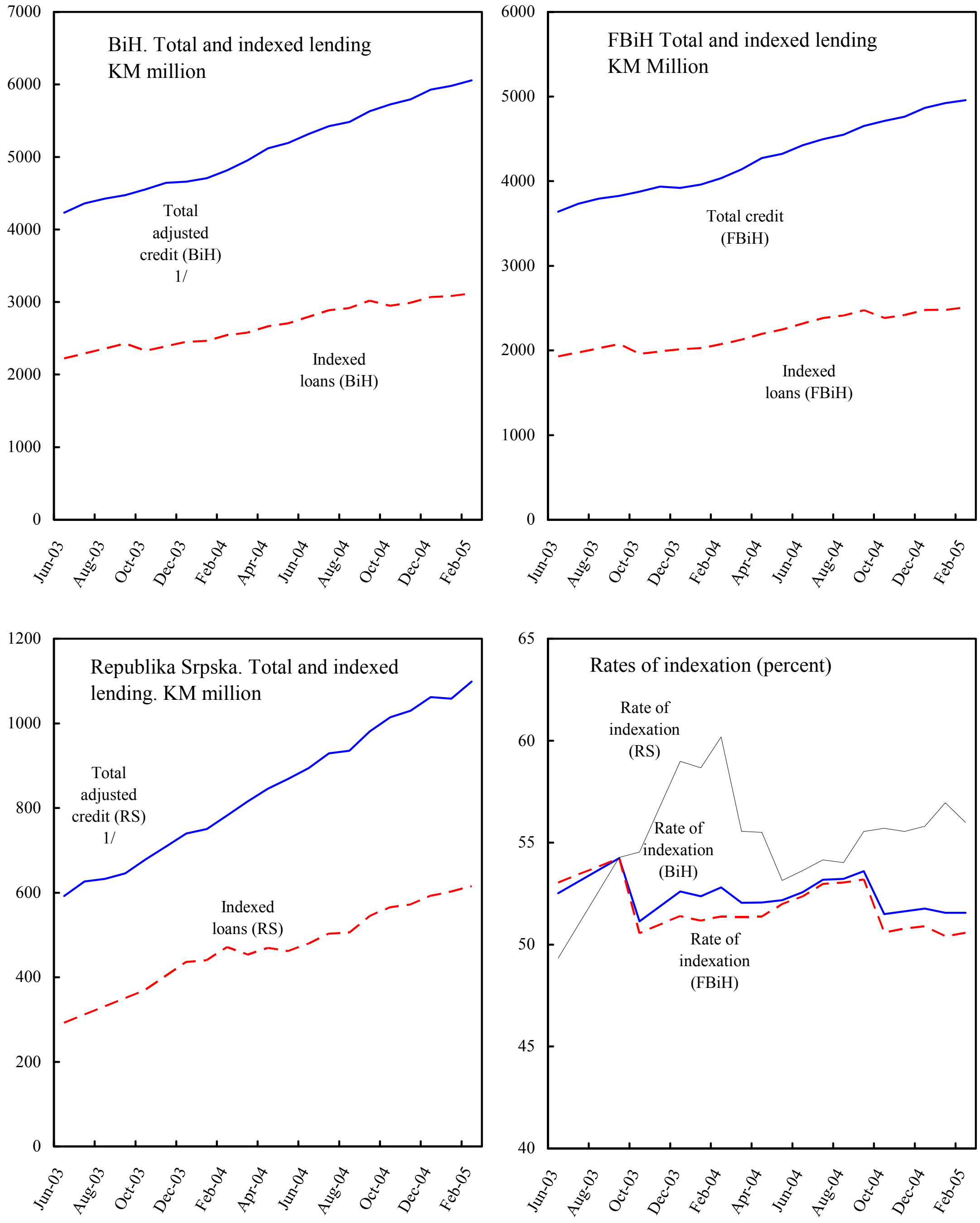


Spread between BiH central rate and 3-month EURIBOR



Sources: Data from the Central Bank of Bosnia and Herzegovina and the European Central Bank.

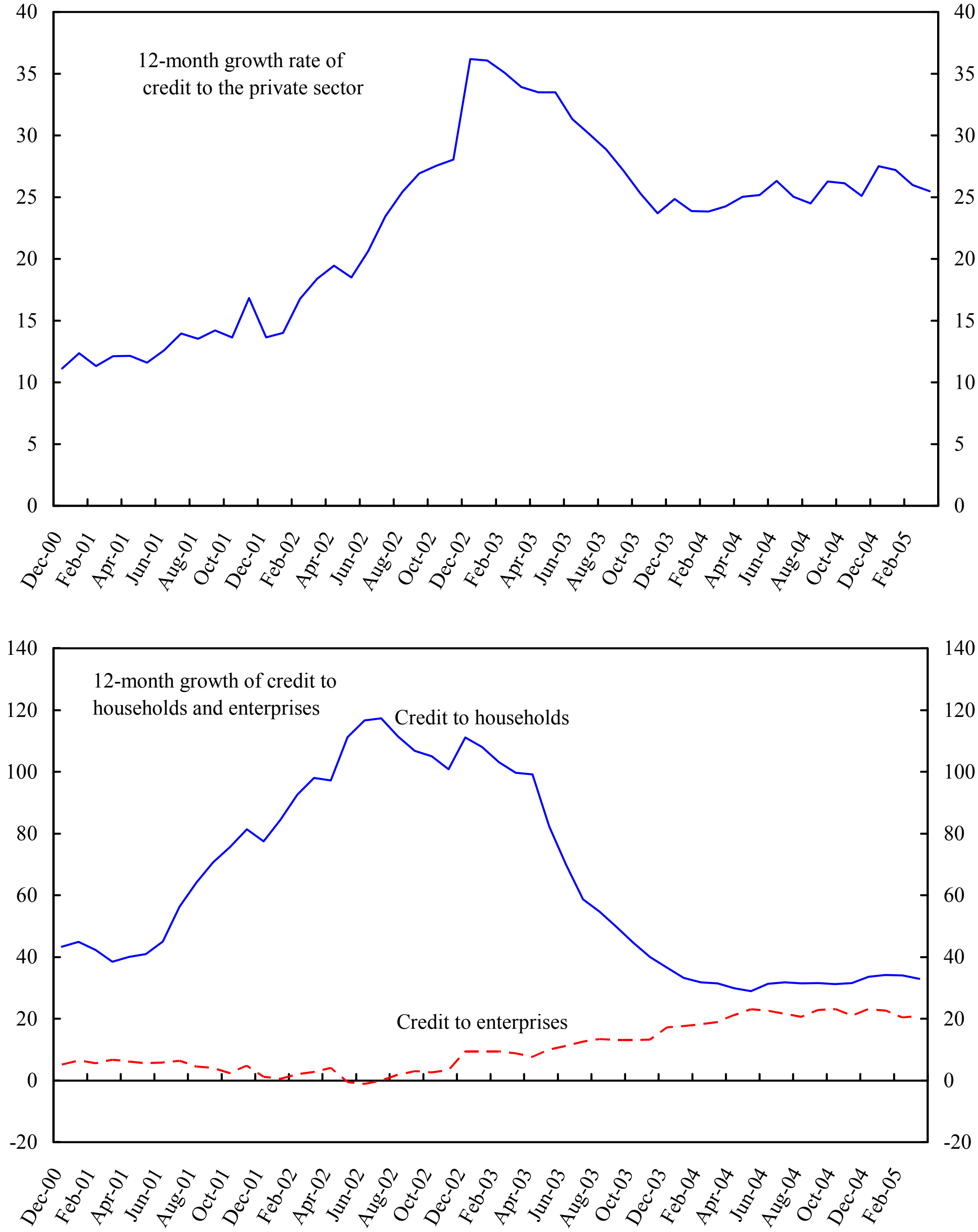
Figure 3. Bosnia and Herzegovina. Indexation of Bank Lending



Sources: Data from the Bosnia and Herzegovina authorities and staff calculations.

1/ Adjusted to correct for the structural break due to the takeover by the RS government, in June 2004, of KM 463 million of old bank claims on RS enterprises.

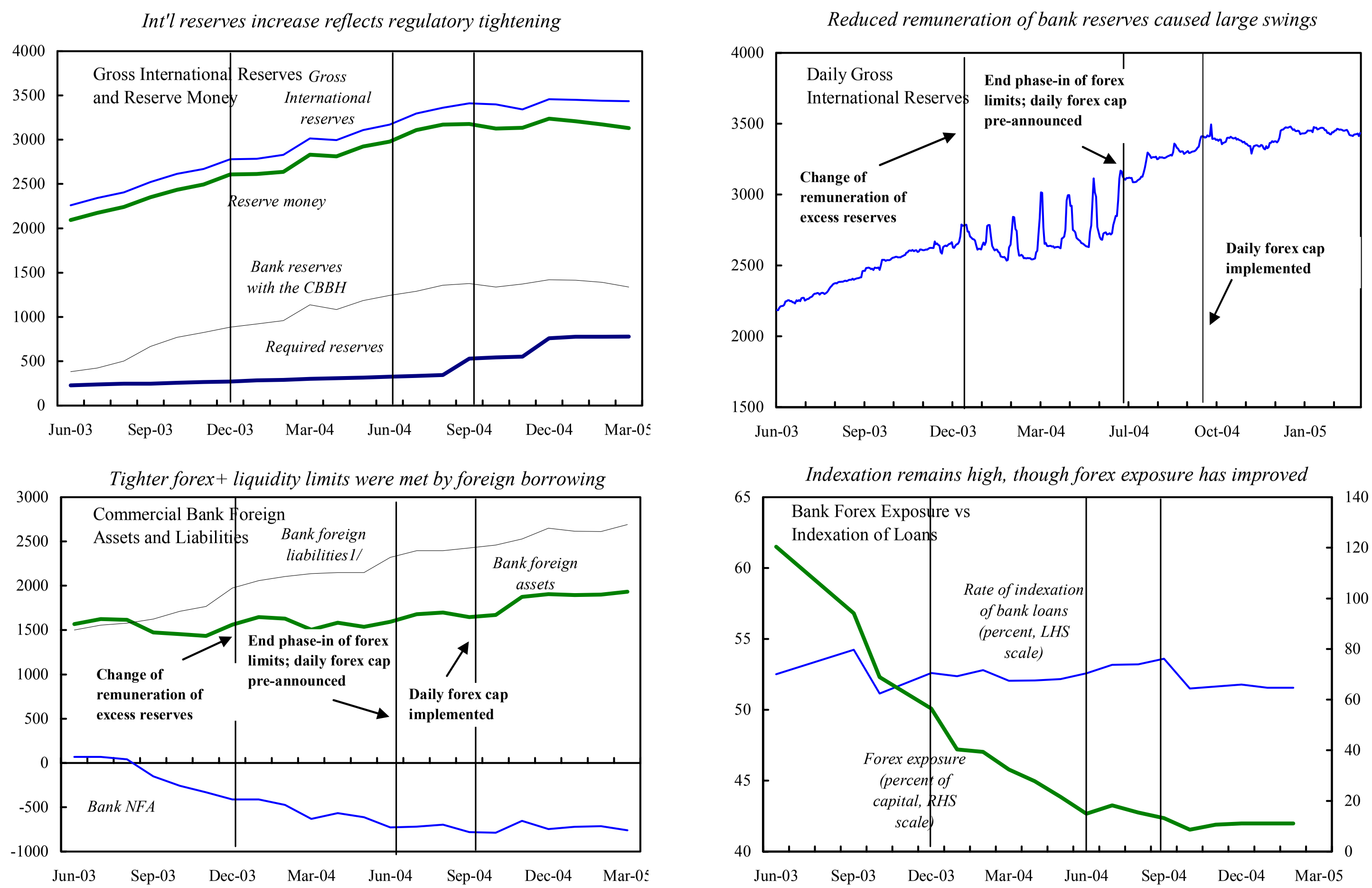
Figure 4. Bosnia and Herzegovina: Growth of Credit to the Private Sector 1/
(in percent)



Sources: Central Bank of Bosnia and Herzegovina, and staff estimates.

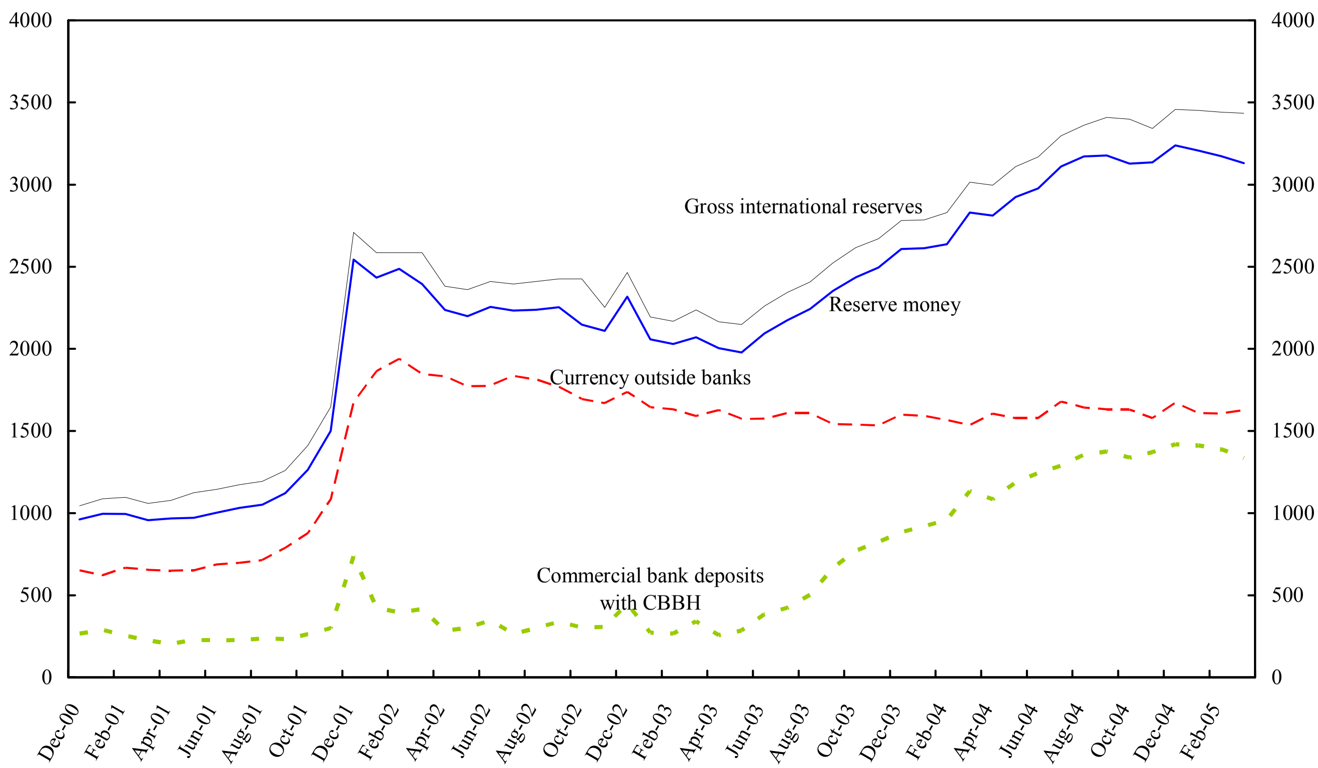
1/ Data on credit to enterprises and credit to the private sector were adjusted to correct for a structural break due to the takeover by the RS government, in June 2004, of KM 463 million of old bank claims on RS enterprises.

Figure 5. BiH: Bank Responses to Regulatory Tightening
(In millions of KM except where otherwise stated)



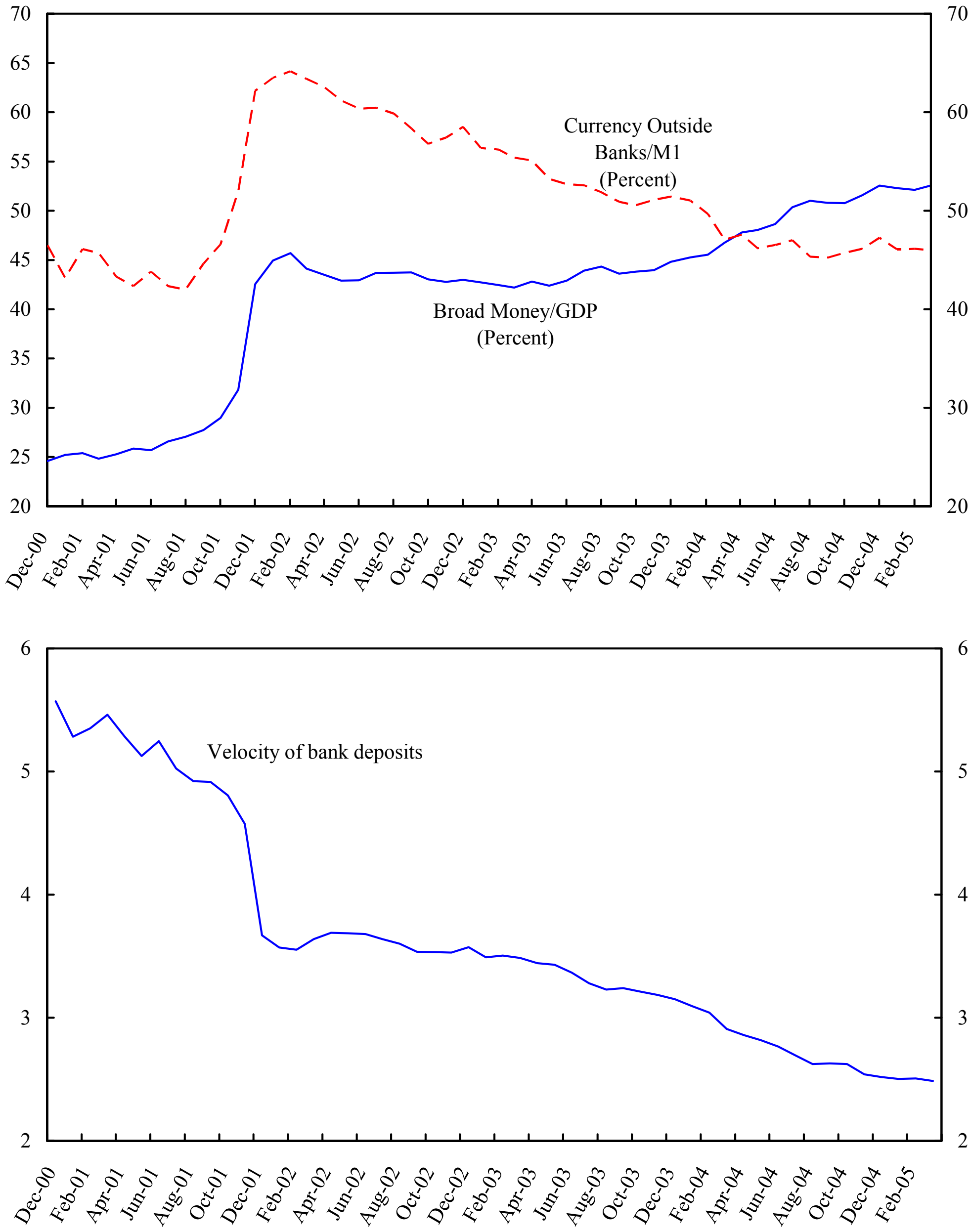
Sources: Bosnia and Herzegovina authorities, and Fund staff estimates
1/ Data prior to June 2004 is adjusted for classification change. In June 2004, the RS government took over KM 463 million of old bank claims on RS enterprises, and associated foreign liabilities, reducing bank claims on enterprises and bank foreign liabilities accordingly.

Figure 6. Gross International Reserves and Reserve Money
(in millions of KM)



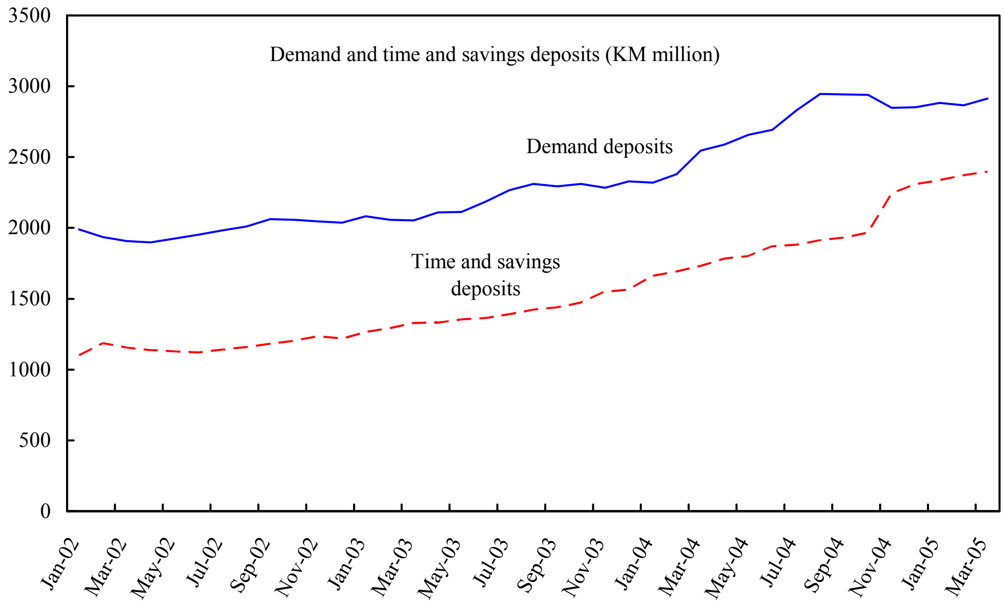
Sources: Data from the CBBH and staff calculations.

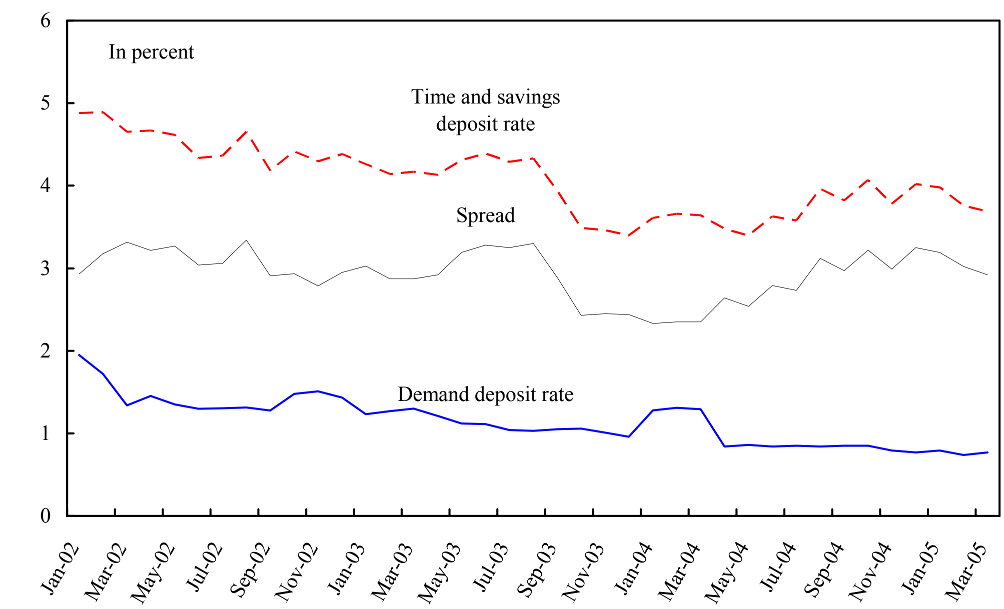
Figure 7. Bosnia and Herzegovina: Indicators of Financial Deepening



Source: Central Bank of Bosnia and Herzegovina, and staff calculations.

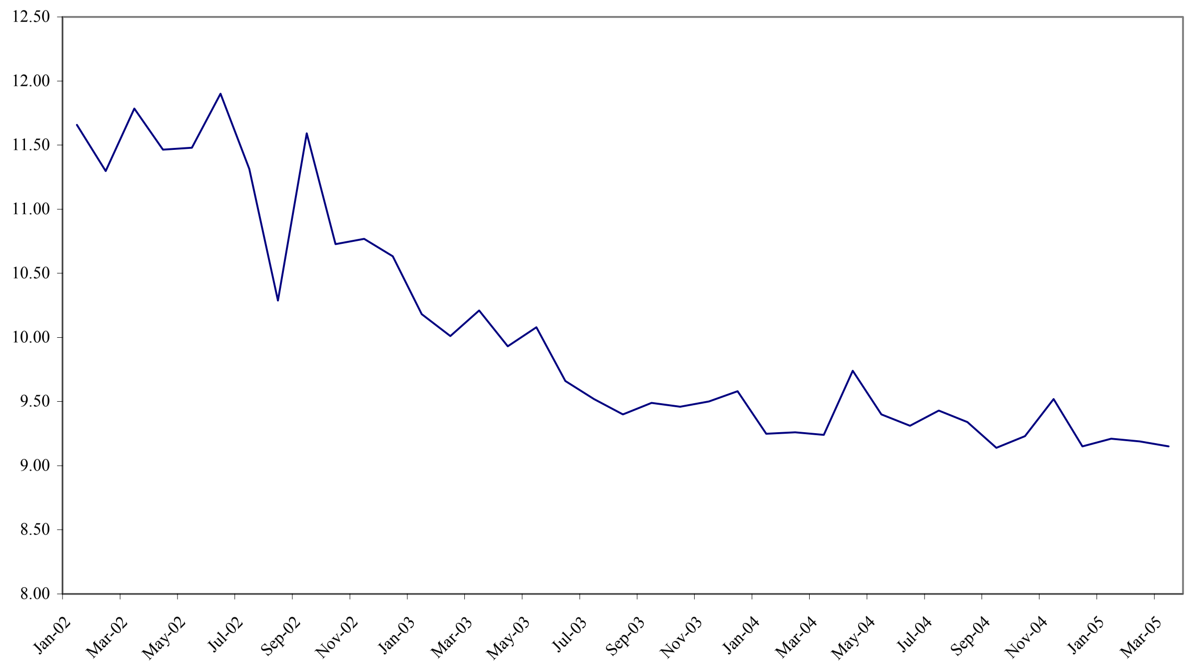
Figure 8. Bosnia and Herzegovina: Demand and Time and Savings Deposits and their Interest Rates





Source: Data provided by the Bosnia and Herzegovina authorities and Fund staff calculations.

Figure 9. Bosnia and Herzegovina: Spread Between Deposit and Lending Rates
(in Percent)



Sources: Data from the CBBH and staff calculations

III. International Experience with Credit Booms and Large Current Account Deficits[1]

A. Introduction

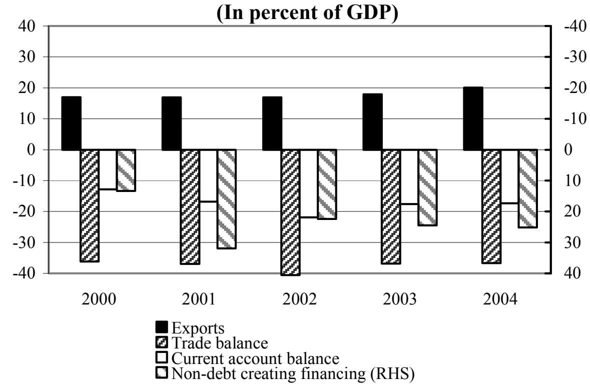
1. **While Bosnia and Herzegovina's output has been recovering since 1995 and inflation is low, major macroeconomic imbalances have emerged.** The external current account deficit stands, according to staff estimates, at about 17 percent of GDP in 2004, and closer to 24 percent of GDP according to official estimates. The deficit is the result of strong import growth. Meanwhile, bank credit to non-government, relative to GDP, has increased by over 20 percentage points in three years. In that time, it has grown almost 120 percent.

