

Bosnia and Herzegovina: Policy Notes for the BH Governments

March 2007

Europe and Central Asia Region



Document of the World Bank

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ACKNOWLEDGEMENTS

These notes, still in draft form, have been prepared by a team led by Ivailo Izvorski and have benefited from valuable comments by Ardo Hansson and Dirk Reinermann.

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POLICY NOTE 1: MACROECONOMIC POLICIES

A. INTRODUCTION

1.1 Bosnia and Herzegovina (BH) has made substantial progress in economic reconstruction since the end of the war, but much more remains to be done to establish conditions for sustainable private sector-led growth, curtail risks to hard-won fiscal stability and create an efficient government. Real GDP growth averaged 5 percent over the last five years, helping bring real GDP close to pre-war levels. Job creation has been slow, however, keeping unemployment high. Inflation has remained modest anchored in the currency board arrangement and supported by impressive fiscal consolidation through 2004. But spending subsequently rose relative to GDP from already very high levels, leaving the government outsized, irrationally decentralized and expensive.

1.2 The banking system has been largely privatized, but progress on other structural reforms has been weak, leaving BH behind all countries in eastern and central Europe in terms of reform implementation. The private sector generates only about one-half of GDP, the lowest level in the region, amid delays in advancing privatization, modest improvements in the business environment and small inflows of foreign direct investment. Efforts to revamp labor markets have stalled, with negative effects on labor mobility and job creation. The authorities are to be congratulated for signing the revised and modernized Central European Free Trade Agreement (CEFTA). Negotiations to join the World Trade Organization (WTO) are ongoing and need to be brought to a successful conclusion.

1.3 This note examines BH's macroeconomic policies and makes recommendations as to the appropriate policy directions going forward. Other policy notes discuss options and recommendations for tackling structural reforms. The rest of the note is organized as follows. Section B presents the key macroeconomic challenges BH faces. Section C discusses policy recommendations and strategies.

B. KEY VULNERABILITIES AND CHALLENGES

1.4 BH faces substantial macroeconomic challenges, which need to be addressed to help improve living standards, complete the transition to a market economy and advance EU integration. Four of these key challenges are discussed below.

High External Imbalances

1.5 Low savings, together with small and undiversified exports that are overly dominated by commodity shipments abroad, are keeping the current account deficit large. The current account deficit is likely to have amounted to about 14 percent of GDP in 2006 (11.5 percent of GDP adjusted for the nonobserved economy). The deficit narrowed

from about 22 percent in 2005, thanks to robust export growth reflecting in part improved statistical coverage. (The latter was due to improved incentives to declare more realistic values of exports following VAT introduction from the start of 2006.) Even at the much-narrower outcome likely for 2006, the current account deficit is large and a cause of concern that needs to be addressed. It is noteworthy that one-half of exports reflect shipments abroad of metals and wood, and a large share of the rest are accounted for by food and semi-processed materials.

1.6 Gross external debt (55 percent of GDP at the end of 2005) is higher than in most other countries in the region, but debt service is moderate given the substantial share of BH's concessional obligations. Inflows of concessional financing and remittances have been large thus far, but are likely to decline going forward, increasing reliance on costlier financing. At current levels, inflows of foreign direct investment finance just one-fifth of the current account deficit, the lowest share in the region, limiting scope for robust export growth to be sustained.

Government Spending is Large and Often Poorly Targeted and Inefficient

1.7 Government spending amounted to 50 percent of GDP in 2005 (42 percent of adjusted GDP), a full 4 percent of GDP higher than in countries with similar levels of income per capita.¹ Government spending is also significantly higher than in faster growing and wealthier economies including Ireland, South Korea and the Baltic states, and is higher than the average for the countries in southeastern Europe. Outlays on public wages and capital spending are substantially larger than among comparator countries, as are health spending and untargeted transfers to war veterans, their families and survivors. The relatively large public wage bill reflects large employment levels in defense, public order and education, and relatively high wage rates at the state level and to a lesser extent in the FBH. Fueled by stronger than planned collection of VAT, spending rose relative to GDP in 2006, further increasing the government burden on the economy.

1.8 The outcomes of government spending tend to be poorer than in other countries in the region. Education enrollment and infant mortality, to take just two indicators, are worse than in most countries in central and eastern Europe, as are indicators of the quality of governance and perceptions of corruption. Indeed, the observed quality of outcomes in BH would be consistent with government spending of 30 percent of adjusted GDP, or 10 percentage points lower than observed.

1.9 The high level of government spending remains supported by a larger than optimal tax burden, primarily reflecting onerous social security contributions. At about 36 percent of gross wages on average, the cumulative social security contribution rate exceeds the average for the relatively highly taxed OECD countries (30 percent). Moreover, levied on a relatively narrow base due to pervasive legal exemptions and rampant evasion, high social security contribution rates are a key cause of the high informalization of economic activity.

¹ For detailed analysis of government spending, see: *Bosnia and Herzegovina: Addressing Fiscal Challenges and Enhancing Growth Prospects, A Public Expenditure and Institutional Review*, The World Bank, 2006.