2. **In an international context, these imbalances and trends are unusual.** This chapter summarizes the international experience with large external deficits and fast credit growth since 1970, including among transition area and currency board countries. It draws some conclusions for Bosnia and Herzegovina from that international experience.

B. Background

3. **The Bosnian current account deficit, according to staff estimates, has remained well above 10 percent of GDP since 2000, peaking at almost 22 percent in 2002.** The deficit appears to be mostly financed by non-debt creating inflows, including capital transfers as one form of remittances and donor support, so the external debt-to-GDP ratio is estimated to be falling. On the other hand, errors and omissions are large and rising, signaling significant measurement error in either the current or capital account or both.

Figure 1. Balance of Payments Developments, 2000-04
(In percent of GDP)



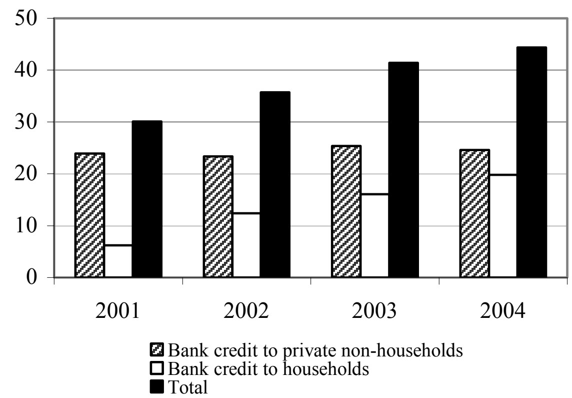
Sources: Authorities and Fund staff estimates.

4. **The domestic counterparts to Bosnia and Herzegovina's external imbalance are notable.** National savings have fallen from about 8 percent of GDP in 2000 to about 3 percent in 2004. But public consumption has not contributed to this decline. The overall deficit of the general government has fallen from about 7 percent of GDP in 2000 to less than 1 percent in 2004. Instead, private sector consumption has expanded by more than 10 percent of GDP since 2000. Alongside, investment spending has stagnated at about 20 percent of GDP for four years.

[1] Prepared by Joerg Zeuner.

5. **The consumption boom has been bank-financed.** Bank credit to non-government, relative to GDP, has increased by over 20 percentage points in 2001–04. Most of the new loans have gone to private households for reconstruction and consumption purposes—with the ratio of bank credit to households rising by 14 percentage points of GDP since 2001. Credit to non-households accounts for most of the remaining one percentage point increase, as bank credit to the government sectors has changed only marginally. This reflects many factors, including the strong restructuring of the banking sector (see Chapter 2 for details).

Figure 2. Bank Credit to Non-Government, 2001-04
(Eop. stocks; as percent of GDP)



Sources: Authorities and Fund staff estimates.

6. **Are Bosnia and Herzegovina's credit boom and external deficits unusual in international experience and what are the implications of this comparison?** The remainder of the chapter explores these issues.

C. International Comparisons

Credit booms

7. **The 1970s saw many episodes of financial and currency instability associated with prior credit booms**.[2] And there is evidence that these were more frequent and marked in the case of fixed exchange rate regimes.[3]

8. **What is the link, in international experience, between banking instability and rapid credit growth?** To examine this question, we used Caprio and Klingebiel's 2003 data set to identify periods of banking sector instability—defined as much or all of the capital of the entire banking system being exhausted—in many countries. They report 117 such banking crises that occurred in 93 countries since the late 1970s. We then matched this data with the behavior of the private sector credit-to-GDP ratio for 140 countries over the same period. For this, we defined a credit boom as a three-year period during which the private sector credit-to-GDP ratio jumped by a cumulative 10 percentage points or more. The private sector credit-to-GDP ratio was calculated based on the Fund's IFS and WEO data.

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[2] Krugman, (1979).

[3] Kaminsky and Reinhart, (1996).

9. **Prolonged credit booms increase the likelihood of a banking crisis.** From the sample of 140 countries, 74 have had at least one episode of difficulties in the banking system as defined by Caprio and Klingebiel (2003). Of these 74, 22 countries experienced growth of private sector credit-to-GDP by more than 10 percentage points for three years preceding these events. These 22 countries account for almost 40 percent of the credit booms, indicating a high frequency of banking instability in countries with credit booms. Thus, in cases where growth of credit is rapid, the incidence of subsequent banking difficulties is high, albeit not inevitable.

10. **The likelihood of a banking crisis following a credit boom seems to be somewhat higher in countries with greater financial depth to begin with.** For the period 1990–2003, countries with private credit-to-GDP ratios of more than 25 percent account for about half of the sample of 140 countries but 75 percent of the 22 countries with both rapid credit growth and banking crisis. Accordingly, the other half of the sample countries with private sector-to-GDP ratios of less than 25 percent account for only one quarter of the crisis countries. Thus, in cases where financial depth is low initially, the likelihood of a credit boom will lead to banking difficulties may be lower, but remains significant.

11. **What is the experience in the transition area?** Most such countries had banking instability in the early-1990s, at the beginning of the transition process, before credit started to expand rapidly. Since then, however, credit has boomed in this group. But notwithstanding the recent vintage of these booms, already three episodes of banking sector difficulties have followed credit booms: namely Poland in 1993, Bulgaria in 1996, and the Slovak Republic in 1997.

Table 1. Private Sector Credit-to-GDP (in percent), 1990-2003
in The Last Year of a Three-year Credit Boom and the First Year (shaded) of a Banking Crisis in Selected Transition Countries in the Region.

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	No. of Credit Booms
Belarus									16						**1**
Bosnia & Herzegovina												6	12	16	**3**
Bulgaria						21	35							26	**3**
Croatia								37					51		**2**
Czech Republic															**0**
Estonia								25						33	**2**
Hungary											32			43	**2**
Latvia													26	35	**2**
Lithuania														21	**1**
Moldova									14						**1**
Poland	21														**1**
Romania	80						11								**2**
Slovak Republic							44	56							**2**
Slovenia															**0**
Ukraine									8					25	**2**
No. of Credit Booms	**2**	**0**	**0**	**0**	**0**	**1**	**3**	**3**	**3**	**0**	**1**	**1**	**3**	**7**	**24**

12. **Since most of these credit booms in the transition area are of recent vintage, it is not clear from the data if they presage banking difficulties.** Broader international experience would suggest that this is the case if they continue, unless rapid credit booms in the transition context are somehow different from those elsewhere. This possibility cannot be determined from the available data. But given that Bosnia and Herzegovina is an outlier even among the transition countries, concerns would naturally be greater than those elsewhere in the transition area.

13. **Bosnia and Herzegovina's credit growth is, however, also an outlier among currency boards.**[4] There are several active currency board countries.[5] Of these, only Bulgaria has, like Bosnia and Herzegovina, experienced rapid credit growth alongside an external deficit, but before it introduced the currency board. Hong Kong also experienced rapid credit growth from 1993–97, but alongside current account surpluses. The non-active currency boards of Argentina (1991–2001), Ireland (until 1979), and Malaysia (1967–73) all had credit growth below the threshold used in this chapter. The exception is Singapore (1967–73), where three-year credit-to-GDP growth exceeded a cumulative 10 percentage points during the last two years before the currency board was abandoned.

14. **This summary of the international data confirms the main conclusions from the literature.** Rapid credit growth is one of the most robust leading indicators for banking difficulties. Numerous studies have found that periods of significant and accelerating credit growth often preceded such events.[6] The likelihood for banking difficulties to follow a lending boom is estimated to be as high as 20 percent, depending on the data set and methodology used. The high costs of a burst of a credit bubble are further described in IMF (April, 2004). The experience of the transition area is too recent, and generally has limited cases of high credit growth, for robust conclusions to be drawn for this narrow group of countries. But even within them, sustained credit growth is on a scale in Bosnia and Herzegovina that renders it an outlier, underscoring concerns there.

15. **Recent empirical evidence also suggests that the exchange regime affects the probability of banking difficulties**. More specifically, economies with rigid exchange rate regimes are more vulnerable to severe economic challenges (Rogoff, et al., 2004). In such cases, commercial banks have tended to underestimate currency risk in fixed exchange rate environments, funding domestic currency lending with foreign currency borrowing.

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[4] This comparison excludes the currency boards of Bermuda, Cayman Islands, Falkland Islands, Faroe Islands, and Gibraltar.

[5] These comprise Bulgaria, Brunei-Darussalam, the East Carribbean Currency Union, Djibouti, Estonia, China, P.R.: Hong Kong, and Lithuania.

[6] Prominent examples are Gavin and Hausmann (1996), Gourinchas, Valdes, and Landerretche (1999), Eichengreen and Arteta (2002), and Kaminsky and Reinhart (1999).

Interestingly, banks in Bosnia and Herzegovina have not followed this route (see Chapter 2 for details).

16. **But Bosnia and Herzegovina exhibits other characteristics which internationally have been associated with banking instability**. International experience suggests that unsustainable macroeconomic policies (Argentina, 2001), wholesale liberalization in the absence of an appropriate and effective prudential regulatory framework (Chile, 1984), direct effects of fiscal difficulties on the domestic banking system (Argentina, 2001), contagion and spillovers (Argentina, 1995), terms of trade shocks and movements in real exchange rates (Venezuela, 1994), and political instability, unrest, and civil conflict can be associated with banking sector difficulties. Bosnia and Herzegovina exhibits some of these features to some degree—including unresolved excess government liabilities, fiscal pressures, and exposure to regional instability.[7]

Large external deficits

17. **Bosnia and Herzegovina's external deficit is unique.** From a WEO sample of 180 countries, Nicaragua is alone in reporting a similar external deficit in 2003 and 2004. Moreover, except for Bosnia and Herzegovina, Jordan, and Lebanon, all other countries in the sample that reported annual current account deficit of more than 15 percent of GDP for at least 3 consecutive years since the mid-1980s are low-income countries, defined as PRGF-eligible, with structural balance of payments deficits.

[7] See Chapters 6 and 10.

18. **Large deficits are often associated with exchange rate instability:**

Table 2. Current Account Deficits of More Than 15 percent of GDP for At Least Three Table 2: Consecutive Years (in percent) and Years of "Large Devaluations" (shaded areas), 1965-85 1/ 2/

Country	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Angola																					
Armenia																					
Azerbaijan																					
Benin																	-25	-30	-17		
Bosnia & Herzegovina																					
Congo, Republic of																					
Ecuador						-151	-232	-98			-169	-51	-222	-218							
Greece	-19	-21	-21	-24	-27	-27	-27	-27	-30	-36	-28										
Guyana															-17	-19	-30	-27	-27	-19	-22
Jordan			-98	-105	-100	-101	-102	-82	-68	-59	-37	-25	-20	-23							
Lebanon																					
Malawi				-16	-18	-21	-16	-20		-16	-23	-17		-24	-31	-17					
Mauritania															-16	-22	-21	-40	-28	-21	
Mozambique																					
Myanmar			-38	-35	-32	-39	-33	-25	-15												
Nicaragua																-27	-33	-27	-23	-20	-24
Sri Lanka																-21	-15	-17			
Sudan																					
Syrian Arab Republic				-55	-48	-50	-43	-31	-16	-17											
Tajikistan																					
Uganda			-29	-19	-18	-15	-21														
Zambia																-15	-22	-19			

1/ Excluding very small countries and countries with large FDI inflows during the years of large current account deficits.
2/ Following Frankel and Rose (1996), a "large devaluation" is defined as a depreciation of the annual average exchange rate against the U.S. dollar by more than two standard deviations of the the 20-year forward looking moving average exchange rate.

Table 2. Current Account Deficits of more than 15 percent of GDP for At Least Three Consecutive Years (in percent) and Years of "Large devaluations" (shaded areas) 1986-2004 1/ 2/ (continued)

Country	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Angola												-21	-30	-40					
Armenia											-18	-17	-21	-17					
Azerbaijan											-26	-23	-31						
Benin																			
Bosnia & Herzegovina																-17	-22	-19	-19
Congo, Republic of									-32	-39	-33								
Ecuador																			
Greece																			
Guyana	-21	-26	-28	-36	-46			-29	-19	-18									
Jordan					-16	-15	-15												
Lebanon			-21	-22	-39	-56	-50	-49	-45	-42	-37	-34	-28	-18	-18	-22			
Malawi																			
Mauritania																			
Mozambique		-18	-17	-20	-16	-18	-21	-24	-23	-21	-18			-22	-19	-22	-20		
Myanmar																			
Nicaragua	-15	-26	-50	-39	-23	-21	-35	-35	-35	-35	-35	-36	-40	-40	-37		-20	-20	-21
Sri Lanka																			
Sudan							-44	-25	-23	-21	-16			-16	-15	-16			
Syrian Arab Republic																			
Tajikistan							-17	-28	-17	-17									
Uganda																			
Zambia															-18	-20	-15		

1/ Excluding very small countries and countries with large FDI inflows during the years of large current account deficits.
2/ Following Frankel and Rose (1996), a "large devaluation" is defined as a depreciation of the annual average exchange rate against the U.S. dollar by more than two standard deviations of the the 20-year forward looking moving average exchange rate.

19. **This observation is again in line with the findings of the literature.** Edwards (1989) and Kamin (1988) both show for their sample of countries that the current account was significantly different for the devaluers than for the control group.

20. **Bosnia and Herzegovina's current account deficit is also an outlier among active currency board countries.** Few other countries have exceeded the 15-percent of GDP mark since 1990 or before. The group which has exeeded this mark largely comprises small island economies, notably the islands of the East Caribbean Currency Union (Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines) which have sometimes even exceeded the 20-percent mark. The only other active currency board, in Brunei-Darussalam, has witnessed an annual average surplus of almost 60 percent of GDP since 1990.

21. **None of the inactive currency boards exhibited high current account deficits either.** Argentina's annual average deficit was equal to 3 percent of GDP during the currency board years. Hong Kong has had an annual average surplus of about 4 percent of GDP since the introduction of the currency board in 1983. Ireland's deficit was equal to 10 percent of GDP on average for the last ten years of its currency board era which ended in 1979. Malaysia's current account balanced out during its currency board era. Only Singapore exited its 6-year currency board in 1973 with a current account deficit of 15 percent of GDP. The average over the 6-year period was 19 percent of GDP.

22. **External imbalances are only one indicator of possible currency instability.** Others include: poor export performance; financial sector instability; low or falling international reserves; rapid money and or credit growth; low real GDP growth; and domestic inflation, and fiscal deficits.[8] Bosnia and Herzegovina scores well on some of these indicators, such as international reserves, inflation, the fiscal balance, and strong banks (see chapter 2). But others give some concern. While the fiscal balance is strong, it is structurally weak, with significant risks attached, GDP growth has slowed since the early 2000s, and bank credit is booming (see chapters 6 and 10).

D. Conclusion

23. **Bosnia and Herzegovina's credit boom and external deficit are remarkable—but not completely unique—in international experience.** Countries elsewhere exhibiting these or similar characteristics have disproportionately, but not always, experienced subsequent periods of instability. On other dimensions of economic behavior which have been associated with volatility internationally, Bosnia and Herzegovina's score is mixed. Even with due allowance for the likely underestimation of GDP, there would therefore seem to be good grounds to moderate credit growth and to lower the external imbalance in Bosnia and Herzegovina so as to underwrite the stability gained so far.[9]

[8] See Kaminsky, Lizondo, and Reinhart (1998) for details.

[9] See Chapter 5.

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IV. The Corporate Sector[1]

A. Introduction

1. **The corporate sector is in severe difficulties.** It appears to be characterized by wide-spread loss making, a heavy debt burden, and excess labor. And a poor business environment compounds the challenges. All this impedes investment, including FDI, and job creation. These problems have multiple roots: former Yugoslav worker-manager structures; disruptions of civil war; voucher privatization; lack of bankruptcy procedures; restrictive labor legislation; corruption; and neglect by the Bosnian authorities and the international community.

2. **But there are bright spots**. A number of privatizations have occurred recently, including to foreign investors, and restructuring is taking place in these companies.

3. **This chapter focuses on four questions.** How bad is the overall situation in corporates? How did it get that way? What has blocked attempts to remedy the situation in the past? And, in the cases where restructuring has occurred, how and why did that work? This analysis provides a backdrop to work being conducted by the IBRD to develop a program of restructuring going forward from here.

B. How Weak is the Corporate Sector?[2]

4. **The analysis in this section uses data from the APIF and AFIP databases of industrial company balance sheet and P&L data.** The findings covers the 1,000 largest companies in both the RS and Federation in 2002, cleansed for SoEs that will not be privatized (e.g. hospitals) and for SoEs that have been privatized. The enterprises included in the sample represent about one third of total employment.

5. **These data are of uncertain quality.** Balance sheets and income statements are not subject to independent auditing, compliance with local audit requirements is weak, and most companies do not make their audited statements publicly available. The application of accounting rules varies across companies and there is liberal use of off-balance sheet accounts.[3] [4] This state of affairs qualifies all assessments of firm level data.

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[1] Prepared by Graham Slack.

[2] This section builds on and extends work undertaken by Mr. Bob Etherington and colleagues at the World Bank.

[3]See World Bank, *Report on Observance of Standards and Codes, Accounting and Auditing,* October 2004.

[4] The notable exception is the financial industry.

Profitability

6. **The corporate sector is dominated by loss making and marginally profitable enterprises.** Profitability is low in both entities with the average gross profit margin (before tax) negative in RS and at breakeven in the Federation (Text Table 1). SoEs are considerably less profitable than private enterprises—70 percent of SoEs and 25 of percent of private enterprises are loss making. And only one in five private enterprises and one in twenty SoEs report profit margins above 5 percent, though profits may be incompletely recorded.

Text Table 1: Profitability, 2002

	Profits/sales	% of firms Loss making
BiH	-1	28
SoEs	-13	71
Private enterprises	1	25
Federation	1	14
SoEs	-7	55
Private enterprises	2	12
RS	-5	45
SoEs	-25	80
VPEs	-1	40
Other private ent.	0	44

7. **Profits have not increased in recent years.** Increases in industrial production in the RS and Federation over the past two years have not yielded larger profit shares for corporates. Instead, increased output has been matched by wage and employment growth (Text Table 2). Profits consequently declined by 10 percent in the Federation between 2002 and 2004. And while profits increased somewhat for RS enterprises in 2003 (helped by the appreciation of the Serbian Dinar) they stagnated in 2004.

Text Table 2. Unit Labor Cost Components 2002=100 [1/]

	2002	2003	2004
Federation			
Production	100	102	120
Wages	100	113	114
Employment	100	100	117
Prices/ ULCs	100	90	90
RS			
Production	100	99	113
Wages	100	111	129
Employment	100	86	84
Prices/ ULCs	100	105	106

[1/] Manufacturing

Costs and sales revenue

8. **Reduced labor costs are not sufficient to restore profitability**. In the SoE sector labor costs as a share of revenues are typically four times higher than in private enterprises. And shedding up to half the labor force, and assuming no consequential loss of output, would leave 40 percent of SoEs continuing to generate losses (Text Table 3). High non-labor related costs likely stem from outdated plant and machinery, poor management, weak corporate governance, low sales volume (see below), and corruption. Administrative and transportation costs associated with a heavy reliance on imported raw materials could also be inflating non-labor related costs.

Text Table 3: Federation: Profitability after Labor Shedding, 2002

	% reduction in labor costs					
	0	-10	-20	-30	-40	-50
Profit/sales						
SoE						
<0%	55	50	48	48	41	39
0-2%	34	20	11	7	9	7
2-5%	5	20	9	16	11	7
Private enterprises						
<0%	12	10	9	8	7	7
0-2%	54	48	42	38	34	30
2-5%	18	23	26	28	28	30

9. **Low sales revenue to assets suggests inadequate organization of production.** SoEs generate considerably less revenue from their assets than private enterprises in both entities and across a range of industries (Text Tables 4 and 5). It is uncertain, however, if assets are realistically valued in the companies books.

Text Table 4: Sales Revenue/Assets, 2002

	Sales revenue /assets	% of firms with sales/assets 0-0.5	0.5-1.0	1.0-3.0	>3.0
BiH	0.66	33	16	33	17
SoEs	0.24	81	12	7	0
Private enterprises	0.89	30	17	35	19
Federation	0.88	10	17	44	29
SoEs	0.28	68	18	14	0
Traded goods sector	0.26	74	21	6	0
Private enterprises	1.25	7	17	46	30
Traded goods sector	0.63	18	31	40	11
RS	0.38	60	17	19	4
SoEs	0.18	87	9	4	0
VPEs	0.47	55	18	22	5
Other private ent.	0.45	65	16	17	2

Text Table 5: Sales Revenue/Assets, 2002 (by Sectors)

	SoEs	Private enterprises
Agriculture	0.55	0.23
Mining	0.36	0.28
Manufacturing	0.23	0.75
Construction	0.32	0.96
Wholesale/retail trade	0.29	2.35
Transport and communication	0.58	1.40

Liquidity and solvency

10. **A large proportion of enterprises are illiquid.** On the available data, half of the SoEs and 40 percent of private enterprises are unable to repay their current (less than 1 year) liabilities from their current assets (Text Table 6). And with the vast majority of companies also unable to repay current liabilities from current income (even over a 10 year horizon), the implication is that they are liquidating fixed assets or securing outside financing to repay their current obligations, and/or simply accumulating arrears, and thereby reducing solvency.

Text Table 6: Liquidity, 2002

	Current assets/ current liabs	% of firms <1
BiH	1.09	42
SoEs	1.08	53
Private enterprises	1.09	41
Federation	1.26	31
SoEs	1.32	43
Private enterprises	1.24	31
RS	0.86	53
Exc. tax and labor debt	1.05	41
SoEs	0.81	58
Exc. tax and labor debt	1.05	46
VPEs	0.85	54
Exc. tax and labor debt	1.03	41
Other private ent.	1.00	50
Exc. tax and labor debt	1.19	35

11. **Enterprise debts, as reported in the RS, are dominated by intercompany arrears.** Over one third of enterprise debts are owed to suppliers (Text Table 7). A further quarter of their debts are in the form of loans. Wage arrears reportedly account for only 5 percent of total enterprise debts, and tax and contribution arrears a further 10 percent. Loss making SoEs have accumulated proportionately more arrears to suppliers than loss making enterprises in the private sector, while the latter have accumulated proportionately more wage and tax arrears than loss-making SoEs. It is unclear, however, if total labor debts are correctly recorded. Under the labor law, wage arrears accumulate even for "fictitious" workers who have long since stopped appearing for work if they have not been given their work books. These debts may be incompletely recorded.

12. **With this proviso, clearance of tax and labor debts would have a limited effect on the corporate debt burden.** Writing off tax and labor debts would return only 15 percent

Text Table 7: Debt Structure , 2002
(in Percent)

	SoE	o/w loss making	VPEs	o/w loss making	Other	o/w loss making
LT liabilities	25	26	16	21	16	24
Affiliates	0	0	0	0	1	0
Loans	23	24	13	18	10	15
Other	2	2	2	3	5	9
ST liabilities	75	74	84	79	84	76
Affiliate loans	1	0	0	1	12	0
Affiliates other	1	2	1	2	1	1
Loans	7	7	12	10	10	12
Advance payments	3	3	12	7	9	3
Suppliers	39	36	38	29	32	28
Wage arrears	6	7	5	9	5	11
Tax and contribution arrears	11	10	9	14	8	15
Other	6	6	6	6	6	5

of companies to a position of being able to pay current liabilities from current assets, leaving some 40 percent of enterprises illiquid, and effectively insolvent (Text Table 6). And loss-making private enterprises would benefit disproportionately from across the board clearance of tax and labor debts because of the concentration of these debts in these companies.

C. How Did The Corporate Sector Get to This Point?

13. **Initial conditions in 1995 were not favorable.** Disruptions of civil war left plant and machinery severely outdated if not destroyed. Know-how was lost through large scale emigration and internal displacement of the labor force. And those enterprises previously part of Bosnia and Herzegovina's vertically integrated industries, found themselves isolated and without traditional local markets.[5] And with the break-up of Yugoslavia, access to the markets in the Former Yugoslav Republics was disrupted. All this left Bosnia and Herzegovina's GDP at a fraction of its prewar level. Manufacturing output was crippled, and at end-2004 had recovered less than half of its pre-war contribution to GDP (see Table 1).

[5] Key industries in Bosnia and Herzegovina were organized under a vertically integrated business model managed by holding companies. SIPAD, UPI, and UNIS for instance managed the entire production of timber, agriculture, and metal-related products, from raw material through to finished product.

Table 1: Growth of Value Added 1/

(in percent, in real terms)

Bosnia and Herzegovina	Sectoral share in 1989	Sectoral share in 1996	Sectoral share in 2004	Sectoral shareof all sectors in 1996	1996	1997	1998	1999	2000	2001	2002	2003	2004	Sectoral share in 2004	Change in Sectoral share
Agriculture, hunting, and forestry	15	20	17	16	68	24	24	-1	-15	2	1	-8	15	11	-4
Fishing	n.a			0	64	22	21	-24	-1	-48	58	-60	1	0	0
Mining	4	2	4	2	71	47	20	18	21	-7	4	23	11	3	1
Manufacturing	49	17	21	12	54	42	27	-4	7	4	4	5	8	14	2
Electricity, gas, and water	4	9	11	6	50	40	29	14	8	7	-11	15	4	8	2
Construction	7	4	9	4	162	63	36	6	1	-8	0	15	6	6	2
Wholesale and retail trade	13	30	19	16	13	4	-1	9	-3	17	11	6	5	13	-3
Hotels and restaurants	2	4	3	3	51	20	3	13	-2	-1	5	14	4	2	0
Transport, storage, and communications	7	14	16	9	36	27	20	20	4	10	7	3	7	11	2
Financial intermediation	n.a			4	97	30	5	6	15	-4	8	16	3	4	0
Real estate, renting, and business services	n.a			4	67	-23	1	13	6	-4	3	23	3	3	-2
Public administration and defense	n.a			12	79	57	6	8	11	3	5	-1	-1	13	1
Education	n.a			6	188	26	13	17	7	-2	2	2	1	5	0
Health and social work	n.a			5	134	16	8	27	9	-4	11	9	1	5	0
Other services	n.a			3	46	20	7	9	-1	2	1	2	1	2	-1
Memo: GDP					62.6	29.9	15.6	9.6	5.5	4.3	5.3	4.0	5.2		

Federation	Sectoral Share in 1996	1996	1997	1998	1999	2000	2001	2002	2003	2004	Sectoral share in 2004	Change in Sectoral share
Agriculture, hunting, and forestry	12	102	11	17	-2	-12	11	2	-4	12	9	-3
Fishing	0	89	9	12	-47	50	-85	470	-36	1	0	0
Mining	2	90	52	15	22	19	-3	9	5	10	3	1
Manufacturing	11	90	52	15	-5	16	12	7	5	9	16	5
Electricity, gas, and water	5	90	52	15	23	3	8	-7	8	5	7	2
Construction	4	149	67	35	-7	0	-11	2	8	4	5	1
Wholesale and retail trade	19	10	-3	-8	7	-7	18	9	5	5	13	-6
Hotels and restaurants	3	53	10	-7	10	-1	-1	1	17	4	2	-1
Transport, storage, and communications	9	36	24	14	20	2	10	8	2	7	11	2
Financial intermediation	5	104	24	0	0	20	-3	9	14	3	5	0
Real estate, renting, and business services	5	71	-27	-8	4	11	-3	4	29	3	3	-2
Public administration and defense	10	54	89	-1	5	16	5	5	-3	-1	13	3
Education	7	259	19	1	17	3	0	5	3	1	6	-1
Health and social work	6	198	10	-6	27	6	1	12	10	1	6	0
Other services	3	49	14	-2	5	4	5	5	2	1	2	-1
Memo: GDP		71.4	28.1	6.2	9.3	7.3	6.1	5.5	3.6	5.1		

Republika Srpska	Sectoral Share in 1996	1996	1997	1998	1999	2000	2001	2002	2003	2004	Sectoral share in 2004	Change in Sectoral share
Agriculture, hunting, and forestry	29	34	43	33	1	-23	-9	-1	-14	19	18	-11
Fishing	0	34	43	33	1	-30	-5	-21	-92	3	0	0
Mining	1	7	18	64	-3	36	-32	-35	282	14	2	1
Manufacturing	17	7	18	64	-3	-16	-18	-9	8	4	10	-7
Electricity, gas, and water	9	7	18	64	-3	17	5	-18	29	1	10	1
Construction	6	198	53	38	39	-1	-1	-4	27	8	10	4
Wholesale and retail trade	6	45	78	44	17	-8	15	17	8	5	11	5
Hotels and restaurants	2	45	70	35	19	-7	1	13	9	5	3	1
Transport, storage, and communications	7	39	42	45	18	9	12	4	8	9	11	4
Financial intermediation	2	18	82	37	33	-1	-9	4	23	4	4	2
Real estate, renting, and business services	1	14	70	80	60	-17	-10	-3	-2	4	1	0
Public administration and defense	14	66	5	37	19	-10	-2	7	4	-1	11	-4
Education	2	-23	113	101	17	12	-9	-8	0	0	4	2
Health and social work	2	-33	80	108	26	10	-20	4	6	0	4	2
Other services	2	27	55	52	22	-28	-11	-15	3	0	1	0
Memo: GDP		29.1	38.0	47.7	10.5	-5.1	-2.0	3.9	5.4	6.0		

Source: Bosnian authorities and staff estimates

1/ Based o the 1993 System of National Accounts starting from 1996. The 1989 figures are based on the former system and therefore not directly comparable to

to subsequent ones.

14. **But subsequent policy choices aggravated these difficulties.**

- SoEs were treated as a social safety net. In the context of demobilization of military personal, SoEs were pressed into hiring large numbers of veterans, inflating their payroll. Alongside, labor regulations afforded generous wage and benefit packages for SoE workers, beyond the means of SoEs to pay. And by requiring the clearance of all unpaid wage and contribution arrears prior to dismissal, labor regulations effectively prevented SoEs from shedding labor.

- Alongside, voucher privatization failed to transform SoEs into profit seeking enterprises.

- With government mandates lasting only 2 years, there was little political will to tackle this difficult agenda.

- Bankruptcies were rare. Prior to the introduction of modern bankruptcy laws in 2003, bankruptcy procedures were protracted and ineffective for securing creditor rights in the Federation, and non-existent in the RS. This led to a build-up of interenterprise arrears, a barter system of trading among enterprises, and bilateral negotiation between creditor and enterprises.

- And unconditional debt write-offs and reschedulings in the RS prolonged the life expectancy of unprofitable enterprises and reduced the profitability of others.

15. **And price stability provided enterprises with no relief from their debt burden.** Anchored by the currency board, prices remained low and stable, so enterprises' real debt burden was not significantly reduced.

D. Why Has Revitalization Proved So Difficult?

16. **Profit seeking for shareholders is not a core motive for enterprises**. Under the current incentive structures, many enterprises do not seek to maximize profits for shareholders or pay workers wages or contributions for pensions and health insurance in full. Hard budget constraints are not enforced because of a reluctance of creditors (including workers) to file bankruptcy proceedings. And voucher privatized enterprise are not under the effective control of private shareholders (see below). Enterprise managers and workers also tend to view the problems they face through the former Yugoslav lens of "government should solve everything" including by boosting aggregate demand and sheltering them from foreign competition. All this renders firms resistant to change.

17. **The current labor legislation is a further impediment**. Tripartite collective bargaining sets contracted wage rates above the ability of firms to pay. With contracted wage rates at least 20 percent higher than paid wage rates, wage, pension, health, and unemployment benefit contributions have gone unpaid. And by requiring the clearance of all wage, benefit, and contribution arrears before a worker can be released, which corporates

simply cannot afford, the labor laws prevent shedding of "excess" and "fictitious" workers.[6] Wage and benefit rates are also inflexible downward because of the fixed system of coefficients for determining wage and benefit rates and, in the Federation, indexation of the minimum price of labor to the average price of labor.

18. **The business environment discourages firm entry.** According to the European Bank for Reconstruction and Development (EBRD) *Transition Report 2004*, out of 27 transition countries, Bosnia and Herzegovina belongs to the lowest-performing five in the area of small and large scale privatization. While it costs 16 per cent of per capita income on average to start a business in the region, it costs more than double this (46 percent) in Bosnia and Herzegovina. Bosnia and Herzegovina also has one of the highest tax burdens in the region. All of these factors discourage investment and push entrepreneurs into the already large informal sector.[7] And corruption levels, ranked among the top five obstacles to doing business by firms operating in Bosnia and Herzegovina, show no sign of abating.[8] Apart from discouraging new capital to enter Bosnia and Herzegovina, these trends risk existing investors relocating their operations outside of Bosnia and Herzegovina.[9] And political considerations feature prominently in decisions on allowing foreign investors to participate in tenders for SoEs. Nevertheless, high world steel and aluminum prices have made Bosnia and Herzegovina's mining and steel industries increasingly attractive to foreign investors.

19. **Bankruptcy procedures are new and largely untested**. There is growing acceptance that bankruptcies are a natural and necessary part of a healthy corporate sector, but this is not yet matched by a willingness to file bankruptcy proceedings, especially on the part of the governments who remain disposed to unconditional debt write-offs for enterprises. The legal administration to enforce the 2003 bankruptcy laws is being developed with the assistance of USAID, and initial indications are that bankruptcy cases are moving through the courts without major delay up to point of sale of assets. Sale of assets is impeded by poor land registry records. Moreover, the potentially large volume of bankruptcy cases needed to revitalize the corporate sector may overwhelm the limited capacity of the courts and trustees, undermining efforts to impose credible hard budget constraints on enterprises.

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[6] Fictitious workers continue to accrue wages and benefits despite not turning up to work for long periods of time.

[7] See Chapter 5.

[8] World Bank, *Anti-Corruption in Transition 2, Corruption in Enterprise-State Interactions in Europe and Central Asia 1999–2004*, 2004.

[9] During IMF Staff interviews with executives of a number of recently privatized enterprises, most responded negatively when asked if, with their current knowledge, they would invest again in Bosnia and Herzegovina. Most saw neighboring countries as more attractive business locations and some acknowledged plans to relocate unless the business environment improved.

20. **Corporate restructuring presents social challenges.** Revitalizing the corporate sector will often initially result in job losses, in some instances in single company towns. Alongside there are limited resources available to ameliorate the social effects—a balance needs to be struck between addressing wage arrears and gaps in pension contributions for workers, and fiscal solvency.

21. **Faced with these realities, corporate restructuring has been neglected by the Bosnian authorities and the international community.** And the ratcheting-up of worker expectations has exacerbated the challenges.

E. Lessons From Earlier Revitalization Initiatives

Voucher privatization

22. **The program of voucher privatization launched in 2000 intended to promote company restructuring by transferring public companies to private ownership** (see Box 1). While this transformed the ownership structure for many SoEs, the hoped-for revitalization did not materialize. Private share holdings in Voucher Privatized Enterprises (VPEs) were pooled and managed by Privatization Investment Funds (PIFs), which received a fixed management fee based on the book value of company assets in their portfolio. PIFs therefore had no incentive to demand increased profitability from VPEs, or to force management change. PIFs were further hampered by regulations limiting their holdings to 30 percent of VPE capital. Even in the absence of these restrictions it is not clear that PIFs were (and are) equipped to oversee corporate restructurings. Alongside, governments retained effective control over VPEs through direct shareholdings and shareholdings of the pension and restitution funds.

23. **The lesson here is that private ownership has to secure control by a competent and financed owner, who is endowed with effective control over the enterprise and the ability to remove management if necessary.**

Debt rescheduling

24. **Following voucher privatization, the RS government engaged in rescheduling of company debts to provide "breathing space" for them to restructure (Box 1)**. After a 2 year grace period on tax and contribution arrears, only 20 percent of participating VPEs began repaying rescheduled liabilities. Companies did not restructure their operations because they did not have to. Because the authorities failed to file bankruptcy proceedings against VPEs that did not pay their current tax and contribution obligations (as required under the terms of the rescheduling) the incentives for companies to restructure was undermined from the outset.[10]

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[10]By contrast, the 1998 restructuring program for Polish coal mines forgave liabilities incurred to government only when, inter alia, restructuring plans were implemented, and timely payments were made on obligations to government agencies.

Box 1. Voucher Privatization and Debt Rescheduling in Bosnia and Herzegovina

In an attempt to revitalize the corporate sector, Bosnia and Herzegovina undertook a voucher privatization scheme between 2000 and 2001. About 1000 enterprises in the Federation and 600 enterprises in the RS were privatized under the program, covering around a quarter of SOE assets.

All citizens of BiH were eligible to receive vouchers. These could be used to "purchase" share capital in companies included under the program, residential property (in combination with a partial cash payment), or could be traded for cash. Frozen foreign currency account holders had the opportunity to convert all or part of their savings into vouchers, and military veterans received additional vouchers. In all, vouchers equivalent to some KM 15 billion (150 percent of 2000 GDP) were issued.

Voucher holders could acquire shareholdings in SOEs directly, but most opted to exchange their vouchers for shares in Privatization Investment Funds (PIFs), which pooled the vouchers to acquire shareholdings in Voucher Privatized Enterprise (VPEs). Key strategic enterprise (56 in the RS and 72 in the Federation) were excluded from the voucher scheme.

Following voucher privatization, some 500 VPEs in RS were granted a rescheduling of liabilities (as of end-2001) owed to the RS government, totaling some KM 430 million (14% of 2001 RS GDP). The intention was to give these recently privatized companies some relief on debt servicing to allow them time to restructure their operations along profitable lines.

As an indictor of the ability of VPEs to stay current on their current tax and contribution arrears during the period of the rescheduling, participating enterprises had to demonstrate that all liabilities were fully paid for the first quarter of 2002. In the event, only a fraction of participating VPEs stayed current on their current obligations to government, without consequence.

When the grace period expired in mid-2004, 80 percent of participating VPEs did not make payments on their rescheduled liabilities. The bank accounts of these companies were initially blocked and later unblocked pending review of their business plans with a view to additional rescheduling for those companies deemed to have sound plans.

25. **The lesson here is that without a tight link between debt write-offs and restructuring (including through bankruptcy), debt write-offs and rescheduling simply delays the needed structural adjustments and encourages firms to expect further reschedulings from government in future.**

Strategic privatization

26. **Following the Voucher Privatization scheme, privatization based on international competitive tenders has been slow.** Out of a total of number of 108 strategic companies, only 18 had been sold by end-2003 (mostly from the Federation portfolio). In large part this is because the privatization agencies do not have control over SoE assets (as is the case in Croatia, for example), and the tender process is subject to interference from line ministries. Alongside, when tenders failed, a common practice in the RS has been to revert to one-on-one negotiations between investors and the government. Knowing in advance that this would occur, investors tended to wait until the tenders failed, and then entered covert negotiations with the authorities. This both undermined the tender process and encouraged corruption. And with cantons responsible for privatizing companies located in their jurisdiction and the central government responsible for privatizing corporates located in more than one canton, the Federation privatization program was fragmented and uncoordinated.

27. **The lesson here is that privatization processes must be transparent, time bound, free from political interference and under the effective control of the single agency in each entity.**

Sale to private owners

28. **If the new executives of recently restructured large companies are to be believed, rapid restructuring will yield high returns.** These executives expect their exports, which were 13 percent of BiH exports in 2003, to exceed all 2003 BiH exports within two years (Text Table 8). All of these companies had attracted foreign investors either as owners, advisors, or partners, with some investors, having been "the first-in" in other transition economies now turning to Bosnia and Herzegovina. And even companies that were sold for a minimal price after several failed tenders have made a significant contribution to the local economy, employment, and exports. A distinctive feature of these companies is that many had been pro-active, prior to sale, in developing business plans for their revival, and in some cases had successfully secured foreign bank financing on the basis of those plans. As a result of these restructurings, industrial output increased strongly in both entities in 2004. This demonstrates that with effective management and fresh capital,

Text Table 8: Large Company Restructurings

	2003	2004	2005	2006	2007
Surveyed firms relative to 2003 BiH outturns (percent)					
Exports	13	26	39	106	139
Imports	4	6	9	22	29
Nominal GDP	0.9	1.5	2.3	4.0	4.8

enterprises can be turned around relatively quickly, and that the authorities can be effective in attracting quality foreign investors to Bosnia and Herzegovina.

29. **The lesson here is that company restructuring, if deep and decisive, can yield results quickly**.

30. **Nevertheless, the optimism of managers of restructured companies is tempered by the business environment.** An aging work force and a lack of skilled engineers and mid-level managers, combined with restrictive labor legislation, are cited as constraints on company growth. A lack of rail capacity, unreliable electricity supply, and government bureaucracy are also seen as key impediments to expanding production. On the latter, one telling example is that long delays in having import documents signed by the relevant line ministry results in repeated loss of competitively priced raw materials, leading one large company to consider relocating its business operations outside of Bosnia and Herzegovina.

F. Conclusions

31. **Bosnian enterprises had a bad start after the war, but policy and neglect since has made matters worse.** A broad program of corporate restructuring is needed to tackle the estimated 60 percent of enterprises in Bosnia and Herzegovina that have debts which they cannot repay.

32. **Quick fixes are unlikely to help.** While enterprises are unlikely to be sold with large debts on their books, indiscriminate write-offs of tax arrears will not deliver a rejuvenated corporate sector. Rather, a comprehensive restructuring program, including reform of the labor market and better corporate governance, are needed to establish profit seeking as the core motive of the corporate sector. This is a complex and challenging task and the authorities are drawing on World Bank expertise in these areas.

33. **The core elements of a remedy, suggested by Bosnia and Herzegovina's own experience with alternatives, are clear:**

- Debt write-offs and reschedulings must be made conditional on restructuring and management change.
- Shareholders must have effective control over the enterprise, including the ability to remove management.
- Governments must demonstrate commitment to bankruptcy proceedings to establish a credible threat to enterprises that do not restructure. This includes addressing capacity and administrative constraints in the bankruptcy procedures.
- The process of privatization must be free from political interference, transparent, and strictly timebound.

- The social aspects of corporate restructuring need to be addressed in the context of limited fiscal resources.[11]

- Labor legislation must be reformed to prevent future accumulation of wage and contribution arrears and to alleviate frictional unemployment during corporate restructuring.

34. **This presents a challenging administrative, social, and political agenda**. But further inaction simply exacerbates these challenges. While there is emerging consensus on the need for broad based corporate restructuring, it is as yet unclear if the political will has emerged to implement it decisively.

[11] See Chapter 6.

V. NON-OBSERVED ACTIVITY[1]

A. Introduction

1. **Official national accounts data in Bosnia and Herzegovina (BiH) understate activity.** A variety of indicators suggest this—including various ratios to GDP such as credit growth (up 21 percentage points of GDP in three years), the velocity of various monetary aggregates (low by regional and international standards), and the external deficit which the central bank estimates at some 23 percent of GDP in 2004. This assessment is widely shared [2]

2. **The question is "by how much"?** This chapter situates estimates for the non-observed activity (NOA) in Bosnia and Herzegovina in an international context, including those for other transition countries. It also summarizes new estimates prepared for BiH suggesting that its NOA is larger than the average in other transition economies, low-middle income, and conflict and post-conflict countries, and is similar to estimates for the CIS area.

B. International Treatment of Non-Observed Activity

3. **Official GDP data in all countries reflect the level of activity and the exhaustiveness of data compilation.** Taking account of the different concepts involved in unobserved activity, many countries attempt to estimate and integrate into their official GDP data legal activities that are unrecorded (Box 1). Most commonly, statistical offices use direct survey methods—of the labor force, unemployment, household budgets, and businesses—alongside official tax, and licensing records, to gauge this activity. These "direct" methods underlie adjustments to data yielded by standard statistical returns to determine the finally published official GDP data. Sometimes, but less often, corrections are also made for deficiencies in the statistical registries and non-response from the surveyed businesses and households. Only a few countries integrate estimates of illegal activity in published GDP numbers.

Box 1. Non Observed Activity—Concepts

OECD identifies several elements of NOA: (i) non-response of surveyed businesses or households; (ii) business registries that are not updated; (iii) omission of businesses in the statistical registries; (iv) underreporting of sales and revenues; (v) under registration of legal entities, e.g. for tax evasion; (vi) informal activity on so modest a scale that it is not captured; and (vii) illegal activity.

4. **Countries in transition make significant adjustments for NOA**. On average the NOA adjustments incorporated in official GDP data amount to 21 percent of officially

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[1] Prepared by Iva Petrova

[2] IMF Country Report No. 04/54, March 9, 2004.

published GDP. These ratios are some 26 percent in former Soviet Republics (CIS) and 13 percent in Southeastern European countries (SEE) (Text Table 1). This contrasts with

Text Table 1. GDP Adjustment for NOA in Transition Economies
(In percent of Officially Published GDP)

	Population (in million)	Year of Estimate	NOA
Former Yugoslav republics			**9**
Croatia	4.4	1999	8
Macedonia	2.0	1999	14
Serbia and Montenegro	10.6	2000	9
Other SEE countries			**19**
Albania 1/	3.2	2002	28
Bulgaria	8.2	2000	16
New EU member states			**14**
Czech Republic	10.3	1998	9
Hungary	10.2	1997	16
Latvia	2.4	1998	17
Lithuania	3.6	1998	18
Poland	38.7	1998	13
Slovakia	5.4	1998	22
CIS Countries			**26**
Armenia	3.1	1999	29
Belarus	10.0	1999	12
Georgia	5.2	2001	34
Kazakhstan	14.9	2000	27
Kyrgyzstan	4.9	1999	48
Moldova	4.3	2000	31
Russian Federation	145.6	2000	25
Transition economies 2/			**21**
Developed economies 3/			**4**

Source: UN (2003); IMF Country Report No. 05/90; Dell'Anno and Piirisild (2004).

1/ From the Albanian authorities.
2/ Excluding Bosnia and Herzegovina.
3/ Belgium, Canada, Ireland, Italy, and USA.

developed economies which tend to make only minor adjustments to correct for deliberately unregistered activities and the informal sector, while transition economies attempt to estimate the whole array of non-observed activities. Many transition economies have developed sophisticated survey-based methods to underlie their adjustments for this, but the Former Yugoslav Republics have yet to match this sophistication. Despite acknowledging that NOA may be considerable, the actual adjustments for NOA in Croatia and Serbia and Montenegro amount to just nine percent of published GDP. Only Albania makes a sizeable adjustment, with 27 percent of published GDP coming from this source.

5. **Analysts—but typically not official statisticians—also attempt to gauge NOA using "indirect" methods.**[3] These typically use various indicators to infer what "true" GDP is (Box 2).

Box 2. Two Indirect Methods

- A straightforward method presumes a stable relationship between a variable—perhaps money or electricity consumption—and "true" GDP. An unusually large quantum of currency in circulation or electricity consumption relative to historical norms provides a crude estimator of "increased" NOA activity. The risk in this approach is that factors other than grey activity could account for the unusual behavior of the monetary aggregates or electricity consumption, distorting the estimates yielded for NOA activity.

- Latent variable based estimates of NOA activity tries to address the shortfalls in the approach above. They attempt to isolate the "grey economy" factors from others in accounting for unusual observations in velocity or other indicators. Thus "grey economy encouraging factors"—such as tax and regulatory burdens and citizens' attitude to tax compliance—are included as independent variables in regressions explaining money demand or electricity consumption. The estimates of NOA activity are derived from the parameter estimates for "grey economy inducing variables" in such equations. Lackó (2000) applies this method to electricity consumption.

6. **Internationally, indirect-based estimates of NOA are typically larger than those produced by official direct (survey) based methods**. This is evident from the fact that even when official published GDP data include "direct" adjustments for NOA, the indirect estimates call for yet further adjustments. The additional adjustments suggested are typically lowest in the developed countries, higher in middle income countries, higher still in the CIS area and highest in the Former Yugoslav area (Text Table 2). It is an open—and much disputed—question, however, if the "indirect" estimates are reliable.

[3] For a detailed survey of the methods see Fleming, Roman, and Farrell (2000), Lackó (2000), OECD (2002), Schneider and Enste (2000), and Schneider (2005)

Text Table 2. NOA Estimates in Transition Economies
(In percent of GDP; unless otherwise specified)

	Household Electricity, 1995 Lackó (2000)	Latent Variables, 2001/2002 Schneider (2005)
Bosnia and Herzegovina		**35**
Former Yugoslav Republics 1/	**38**	**36**
Croatia	36	34
Macedonia, FYR	44	35
Serbia and Montenegro		37
Other SEE Countries	**30**	**36**
Albania		35
Bulgaria	34	37
Romania	28	36
New EU Member States	**27**	**27**
Czech Republic	22	20
Estonia	36	39
Hungary	30	26
Latvia	44	41
Lithuania	46	31
Poland	24	28
Slovak Republic	28	19
Slovenia	23	28
CIS Countries	**41**	**48**
Armenia		48
Azerbaijan	48	61
Belarus	35	49
Georgia	57	68
Kazakhstan	38	44
Kyrgyz Republic	35	40
Moldova		47
Russian Federation	39	48
Ukraine	53	54
Uzbekistan	30	36
Transition Economies 1/	**37**	**43**
Developed Countries 2/	**12**	**12**

Source: Schneider (2005), Lackó (2000)

1/ Excluding Bosnia and Herzegovina
2/ Belgium, Canada, Ireland, Italy, and USA. Lackó estimates are for 1990.

C. NOA in Bosnia and Herzegovina

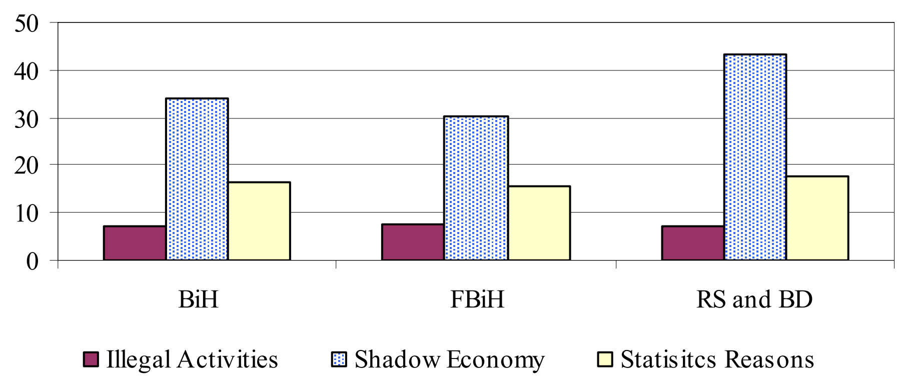
7. **BiH makes no adjustment for NOA in the official published GDP numbers**. Lack of administrative resources and proper organizational incentives has delayed

initiatives to address this shortfall. In this context, some foreign donors have produced their own "informal" estimates of NOA activity in BiH, but these have not been reflected in any official agencies' data.

8. **BiH's NOA implied by non-official application of "direct methods" appears to be similar to those implied by official adjustments to data in CIS economies.** The estimates of the IMF Statistical Advisor in BiH suggest that NOA was around 40 percent of unadjusted (official) GDP in 1999-2002, albeit on a declining trend.[4] This would put the NOA at some 28 percent of total—officially published GDP plus NOA—activity, suggesting that NOA in Bosnia and Herzegovina is proportionately close to the CIS group and above those for other transition and former Yugoslav countries (Table 2).

9. **A more recent study, applying the "direct method" to BiH assessed NOA at 58 percent of official GDP in 2001 (Text Figure 1).**[5] This would put the NOA at some 40 percent of total activity, much higher even than the official adjustments using direct methods that are made in the CIS area. This study also attempts a decomposition of the NOA sector (See annex 1). This finds that only around seven percentage points of GDP of their NOA estimate concerns illegal activities. This suggests that shortcomings in the statistical system, rather than illegal activity, overwhelmingly account for difficulties in reflecting NOA in official data (Text Figure 1). On these estimates, the largest share of NOA comprises the shadow economy. Enterprises underreporting revenue, companies using false registration numbers, and small merchants produce a third of BiH's and more than 40 percent of Republika Srpska's (RS) officially published GDP.

Text Figure 1. Bosnia and Herzegovina: Structure of NOA in 2001
(In percent of respective officially published GDP)



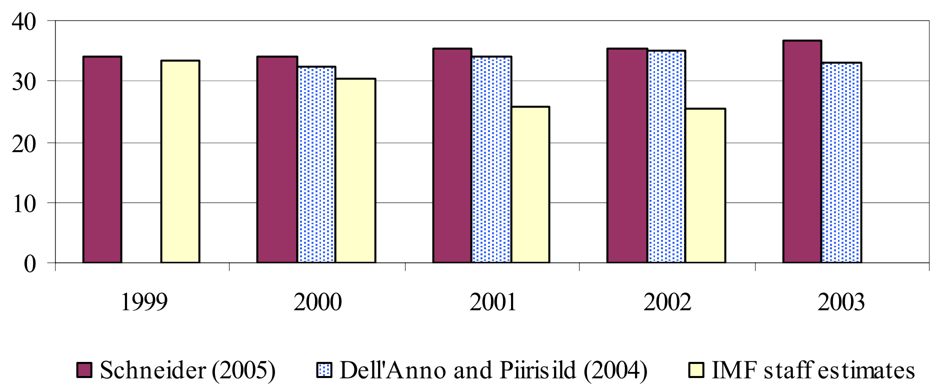
Source: Dell'Anno and Piirisild (2004)

[4] IMF Country Report No. 04/54, March 9, 2004.

[5] Dell'Anno and Piirisild (2004) for the Financial Services Volunteer Corps.

10. **However, while indirect methods applied internationally generally imply that official adjustments for NOA are too cautious, this does not appear to be the case for BiH (See Text Table 2).** Two sets of NOA estimates applying the latent variable approach to BiH are available.[6] According to both of them, the grey economy was 30–37 percent of officially published GDP in 1999–2003, lower than—rather than well above as is typical in international experience—the available estimates yielded by "direct" methods. The reasons for this are not clear. Nevertheless, note also that the two indirect estimates differ regarding the trends, with Schneider (2005) setting it on an increasing trend, while Dell'Anno and Piirisild's (2004) estimates suggest that it has decreased slightly since 2002 (Text Figure 2).