Large Fiscal Pressures Have Emerged and Would Multiply over the Coming Years

1.10 Fiscal pressures are substantial and rising. Fiscal pressures include the need to formalize and settle the large stock of domestic claims, strengthen the state government and handle property restitution. Assuming a modest increase in capital spending of 1 percent of GDP to help rehabilitate roads and other infrastructure, these spending pressures would add 2-3 percent of GDP to government spending by 2010 compared with 2005. Moreover, the governments are moving ahead with plans to engage in large energy and other infrastructure projects, often without prioritized plans, with projected total costs of one-half of annual GDP or more. These pressures are compounded by the recent adoption of legislation that promises substantially more generous social benefits than fiscally possible, including those under the amended law on rights of veterans in the FBH and the proposed amendments to the law on frozen foreign currency deposits. Raising tax rates to cope with these challenges will be counterproductive, given the already large government burden on the economy, and most probably will be politically infeasible. Adopting laws that cannot be implemented is not sound fiscal policy. Doing so will ultimately build up new domestic claims and continue to muddle the fiscal outlook, as governments pay benefits that are only a fraction of those mandated by law.

The Basis for Economic Growth is Narrow and Unemployment is High

1.11 The basis for economic growth remains narrow, limiting scope for job creation and sustaining the vulnerability to an ultimate downward adjustment in international commodity prices. Further, with small inflows of foreign direct investment, opportunities for diversifying the economy and moving up the value-added chain will remain limited. Unemployment is high and little changed over the last several years, amounting to about 23 percent of the labor force, despite ongoing modest job creation.

C. POLICY RECOMMENDATIONS

1.12 Improving living standards and addressing the macroeconomic challenges would require that the authorities sustain the currency board arrangement while embarking on an ambitious program of macroeconomic and structural reforms. This note focuses on the macroeconomic policy agenda. The other policy notes address the structural agenda, with Policy Note 2 focusing on the need to advance privatization, streamline the business environment and revamp labor markets.

1.13 Addressing the macroeconomic challenges requires reforms in a number of areas, as described in more detail in the remainder of the note. The following three-point agenda highlights the key priorities:

- **Sustain the currency board arrangement (CBA).** Prudent fiscal policy and structural reforms are needed to help sustain the CBA, especially given the authorities' intentions to adhere to the board until if not after ultimate EU accession. Given that reforms to sustain competitiveness take hold with some delay, the authorities are well advised to lose no time in embarking on vigorous macroeconomic and structural reforms.
- **Adopt prudent budgets for 2007 that reduce spending relative to GDP and incorporate reductions in payroll contribution rates.** Efforts to reduce the government burden on the economy should help boost growth in output and exports, with social

entitlements and the public wage bill offering ample opportunities for reduction, as detailed in the Public Expenditure and Institutional Review (PEIR). On payroll taxes, reducing the contribution rate for unemployment insurance in the FBH and eliminating cross-flows between the extrabudgetary funds for pensions, health and unemployment could be seen as first steps. Scope for rate cuts would increase should the new income tax laws prove to be revenue positive, or VAT revenues continue to be robust.

- **Settle frozen currency deposits and war claims in line with the current laws.**

These laws offer the best compromise between the public and private interest and enable a fiscally sustainable settlement. Amendments to the law on frozen currency deposits that aim to shorten the maturity of the bonds to be issued for settlement, while boosting the interest rate, will put public debt on an upward path.

1.14 The broader agenda going forward should help ensure that fiscal and expenditure policies support the currency board arrangement and help enhance growth, while minimizing both the government burden on the economy and disincentives to work and invest. Achieving these objectives would require measures to improve the structure of revenues and expenditures and rationalize public financial management.

Tax Policies

1.15 The authorities should continue to shift raising funds from direct taxes and distortionary social security contributions to indirect taxes. As a first step, the authorities should resist the temptation to change the single-rate VAT, as the current structure provides for optimum administrative efficiency and limits opportunities for fraud. In addition, the following steps are suggested:

- **Harmonize the corporate and personal income tax laws in the entities and the District of Brcko.** Consider ways to further eliminate exemptions to create a level playing field for all companies, domestic and foreign.

- **Improve collection of taxes and social security contributions.** Move to unify the base for personal income taxation and social security contributions.

Expenditure Policies

- **Reduce the level of government spending by at least 5 percent of GDP over the medium term, moving outlays closer to the levels among the faster growing economies and countries with broadly similar incomes per capita.** This should help lighten the government's burden on the economy and create room for private sector-led growth.

- **As a general rule, eliminate inefficiencies in sectors or programs before committing new funds to these areas.**

- **Using the analysis in the remaining policy notes and the PEIR quoted above, improve the structure of government spending to reduce the share of expenditures that are often seen as not conducive to boosting economic growth and reducing poverty.** As a first step, move to reduce the share of current spending and increasing the share of expenditures on operations and maintenance. Minimize tax write-offs unrelated to corporate restructuring and cut subsidies to companies.