Text Figure 2. Bosnia and Herzegovina: Estimates of NOA, 1999-2003
(In percent of officially published GDP)



D. New Estimates of NOA

11. **Both direct and indirect approaches suggest significant NOA in Bosnia and Herzegovina.** But, surprisingly, the direct estimates are higher than those yielded by indirect methods, raising some doubts as to the reliability of both. In this light, a further approach was attempted to estimate NOA in BiH.[7]

12. **Extending the one-variable methods using currency in circulation and electricity consumption, it uses international panel data to estimate the "typical" correlation between such variables and GDP.** The values of those variables for Bosnia and Herzegovina are then inserted into the equation, yielding the "estimated GDP for BiH." The difference between that and "official GDP" is the implicit estimate of NOA.

[6] Dell'Anno and Piirisild (2004) and Schneider (2005).

[7] The approach builds on Beckerman and Bacon (1966) and Gilbert (1982).

13. **The exercise proceeded in several steps.** Variables for which observations are available after 1999 in BiH were identified—such as telephone lines, health, and macroeconomic indicators. Data on the same variables for a panel of some 193 countries were assembled, and the bivariate correlations of each with nominal GDP were calculated and those with low bivariate correlations were discarded. The variables remaining were included in a large regression, and progressively eliminated using a standard "step down" procedure until a parsimonious regression remained (Text Table 3).

Text Table 3. Pooled Regression with Robust Standard Errors, 1999-2002

Dependent Variable: GDP per capita (in logarithm of US dollar value)	Coefficient	
Currency in circulation per capita (in logarithm of US dollar value)	0.065 (0.033)	**
Exports per capita (in logarithm of US dollar value)	0.272 (0.035)	***
Health care expenditures per capita (in logarithm of US dollar value)	0.489 (0.045)	***
Cereal production (in logarithm of kilograms per hectare)	0.070 (0.040)	*
Number of air passengers per capita (in logarithm)	0.031 (0.019)	
Population below 14 years of age (in percent of total population)	0.005 (0.003)	
Rural population (in percent of total population)	0.003 (0.002)	
Debt service of public an publicly guaranteed debt per capita (in logarithm of US dollar value)	0.005 (0.028)	
Constant	2.712 (0.454)	***

R-Squared: 0.9574
Number of Observations: 349
Number of Countries: 96 (Excluding BiH)

Note: Standard errors are in parenthesis. *** - significant at 1% level, ** - significant at 5 % level, * - significant at 10 % level

Data source: World Development Indicators, International Financial Statistic

14. **Only a few variables have high explanatory power**. Among them health care expenditures, exports, and currency in circulation "account for" more than 90 percent of the

variation in GDP.[8] The set of "significant bilateral correlation" variables was available for 96 countries in the period 1999–2002, among them 22 transition economies, 44 low-middle income countries, and 22 conflict and post-conflict countries.[9]

15. **On this basis, NOA in BiH is significant.** Between 1999 and 2002, the available indicators fitted to the full sample of available countries suggest that official GDP estimates in BiH should be increased by 30–33 percent (Text Table 4, Text Figure 3a). This is the level of activity which would be expected from that array of indicators based on international experience.

16. **Note this is not to say that NOA *is* some 1/3 of official BiH GDP.** Two considerations apply here.

- First, the exercise reports that those health and other indicators in the regression in BiH would, internationally, be associated with "*official*" GDP estimates 1/3 higher than is the case in BiH. Given that evidence from indirect estimates is that internationally, GDP is also underestimated, the implied NOA could be a higher proportion of BiH published GDP data still.

- Second—and this goes in the opposite direction—the implied discrepancy between published and "estimated" GDP could reflect factors other than NOA. For example, if some characteristic of the BiH economy compromises efficiency by more than is typical in international experience—such as post-conflict complications or X-inefficiencies in the corporate sector—then true GDP in BiH will be below levels which would otherwise be predicted on the basis of international experience, given the BiH scores for health and other indicators.[10] The intuition here is that "potential GDP", as suggested by these health and other indicators, could be above "actual" BiH GDP. If so, then the discrepancy between estimated and published BiH GDP exaggerates NOA.

17. **With these key caveats, further conclusions can be drawn.** The regression was reestimated excluding all transition economies, and it was used to "predict" BiH GDP. On this basis, official GDP in BiH would be expected to be some 45–50 percent higher than reported, based on non-transition international experience (Text Table 4, column 2). This,

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[8] Note that causality cannot be inferred from this regression—good health does not "cause" high GDP—because no corrections for endogeneity have been made. The exercise yields correlations, not causation.

[9] According to the World Bank's income classification, BiH is in the group of low-middle income countries. The armed conflict classification is from the Center for the Study of Civil War: http://www.prio.no/cwp/armedconflict.

[10] See Chapter 4.

along with the first result, implies that underreporting (or output impairing inefficiencies) is systematically heavy in the transition area. This possibility is also suggested by an exercise re-estimating the regression using non-transition countries, and comparing "forecast" with "published" GDP for all transition countries' GDP (Text Table 4, column 3). And a similar exercise confirms for Former Yugoslav countries suggests that they also significantly underreport activity compared with international non-transition experience.

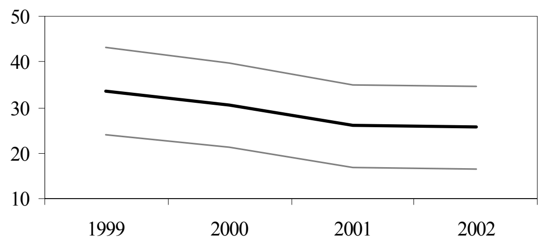
Text Table 4. NOA in Transition Economies Relative to the Rest of the World, 1999-2002
(In percent of official GDP)

Year	Bosnia and Herzegovina (Based on All Countries)	Bosnia and Herzegovina (Based on Non-Transition Countries)	Transition Economies (Based on Non-Transition Countries)	Former Yugoslav Republics (Based on Non-Transition Countries)
1999	33	50	30	30
2000	30	50	29	34
2001	26	41	27	29
2002	26	39	23	21
Average	29	45	28	29

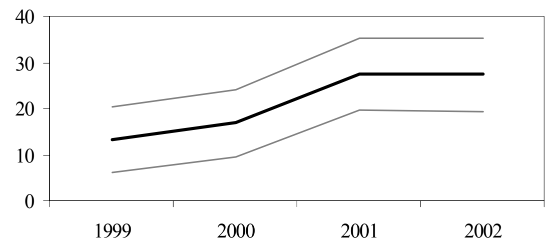
Source: IMF Staff Estimates

18. **Moreover, within the cluster of transition economies, BiH's NOA has increased in 1999–2002**. This finding suggests that BiH lags behind other transition countries in meeting OECD's exhaustiveness criteria for GDP compilation, in combating grey activity, or/and in curtailing production inefficiencies (Text Figure 3b). Similarly, BiH exhibits high NOA estimates relative to low middle income and conflict and post-conflict economies, respectively (Text Figures 3c–3d).

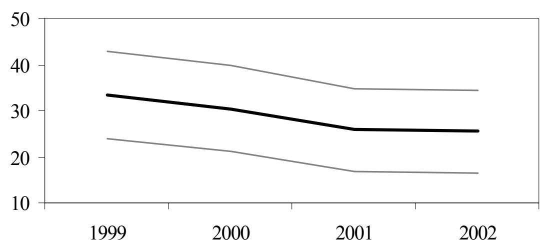
Text Figure 3a. Bosnia and Herzegovina: Size of NOA Based on 96 Countries
(In percent of official GDP)



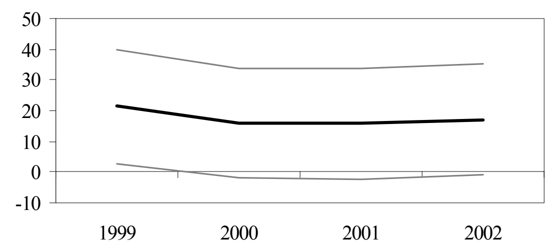
Text Figure 3b. Bosnia and Herzegovina: Size of NOA Based on 22 Transition Economies
(In percent of official GDP)



Text Figure 3c. Bosnia and Herzegovina: Size of NOA Based on 44 Low Middle Income Countries
(In percent of official GDP)



Text Figure 3d. Bosnia and Herzegovina: Size of NOA Based on 22 Post-Conflict Countries
(In percent of official GDP)



Source: IMF Staff estimates
Note: Grey lines represent two standard deviations around NOA estimates.

E. Concluding Observations

19. **Considerable evidence points to understatement of activity in official BiH national accounts data.** Direct, indirect, and the staff methods—just described—all point in this direction. Staff estimates—30–50 percent—straddle the IMF Statistical advisor's and other "direct" estimates prepared for BiH, reported in ¶8–9. However, this "confirmation" of the range of those estimates, even in the face of direct and indirect estimates of similar magnitude, is qualified to the extent that our methodology does not allow estimates for NOA to be distinguished from deviations of actual from potential output.

20. **On this basis, the case to commence efforts in BiH to make adjustments to official data for NOA are strong.** Even if, like countries in the region, these adjustments are modest initially, this would strengthen the national accounts statistics. Efforts to set up surveys etc which could form the basis for such "direct method" adjustments would therefore be appropriate.

21. **But the evidence that NOA is disproportionately large in BiH is mixed.** The direct and indirect measures, as well as the staff estimates, put BiH somewhere in the middle of the CIS group, although this group does seem to have disproportionately large

non-observed activity compared with other countries internationally. And while the staff approach suggests that NOA in BiH is high relative to transition and Former Yugoslav cases, this conclusion is qualified by the "potential output issue."

22. **Subject to this last qualification, the available evidence implies that economic indicators for BiH measured as ratios to GDP, including current account deficit and government spending, are likely to be overstated**. But in assessing the implications for interpretation of such indicators, caution is warranted. Those other data, like the GDP data, also have shortcomings.

- So while an "upward revision" to GDP estimates would lower the estimated external current account deficit relative to GDP, it should be recalled that merchandise imports are also likely significantly underreported. For example, using the Central Bank measure of the current account balance in euros—which adjusts for this factor—and expressing that relative to "adjusted" GDP 50 percent higher than the official estimate, yields a deficit of 16 percent of GDP, close to the current staff estimate of 17 percent of GDP.

- Similarly, though on staff data—used because the authorities do not compile data on this key aggregate—consolidated government spending accounts for some 50 percent of GDP, this takes no account of road funds and other extra budgetary funds below entity central government level, nor of quasi-fiscal activities which could be considerable, notably in the corporate sector.[11]

23. **All these considerations underscore the need to strengthen statistics to provide better guidance for policymaking and surveillance.** This would form a key par of BiH's strengthened fiscal architecture.[12]

[11] See Chapter 4.

[12] See Chapter 10.

Annex 1. Decomposing NOA

Dell'Anno and Piirisild (2004) estimated, for 2001, all NOA elements in BiH except the effect of outdated registries and omission of businesses for statistical reasons.

- To estimate the size of NOA due to non-response, Dell'Anno and Piirisild used information from the Federation Bureau of Statistics, which evaluated that non-response was around 10 percent of surveyed units. The same percentage of non-response was assumed to hold in the RS. Non-response accounted for 5.9 % of official GDP.

- Underreporting of value added was calculated using tax inspections data from the RS Tax Administration. Undeclared sales amounted to seven percent of large tax payers' declared sales, or, as roughly estimated, 21 percent of declared sales of all tax payers. Underreporting, adjusted with an estimate for restaurant tips, was evaluated at 12.7 percent of official GDP.

- Using Federation tax audit data, unregistered activities were estimated as the ratio of discovered underground businesses to active legal entities. The underground value added amounted to 2.3 percent of official GDP.

- The size of the informal sector was estimated by reducing labor productivity in the formal sector and multiplying it by the number of informal workers from World Bank (2002) data. The procedure was carried out for each branch of the economy and each entity separately. With an additional assessment of actual and imputed rents, the size of the informal sector was estimated at 29.4 percent.

- Illegal production estimate was based on information about the average bribe amount and the percentage of the population having paid bribes, as well as a CBBH's assessment of the value added of prostitution activities. Illegal production was evaluated at 7.3 percent of official GDP.

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VI. Fiscal Sustainability and Budget Spending[1]

A. Introduction

1. **In 2004, a major restructuring of government domestic liabilities and strong budgets were adopted.** The former, the "domestic claims plan", envisaged lowering government domestic liabilities from over 200 percent of GDP to a NPV of 10 percent of GDP. And the 2004 budgets targeted an underlying primary surplus of 1 percent of GDP. These actions together were consistent with fiscal sustainability—i.e., with non increasing ratios of public debt to GDP and overall fiscal balances which can be financed. They therefore put in place a major ingredient for economic growth.

2. **But fiscal sustainability is not secure.**

- First, the constitutional court has rejected the terms of the domestic claims plan in the Republika Sprska regarding war damages, and of that in the Federation concerning frozen foreign currency accounts.
- Second, domestic liabilities of government may increase further due to restitution payouts now under discussion and in the context of write offs of corporate arrears for pension contributions.
- Third, various public expenditure plans, including some sought by the International Community, would greatly increase public spending.

3. **This note assesses the significance of these three issues and draws policy implications**. To do so, it quantifies the permanent cuts in budget spending that these developments imply is necessary to reestablish fiscal sustainability.

4. **The implications are stark.** The necessary cuts in budget spending are large. If the court ruling on domestic claims means in NPV terms that a quarter of the current estimate of total claims must be paid, if restitution and pension arrears write-offs are moderate, and the priority projects proceed as now envisaged, permanent cuts in budget spending of at least 7 percent of GDP (KM 980 million) will be needed. That is almost exactly than the spending of one of the Entity Central Governments. These funds will be needed to pay the debt and pension payments and to fund the priority projects.

B. Domestic Claims

5. **Several laws restructured domestic liabilities of governments in 2004:** the Republika Sprska (RS) law of July 2004, the Federation law of November 2004, and parallel laws for the State and Brcko District. These were based on best—but inadequate—estimates

[1] Prepared by Peter Doyle.

of the various liabilities of government available at the time—for war damages, expenditure arrears, frozen foreign currency accounts, to banks, and so on. They anticipate "verification" processes now underway to check each individual claim. And they anticipate settlement of the claims in a mix of cash payouts, which have already begun, and zero coupon or sub-market coupon bonds with maturities up to 50 years. Terms of the payouts were anticipted to reflect the verified claims.

6. **The below market coupon long bond structures reflected legal advice from the authorities on what they anticipated might be accepted by the courts.** Given a technical assessment that all claims could not be paid in full consistent with the authorities' public expenditure ambitions, it was suggested that courts could accept payouts of nominal sums equal to the claims via long term sub-market interest bonds. This was anticipated to secure an acceptable balance between the rights of the claimants and the public interest in solvency of government in the assessment of the courts.

7. **The structure of the domestic claims plans was the outcome of a complex negotiation**. Within the constraints of fiscal sustainability and very different indebtedness of the two Entities, efforts were made to secure reasonably common treatment of classes of claims between the two Entities, notably in respect of frozen foreign currency holdings.

8. **But the RS restructuring was struck down in court.** On December 17, 2004, the Constitutional Court of Bosnia and Herzegovina heard an appeal against the Republika Sprska for failure to implement a ruling of the Basic Court in Banja Luka of 12 April 2002. The 2002 ruling was in respect of compensation of KM 24,000 (Euro 12,000) due from the Ministry of Defense to the widow and son of a man killed during the war as a reserve soldier in the RS army. The Constitutional court concluded, in respect of the "Law on Establishment and Manner of the Internal Debt of the Republika Sprska of July 2004":

> "Regardless of the evident public interest of the state to adopt this law, due to the enormous debt which was incurred as a result of the pecuniary and non-pecuniary damages caused by the war actions and which is contained in Article 18 of the Law in question, the Constitutional Court holds that by adoption of such law, an excessive burden was placed on the individuals and therefore the requirement of proportionality between the public interest of the community and fundamental rights of individuals was not met. The Constitutional Court sees the excessive burden which is placed on the individual in the fact that Article 21 paragraph 1 of this Law provides that claims which were established in the legally binding court judgments shall be settled "by issuing of bonds with the maturity date of up to 50 years" which justifiably imposes the question whether any of the citizens who will possess such type of bonds will live to charge these bonds and thus realize their rights. Moreover, the challenged law provides that the obligations shall be settled without interest rates being charged, which, considering the mentioned grace period, surely means that the amounts to be paid out to the individuals shall be considerably diminished."

9. **This was followed by a set of rulings on Frozen Foreign Currency Deposits.** On April 6, 2005, the Human Rights Commission (HRC) of the Bosnia and Herzegovina Constitutional Court delivered a decision concerning the treatment of these accounts in the Federation. While the court found that interest due on the frozen accounts after January 1, 1992 could be validly written off in the public interest (para. 1243) and that the verified claims could be paid in the form of bonds, both as the 2004 law anticipated, other aspects of the restructuring were adjudged to violate the account-holders' constitutional rights to property and to a fair trial. Notably, the court mandated that the maturity of the bonds should not exceed 15 years and that they should carry fair interest, i.e., the value that "would reflect the realistic value of invested foreign currency, including the average rate of inflation (paras. 1245 and 1246). The court also laid out a number of procedural requirements. These include that the State (rather than the Entities) should issue a law governing the frozen foreign currency accounts within six months, and that this law should provide explicit constitutional justification for any difference in treatment of claimants, including between the two Entities.

10. **Much about these rulings is unclear.** They both recognize that a balance has to be struck between the public and individual interest. But they find that this balance is not appropriately struck in by the July 2004 RS and November 2004 Federation laws. And the implication, in the last sentence of the December ruling, that "considerable diminishment" of the claims is unwarranted could imply that only "moderate" write downs would meet the criteria of the court. And though the December ruling refers to the RS law's treatment of war claims only, it is likely that the Federation Law's handling of war claims would be adjudged similarly if it was to be tested in court. Similarly, it is likely that the ruling on Federation Frozen accounts would affect the RS law on those accounts, given that it provided for even less generaous payouts than those envisaged in the Federation law.

11. **But the implications are sobering.** If, for illustration, the courts were to impose requirements implying that a 75 percent NPV write down of claims as "not considerably diminished", that would leave Bosnia and Herzegovina (BiH) with domestic indebtedness with a NPV of some 50 percent of GDP. This assumes that the estimates of total claims are correct, at about 200 percent of GDP. Focus on this possible estimate of the NPV payout is helpful because under some assumptions—notably that the court approves cancellation of privatization vouchers still outstanding—it coincides with plausible interpretations of the court's rulings on frozen foreign currency accounts.[2] In particular, if the court mandate for "fair" interest rates means that "market" interest rates be paid, and that they be paid on *all* bonds to be issued as part of the domestic claims settlement with accrued interest to date on *all* claims written off (not just Federation frozen foreign currency accounts), then the NPV of the total payouts could amount to some 50 percent of GDP.

12. **To assess the implications, the sustainability analysis underpinning the original domestic claims plan is repeated (Text Table 1).** Column (a) shows the analysis underlying

[2] Such interpretations will need to be confirmed by the authorities and the courts.

the domestic claims plan that recognition of new claims with an NPV of 10 percent of GDP is compatible with non-increasing government indebtedness in a long-term scenario. As before, it abstracts from the short term characteristics of the Bosnia and Herzegovina economy, and assumes real interest rates 2 percentage points above long term growth.[3] A primary surplus of 1 percent of GDP yields non-increasing indebtedness and a financeable overall balance in this context.

Text Table 1. Public Debt (In percent of GDP)

	2003	2010 (a)	2010 (b)	2010 (c)
NPV domestic claims in 2004		10	50	
NPV of public debt	26	33	76	61
Primary balance	1	1	1½	4
Overall balance	-1	-1	-4	-½
Real interest rates less real GDP growth	4	2	2	2

13. **Column (b) derives the primary balance needed to secure sustainability if claims of 50 percent of GDP are recognized instead.** It shows that the sustainable primary balance rises to a surplus of 1½ percent of GDP. But note that a budget primary surplus of 1½ percent implies an overall deficit of 4 percent of GDP—on account of the added burden of interest payments accruing from the court-mandated domestic debt of government. This overall balance could not be financed in an orderly manner—without arrears. Creditors cannot be found to supply that volume of credit annually, now, and would be even less willing to do so in the context of high debts.

14. **So column C shows that the budget primary surplus would need to strengthen to 4 percent of GDP in 2010 to yield a financable path for the overall budget deficit upto then.** And even a budget this strong, maintained throughout the medium term, would suffice only to lower the NPV of public debt to just over 60 percent of GDP by 2010.

15. **Given budget revenue ratios to GDP, the implications for spending are stark.** Increasing the primary surplus to 4 percent of GDP would require permanent reductions in public spending, compared to the 2005 budget levels, of 3 percent of GDP or some KM420 million. Even if the entire Federation Central Government program of benefits for war veterans was to be cancelled as part of efforts to realize this adjustment, this would not suffice. A further KM 120 million in savings would still be needed, equivalent to approximately one third of all administrative expenses of the State.

[3] See Chapter 4, *Domestic Claims on the Governments*, IMF Country Report No. 04/54, March 9, 2004..

16. **These are "low range" estimates of the permanent budget spending cuts required.** If the constitutional court rulings necessitate payouts with an NPV of more than 50 percent of GDP, say 75 percent of GDP, to avoid "considerable diminishment", then even larger permanent cuts in spending will be required. And further, in quantifying the necessary cuts, the differential between interest rates and real GDP growth has been assumed to be unaffected by the level of debt. But with the much higher debt burden than was anticipated under the domestic claims plan, this differential would likely be higher: credit risk premia would be higher; and GDP growth would be lower for lack of the contribution of public spending to the structural strengthening of the economy. Both factors would increase yet further the estimates of the budget spending cuts necessary to maintain fiscal sustainability—non increasing public debt ratios, and overall fiscal balances which can be financed. Only if verification processes yielded total claims below those currently estimated would these implications for spending be overstated. Verification could do that, as well as the reverse. And since these are "low range" estimates—assuming that the estimates of total outstanding claims are approximately correct—adjustment even on this magnitude would not necessarily be sufficient for a program with the Fund.

17. **Primary surpluses on this order of magnitude are not without international precedent.** Other highly indebted and distressed economies run similar surpluses, including Turkey (primary surplus 7 percent of GDP in 2004) and Argentina (primary surplus of 5½ percent in 2004). But the adjustment would be challenging.

18. **In addition, without a court-endorsed overall framework, lower courts can mandate immediate execution of awards to litigants.** These awards threaten normal government operations which depend on the cash and assets seized. And given that the total of litigants' claims is too large to be met, the several thousand cases now in the courts amount to a "run on government deposits and assets" through the courts. This threat has already been realized in the case of a RS Municipality, Trebijne. Other government units are similarly exposed. With a large number of court cases coming through, the immediate cash flow burden to settle court awards could be heavy—requiring immediate cuts in spending. Depending on the flow of cases and awards, these demands to implement awards—the cash flow effect—could require spending cuts even greater than those discussed above.

19. **What are the options?** The authorities will need to identify as soon as possible the level of NPV of domestic debt that would be accepted by the courts as constitutionally valid. That will require prompt identification of how this determination can be done speedily in this legal system, so as to minimize delays thet would be inherent in an iterative process of amending the restructuring law and waiting for further judicial review of the amended laws in the context of dispute submitted to the courts. These options need to be examined promptly.

C. Restitution and Other New Claims on Government

20. **Challenging as the issues above are, they are compounded by additional domestic claims on government.** A commission is examining restitution issues, likely

focusing on those post 1945. It will need to consider which type of such claims shall be deemed valid, which kinds will be enforced by the courts, how much and in what form compensation shall be paid, and which tier(s) of government shall be liable for such payments. With claims dating back so far—and possibly including property seizures occurring during the 1992–95 war—the sum of potential claims is very large indeed, albeit unknown now.

21. **There is need for the Commission to specify payouts consistent with fiscal sustainability.** Given the sustainability analysis completed by Fund staff in the context of preparations for the 2004 Domestic Claims Plan, and assuming that the Court rejection of that plan were to be reversed, there is room for payouts with a NPV of some two percent of GDP. Larger settlements would require the sort of offsetting cuts in budget spending noted above. And given the court rejection of the 2004 domestic claims laws, there would appear to be little scope for any payouts under restitution as the outstanding claims on government already require such large offsetting budget spending cuts.

22. **For similar reasons, claims emanating from prospective corporate restructuring need to be minimized.**[4] The most difficult issue in this context is arrears of pension contributions—the so called "gaps" in worker contribution histories. These gaps diminish affected pensioners' monthly pensions, which are determined in relation to paid, not accrued, contribution histories.

23. **Social pressure to ignore these contribution gaps in determining monthly pensions is strong.** But accommodating this demand would increase the stock of claims of citizens on government yet further in the form of future pensions, without any corresponding increase in revenue to pay for them. Under the current pension system, which operates on a cash-rationing basis, such a shock to eligibility could—theoretically—be handled by lowering the average pensions of all other pensioners pro-rata until monthly total pension payouts again matched monthly collections. But such a radical adjustment (cut) in the monthly pensions of existing pensioners would be socially difficult to absorb. So, if pension contribution gaps were to be simply ignored, this would represent yet a further claim on government, driving it even more deeply into debt. A resolution here needs to provide at most partial closure of these gaps, conditional on fundamental restructuring of the companies involved so as to provide resources for the corresponding pension payouts from economic growth borne of that profound restructuring.

D. Consolidated Government Expenditure

24. **The sustainability concerns above could imply need for large permanent spending reductions.**

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[4] See Chapter 4.

25. **But many plans to strengthen Bosnia and Herzegovina imply more, not less, public spending.** There are many aspirations to raise public investment. And various other priority spending projects are also under consideration (Text Table 2). These include shifting

Text Table 2. Costs of Priority Projects

Project	Increase in budget spending in percentage points of GDP	Lead International Agency
1. Police reform	0.6 permanently, even including downsizing of 17 percent, and somewhat higher including the transitional and costs of meeting the requirements of the civil service laws.	EU
2. Defense reform	0.6, if there is no wage cut at the State level and no downsizing from end 2004 levels. Downsizing by 1/4 could bring the cost down to 0.1. See Table 1.	NATO, OHR
3. Civil service reform	New civil service laws are now being implemented in the State and Entities. These require ethnically diverse composition of the governments in accordance with the 1991 census. So the authorities are now recruiting with ethnic targets in mind, affecting the flow, but more radical—and expensive—steps are also proposed.	EU
4. Expansion of Cantonal and municipal spending	The lead agencies call for borrowing to be capped to prevent debt service exceeding 10 percent of revenues. This could accommodate increased borrowing of upto 4 percent of GDP, funded by these agencies and commercial banks. Flows of up to 2 percent of GDP are likely under this proposed rule	USAID, EBRD, IBRD, Kreditanstalt (KfW), EIB.
5. Expansion of state institutions	Estimates of the permanent cost of new, mostly EU required, institutions are not yet available. But the list of these institutions is long, and many existing institutions apparently require considerable additional staff.	EU, OHR
6. Increased budget investment and operations and maintenance spending	In recent years, on and off budget (aid) investment spending has collapsed. There is a consensus that on-budget investment should increase significantly, both to reverse the recent decline and to switch investment from off- to on-budget. Road-repair and building is one major objective—The EBRD has already committed lending of ½ a percent of GDP for this purpose.	IBRD, EBRD

security functions from the Entities to the State, efforts to ensure ethnic diversification at all levels of the governments' civil service, expansion of Cantonal and municipal activities in infrastructure and provision of public services, and establishment and expansion of many institutions at State level in order to meet the requirements of eventual EU accession.[5] These priority projects are strongly backed by the International Community and by many amongst the authorities.

26. **Even under the now rejected domestic claims laws, these priority projects would have been difficult to accommodate within the fiscally sustainable primary surplus of 1 percent of GDP consistent with those laws.** As currently configured, they will raise public spending by some 4 percent of GDP or more permanently, with transitional costs above that in a number of cases.

27. **These increases cannot be funded from additional revenue**. With fiscal revenue (including grants) some 49 percent of GDP and the tax authorities hard pressed to raise even that amount, scope for expansion is limited. Even the coming VAT may not provide relief.[6] Its yield is highly uncertain—given the poor quality of data on which estimates for the yield are based—and as with any major tax reform, the transitional implementation difficulties may prove to be severe.

28. **So permanent savings in "other" spending of at least 4 percentage points of GDP are required—equivalent to half of the RS central government budget to offset these high priority plans.** This will be a considerable challenge. There is certainly need and scope for a concerted effort by the authorities to eliminate low quality spending. But even if large adjustments in "wasteful" spending are secured—as they should be—there is need to economize in the proposed new spending programs. Coordination within the international community and between the international community and the authorities is needed to address this challange.

E. Conclusion

29. **The impact of BiH government excess liabilities—long hidden—is increasingly visible.** While this has been one of many factors discouraging new private investment, the fact that courts have, until now, not pressed the claims—or have been impeded from doing so by the various laws postponing enforcement—has limited the visible impact of insolvency on government operations. But with the courts increasingly processing such claims, the risk to operations is materializing. And increased activism by pensioners is also bringing the contribution gap issue into the open.

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[5] See Chapter 7.

[6] See Chapter 8.

30. **The 2004 domestic claims laws were intended to address this problem.** And the 2004–05 budget spending plans were consistent with them. The court's rejection of the RS and the Federation laws therefore represents a major challenge. If those rulings require even one quarter of the estimated outstanding claims to be paid in NPV terms, then permanent cuts in budget spending of some 3 percent of GDP will be necessary. In this context, there is urgent need clarify exactly what would meet the court's prescriptions. The cuts in budget spending that will eventually be necessary will depend on exactly what domestic claims settlements the court accepts as valid.

31. **Securing government operations from threats to cash flow arising from execution proceedings is also necessary.** This requires both a short-term remedy for the cases where awards have already been court-mandated, and a strategy to address cases still in the courts. The key element here will be effective monitoring of the latter, so that government lawyers can be fully prepared to make their case in each court.

32. **In this context, additional domestic claims on government should be minimized.** Thus, compensation for restitution and accommodation of old pension arrears must be strictly limited. This will need to be reflected in the recommendations from the restitution commission, as well as appropriate legal underpinnings for those recommendations. If such mandated restitution claims are large, then sizeable cuts to public spending could be required to reestablish fiscal sustainability in that context.

33. **Scope for the priority projects will be limited if the domestic debt of government is higher than anticipated in the 2004 domestic claims plans.** And even if those plans are reinstated and additional liabilities on government capped at low levels, major cuts in budget spending may be necessary to make room for the priority projects—because they require equal and offsetting cuts in other spending. These ambitions currently imply need for 4 percentage points of GDP or more in spending cuts.

34. **These matters have informed much recent IMF advice to Bosnia and Herzegovina.** They underlie the encouragement given to adoption of the domestic claims plan in the first place—to secure fiscal sustainability; to adopt it with a NPV of only 10 percent of GDP—to reflect the authorities' budget spending ambitions and legal advice that the courts might accept such arrangements; placement of one-off receipts into escrow—to fund court awards and other payouts; and the establishment of the "Fiscal Sustainability Group"—to identify expenditure cuts that will be needed to facilitate priority spending. And they account for encouragement given to those developing the priority spending plans to coordinate and rationalize them.

35. **But major budget adjustment may now be necessary.** If the estimates of total claims are broadly correct, if the court ruling implies that quarter of these must be paid in NPV terms, if restitution and closure of gaps in pension contributions are no more than symbolic, and if priority projects are implemented as now configured, then permanent budget spending cuts substantially more than 7 percent of GDP are required. But as noted at the outset, that amount is equivalent to the annual spending of one of the Entity Central

Governments. This spending would be cancelled entirely—not shifted to other levels of government. Instead, the resources released by these actions would be needed for the additional burden of government domestic debt and pension payments and the priority projects, consistent with fiscal sustainability.

VII. The Value Added Tax[1]

A. Introduction

1. **The task of introducing a value added tax, now scheduled for end-2005, has been unusually challenging.** In addition to the change in tax structure and the technical preparations of tax officials and taxpayers, which have exact parallels with VAT reforms elsewhere, this reform in Bosnia and Herzegovina (BiH) has required:

- abolition of multiple prior sales taxes;
- arrangements to shift the constitutional competence for indirect taxation from the Entity to State level;
- a step by step unification of multiple indirect tax and customs administrations;
- new arrangements for policymaking structures governing indirect taxation; and
- a new configuration of rules to allocate indirect tax revenue between the different governments.

Many of these steps have been completed. But difficult challenges remain to be resolved before VAT can go into effect.

2. **This chapter has four parts.** First, it outlines the "starting point"—the sales tax and its administrative structures—from which the VAT initiative began some two years ago. Second, it describes steps already taken to build structures needed for VAT. Third, it outlines the main features of the VAT. And last, it outlines what remains to be done before VAT implementation can proceed.

B. Tax Policy and Administration in 2003

3. **Until late 2003, indirect tax policy in BiH was determined and mostly administered at the Entity level.** [2] The State was responsible for foreign trade policy and customs policy, including determining external tariffs (Figure 1). The entities and the Brcko District (BD) each had their own "domestic" indirect tax legislation (implying three sales tax, three excise tax laws etc). This domestic legislation was administered by three separate tax administrations, one in each Entity and a further administration in Brcko District. The entities also administered customs taxes and collected these within their own jurisdictions. These arrangements reflected arrangements set out at Dayton.

4. **The entities did not coordinate sales or excise tax policy or administration.** Given the absence of internal borders, this generated significant tax competition, instability in revenue, and a non-harmonized indirect tax structure (Box 1). It also induced significant tax fraud and corruption, notably given absence of cooperation amongst the tax administrations with each other in verifying taxpayer returns, resulting in major revenue losses (Table 1). All these problems compounded those typically associated with all sales taxes (Annex 1).

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[1] Prepared by Nombulelo Wandwasi.

[2] The Entities are the Republika Srpska and the Federation.

Figure 1. Tax and Customs Policy Determination and Administration in BiH: Before Indirect Tax Reform

(2003 and earlier)

State

Responsible Ministry:
Foreign Trade and Economic Relations

Responsibility:
Foreign Trade Policy
Customs Policy

Federation

Responsible Ministry:
Ministry of Finance

Responsibility:
- Customs Administration
- Tax Policy (sales tax, excises, and direct taxes)
- Tax Administration (sales tax, excises, customs and direct taxes)

Brcko District

Responsible Ministry:
Ministry of Finance

Responsibility:
- Tax Policy (sales tax, excises, and direct taxes)
- Tax Administration (sales tax, excises, customs and direct taxes)

Republika Srpska

Responsible Ministry:
Ministry of Finance

Responsibility:
- Customs Administration
- Tax Policy (sales tax, excises, and direct taxes)
- Tax Administration (sales tax, excises, customs and direct taxes)

Box 1. Indirect Tax Structure in BiH Before the Indirect Tax Reforms

Up to 2003, each entity had its own indirect tax laws. These laws had different structures across entities. The RS law combined the regulation of excises with the sales tax in one law whereas the Federation had a separate law on sales tax and a law for each type of excise. Brcko had a separate law on sales tax and another law on excises.

There were differences across entities in the sales tax. The RS sales tax had a standard rate of 18 percent and a reduced rate of 8 percent with the sales tax on services at 8 percent. The Federation had a standard rate of 20 percent and a reduced rate of 10 percent with the sales tax on services at 10 percent. The sales tax rates in the Brcko District were similar to those in the RS. Exemptions and goods covered under the reduced rate also differed across entities. The tax base, however, included excises and customs in all entities and the District.

There were differences in excises across entities as well. For example, the excise on wine was KM0.20 per litre in the Federation and KM0.25 per litre in the RS; the excise on heating oil was KM0.09 per litre and KM0.30 per litre in the Federation and the RS respectively.

Table 1. Estimated Revenue Loss Due To Tax Fraud in BiH

Fraud	Revenue loss in million Euro (years)	In percent of GDP
Customs	43 (1997-1999)	1.1
	92 (2000-2003)	1.6
Sales tax	250 (2002-2003)	4.1
Due to shortcomings in customs procedures	250 (2002-2003)	4.1

Source: European Union-Customs and Fiscal Assistance Office and Staff estimates.

C. Steps Taken Towards the VAT

5. **From this starting point, steps towards VAT required multiple changes in tax policy and administration.**

6. **The changes began with the formation of an Indirect Tax Policy Commission in early 2003.** With active international community support, the commission was formed with representatives from the entities, the State and the international community. It was tasked to make recommendations to improve tax policy and administration, and three were central:

- Merge the customs administrations into a single unit,
- Establish a single administration for all indirect taxation, and
- Replace the sales tax with a VAT.

These recommendations were aimed at making BiH a "single economic space" and to secure a strong revenue base for government operations.

7. **In December 2003, the Indirect Tax System Law was adopted, establishing the Indirect Tax Authority (ITA).** Under this law, the ITA alone is charged with implementing indirect tax legislation.[3] It's Board consists of the State and the two Entity Ministers of Finance, and nominated "experts" and the Board is responsible for formulation of indirect tax policy, including making preparations to introduce the VAT.

8. **Movement from the devolved to the unified policy determination and administrative structure was planned to occur in stages (Figure 2).**

- In mid-2004, the Entity customs administrations were placed under the effective authority of the newly formed ITA. However, in this context, and for a temporary period, collection of sales tax and excises tax revenues on domestic consumption is still executed at Entity level and under Entity authority, while sales taxes and excises on imports are collected by the ITA directly.

- Alongside, preparations began to shift the sales and entity tax laws from Entity to the State level. This step would necessitate pooling of the receipts from these taxes into the so-called "single account," requiring a mechanism to distribute them from the single account to the various governments (Box 2). Agreement on this formula was reached late in 2004 and on December 31, 2004, new State-level sales tax and excise tax laws were passed and implemented on January 1, 2005, and the parallel Entity laws fell into abeyance.

9. **This last step secured harmonization of all these tax structures and laid the basis for the operation of the single account.** Thus, the sales tax has a standard rate of 20 percent and the reduced rate is 10 percent. The tax base includes excises and customs. Excise rates are also now harmonized across the entities.

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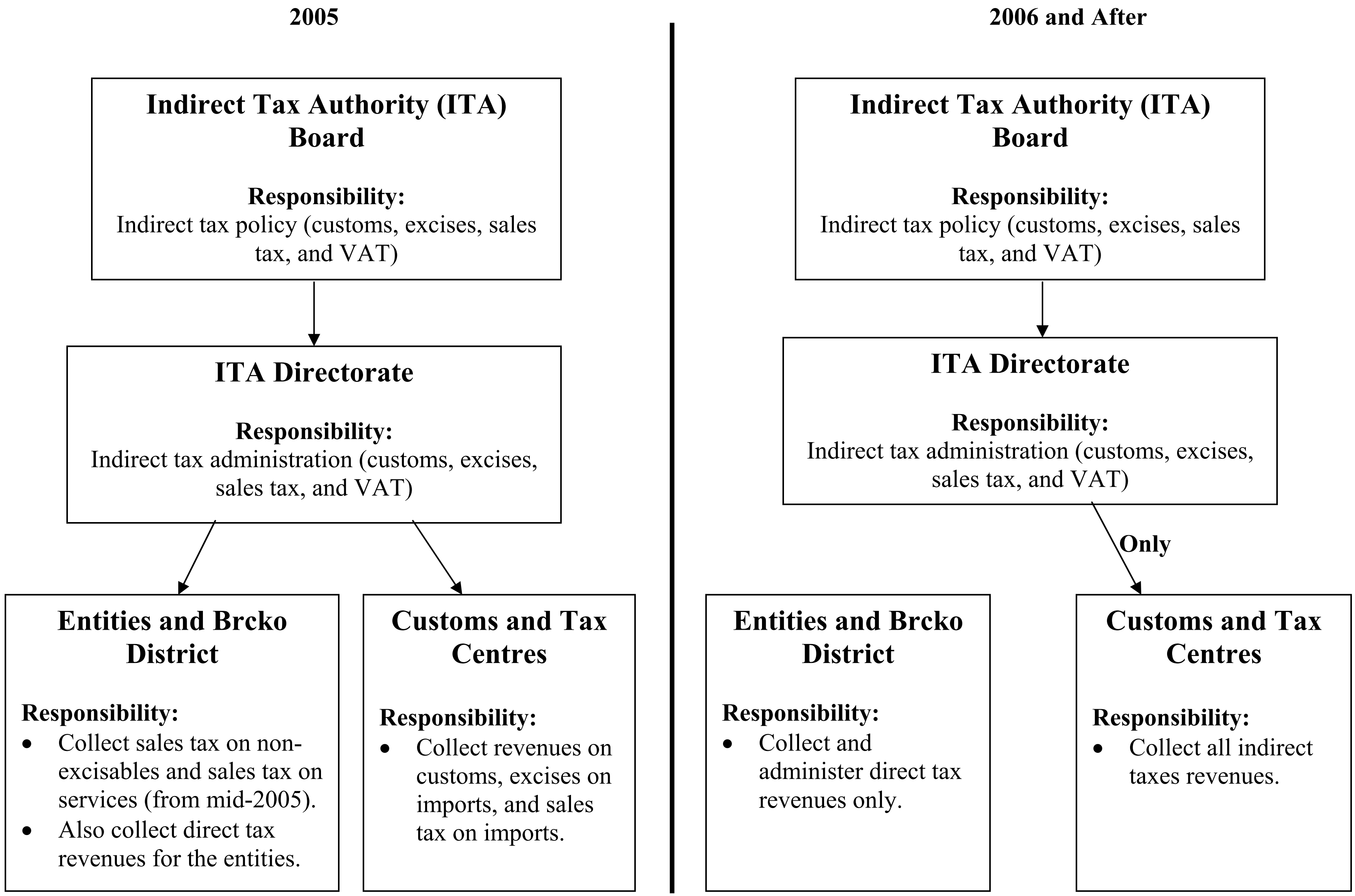
[3] Interpretations of the relationship between the ITA Board and the State Parliament vary, a key "fiscal architectural" issue. See Chapters 8 and 10.

Figure 2. Tax and Customs Policy Determination and Administration in BiH: After Indirect Tax Reform



Box 2. The Single Account

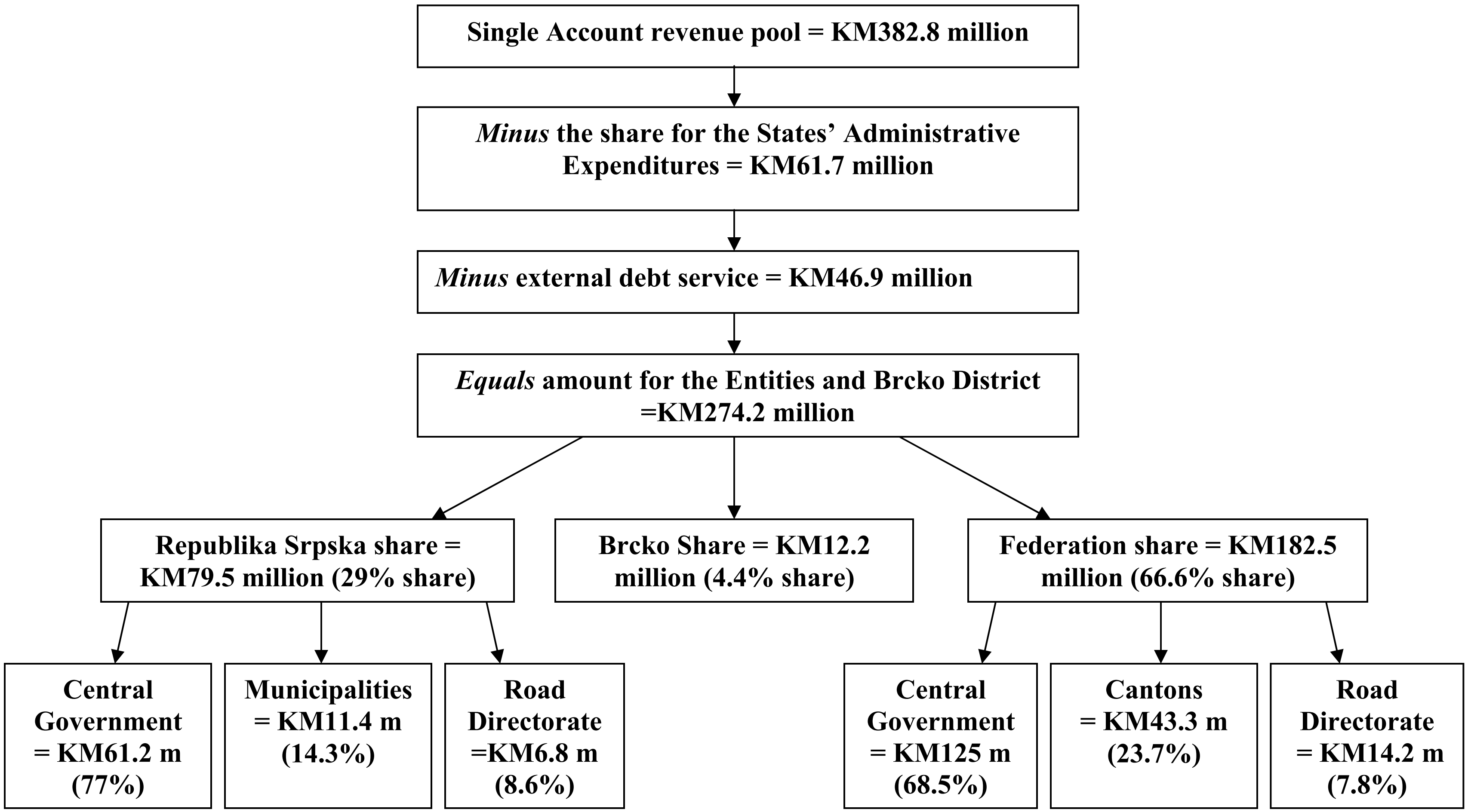
The single account became operational on January 1, 2005. Payments into the account are regulated under the Law on Payment Into the Single Account and Distribution of Revenues. Under this law, all indirect taxes (including import and export duties, excises, taxes chargeable on goods and services including the sales tax on excisables and the road tax) for which the ITA is responsible for must be paid into this account. These revenues started flowing through the Single Account when it became operational. Once VAT goes into effect, all VAT revenues will also be paid into this account.

Pooling indirect tax revenues in the single account required a means of distributing these revenues back to the Entities and the Brcko District. Currently, this is done according to coefficients based on Entity shares in final consumption as revealed in sales tax data. The law envisages that allocation coefficients will be calculated every month with the amounts due to the Entities and the BD to be allocated by multiplying the "relevant amount" in the Single Account by their allocation coefficients. The "relevant amount" is the total amount in the Single Account less the part for the State for financing the institutions of BiH, debt service payments, and the reserve. The allocation coefficient is the result of dividing final consumption for the Entity and BD over twelve months (as revealed by tax return data) by the sum of the final consumption in BiH for the same period. The allocation coefficients in the first part of 2005 for the Federation, Republika Srpska (RS), and the BD are 66.6 percent, 29 percent, and 4.4 percent respectively (Figure 3). However, for practical reasons, the "moving average" feature of the calculation of coefficients has not yet gone into effect, and the coefficients have been fixed for the first part of 2005. Once the ITA Board is satisfied that the practical difficulties in implementing the moving average system have been overcome, it will authorize a shift to the envisaged moving average system.

Indirect tax revenue distribution mechanisms also exist within the Entities. In the Federation, the Single Account revenue is shared between the central government, cantons, and the Road Directorate with the Federation central government receiving 68.5 percent, cantons 23.7 percent, and the Road Directorate 7.8 percent. In the Republika Srpska, the revenue is shared between the central government, the municipalities, and the Road Directorate with each receiving 77.1 percent, 14.3 percent, and 8.6 percent respectively (see Figure 3).

The Single Account consists of accounts at 12 commercial banks where individual revenues are collected. All revenues collected into these account are transferred to the Central Bank on a daily basis. The ITA uses the 12 commercial banks for purposes of refunds, and all payment transactions made are reported to the ITA on a daily basis. The modalities for the distribution of revenues from the Single Account are discussed in the following section.

Figure 3. Illustrative Example of the Distribution of Revenues from the Single Account[4]



[4] This illustration is based on payment from the Single Account in the first quarter of 2005.

D. VAT Structure

10. **The VAT law was approved in January 2005 and is generally modelled against the EU's Sixth VAT Directive.** This section describes the proposed structure of the VAT.[5]

11. **The VAT will be a single rate consumption tax, in contrast to the current retail sales tax with two rates.** The proposed VAT rate will be 17 percent.[6] This decision was controversial. The state parliament preferred two rates, following precedents in many other countries, emphasizing that replacing a two-rate retail sales tax with a single rate VAT would adversely affect the poor (Annex 2). But a single rate was eventually chosen in order to minimize administrative complexities that a multiple rate structure would imply, an urgent consideration given the many other administrative challenges in implementing the VAT in Bosnia and Herzegovina's specific case.

12. **The exemptions in the BiH VAT law follow closely the exemptions required in the EU's Sixth VAT Directive.** The VAT law exempts financial and monetary services, activities in the public interest, imports of diplomatic and international organizations, imports into and supply to and within customs-free zones and customs-free warehouses, and international transportation. Fewer goods will be VAT exempt than under the Sales tax.

13. **A registration threshold of KM50,000 (US$30,000) will be applied**. The threshold aims to balance the administrative and compliance costs against the need for additional revenue. In determining whether a threshold of KM50,000 is met, turnover of companies and other bodies under common direct or indirect control (through possession of shares or in any other way) will be taken into account. The turnover threshold of KM50,000 accounts for about 90 percent of the receipts reported on sales tax returns. It is estimated that about 4000 companies not currently registered for the sales tax will be required to register for the VAT.

14. **In line with good practice, the BiH VAT base includes customs duties and excises.** The VAT on imports is collected at the time when goods are entered for customs purposes. The VAT base also includes other import charges as well as other public revenues; any indirect costs charged by the supplier to the recipient of goods and services (such as commission, packaging costs, transport and insurance, etc.); and any costs of connection, installation charges, and other amounts charged to the purchaser by the supplier as a condition of supplying goods and services.

15. **The VAT law contains clear rules for the place of supply of services that is consistent with international practice.** The law specifies that the supply of services will be deemed to have taken place in BiH if the taxpayer has a permanent base in BiH from

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[5] The BiH authorities received extensive technical assistance (TA) from the IMFs' Fiscal Affairs Department (FAD) and from the European Union-Customs and Fiscal Assistance Office (EU-CAFAO) in the design of and preparatory work for the VAT.
[6] An FAD TA mission in June 2004 estimated that the revenue neutral rate is 16 percent.

which services are provided or, in the absence of such a base, has his permanent address or usual place of residence in BiH.

16. **Tax returns are required.** All taxpayers should submit a VAT tax return for each accounting period by the 10th day of the calendar month following the end of the accounting period and must pay the tax for each accounting period by the deadline for filing the return. VAT refunds will be paid within 60 days of submission of a VAT return. This is in line with best practice. However, given that the administration is new and is expected to be weak initially, dealing with refunds for all tax payers may be difficult.

E. Next Steps

17. **Despite progress made, five major challenges still lie ahead before VAT implementation can proceed.** These include: various technical preparations, including development of Information Technology (IT); incorporation of excise tax administration into the ITA; a comprehensive reform of arrangements to distribute indirect tax receipts among cantons and municipalities; arrangements to offset the impact of the VAT on the poor; and steps to anticipate uncertainty is collections in the initial period of VAT implementation.

Administrative preparations

18. **The following still needs to be completed:**

- Preparation of the information technology systems has been slow. Development of software for VAT returns and payment processing has just started. Computer software testing has not started and should start well in advance of implementation.

- Staffing and recruitment for the new VAT administration has lagged and progress is needed urgently. A number of recruitment-unfriendly rules in labour legislation, the inadequate quality of applicants, and a non-transparent recruitment process have hindered progress.

- Taxpayer education has started but should be much strengthened.

- The preparation of Regional Tax Centres is lagging and need to be ready in time for VAT introduction.

- Implementing regulations remain to be defined, including guidelines on taxpayer registration, and guidelines on enforcement procedures.

Incorporation of excise administrations into the ITA

19. **For purposes of administrative efficiency, excise administration will be incorporated into the ITA.** This will ensure that indirect taxes with closely related tax bases (i.e., customs duties, excises, and the VAT) are collected and controlled by the same administrative entity at the State level, as foreseen by the ITS law and the nationwide excise tax law that was adopted at end-2004. It will further help in preventing

tax induced distortions of production and trade, and will reduce companies' compliance costs. The integration has already taken place as far as excises on imported goods are concerned, while the deadline for the integration into the ITA of the administration of domestic excisables is July 1 this year. The deadline is expected to be met, in part because very few companies are involved, and the precondition is that no further excise taxes will be introduced.

Revenue Allocation for Cantons and Municipalities

20. **Intra-Entity distribution of indirect tax revenues will have to change.** Under the sales tax, collections were administered by the central government in the Federation and allocated to the Cantons and Municipalities. In the RS, collections were administered by the central government and shared between the central government and the municipalities. Even in the current "intermediate" stage—where the sales tax on excisables is pooled in the single account—this allocation rule remains viable (and in place) because the sales tax data are still collected and provide a basis to distribute those funds from the single account within each Entity on that basis. But this key will not be available once the VAT is introduced because tax origin will not be recorded under the VAT at the sub-entity level.

21. **The authorities are receiving TA in this area**.[7] Among the ideas being considered for replacing origin based sales taxes are the introduction of a uniform minimum municipal share of the new personal income tax (which is expected to replace the wage and citizen taxes by January 1, 2006), possibly combined with general equalizing revenue grants from the entity central governments directly to the municipalities, calculated as fixed amounts per capita. For the Cantons, different models involving general revenue grants are being analyzed. This work will need to be completed swiftly given the deadlines for the VAT.

Impact of VAT on the poor

22. **The authorities hope to address the impact of the VAT on the poor.** A FAD TA mission in March 2005 assessed this impact, finding as follows:

- The average increase in the tax burden is estimated at KM 300 (2.4 percent of consumption spending) per annum per household.
- The absolute increase in the tax burden falls disproportionately on richer households. Households in the upper income deciles would pick up about 16 percent of the increase in the total burden, while those in the lower deciles only about 4 percent.
- But as a proportion of household consumption, however, the *additional* tax burden (compared with the sales tax) is regressively distributed. It amounts to 2.6 and

[7] TA is being provided by the the Governance Accountability Project (GAP), financed jointly by USAID and the Swedish International Development Cooperation Agency (SIDA) and supported by the international community.

1.9 percent of consumption spending for the lowest deciles and highest deciles, respectively.

- There are also important inter- and intra-entity differences in the distribution of the additional tax burden. Households in the Federation will bear a higher burden than those in the RS. Also, urban households will be more adversely affected than households in rural municipalities.

23. **The FAD mission advised that an Entity-level social welfare program is the most appropriate instrument to compensate households which will be adversely affected by the VAT.** But establishing such a suitable mechanism will be challenging because the existing programs are poorly targeted and their separate policy formulation, financing, and implementation has resulted in wide variation of service provision across cantons and municipalities.[8] The mission favoured centralization of these social programs at Entity level and laws to this effect are being drafted with assistance from the World Bank.

Collection uncertainty immediately following implementation

24. **Even if all administrative preparations proceed smoothly, the revenue yield from VAT is uncertain.** The estimates of the "revenue neutral" rate (of 16 percent) are based on BiH macroeconomic data, which are less than completely reliable.[9] Errors in the estimate could go both ways.

25. **Preparations for the 2006 budgets will need to anticipate this uncertainty in order to ensure continued control over the consolidated fiscal balance.**

- To address risk of lower than expected revenues, a spending reserve—a so-called "delayed spending list"—should be established in the 2005 budgets, with the spending in the reserve only authorized during 2006 in light of actual collections. This spending reserve should be created at the State level, and at the Entity central Government level. Arrangements for revenue allocation from the Single Account will need to be set up so as to implement this approach. Given that interpretation of collections—whatever they are—following VAT introduction cannot be confirmed swiftly, the reserves should be created to be in place for at least six months, to allow appropriate analysis of the collections data in the early months of 2006.

- In the event that revenue exceeds expectations—and this trend is confirmed after an appropriate period to ensure that this is not "noise" in the early months—consideration will have to be given to the appropriate use of the "permanent windfall" receipts. Given considerable inefficiencies in government spending, proposals to apply the windfall to additional programs should be resisted. Instead, a better option would be to apply the "permanent windfall" to reductions in labor taxes. These are currently heavy—52 percent of the net wage (including benefits) in the RS and 69

[8] See Staff Report, Text Box 4.
[9] See Chapter 5.

percent of the net wage (excluding benefits) in the Federation. At these levels, this taxation discourages tax compliance and job creation. Use of a permanent VAT windfall to lower the burden of labor taxation would secure an appropriate shift from direct to indirect taxation in the tax system, and prevent further expansions in the size of government which application of any permanent VAT windfall to spending would imply.

Annex 1. Advantages of a VAT Compared With a Sales Tax

The main features of the VAT widely accepted as constituting best practice in consumption tax design include production efficiency and absence of cascading.[10]

As a tax on consumption, VAT meets the production efficiency criterion. Since VAT does not fall on intermediate production, any VAT paid by a supplier or in intermediate production is refunded. As a result, it does not distort the production process.

The VAT does not cascade. Cascading occurs when a tax is levied on both inputs and outputs of the same production process. The higher the number of production stages, the higher the tax burden would be if a tax is not levied on final consumption. Cascading results in a much higher tax burden than would otherwise be the case if the tax were only levied on final consumption. Though the VAT is levied in all stages of production, refunds on inputs ensure that the VAT ultimately is only levied on final consumption.

The retail sales tax that the VAT will replace in BiH is also a production efficient tax but involves cascading. Since the retail sales tax charged on inputs is not refunded it generally results in a much higher tax burden than would otherwise be the case. Cascading of the sales tax in BiH is, however, limited as it is primarily collected at the retail stage (except for excisables that are taxed at the import and manufacturing stages). Also, the raw materials and semi-finished goods used in the production of excisable products are exempt.

[10] For a detailed discussion, see L. Ebrill, M. Keen J.Bodin , and V. Summers, *The Modern VAT*, (Washington: International Monetary Fund, 2001).

Annex 2. VAT Rates Applied in the European Commission Member States (as of September 1, 2004)

EU Member State	Super Reduced VAT Rate	Reduced Rate	Standard Rate
Belgium	-	6	21
Czech Republic	-	5	19
Denmark	-	-	25
Germany	-	7	16
Estonia	-	5	18
Greece	4	8	18
Spain	4	7	16
France	2.1	5.5	19.6
Ireland	4.4	13.5	21
Italy	4	10	20
Cyprus	-	5	15
Latvia	-	5	18
Lithuania	-	5 / 9	18
Luxembourg	3	6	15
Hungary	-	5 / 15	25
Malta	-	5	18
Netherlands	-	6	19
Austria	-	10	20
Poland	3	7	22
Portugal	-	5 / 12	19
Slovenia	-	8.5	20
Slovakia	-	-	19
Finland	-	8 / 17	22
Sweden	-	6 /12	25
United Kingdom	**-**	**5**	17.5

Source: European Commission.

VIII. State-building[1]

A. Introduction

1. **The State government is expanding**. In addition to hiring new staff across the board, in 2004 key functions shifted from lower levels of government to the State level. Accession to NATO's partnership for peace and eventually to the EU will require significant further steps in this direction.

2. **The IMF supports these efforts.** But we have concerns with the nature of the current approach to implementing State-building, notably its implications for fiscal and macroeconomic stability. Accordingly, this note focuses on how to reconcile State-building with macroeconomic objectives—preventing increases in the size of consolidated government and of the consolidated fiscal deficit. A strategy is proposed to accomplish these tasks.

B. Background

3. **The diminutive State derives from Dayton.** Reflecting the sensitivities which shaped the peace compromise, the Dayton Peace Agreement (DPA) originally confined the State mandate to foreign relations and selected domestic policies. Any mandate not explicitly attributed to the State by the DPA can only be assumed by the State if it is voluntarily relinquished by both Entities.

Text Table 1. State Government Responsibilities in the DPA
Foreign relations (including payment of international obligations of BIH incurred with the consent of both entities)
Trade and customs regulation
Regulation on international and inter-entity criminal laws, telecommunications systems, transport systems, and traffic control
Immigration, refugees, and asylum policies
Monetary policy (currency board)

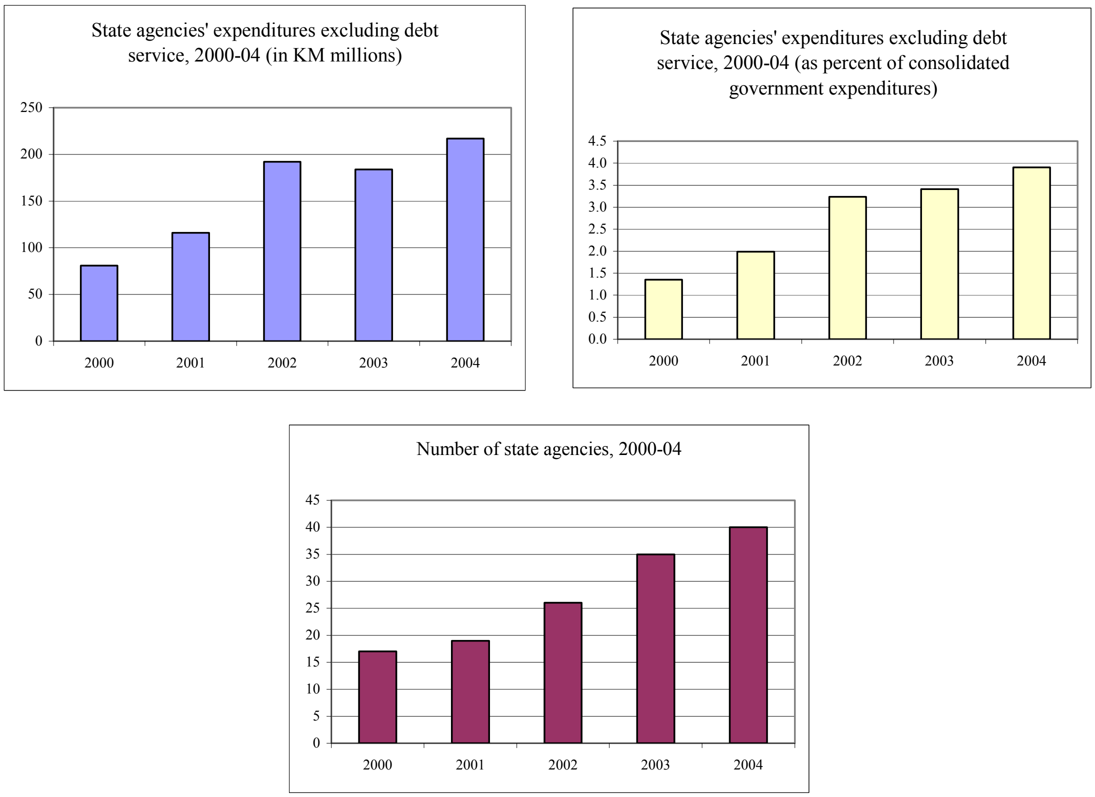
4. **The DPA left the State without an independent source of funding.** Until 2005, cash transfers were made monthly from the Entities—and at their discretion—to the State to fund its activities. The determination of the annual transfers to the State was entirely ad hoc and the agreed payments were often settled in arrears.

5. **Nevertheless, the State has grown**. Several functions were shifted to the State, recently, including the Indirect Tax Authority (ITA), the State Border Service (SBS), the Secret Service, and some defense functions. The number of State agencies increased from

[1] Prepared by Peter Doyle, Iva Petrova, and Joerg Zeuner.

17 institutions in 2000 to 40 four years later. In 2004, the administrative expenses of the State were 1.7 percent of GDP, up from less than one percent in 2000 (Text Figure 1).

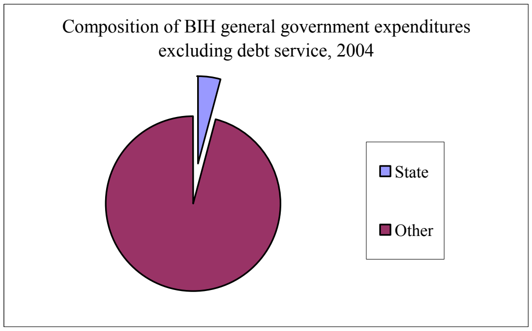
Text Figure 1. The Evolution of the State

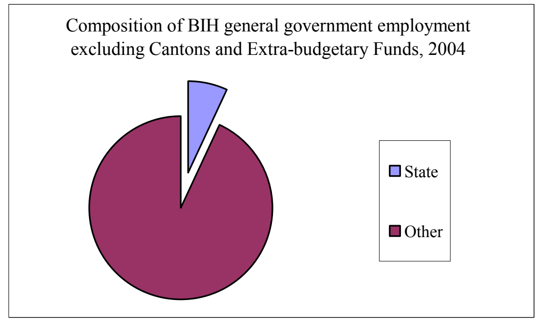


6. **This largely reflects the aims of the international community.** It seeks a single counterpart for negotiation with the outside world, an eventual replacement for the Office of the High Representative (OHR) as a coordinator of domestic and foreign policies, a counter to the centrifugal forces in Bosnia and Herzegovina (BiH), and a government structure which bears a closer resemblance to those in the rest of the world. These aims have their echoes in domestic political debates over State-building. But these debates—pro and con—more profoundly reflect the persistence of the sensitivities which underlay the Dayton agreement in the first place.

7. **But the State is still small.** Excluding the ITA, which is an unusual State cum Entity hybrid, its share in general government expenditures was less than 5 percent in 2004. At 1.7 percent of GDP, its spending in 2004 was well below that in each entity central government (10 percent of GDP in the Federation and 10½ percent in the Republika Srpska, RS, including municipalities). But the State accounted for about 7 percent of total government employment (excluding Cantons and Extra-budgetary funds) in 2004 (Text Figure 2).

Text Figure 2. The Size of the State





8. **Looking ahead, further State-building is anticipated.** This will reflect expansion in its capacity and staffing for its existing mandates, adoption of new mandates not executed by any level of government yet, and further shifts in functions from lower levels of government. These processes are already underway. Initial State spending goals for the 2005 budget doubled 2004 expenditures, albeit that these were reined back in the face of Entity resistance. Administrative spending is now targeted to rise by about 60 percent from 2004. Further ahead, BiH aspirations to enter NATO and the EU imply additional expansion, well beyond 2005, reflecting integration of the entity police and army forces into two single State-level forces. And in many other spheres, the EU vision of the future State looks very different from its present configuration (Box 1).

Box 1: The State and EU Stabilization and Association Agreement

The EU has the most comprehensive view in the international community on the evolution of State government operations. Table 1 lists the institutions that are the minimum requirements before the negotiations for a Stabilization and Association Agreement (SAA) can start. They should be established by end-2005. The table also summarizes the institutional priorities of the EU's medium-term public administration reform program. The development of these institutions is expected to be key to the success of the SAA negotiation process.

These EU-related plans are consistent with those of the OHR. The latter's institutional priorities are concentrated in the areas of security and home affairs, and are immediate goals. From OHR's viewpoint, all their priority institutions should ideally be fully operational (staffed, resourced, and in premises) by mid-2005. In December 2004, the OHR added police and defense reforms to their goals.

C. Assessment

9. **Relative to some hopes, State-building has been slow.** The State remains a small part of government, and given staff shortages, many of its institutions can carry out their functions in name only. Growth of actual State level employment has been well below the "full complement" specified in State institution rule books.

10. **The lack of an independent revenue source has played only a minor role in this.** While the Entities have resisted increasing annual transfers to the State, these have risen steadily over the years. And even if the State had enjoyed an entirely independent revenue source, concerns to limit the overall tax burden—including taxes levied by other government levels—would have required close coordination with the Entities, implicitly mimicking the coordination that was forced through the administrative transfer system.

11. **But State-building has been haphazard.** Institutions have tended to be established with scant regard to the overall coherence or cost of the State: the rationale for the target staffing levels in the rule books adopted by each of the new ministries is not apparent; office space for workers is in short supply; and hiring processes are protracted, often reflecting bureaucratic procedures, sensitivity to the ethnic diversity, and other restrictions—for example, the State level police (SIPA) can currently only recruit from other police forces. Further, the political and administrative capacity of the State to build itself is limited, notwithstanding attempts to boost this, such as with the establishment of a State Treasury in 1999. And in practice, State-building initiatives have tended to reflect the uncoordinated priorities of the international community, including in regard to the State Border Service and Judicial functions.

12. **Thus, expansion has been costly.** The remuneration structures established in the various State ministries are far more generous than those in Entity governments and elsewhere in the economy.

- Average remuneration in 2004 for a State government employee was almost 50 percent higher than in the Federation government and 180 percent higher than the RS government (Text Figure 3).

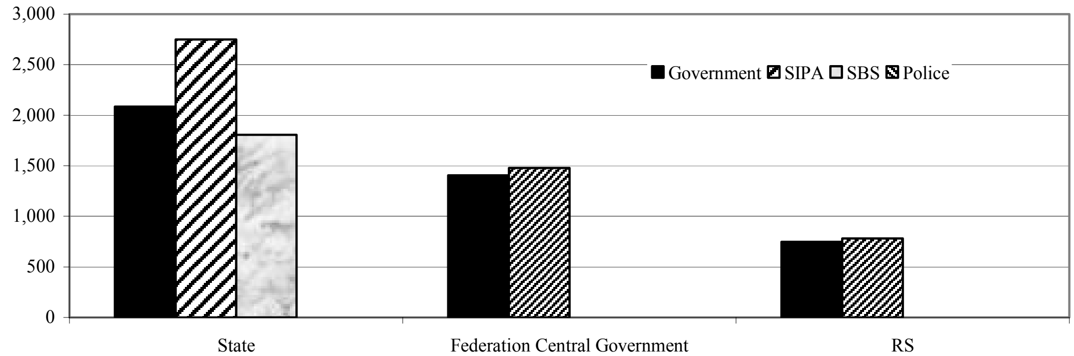
- Even for similar employees, such as in the Police and State Border Service, remuneration discrepancies are large. The SBS enjoys remuneration more than 22 percent above that of the Federation Police force and 130 percent above the RS police. And SIPA employees enjoy a pay premium of some 80 percent and 250 percent over the Federation and RS police respectively (Text Figure 3).

- In the State judicial system, the average remuneration of employees in the Prosecutors office for 2004 was more than KM 4,500 per month. This is over 16 times the average per capita income in Bosnia and Herzegovina. By comparison, Italian High Court judges earn only 3 times the average per capita income of Italy.

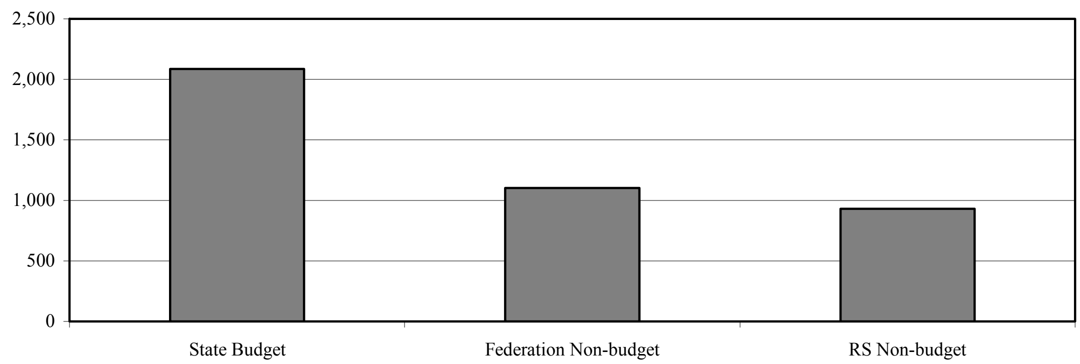
- Compared to remuneration outside government—with due allowance for data quality and possible underreporting in that sector—State employees' wages and benefits are estimated to exceed those of workers outside the budgets by 90 percent in the Federation, and some 125 percent in the RS in 2004 (Text Figure 4).

Notwithstanding concerns to ensure an ethnically diverse workforce, there is little evidence that the generosity of remuneration of State employees is warranted.

Text Figure 3. Average Budget Monthly Gross Remuneration, Including Benefits, 2004 (In KM)



Text Figure 4. Monthly Gross Remuneration, Including Benefits, 2004 (In KM)



13. **As a result of these remuneration differentials, when functions shift to the State, their costs rise sharply**. The consolidated wage bill of customs in 2004, when it was at entity level, was a little under KM 30 million, or 0.2 percent of GDP. The 2005 budget for the ITA (which took over customs administration as a State level function) anticipates a wage bill (excluding severance) of KM 46 million and 0.3 percent of GDP. This is an increase of over 50 percent. In large part, this increase simply reflects the rise in customs officials remuneration—of some 160 percent for former RS customs officers, and 60 percent for former Federation officials—at the point where, doing precisely the same tasks, they changed status from Entity to State employees. There is no evidence that this wage differential with the Entities, or the wage increase as functions shift to the State, is matched by corresponding differentials in the quality of delivery of the affected public services.

14. **Nevertheless, consolidated government spending has dropped relative to GDP since 2000.** Although State functions and spending have grown, these trends have hitherto been offset by a compression of other spending—at Entity level—relative to GDP. Thus, consolidated expenditure relative to GDP has fallen from above 55 percent of GDP to about 50 percent between 2000 and 2004. But with State spending growing rapidly, this has

required a cumulative 11½ percent reduction in real public spending outside of State government (excluding Entity spending on transfers to the State) over this period.

15. **Looking ahead, the macroeconomic strains in State-building will increase.** With nominal GDP growth slowing from early 2000 rates, and with real State spending set to rise sharply, further State-building will require additional sharp real cuts in Entity spending. This is necessary if consolidated government expenditure is to remain on a downward track, and, given consolidated revenue, if the consolidated fiscal deficit is not to grow. If the latter two conditions are not met, the consequent fiscal impulse would fuel domestic demand, driving imports up further. This, in turn, would widen the current account deficit which is already extremely high by any standard.[2]

16. **Police and defense reforms are the immediate—but not the sole—focus of these concerns (Box 2).** These two reforms will transform the State. They alone will increase total employment in the State budget from some 5,600 in 2004, to 33,000, an increase of almost 6 times. In this context, our estimates suggest that far from securing savings, the envisaged police reforms will raise consolidated Entity and State government expenditure on police by 0.6 percent of GDP permanently. And this cost could be higher still when account is taken of the added burdens emanating from the 2002-03 Civil Service Laws which mandate ethnic diversity in government employment. Defense reforms, unless significantly adjusted from current broad indications, will also significantly raise consolidated spending on defense. But in addition, as noted, there are aspirations to significantly expand existing State institutions and to open various new ones. And outside the State-building arena, donors hope to expand municipal spending, deficits, and borrowing to expand other government functions and the authorities are committed to ensuring thorough ethnic diversity at all levels of government. Given total revenue, such expansions in State, municipal, and other activities will raise the size of consolidated government and the overall fiscal deficit significantly, unless accompanied by matching—and draconian—cuts in other government expenditures.

17. **And new State funding arrangements introduce further difficulties.** From 2005, under the Indirect Tax System law, the process of discretionary monthly cash transfers to the State by the Entities has ended. It has been replaced by the automatic transfer of funds from the ITA single account to the State for its administrative and debt servicing obligations. The annual amount of these funds is determined by the State alone, without any formal reference to the Entity budgets. Thus, while its former reliance on Entity goodwill to make monthly payments is gone, so is the requirement on the State to coordinate its annual spending plans

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[2] See Chapter 3.

Box 2: Police Reform

The police reform may commence in the second half of 2005. New State level police forces will be established in every region of the country, likely in a phased manner, replacing the Entity police in an orderly sequence. In a numerical exercise here, we assume phased implementation in the RS and the Federation over two years, including the Cantonal Police forces. By end-2007, efficiency gains are assumed to secure a reduction of the police force of 17 percent.

However, as employees move from the Entity to the State, their remuneration is modeled to increase to the average SBS level, thereby more than offsetting the gains from downsizing. With average SBS remuneration of KM 1807 per month in 2004, increasing annually at the rate of GDP growth, the total wage bill will swell by KM 142 million (61 percent) in 2005-07. And the wage bill will rise from 1.8 percent of GDP to 2.4 percent, and stay there afterwards. This is a permanent increase of 0.6 percentage points of GDP. In addition, a variety of transitional costs will be incurred – from severance pay to new equipment, etc. for the new forces.

If, instead of remuneration rising to the current SBS level, police pay in the unified State force was set at the current level of the Federation Central Government police force—a 20 percent cut in assumed pay—the Police reform would raise BiH spending on Police by only 0.2 percent of GDP.

		2004	2005	2006	2007
Republika Srpska	Average wage (in KM) 1/	782	809	847	
	Employees	7,772	6,477	1,295	0
	Wage bill (in KM million)	73	63	13	0
Federation Central Government	Average wage (in KM) 1/	1,479	1,523		
	Employees	1,278	959	0	0
	Wage bill (in KM million)	23	18	0	0
Cantons	Average wage (in KM) 1/	1,300	1,346	1,419	
	Employees	8,890	7,938	3,175	0
	Wage bill (in KM million)	139	128	54	0
State	Average wage (in KM) 1/		1,905	1,993	2,106
	Employees	0	2,439	11,988	14,890
	Wage bill (in KM million)	0	56	287	376
Total	Average wage (in KM) 1/	1,088	1,236	1,792	2,106
	Employees	17,940	17,812	16,458	14,890
	Wage bill (in KM million)	234	264	354	376
Memorandum items:					
Nominal GDP		13,021	13,865	14,697	15,579
Annual wage bill (in percent of GDP)		1.8	1.9	2.4	2.4

1/ Gross, and including benefits.

with the Entities. This may ease State-building at the margin. But it also removes all incentive for the State to economize on its already wasteful use of resources. And by removing any need for it to coordinate its consolidated spending with that of the Entities, disorderly macroeconomic outcomes are clearly possible.

18. **State-building has to change course.** While the State was small, and increments were modest relative to total government, the disorderly approach, while regrettable, was not destabilizing in a macroeconomic sense. But the scale of future State-building ambitions—notably the police and defense reforms and aspirations to fully staff a raft of other institutions—and the additional pressures arising from the court rulings on domestic claims changes all this.[3] And the change in financing arrangements for the State, just at the point when State-building is about to take a quantum leap forward, risks compromising overall macro and fiscal goals. If these matters are not corrected, they risk enflaming the underlying domestic political sensitivities inherent in State-building.

D. A Better Approach

19. **Recent experience points to a number of areas where improvements can be made:**

20. **The EU can assist by clarifying its priorities.** With EU accession the fixed point around which plans for developing State institutions are ultimately oriented, the EU can help the authorities to prioritize their efforts to realize its requirements. Prioritization would best not only cover the sequence for the formal establishment of new institutions, but also their de facto establishment through completion of the necessary complement of staff. The detail and coherence of the resultant roadmap would also help to minimize the inevitable uncertainties among civil servants, often at Entity level, who reasonably seek early assurance about the implications of such government reforms for their job security. And assessments of the phasing of this growth of State institutions should be based on frank acknowledgement of the administrative constraints on the State to build itself. The record of ambitious recruiting targets not met—even when funding is fully available—is salutary. And the analytical basis for the target staffing levels encoded in each of the ministries' rule books should be thoroughly reexamined to ensure a coherent framework for recruitment in each ministry.

21. **Cuts in sub-State spending need to be identified.** In cases where State-building raises consolidated government spending—where it is not matched by automatic parallel cuts at sub-State level—there is need to identify exactly where and how offsetting reductions can be made. The recent initiative from OHR, the fiscal sustainability group—consisting of a range of Entity, State, and Cantonal representatives tasked to identify savings in budgets—is timely from this perspective. A promising place for it to focus will be war veterans' benefits. However, finding scope for savings is insufficient. Mechanisms to ensure delivery of the

[3] See Chapter 6.

savings are also required. A key possibility here is the use of the coefficients allocating revenue from the single account within the Federation. Appropriately set, these can draw resources from the Cantons as opposed to the Central Government to support efforts at State-building. But if this mechanism is used, there is need for this to be closely coordinated with Cantonal budgeting to ensure that they can make the appropriate adjustments on a timely basis.

22. **Remuneration rates at State level need to be lowered**. Functions shifted to the State become more expensive because of the elevated remuneration rates there compared with those in the Entities. With large functions due to shift to the State soon, notably Police and Defense, a reduction in State remuneration rates towards Entity rates is essential if such welcome reforms are not to put intolerable pressure on the consolidated budgets. As noted in Box 2 above, the rise in spending due to the police reforms can be lowered from 0.6 to 0.2 percent of GDP with a 20 percent cut in State wage and benefit rates. The authorities have attempted a step in this direction with a proposed 10-percent wage rate cut for State level employees in 2005. While commendable as a sign of intent, this cut has yet to be implemented and is too small, not least because it leaves benefits untouched, and therefore it still leaves large differentials vis-à-vis the Entities and the private sector. Given the wide gaps with the Entity budget remuneration rates and the iconic importance of generous State level pay in wider wage determination, the State needs to go further in this direction. In this context, the recent initiative for a DFID consultant to examine the remuneration structure at State level is timely. That exercise should not simply focus on rationalizing the remuneration structures within the State, but also between the State and Entity governments, and between the State and the non-budget sector.

23. **Large reforms should cut, not increase, costs.** The scope and phasing of large reforms such as those for Police and Defense requires close examination given their costs. Further, the impact of the combination of all the reforms on total consolidated budget expenditure year by year, and over the medium term needs to inform the pace, sequence, and design of the reforms themselves to ensure that they are consistent with good fiscal order. This will require much closer coordination of the planning for these reforms with each other than has been the case hitherto.

24. **The funding arrangements for the State also need to change.** Given the single account, the annual budget for administrative expenses of the State should require the formal endorsement of the Entities before the funds can be withdrawn from the single account to fund those expenses. This procedure will institute formal accountability into the State for its absorption of resources under the new Single Account system, and ensure full coordination between the Entity and State budgets. To prevent this negotiation leading to logjam each year in budget preparations, processes to break negotiating deadlocks between the Entities and the State will be needed. These elements form part of the proposed "fiscal architecture" for Bosnia and Herzegovina, including arrangements to be made for the proposed National Fiscal Council.

Table 1. Bosnia and Herzegovina: Future State Institutions and Functions

By end-2005		2006-10
OHR	European Union 1/	European Union 4/
War Crimes Chamber of the State Court	FBIH Civil Service Agency	Ministry of Agriculture and Rural Development 3/
SIPA - State Investigation and Protection Agency	BIH Return Fund 2/	Ministry of Security: 3/
Indirect Tax Authority	Regional Centers for the Ministry of Human Rights and Refugees (4) 2/	Police Administration Agency
Ministry of Justice	Human Rights Committee of the BIH Constitutional Court	Forensics Institute
Ministry of Civil Affairs	Merged BIH Ombudsman Institution	Police Directorate
Ministry of Security	High Judicial and Prosecutorial Council of BIH	Public Complaints Bureau
Ministry of Defense	SIPA - State Investigation and Protection Agency	State Environmental Agency
Intelligence and Security Agency (OSA)	BIH Data Protection Agency	Coordination Body for Public Health
	Information Society Agency	Drug Agency
	Indirect Tax Authority	Quality and Accreditation Agency
	BIH Statistics Agency	Education Department within the Ministry of Civil Affairs 3/
	Satistics Council 3/	Education Standards and Assessment Agency
	BIH Animal Identification Agency	Education Qualification Agency
	BIH Phytosanitary Agency	
	BIH Electricity Regulatory Commission 3/	
	FBIH Electricity Regulatory Commission 3/	European Union and Others
	RS Electricity Regulatory Commission 3/	Police Reform
	BIH Independent Systems Operator (ISO) 3/	Army Reform
	Transmission Company (TRANSCO) 3/	
	BIH Competition Council	
	FBIH Office of Competition and Consumer Protection	
	RS Office of Competition and Consumer Protection	
	Public Procurement Agency	
	Procurement Review Body	
	BIH Institute for Standardization	
	BIH Institute for Metrology	
	BIH Institute for Intellectual Property	
	Institution for General Food Safety, General Product Safety, Market Surveillance and Conformity Assessment	

1/ Minimum requirements for Stabilization and Association Agreement with the EU. Not all of them need to be fully operational.
2/ Transitional institutions.
3/ Institutional form still to be decided.
4/ Already identified minimum requirements for EU membership negotiations. Not all of them need to be fully operational.

IX. Consolidated Cantonal and Municipal Fiscal Balances[1]

A. Introduction

1. **Consolidated fiscal balances at cantonal and municipal levels need to be controlled.** This is one essential component of effective control of overall government balances, compatible with fiscal sustainability and macro economic stability and is key to the effective working of the National Fiscal Council (NFC).[2] These concerns need to be met, however, in a manner which allows cantons and municipalities to apply resources prudently to their individual spending priorities as far as is possible.

2. **Present arrangements do not meet these requirements**. They neither secure control over consolidated balances, nor provide flexibility to individual cantons and municipalities. The potential for arrears accumulation, the ad hoc nature of borrowing embargoes, unrestricted use of resources from privatization, and the lack of restrictions on issuance of guarantees undermine control over the consolidated balance. And the same ad hoc restrictions on borrowing are inflexible and have prevented the development of a market for local government debt. Partly as a result of the latter, utility and other local infrastructure has been decaying for years.

3. **This chapter discusses how these arrangements should be reformed**.[3] Its proposals are nested within arrangements to establish a NFC.

B. Background and Assessment

4. **Central control over the consolidated fiscal balances of cantons and municipalities is not secure**. Arrears accumulation and uncoordinated cantonal disposal of privatization and other one off receipts have undermined this in the past.[4]

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[1] Prepared by Peter Doyle and John Norregaard.

[2] See Chapter 10.

[3] The establishment of a legal framework has commenced at the State level with the draft *Law on Debt and Guarantees of Bosnia and Herzegovina* with the dual purpose of establishing legal frameworks for sovereign debt creation and for a national securities market. The draft State debt law prescribes that, following adoption of the law, the entities must adopt their debt framework laws within 90 days to regulate entity central government debt as well as cantonal and municipal borrowing. Also, a State organic budget law has been adopted with provisions aimed at preventing expenditure arrears.

[4] Payment arrears to suppliers have apparently been used mainly for utility services, leading to barter arrangements to settle the arrears such as tax off-sets between local governments and companies with claims on local budgets.

5. **Thus, arrears accumulation and use of privatization and other one off receipts by cantons and municipalities are not properly regulated.** The former has, apparently, resulted in sizeable arrears, notably of wage payments and claims of suppliers. And the latter, notably in 2005, has resulted in emergence of a large planned fiscal deficit in Sarajevo Canton—KM 55 million, 0.4 percent of GDP—significantly larger than the deficits anticipated for either the State or the two Entity Central governments in 2005.

6. **On the other hand, central control over borrowing has enjoyed some success.** This is reflected in low indebtedness to domestic banks. But this has been secured, in part, by administrative measures which overrode the underlying legal framework regulating borrowing.

7. **The underlying framework regulating Cantonal and municipal borrowing is expressed in by organic budget laws.** In contrast, in the Brcko District, domestic borrowing is regulated by the Law on Domestic Debt adopted in July 2004, with its external borrowing regulated only by State legislation. Table 1 summarizes present provisions.

8. **Arrangements for prior approval by Entity Central Governments of cantonal and municipal borrowing vary.** In Republika Srpska, the ministry of finance must approve borrowing in excess of the indicated long term limit, but short term borrowing is not subject to this approval. In the Federation, there are no arrangements for prior approval. Instead, borrowing procedures differ across cantons. The individual cantonal assemblies endorse annual borrowing limits, whereas approval procedures differ for cities and municipalities in accordance with respective cantonal laws on self-government: in some cantons, municipal borrowing must be approved by the cantonal parliaments, while in others approval by the municipal councils suffice.

9. **These frameworks have been applied in an ad hoc manner.** In the Republika Srpska, in the context of previous Stand-by arrangements with the Fund, government decisions were adopted that strictly limited actual municipal borrowing. The government decision adopted in May 2003 limited the stock of central government and municipal debt to 9 million KM, and municipal borrowing (and issuance of guarantees) was allowed only upon approval by the minister of finance. This decision has been extended and is still in force. Similarly, in the Federation, in spite of the general borrowing provisions described above, recent budget execution laws, including for 2005, have banned any new commercial borrowing by sub-entity governments.[5]

[5] Article 39 of the 2005 Federation budget execution law states that "Cantons, cities, and municipalities can not borrow under commercial terms domestically and abroad to finance current expenditures and capital and investment costs."

Table 1. Summary of Present Sub-entity Borrowing Rules

	Republika Srpska	Federation[6]		Brcko District
		Cantons	Municipalities	
Short term	Organic budget law (Official Gazette of RS, November 24, 2003) prescribes that cities and municipalities can borrow short term from the Republican budget to finance investment and within-year deficits.	According to the present organic budget law adopted in 1998, short term (within-year) borrowing from the central budget is allowed.	Same, although approval procedures differ across cantons	According to the Law on Domestic Debt, short term commercial borrowing is permitted to overcome liquidity problems. Ceiling on debt service is set at 5 percent of budget revenues of the previous year.
Long term				
(1) Source	Domestic and foreign borrowing allowed	Domestic and foreign borrowing allowed	Same (see above)	Domestic borrowing
(2) Limits on borrowing volumes or debt service	Up to 10 percent of own revenues collected in the previous fiscal year	Total borrowing (short and long term) cannot exceed 20 percent of budgeted revenue	Same (see above)	Debt service subject to a ceiling of 10 percent of budget revenues of previous year
(3) Purpose	Capital investment and deficits.	Capital investment	Same (see above)	Capital investment

[6] According to the new draft Federation organic budget law (Articles 52 and 53) now in procedure, cantons, cities, and municipalities can borrow only domestically and subject to a ceiling on total debt service costs (including on guaranteed borrowing) equal to 10 percent of the revenue collections in the previous fiscal year (note that the new limit applies to debt service as opposed to borrowing volumes under present provisions).

10. **A further factor inhibiting Cantonal and municipal borrowing is lack of creditworthiness.** This reflects the lack of transparency, revenue autonomy, adequate financial management systems, and accountability of many of them.

11. **But short term bank lending to cantons and municipalities does occur**. As new treasury and payment systems are introduced at local level, alongside the general economic recovery, local banks have opened short term credit lines to their municipalities, in part to get the opportunity to manage their accounts.

12. **And long-term bank lending to cantons and municipalities is also in evidence.** There is anecdotal evidence of—albeit modest—breaches of the regulations. This may reflect the complex nature of those regulations, weak monitoring and enforcement, inadequate in-house auditing and controls, and incomplete or possible inaccurate statistics on local government borrowing that are needed for effective monitoring. And new lending projects of international donors—exempt from the general borrowing embargoes—involve intermediate or guaranteed bank lending to municipalities.

13. **Contingent liabilities have been widely used.** Guarantees have been provided to local enterprises, in particular utilities, owned by cantons and municipalities, posing a fiscal risk of unknown magnitude. And looming over all are possibly large liabilities for war claims and claims for restitution. [7]

14. **None of this is satisfactory.** Stronger discipline over arrears accumulation and use of privatization receipts is needed. A coherent framework for borrowing—not one which is overridden—needs to be established. And with cantons and municipalities increasingly gaining access to domestic and external credit, the threat of loss of control over the consolidated fiscal balance of government is rising. But in addition, the current borrowing frameworks, as applied, have impeded sensible borrowing potential by Cantons and municipalities for sound infrastructure and other projects. Reforms must therefore carefully balance the need for effective central control over the consolidated balances of cantons and municipalities with need for appropriate flexibility for these individual government units to apply resources prudently.

C. Issues

15. **New arrangements are needed for arrears, use of privatization receipts, guarantees, and borrowing by cantons and municipalities.** With new debt laws under preparation, consideration of these options is timely.

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[7] See Chapter 7.

D. New Arrears and Use of Privatization Receipts

16. **The key to combating arrears accumulation is enforcement and bankruptcy procedures**. Municipalities and cantons have not faced the threat of bankruptcy when accruing arrears. And this is reflected in past lack of discipline on their part in this area. The new 2004 bankruptcy laws, however, exempt municipalities and cantons from these procedures. To secure discipline over accumulation of arrears, a way needs to be found to render them liable for these procedures.[8] But this will have to be consistent with the broader resolution of the war claims and restitution issues. If these levels of government are made liable to bankruptcy and enforcement, this could result in many or all of them being placed into bankruptcy on account of potential war damage and restitution claims.

17. **Cantonal and municipal use of privatization receipts raise various issues**. Under current arrangements, they have substantial freedom to dispose of these resources. While only a small number are well endowed with such funds, they can impart large shocks to the consolidated fiscal stance, as seen in the case of Sarajevo Canton in 2005. At the least, a system of "advance warning" could be set up—so that the central Entity Ministries of Finance should be alerted of cantons' or others' intention to use these resources. Advance notice should be long enough to allow the central governments time to offset the fiscal effects in their own budgets—for example, to make matching expenditure cuts. But since, given a target for the consolidated fiscal balance, the corollary of cantonal and municipal use of these funds will be offsetting adjustments at Entity central government levels, there may also be a case to make use of these resources subject to some sort of prior approval by the central Entity governments. These steps would also reflect the need to improve the general reporting of cantonal and municipal operations.

E. Borrowing Rules[9]

18. **These raise the more complex technical issues.** Based on international experience, country approaches to the control of sub-national borrowing fall into four broad categories although many use a combination of them: reliance on market discipline; a cooperative approach; a rules based approach; and direct central government control of borrowing. These options, and their applicability to Bosnia and Herzegovina (BiH), are discussed in Box 1.

[8] Alternatively, provisions could be introduced in the entity organic budget laws pertaining to cantons and municipalities similar to those introduced in the State organic budget law (see footnote 3).

[9] This section is based on Teresa Ter-Minassian and Jon Craig, *Control of Subnational Government Borrowing*, in *Fiscal Federalism in Theory and Practice*, ed. T. Ter-Minassian, (Washington, International Monetary Fund, 1997).

19. **On balance, a rules-based approach appears appropriate for Bosnia and Herzegovina now.** While the conditions for a smoothly working cooperative approach do not appear to be present at the moment, [10] and full reliance on market forces is not feasible, direct central control or a rules-based approach are the remaining options. While both approaches are conducive to securing control over consolidated fiscal balances, it may prove difficult to implement fully uniform nationwide direct controls in the context of the present and highly decentralized fiscal structure of the country. And direct controls leave no flexibility for local governments to meet their individual borrowing requirements. So a rules based approach would seem most appropriate as it can be calibrated to secure control over the fiscal balance and to allow a prudent degree of flexibility to Cantonal and Municipal governments.

F. Borrowing Rules in Steady State

20. **The requirements for such rules are demanding.** They must be transparent and easy to administer for the sub-national governments, and easy to monitor for higher levels of government, while being sufficiently flexible and able to deliver the appropriate volume of credit to local governments. And they must ensure that borrowing by Cantons and Municipalities is compatible with effective control over the consolidated balance of all governments. Administratively, they must be executed through transparent and efficient financial management systems that maximizes the probability of debt being serviced.

21. **A rules based approach that mimics market discipline will appropriately address flexibility and transparency considerations.** Setting limits for the amount of debt service costs expressed as a ratio of current revenue of individual local governments, possibly under "golden rule" criteria, constitutes a transparent and easily monitorable arrangement that provides the local governments with a sufficient degree of flexibility to issue debt consistent with local needs.

22. **This approach has the considerable merit of "mimicking" market discipline.** With debt service in any future year capped as a percentage of last year's outturn revenue, Cantons or Municipalities can borrow more, year after year, as their revenue rises. They can also increase borrowing if they increase their creditworthiness, and therefore, the term over which creditors are willing to lend to them. This model is incorporated in the draft Federation organic budget law, and is envisaged also in the entity and State framework laws. The proposed borrowing test in these draft laws is defined as a ceiling on the allowed future annual debt service of individual cantons and municipalities of 10 percent of current revenue collections in the previous fiscal year.

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[10] Although the associated benefits in terms of cooperation and exchange of information should be promoted in other ways.

Box 1. Approaches to Borrowing Rules for Sub-National Levels of Government

Sole reliance on market discipline has rarely been adopted. Canada is one case, but this resulted in steadily increasing provincial indebtedness despite clear deterioration in ratings of provincial bonds. Brazil is another, and a rapid accumulation of sub-national debt eventually prompted the government to institute such controls. But this approach has worked reasonably in Finland, France, and Sweden.

But it is unlikely to suit BiH. The benefits of full borrowing flexibility for local governments are outweighed by the absence of control over the consolidated fiscal balance. Its limited use reflects the stringency of conditions for success: free and open financial markets; no borrower privileges for governments; public information on a borrower's debt and repayment capacity; and no possibility of bailouts. And without efficient financial management systems of lower levels of government in BiH, the approach will prove unworkable.

A cooperative approach to debt controls is an alternative. This is applied in Australia and Scandinavia and is based on annual agreements between different levels of government concerning fiscal projections and targets, including limits on borrowing. This approach maximizes local government borrowing flexibility while securing control over the consolidated balance of all governments. But it can be time consuming, may not work in countries with weak fiscal management, and where consensus is difficult to secure. For these reasons, it does not seem best suited to Bosnia and Herzegovina.

Many countries apply a rules based approach. Limits may be set on the level or the purpose of borrowing, and limits may refer to ceilings on the ratio of debt-service to revenue or on the total debt stock. Borrowing from central banks and for consumption is often disallowed ("golden rules"). This approach is transparent, uniform, avoids time-consuming bargaining processes, and can secure control over consolidated fiscal balances. But it may be inflexible and rule evasion may occur. It works best with clear, uniform, and enforceable accounting standards, minimal off-budget operations, and modern financial management systems. For Bosnia and Herzegovina, this approach could ensure control over consolidated fiscal balances, in a transparent and simple way, while mimicking market discipline.

Direct central control is a further alternative. This may reflect central authorization provisions or centralized borrowing and on-lending to lower levels of government. While appropriate for external borrowing, the rationale is less compelling for domestic borrowing by sub-national governments, renders central government highly intrusive in local government matters, and may oblige bailouts when local governments are under financial stress. This "direct control" approach is what Bosnia and Herzegovina has applied to date. And while it has helped to secure control of the consolidated fiscal balance, it is overly restrictive.

23. **A debt service limit of 10 percent of local government revenue is consistent with effective control of the consolidated fiscal balance over the medium-term.**[11] Under reasonable steady-state assumptions, a 10 percent debt service limit that is fully and permanently used would, ceteris paribus, be consistent with a stable consolidated cantonal and municipal deficit of around 0.3-0.4 percent of GDP.[12] This is a magnitude small enough to allow manageable offsetting adjustments year by year in the central government balances so as to secure annual consolidated general government fiscal balances.

G. Transitional Issues

24. **Transitional issues towards these permanent arrangements will be considerable.** They arise from the very low level of outstanding debt and the expected expansion of local debt issuance to finance local infrastructure projects. The World Bank argues that

> "Obviously, during an interim period, public indebtedness (including those of individual sub national governments) should be limited to lower levels, and only allowed to converge to that long-term general asymptotic maximum gradually, as macroeconomic conditions permit."[13]

25. **This raises the question of the *potential* magnitude of borrowing in the short term that this regime could entail**. Staff projections for 2005 (see Table 2) imply that if all cantons and municipalities immediately upon introduction of a 10 percent ceiling borrow to the limit, it would result in a borrowing volume (and, if immediately spent, an increase in the fiscal deficit) of about 3.6 percent of GDP.[14] This estimate reflects projected current revenue of all cantonal and municipal governments in 2005[15] of some 1.7 billion KM, or 12½ percent of GDP, with close to 1.3 billion to the cantons (9.1 percent of GDP) and about 450 million to municipalities nationwide (3.2 percent of GDP). The

[11] In Croatia, the debt service ratio to revenue is 20 percent, while in Poland and the Czech Republic the limit is 15 percent. In Hungary it is 70 percent of own current revenue, while in Romania it is 20 percent of current revenue. However, the significant differences across countries in the level and structure of local government revenue, in the relative size of local governments subject to the ceilings, as well as in the specific definitions of the limits applied practically render cross country comparisons meaningless.

[12] The actual deficit could be higher if projects are also financed from escrow accounts.

[13] See draft IBRD report op cit, page 90.

[14] Assuming projected current revenue of 1,714 million KM, 5 year average maturity and 10 percent average interest rate.

[15] Adjusted for the impact of the Single Account and based on data for 2003 actual outcome (2004 execution data will be available only in May, 2005).

existing and very modest debt service obligations would allow on the order of 1¼ percent of GDP in "new" annual debt service costs.

Table 2. Cantonal and Municipal Revenue and Debt Service, 2003 and 2005
(KM millions)

	Cantons		Municipalities		Total	
	2003	2005	2003	2005	2003	2005
Revenue	1,250.0	1,295.2	440.0	472.5	1,690.0	1,767.7
Current revenue	1,218.8	1,263.7	419.1	450.0	1,637.9	1,713.7
Debt service	9.5	9.5	6.0	10.0	15.5	19.5

26. **This represents a considerable risk to the consolidated fiscal balance.** Even though this risk is mitigated by low creditworthiness, this mitigation is difficult to quantify. While external official creditors are cautious in their intentions to provide new credit, in part reflecting concerns with creditworthiness, domestic commercial banks have been engaged in a three year rapid expansion of credit to the private sector—indicative of a considerable appetite for risk. And they have indicated their desire to expand their lending to government, including municipal and cantonal governments, considerably. And some have negotiated considerable external commercial funding precisely for this purpose.

27. **So the risks of a destabilizing fiscal impulse are significant, even if difficult to quantify precisely.** And even a moderate fiscal weakening from this source would put serious pressure on a current account already in substantial deficit. These concerns would be compounded if initiatives to control arrears accumulation and use of privatization receipts are not secure. And they are compounded by other fiscal initiatives to increase expenditure.[16] Hence, remedial measures for the transition period need to be developed.

28. **There are various options to ensure that these "transitional" risks to the consolidated fiscal balance are addressed.**

29. **One of these is to follow the World Bank suggestion and phase the borrowing limit in**. By gradually increasing annual ceilings for individual municipalities and cantons in terms of revenue—as an illustrative example, a five year 2%-4%-6%-8%-10% schedule—the risk of a surge of borrowing and the consequent increase in the fiscal deficit

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[16] See Chapters 8 and 10.

of consolidated government would be minimized. Hence, a 2 percent limit would allow a maximum of new borrowing of about half of one tenth of a percent of GDP. Under this proposal, the move from one ceiling to the next would not be automatic. It would occur only when individual cantons and municipalities have reached the preceding ceiling (to avoid abrupt credit expansions owing to "unused" credit ceilings of previous years).

30. **The main advantage of this framework is that it ensures control over the consolidated fiscal balance throughout the phase in period.** However, because of the low ceilings as the phase-in progresses, it could restrict individual well-prepared municipal borrowing projects, including those sponsored by donors, delay the development of a municipal debt market, and it would be complex to implement. These concerns could be alleviated in three different fashions.

31. **First, a simplification of the phasing-in mechanism could be considered.** If the move through the steps is automatic and simultaneous, then all Cantons and municipalities would reach the 10 percent ceiling in the 5th year, notwithstanding their actual borrowing during the period. Or, building on the fact that only some Cantons and Municipalities are creditworthy and hence able to obtain bank credit in any meaningful volume, the initial ceiling could be set higher than the 2 percent, for example at 4%-6%-8%-10% or 3 1/3 %-3 1/3 %-3 1/3 %, on an automatic and simultaneous basis. This could allow some municipalities to go ahead with financially sound projects while still limiting the macro risks from credit expansion. The basic question on this way forward is whether the marginal simplifications achieved are sufficient to address the concern, while not simultaneously loosening control of the consolidated fiscal balance.

32. **Second, the approach above could be developed.** A Cantonal and Municipal Credit Board (CMCB) could be established at entity level with participation of all stakeholders (entity ministries of finance, representatives of cantonal and municipal governments, donors, commercial banks, and possibly the central bank) to monitor and control overall local government borrowing volumes. The key objective would be to ensure that the consolidated borrowing of all cantons and municipalities combined is compatible with the consolidated fiscal balance target. Within this constraint, the CMCB could grant individual exemptions to cantons and municipalities from the phasing-in ceilings on borrowing. Where projects are sound, such exemptions would allow the individual cantons and municipalities to go straight to the 10 percent borrowing limit. But this flexibility would be allowed only if it was consistent with the target consolidated fiscal balance. While this proposed arrangement would ensure effective control over the consolidated fiscal balance, and allow significant flexibility for individual cantons and municipalities to borrow immediately up to the full 10 percent limit, it does require that the CMCB is an effective and appropriately neutral decision-making body.

33. **A third approach would be to apply the phase-in rules differently between the Cantons on one hand and the municipalities on the other.** Municipalities could be subjected, immediately and only, to the general 10 percent limit without any phase-in or exceptions arrangements. But alongside, cantons could be disallowed any borrowing, as

under the present prohibition arrangement. Eventually, however, a phasing-in system (2%-4%-6%-8%-10% or some other schedule) could be envisaged for them, along, perhaps, with establishment of a Cantonal Credit Board to handle requests for exceptions.

34. **This approach would cap aggregate borrowing in a different manner to the approaches described above** (¶29–32). Based on the data and projections presented above (¶24 and Table 2), this would cap new municipal borrowing at some 0.7 percent of GDP assuming that all 137 municipalities immediately borrow the full amount allowed under the ceiling. Clearly, a number of them will not be sufficiently creditworthy to borrow to the full extent allowable under this regulation. But given need to curb aggregate expenditure of consolidated government considerably, even this approach in regard of municipalities would require support of other expenditure-cutting measures elsewhere and an appropriate regime to control Cantonal use of their privatization receipts to make room for even a modest expansion in municipal activities. And given various uncertainties in future revenue prospects for the municipalities, including the impact of the VAT on them, the rule adopted for them should be reviewed in light both of their actual borrowing activity and the revenue shocks.

35. **The simplicity, flexibility, and control over consolidated borrowing in this third approach commends it.** But it might be viewed as discriminating in the treatment of local borrowing rules between the two entities. This follows because Federation Cantons are responsible for tasks that are the responsibility of the central government and municipalities in the RS. But with the structure of governments in the two entities so different under Dayton, fully equal treatment is likely not feasible. But this issue also highlights that the case for differential treatment of cantons and municipalities should also reflect their relative needs to borrow. [17], [18]

[17] Within the Federation, total cantonal revenue is about 3½ times higher than total municipal revenues, or about 78 percent of total Federation sub-entity revenue.

[18] While these are the main options available for BiH, international approaches provide some further scope for refinements. For example, a system of local government debt control that has been applied in some US States constrains borrowing by local governments to those with an efficient financial management system. In effect, this allows borrowing only by larger municipalities which are, however, assumed to have the largest borrowing needs. Applied to BiH, this would entail a phasing-in of local borrowing contemporaneously with the gradual improvement of local financial management systems. Also, while most countries, including BiH, restrict sub-national borrowing in accordance with golden rule principles, i.e., borrowing is allowed only or mainly for capital investment purposes, some go further and limit borrowing only for well-specified types of capital projects (for example environmental or energy saving). Applied to BiH, the list of eligible investment purposes could be gradually expanded to secure a controlled credit expansion in the same manner as provided by the systems described above.

X. FISCAL SOVEREIGNTY[1]

A. Introduction

1. **Bosnia and Herzegovina (BiH) lacks an institution responsible for aggregate fiscal policy**. Such a body would be charged to:

- Secure fiscal sustainability, including management of total public debt and liabilities;
- Determine the target aggregate annual fiscal balance and secure its realization;
- Set the aggregate tax burden and its structure;
- Determine policy on the economic composition of consolidated public expenditure;
- Set policy on financing the annual consolidated fiscal balance, and the public debt structure
- Publish data and reports on general fiscal developments and plans.

2. **In other countries, these functions are typically assigned to "the" Ministry of Finance.** But under its Dayton Constitution, Bosnia and Herzegovina has 14 autonomous and highly interdependent such Ministries (one in each of the State, the Entities, Brcko District, and the 10 Cantons) as well as some 140 municipalities, a plethora of independent extrabudgetary funds at most levels of government, and large "off budget" fiscal operations—notably donor funded projects. Policy on the five issues noted emerges as the "sum" of the actions of these various bodies. But the absence of disciplined coordination among them and the "free riding" behavior that this gives rise to, means that the "sum" is a poor reflection of public preferences on these key issues.[2]

3. **Among the six issues noted, fiscal sustainability and aggregate fiscal balances are particularly susceptible to these free-riding distortions.** But strong policy on them, while critical in its own right, also provides essential support to the monetary and exchange rate arrangement—in this case, the currency board. And given the currency board, policy on them constitutes the key discretionary macroeconomic instrument available to policymakers. Without a body to coordinate policy among all the ministries of finance on these two key matters, Bosnia and Herzegovina lacks control over macroeconomic policy making, a gap which has hitherto been filled by the Office of the High Representative and the IMF.

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[1] Prepared by Peter Doyle and John Norregaard.

[2] IMF Country Report No. 04/54, March 9, 2004

4. **If Bosnia and Herzegovina is to gain both sovereignty and effective control over macroeconomic policy, it needs a coordinating body.** This would coordinate its Ministries of Finance, municipalities, and so on—a "National Fiscal Council (NFC)." Like the philosophy underlying the ITA Board, this proposal pools rather than transfers sovereignty within the Dayton constitution. This Chapter discusses how such a body might be established.

B. Background

5. **The kernel for such a body already exists, in the Board of the ITA and in various ad hoc arrangements in the annual budget cycle.** The ITA Board is the first body in Bosnia and Herzegovina where the three main Ministers of Finance are obliged to work together—and actually do so—on matters of mutual interest, with the CBBH represented as an observer. A nascent macroeconomic analysis unit (MAU) is attached to it, with IMF technical assistance in support. Beyond the ITA, there is an implicit annual budget cycle for the consolidated fiscal structure inherent in the budget cycles of the two entities and the State, both of which are required to secure adoption of annual budgets by the end of each calendar year, with submission into parliament required usually one month prior, and into governments two months prior to that. And various ad hoc restrictions on borrowing rights of Cantons and Municipalities and extra budgetary funds along with their limited creditworthiness so far, allow a modicum of control over sub-Entity Central Governments.[3] And the actual and planned transfers of functions to the State level—e.g. customs and indirect tax collection and security services—will implicitly secure greater coordination in these areas.[4]

6. **But that is all.** There are no arrangements in these calendars for formal coordination, even though the budgets are highly intertwined—notably regarding the administrative expenses of the State. As a result, budgets are typically adopted late (notably in the Federation and the State), and their preparation is rushed. Furthermore, current arrangements provide at best rudimentary macroeconomic assessments before budget policies are determined and similarly limited overviews of the financing implications of aggregate fiscal balances. There are no domestic arrangements covering monitoring and execution of consolidated fiscal policy. And Cantons are free to spend their privatization receipts—with Sarajevo Canton alone planning spending of some 0.4 percent of BiH GDP from this source in 2005, and Cantons and municipalities are increasingly creditworthy. All this makes supervision of the evolution of consolidated fiscal policy increasingly trouble prone.

7. **Furthermore, the ITA Board, as currently operated, is not suited to oversee execution of the consolidated budgets.** The authorities do not provide comprehensive

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[3] See Chapter 9.

[4] See Chapter 8.

monthly fiscal outturn data to each other, which compromises their ability to monitor aggregate fiscal developments, through the ITA Board or anywhere else. And even if they did, the ITA board is overly focused on internal technical and administrative issues, leaving insufficient time even for focus on indirect tax policy, let alone policy issues beyond that. Partly for these reasons, the Ministers of Finance represented on the ITA Board are prone to work there reflecting the narrow concerns of their Ministries, rather than acting as delegates on behalf of their whole governments. This behavior would need to change in order for the ITA board to adopt a wider aggregate budget surveillance remit. And it has limited authority vis-à-vis the State parliament, at least as this relationship is currently practiced. This is seen in the 2004-05 discussions over the VAT law and its implementation date and in decision-making procedures regarding adjustments to the regional Free Trade Area agreements. For this reason, the ITA Board is not yet a body which will attract the necessary political focus for it to secure a role as the core of Bosnia and Herzegovina's efforts to implement oversight of consolidated fiscal policy.

8. **And no domestic body is charged to execute oversight on critical overarching fiscal issues.** So discussions regarding domestic claims, restitution, state building, or budget financing are left to ad hoc administrative arrangements between the various governments.[5] This greatly reduces the effective voice of the authorities in these issues and delinks their resolution from the necessary grounding in budgets.

9. **And just as there is no executive body monitoring overall fiscal policy, there is no parliamentary body doing so either.**

10. **For all these reasons, current practice requires considerable input from the OHR and the IMF to fill these many gaps.** This is necessary to adhere to the budget calendars and to secure, albeit informally, both a prior macroeconomic assessment into budget preparation and mechanisms to break negotiating deadlocks between the various fiscal interests on issues such as determination of the annual State administrative expenditures, where coordination is required. And this external input is necessary to oversee execution of the consolidated fiscal balance through the year, and to secure appropriate adjustments to that consolidated budget policy in the event of unanticipated macroeconomic shocks or deviations of key budget variables from projections.

11. **This reliance on external inputs weakens effective sovereignty over fiscal issues.** At a time when all are seeking to reduce the role of the international community in Bosnia and Herzegovina's internal affairs, and when ties with the European Union are being strengthened, fundamental corrections to these arrangements would be timely.

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[5] See Chapters 6 and 8.

C. A National Fiscal Council

12. **The core of our proposals, nested within Dayton, is that sovereignty over these issues could be pooled rather than transferred.** Clearly, wider—and macroeconomically more attractive—options would exist were Dayton to be radically transformed.[6] But until that prospect is imminent, improvements in fiscal management within the current constitution are appropriate and necessary so as to secure more effective sovereignty over these issues.

13. **Several steps are envisaged.** In sum, they imply that the two Entities and the State would jointly take control over the determination and supervision of aggregate fiscal policy.

Preparations of annual consolidated budgets

14. **For this purpose, the Entities and the State will need to work to a strict integrated budget timetable.** This will need to:

- formally integrate all budget calendars;
- incorporate a specific date for finalization of macroeconomic assessments for the year ahead;
- a date for the derivation from those macro assessments of the associated consolidated budget balance target;
- a date for the subdivision of that consolidated balance target into the budget balances for the various components of Bosnia and Herzegovina's fiscal system;
- a date for the determination of indirect tax policy changes so that these may be properly reflected in year ahead revenue projections;
- a date by which the year ahead total administrative expenditures of the State are determined in order that this can be reflected in the State and Entity budgets;
- And, as presently, dates for presentation of the Entity and State budgets to their respective governments and into Parliament.

15. **Execution of these budget agreements through the subsequent year would be monitored through "mutual surveillance."** Thus, the three Ministries of Finance would monitor each others' execution of their individual budgets, so as to provide assurance to all that each is adhering to their part of the package of policies which is aimed to secure the overall fiscal stance agreed at the start of the budget calendar cycle. This process will also be

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[6] See Staff Report, Box 5.

the means through which any necessary adjustments to either the aggregate budget targets or the targets for the individual components of the total are determined in a coordinated manner.

16. **Securing adherence to the budget calendar and ensuring effective execution of agreed budgets requires suitable parliamentary oversight.** Within the budget preparation calendar, and through the budget execution cycle, the NFC should provide full reports to a body representing the State and the two Entity parliaments—possibly drawn from the members of the Finance committees of the three parliaments, and to which they would report back in turn. This Joint Finance Committee (JFC) not only provides a means of accountability of the executive to the legislative within the Dayton framework. But this reporting requirement also constitutes a means of encouraging each of the Ministers of Finance to resolve any negotiating difficulties with their counterparts which may be jeopardizing the budget calendar or budget execution. And if the JFC is drawn from the three parliaments, this also provides all those parliaments with reassurance that they can exercise direct oversight over the NFC operations, rather than, as a counterexample, relying solely on the State Parliament or its Finance Committee to provide this key reassurance indirectly.

17. **This sketch of the overall framework requires many supporting elements.** These are highlighted in what follows.

18. **First, a key issue is how to encourage adherence to the integrated budget timetable.** The challenge is that adherence will require the resolution of many complex interrelated negotiations each year, which may often result in deadlock. As noted above, a key discipline on this is the requirement to report publicly on key stages within the budget preparation calendar to the JFC. This provides a "threat of embarrassment" incentive on the three Ministers of Finance to reach resolutions on key issues on time.

19. **Given this role, the key stages at which the Joint Finance Committee (JFC) should receive public reports would seem to be**

(i) the overall macro assessment and the related agreement on the appropriate overall fiscal balance for the year ahead.

(ii) Then, at a later date in the fiscal year, a report should also be submitted when agreement has been reached on the subdivision of the year ahead aggregate fiscal balance between the various parts of the fiscal system, and the agreement on the State administrative expenses should be submitted at the same time.

Both of these dates should be set to occur well before budgets for the Entities and State are submitted into their governments.

20. **Within this calendar, what is required for effective determination of the target fiscal balance?** The key needs are for good quality macroeconomic data on which sound macro assessments can be based. And then, sound assessments of those data are required. The former requires significantly improved quality of statistics from the statistics agencies. For this, we recommend that a plan be prepared to operate the three under a single budget.

Sound analysis of those higher quality data requires strengthening the research capacity of the MAU in the ITA and similar analytical capacity in the CBBH. Further, a soundly based annual year ahead budget balance target should reflect assessments of the available financing, notably external financing. With donor conditionality on the latter still focused on compliance by all governments, in all respects, securing this requires the increase in formal coordination among the three governments in the NFC to ensure that all comply with all conditions. Once this compliance is secured, the MAU could simply collate anticipated disbursements from donors. And last, the scope for borrowing by each participant government in the NFC could usefully be circumscribed by overall borrowing ceilings for them set in their individual borrowing laws, as is now in principle envisaged in the draft State debt and Entity debt laws.

21. **With the aggregate annual fiscal balance determined, what is required to subdivide it into the balances of the component governments effectively?** Two matters seem critical to this.

- There is need for effective control to be exercised from the central governments of each Entity over the consolidated balance of the Cantons, municipalities, extrabudgetary funds, and Brcko District. [7] If the NFC is to function as an effective decision-making body, it is not possible to have the Ministers of Finance from all these bodies represented and empowered on it. So a rules-based system governing the balances of these other parts of consolidated general government is required certainly in order to render their consolidated balances predictable one year ahead. This could come in the form of requiring advance warning—given long in advance—of their intentions regarding their balance, or because this is unlikely to work well in practice, controls over their borrowing and their use of privatization receipts. The example of Sarajevo Canton in 2005 underscores the need for the latter. But this framework still leaves open risk that expenditure arrears accrued at cantonal and municipal levels could undermine the process of effective subdivision of the consolidated fiscal target. This latter risk could be addressed by rendering these levels of government subject to bankruptcy procedures, so that creditors can enforce their claims in court. This discipline on these levels of government will be a key underpinning of the process to subdivide the consolidated budget balance into balances for the component parts of consolidated government.

- The current arrangement in the ITS law allowing the State to determine without consulting the Entities over its annual drawings from the single account needs to be reformed. Without a requirement for formal Entity approval of this, the State can in principle draw as much as it likes. But as the Entity budgets are substantially funded from this revenue source, if the “residual” which the State leaves to them is lowered sharply by a unilateral State decision—a case of pure free-riding—this prevents

[7] See Chapter 9.

appropriate budget preparation at Entity level and undermines fiscal accountability at all levels. To avoid this risk of disorder in the determination of the annual budgets, and in the allocation of the agreed consolidated deficit among all components of government, State annual drawings from the Single account should require the formal prior approval of the entities.

22. **But even with these elements in place, the arrangements may founder on unrealistic year ahead revenue projections.** Put simply, an Entity government can reflect its agreed year ahead fiscal balance in a budget which artificially boosts revenue estimates. In this case, the balance outturn is likely to be weaker than the budgeted outturn. To address this risk, before it materializes, there would be a case to require the agreement on subdivision of the year ahead consolidated fiscal balance to also reflect precise estimates of the revenues of the budgets concerned. All three ministers of finance would jointly have to sign off both on the budget balance allocation and the revenue estimates in all budgets. This joint signing commitment could prove one—albeit not necessarily a failsafe—mechanism to check over optimism on revenue projections. Further, with such revenue projections also submitted to the JFC, along with a full explanation of why such revenue projections differ from those produced by the MAU, the JFC will have opportunity to scrutinize them in public and deliver their verdict publicly. Having done the latter, the JFC is then itself publicly accountable if the eventual outturn deviates significantly from the revenue estimates it "approved". In this light, the JFC would need appropriate technical support to prepare the analysis of the proposed revenue estimates each year. A further support for appropriate budget setting would be for the CBBH to provide public assessments of the proposed fiscal stance, the revenue estimates, and the budget outturns at each of the critical stages of the budget preparation and implementation cycles.

23. **How should inevitable negotiating disputes over the consolidated balance, its subdivision, state spending, and revenue estimates be resolved ?** This may prove to be—as it is under current arrangements—the most difficult issue to address in Bosnia and Herzegovina's fiscal architecture. A "strong" option—in spirit identical to the deadlock-breaking rules within the ITA Board—would provide that if a specific change from previous year's agreement on the consolidated budget balance, its subdivision, and on the annual State drawings from the single account is not secured by a specific date, then old agreement from last year shall apply to the coming year—the identical KM numbers. This would also apply to the estimates used for year ahead revenue (excluding privatization). This approach is basic, but it would strongly encourage all parties to reach compromises with each other, thus breaking negotiating deadlocks, thus allowing preparation of budgets to proceed. And the suggested rule on "last year's revenue estimate" means that this deadlock-breaking rule places a deficit consolidation and a counter-cyclical bias into the system. But it would require parallel commitments by all to leave the non-indirect tax structures to remain unchanged from the previous year also. This procedure would require clearly defined accounting rules, and would also be overseen by the JFC. Basic as such a deadlock-breaking procedure is, it is necessary to ensure that the budget preparation cycle is able to go ahead, reducing risk that, as in the past, fiscal years had long begun before the relevant budgets were adopted, with associated risk to disorder in payouts of entitlement and other spending.

24. **An integrated budget calendar will also help medium-term fiscal planning.** By rendering annual budget determination and management more stable than it now is, medium-term considerations will be able to play a greater role than now, reducing the current "ad hoc" nature of many of those annual decisions. So efforts recently to adopt a medium-term budget framework will be supported by these proposals. Similarly, the work of the Economic Policy Planning Unit, focusing on analysis of medium-term structural and public expenditure issues, can also find fuller expression in the more stable annual budget cycle.

25. **Preparation of consolidated fiscal policy is uniquely challenging given the need to coordinate so many autonomous units.** For this reason, there may even be need to consider shifting the fiscal year. It currently follows the calendar year. But, in practice, this has a significant drawback. With all officials and governments effectively out of the office during August each year, it proves impossible to realize all the necessary technical and political coordination work in time each year to meet the end-year budget adoption deadline. Were the budget year instead shifted to August 1 to July 31 each year, this would maximize the unbroken sequence of months at which all officials and Ministers are at work—from end-January when the RS returns to work, until end-July, when everyone leaves. And setting the deadline for adoption of annual budgets at July 31 each year would further increase the incentives on all involved to finalize the budgets in a timely basis—so that all can then depart on their planned summer vacations.

Execution of annual consolidated budgets

26. **As with budget preparation, a number of requirements will need to be met.** Prime among these is need for full data and policy transparency. Publication of detailed monthly fiscal outturn data from the treasury systems for all levels of government will be needed, on revenue, expenditure, and financing. The IMF has proposed a detailed template for this data. Transparency in this area will ensure that budget outturn data on all parts of government are available to each of the members of the NFC. That will allow them to complete detailed reviews of progress among their partners, and thereby to reassure themselves that their partners are indeed adhering to the overall budget framework agreed. This is a process of "mutual surveillance". And this process should be buttressed by regular—perhaps quarterly—reports on all the outturns to be submitted to the JFC and subjected to cross questioning there.

27. **The proposal of submission of these data and reports to the JFC is not a courtesy to it.** If implementation of the annual budget agreements by one party relies solely on the threat that if they do not, then others will also break their parts of the agreements, then the fiscal system will be highly fragile. This is so because it implicitly relies on the threat that if one party is noncompliant, then others will follow suit, threatening macroeconomic disorder. Given this outturn, the threat may lack credibility on some occasions, and have to be carried through on others. Given all this, there is clear need to have "compliance enforcing mechanisms" introduced earlier into the process. If detailed outturn reports are submitted to the JFC regularly, and in a timely manner (quarterly) it can serve as a "whistle-blower" to the public in cases where deviations are occurring. And if the JFC fails to publicly announce

such difficulties as they are occurring, then its failure in this regard will be evident to the public when budget outturns are eventually published. All this may provide some further discipline on governments to adhere to their annual budget commitments to their partners in the NFC.

28. **How should standard fiscal shocks through the year be dealt with?** These could include standard revenue shortfalls, new expenditure needs in individual or all budgets, and other such matters. The process of mutual surveillance is key. This will alert all NFC members to *force majeure* developments in each or all of their budgets, allowing appropriate adjustments to be determined and agreed by all. But given the complexities in coordinating the annual agreements, mid-course adjustments should be minimized. This underscores the need for cautious revenue estimates underlying the individual budgets. But if unexpected macroeconomic shocks are significant, there may be no option but to rebalance the whole consolidated budget framework—from the consolidated budget balance target, through to the drawings of the State from the ITA single account, to the allocation of the consolidated budget balance target among the component parts of general government. In this way, even the State would take its part in sharing the burden of such adjustments, in contrast to current arrangements.

The ITA Board

29. **If the ITA Board is to do all this, it needs to radically change its current mode of business**. Its current preoccupation with detailed minutiae of indirect tax administration, etc., needs to end. These matters would need to be addressed within the ITA administration rather than at its Board. This will allow the ITA board to focus on policy issues, including those of indirect tax policy.

30. **Furthermore, these wider budget responsibilities would require that more organized political input into the Board's deliberations is needed.** Thus, whereas hitherto the Ministers of Finance have tended to act there in the interest of their ministries, they would need to act much more as delegates from their governments. To allow the appropriate discussion in component governments of fiscal matters for discussion at the NFC/ITA board, this would also require a formal process to determine the dates and agenda of meetings, so that member governments can debate the issues in advance and guide their Ministers of Finance accordingly.

31. **If the NFC is lodged in the ITA, careful consideration would need to be given to membership of the NFC.** These wide budget functions certainly go beyond the purposes for which the "experts" were appointed to the ITA board. So to the extent that the ITA board forms the nucleus of the NFC, the experts role may be appropriately restricted to indirect tax matters only, giving them no role in these wider fiscal matters. But otherwise, there is merit in lodging the NFC in the ITA because it already encompasses formal voting procedures which can be used to break deadlocks and to avoid further proliferation of fiscal institutions.

32. **But there is also a case to avoid inclusion of the two Prime Ministers and the Chair of the Council of Ministers in the NFC.** Given the many tasks of the NFC in aggregate fiscal policy, it is clear why these persons would like a formal voice in its deliberations. But the time consuming and technical nature of many of these NFC functions counsels against formal membership for them. And the body needs to be small enough to function. Furthermore, if the two Prime Ministers and the Chairman of the Council of Ministers are not represented on the NFC, they could constitute a "Court of final appeal" for the NFC in cases when it is unable to resolve negotiating deadlocks.

What legislative basis is needed for the NFC?

33. **The NFC cannot be an informal body.** Many of the steps in the calendar for preparation of integrated budgets need to be mandatory as do many steps in its execution. And for this to be effective, there should be no right of unilateral withdrawal from those obligations by any member of the NFC. Thus, the NFC members must make formal legal commitments to adhere to these processes. It requires transparency of data, so all must have a legal obligation to publish it in an agreed format, without right of unilateral suspension of those obligations. And it requires the JFC to provide essential discipline into the processes as well as parliamentary oversight of them. So the JFC will also require a legal basis.

34. **All this seems to require that the NFC be established, with such rules, in State level law.** But the competencies involved should only shift there on the basis that subsequent changes to the NFC law can only be adopted with formal prior Entity assent. This would prevent imposition of unilateral changes to the arrangements by the State parliament.

35. **And more ambitiously, the NFC law could provide that the broader framework underpinning it could also only be amended with formal consent of the NFC.** Thus, arrangements for borrowing rules at State and Entity levels, use of privatization receipts, bankruptcy arrangements for sub Entity Central government tiers, Entity or State budget calanders, data publication obligations, tax and expenditure assignments in the Entities or the State could only be altered with its formal prior assent. As with the proposed arrangements for the ITA governing board, these changes in the framework arrangements and procedures supporting the NFC could also require the approval of the State Parliament. This would assure that any changes in these areas, which fundamentally affect the way in which the NFC works, could not be made unilaterally.

Administration

36. **The NFC will need the support of a bureaucracy.** It is an open question if the NFC should have its own administration, growing out of the MAU, or if there should be a cooperative administrative structure set up between the three Ministries of Finance. A mix of both is likely best. But in any event, the unusually complex character of the fiscal architecture in Bosnia and Herzegovina underscores need to strengthen greatly the quality of the administrations in the three Ministries of Finance

Implementation

37. **There is no need to implement all this at once.** The system can and should be built over time, not least because many of its characteristics should be worked out through a further process of "learning by doing"—a process which has informed much of the preceding discussion.

38. **However, some steps are urgent, regardless of the ultimate shape of the NFC and its supportive legislative and administrative structures.** Key among these are:

- The ITS law should be amended to provide that changes to indirect tax policy require the formal endorsement of both the ITA board and the State parliament;
- The ITS law should also be amended to provide that annual drawings from the single account by the State require the formal prior approval of the Entity ministers of finance;
- New laws governing the Cantons and municipalities are required, along with arrangements to control their discretion over use of privatization receipts; and
- Cantons and municipalities should be rendered liable to bankruptcy proceedings.

D. Conclusion

39. **This Chapter has laid out a framework to strengthen fiscal sovereignty within the Dayton framework**. It embodies pooling of competencies, rather than shifts in them, in the spirit of the ITA. It has been designed with an eye to trying to ensure that the system has incentives to encourage its functioning even when political circumstances are adverse—when governments in one or more constituent parts of the fiscal system fall, during and after general elections, and when tensions between communities are high. But not all contingencies can be addressed in this way; a system like this will work better if the authorities determinedly coordinate with each other to make it work.

40. **The ultimate intention is to secure effective domestic sovereignty over aggregate fiscal policy**. But that comes at the price of a loss of unfettered sovereignty over components of that policy—so discretion of the Entities and the State will become subject to engagement by each other—with all voices expressed, within the mutually constrained framework, in the NFC.

41. **And the NFC would not just be a "budget-making" body.** It would also provide Bosnia and Herzegovina with a body with powers and technical support necessary to address issues of fiscal sustainability and broader fiscal matters.

42. **The voice of the legislatures—also now absent in regard to consolidated fiscal policy—is also integrated into the proposals via the JFC**. As noted, that is not a courtesy:

their inclusion, along with a parallel role for the CBBH, is a key element of the system which will help the NFC system to work.

43. **Success will not come easily**. While non-cooperative behavior continues, no system can overcome it readily; a timetable certainly cannot by itself prevent such behavior, and if relations between the NFC and JFC sour, additional complications may arise. But unlike current fiscal structures, the NFC/JFC system at least "leans in the cooperative direction", encouraging this attitude between the constituent governments on the NFC, and between the NFC and the JFC. And with TA support, notably for the MAU, the CBBH, the Ministries of Finance, and so on, administrative hiccoughs will be reduced over time, and the quality of input into fiscal deliberations and management will strengthen.

44. **The NFC will be busy.** In part, this is because it will take over some of these policy making functions now carried out by the OHR and the IMF. And so the burden of work on domestic authorities will increase. But there are offsets too. The workload now in running budgets is considerably aggravated by the lack of formal coordinating or deadlock-breaking mechanisms in the fiscal system. This renders budget making very much more difficult in practice than is the case in other countries, with other constitutional arrangements. In this context, increased coordination is essential. And if that increases workload for the domestic authorities, this is one of the prices of acquisition of sovereignty over these aggregate fiscal matters. In the Dayton context, this is how sovereignty on aggregate fiscal policy may be secured.

Issues for Discussion

Chapter II. Market Indicators of Confidence in the KM and the Banking System since 2000

- Why is such a high proportion of bank lending still indexed?
- Should indexation of loans be discouraged? If so, how?
- Are households really so confident in the KM? Or is confidence increasing but still low? Do trends—however informally measured—in household holdings of Euro notes and coin shed any light on this?
- Why has confidence in the KM not been shaken by elections or more recent political uncertainty?
- Has confidence in the KM been secured?
- Why have there been no bank runs in Bosnia and Herzegovina?
- Is continued depositor confidence in banks consistent with the current pace of credit expansion?
- What needs to be done to safeguard credit quality? Is there scope for further prudential regulation, such as on provisioning requirements?

Chapter III. International Experience with Credit Booms and Large Current Account Deficits

- What comfort does international experience provide in regard to Bosnia's credit boom and external deficit?
- To what extent are concerns in Bosnia mitigated by underrecording of GDP, or are the same mismeasurements apparent in other countries also?
- Is evidence of growing confidence in the KM and the banking system (see companion paper) inconsistent with this international evidence, or does it reflect the low public awareness of the macroeconomic imbalances?
- What accounts for the uniqueness of Bosnia's credit growth and external deficits among currency boards?
- What about transition, or about Bosnia's experience of transition, suggests that rapid credit growth and large external deficits are of less concern than they would be in other contexts?

Chapter IV. Corporate Sector Issues

- Is the condition of the corporate sector as bad as suggested by the data, or is it worse?
- Is there a need for a comprehensive corporate restructuring strategy, or is the ad hoc company-by-company approach adopted in recent years adequate?
- Are there alternatives to bankruptcy for unprofitable companies?
- Is excess and or fictitious labor the key impediment to rejuvenating enterprises? If so, how should it be tackled?
- Is the current labor legislation and wage bargaining process a key impediment to realizing corporate revitalization?

Chapter VIII. State-Building

- Will State-building, if implemented as in the past, undermine fiscal and macroeconomic sustainability?
- Is the level of State remuneration rates per capita the key problem?
- If State remuneration rates per capita are not lowered significantly, should State building aspirations be curtailed or delayed?
- How can savings be found, within the Police and Defense reforms, given State level remuneration rates?
- Which, in the view of the EU, are the three most important State institutions which must be fully functional by end 2006?
- Should veterans benefits be the main focus of expenditures which are cut to offset the expansion of State activities? If not, what other spending should be cut, and at which levels of government?
- Does fiscal stability without OHR supervision require prior Entity agreement on annual State administrative expenditures?

Chapter IX. Consolidated Cantonal and Municipal Fiscal Balances

- How can arrears accumulation of cantons and municipalities be prevented? Through a tightening of bankruptcy procedures? Through provisions in the entity organic budget laws? Or in some other way?
- How could an “early warning system” or direct controls over the use of escrow resources best be developed?

- Is a rules-based approach to cantonal and municipal borrowing appropriate?
- If yes, is a debt-service to revenue ratio the appropriate form of the limit?
- What procedures should govern the appointment of a CMCB to ensure its technical effectiveness and political neutrality?
- Should cantons and municipalities be treated differently in the transitional arrangements?

Chapter X. Fiscal Sovereignty

- What are the three main problems in the current arrangements for budget design and execution?
- Will the proposals in this note improve matters, or make them worse?
- Sovereignty over aggregate fiscal policy requires a diminution in the autonomy now enjoyed by component governments. Is it worth it?
- How can deadlocks in negotiations over fiscal matters be resolved without the intervention of the OHR or the IMF?
- Will public scrutiny by the JFC and the CBBH be able to provide a useful discipline on budget preparation and execution?
- What, apart from regular and complete fiscal data publication, is required to make "mutual surveillance" work?
- What arrangements to control Cantonal, Municipal, and extrabudgetary funds deficits are necessary to ensure that the NFC has effective control over the consolidated fiscal balance of governments in Bosnia and Herzegovina?
- What should the relative roles of the MAU and the EPPU be?