- **Establish a realistic target for reducing the size of public employment across governments and begin working to meet this target.** Follow this with a strategic review that: (i) reduces areas of likely duplication across levels of government, and (ii) prioritizes remaining functions/activities at the entity and the cantonal level to strengthen those that are understaffed and significantly scale back those that are less critical.

- **In advancing defense and police reform,** set wage rates and employment levels in a fashion that would be fiscally sustainable while providing for incentives to retain and recruit capable personnel in line with the governments' longer-term priorities.

- **Prioritized and carefully planned strengthening of state institutions should help limit costs.** As a principle, shifting institutions from the sub-national to the national level of government without adding functions should be at least cost-neutral. The authorities should work toward offsetting costs related to creating new or strengthening existing state-level institutions and functions through reductions in spending elsewhere.

- **Settle the outstanding domestic claims and handle restitution to balance the public and the private interest.** Whether restitution will be in kind or monetary needs to be determined by efforts to limit fiscal consequences.

- **Introduce means testing for veterans' benefits and prevent double dipping by veterans from other social programs, while conducting a comprehensive review of all sub-entity veterans' programs.** The inability to curb growth in veterans' benefits 11 years after the war is a key challenge for the authorities, keeping outlays on social welfare and child protection one of the lowest in central and eastern Europe.

Public Financial and Expenditure Management and Control

- **Strengthen fiscal coordination, starting with the urgent enactment of the law on the National Fiscal Council (NFC).** Make the Council operational.

- **Strengthen the budget preparation process by cementing the key role of the Medium-Term Expenditure Frameworks as anchors for the annual budgets and by shifting toward program budgeting.** Government priorities need to be fully integrated into the budget process, with a specific emphasis on capital spending. Create an efficient and transparent mechanism for evaluating all capital outlays within the overall fiscal envelope, consistent with the government priorities. Strengthen the capacity for Public Private Partnerships.

- **Align the internal financial control framework with the EU prescribed model of Public Internal Financial Control (PIFC).** Adopt the legislative and organization framework for a sound internal audit system and move swiftly to implement the laws.

- **Make the Public Procurement Review Body operational and stick to the letter and spirit of the public procurement law.** Criteria for evaluation of tenders for both

works and goods should be changed to monetarily quantifiable criteria, as the current point-system is prone to abuse and manipulation.²

- **Strengthen the external audit institutions and focus on financial audits until ministries develop proper performance planning and monitoring systems; the latter should enable auditors to carry out performance audits.** Form a secretariat for the coordination committee for the three external audit institutions to set the agenda and advance common issues, such as preparation of a common audit methodology. Devise a strategy for auditing local governments.

- **Data quality needs to be improved dramatically and capacity for consolidating fiscal data strengthened substantially to enable reliable analysis.** Preparing consolidated fiscal accounts at least at annual frequency should be a priority. Explicitly including foreign-financed investment projects in the entity and state budgets should also be carried out to help improve transparency and the ability to analyze fiscal developments.

² Consult Chapter 7 of the BH Fiduciary Update for further details and recommendations.

POLICY NOTE 2: PRIVATE SECTOR DEVELOPMENT AND LABOR MARKETS

A. INTRODUCTION

2.1 Helped to a large degree by high international metal prices, exceptionally large remittances and the effect of modest past reforms, economic growth in BH has been robust over the last several years. Renewed efforts to advance structural reforms are needed to ensure that growth is sustained and employment reduced. Strong political will be needed to restart stalled privatization efforts in the Federation, accelerate corporate restructuring after backtracking of late and liberalize labor markets. Indicators of structural reforms suggest that BH lags all countries in central and eastern Europe, a worrying signal that the authorities would be well advised to address urgently.

2.2 Progress on structural reforms since the war has been slow and uneven. Reforms of the financial sector, trade policy and public finance have seen measurable progress. By contrast, progress has been slow in non-bank privatization and corporate restructuring, improvements of the business environment and labor market reforms. Successful restructuring of the corporate sector is a prerequisite for achieving sustained and rapid economic growth. Securing stronger growth will also require labor market reforms which help align increases in real wages with productivity gains, thus increasing employment in the formal sector and helping secure the higher enterprise profitability needed to finance new investments.

2.3 This note highlights the key issues related to corporate restructuring and privatization, improving the business environment and revamping labor markets. The note presents recommendations for tackling the issues that are central to the country's development objectives and key to improving standards of living.

B. CORPORATE RESTRUCTURING AND PRIVATIZATION

Key Issues and Challenges

2.4 The restructuring of the corporate sector and the need to increase corporate profitability are both an immediate macroeconomic concern and a major challenge to be addressed over the medium term. Tackling this challenge should enable BH to move firmly to sustainable and robust growth in output and employment.

2.5 A large non-bank privatization agenda is still outstanding, with government-owned enterprises still generating about one-half of GDP, the highest level in central

and southeastern Europe. About 350 enterprises remain state-owned in BH despite substantial progress over the last several years in the RS.³ Overall progress in advancing privatization has been hampered by weak political will and pressure from vested interests. Lack of a social safety net and issues related to unpaid pension contributions have also engendered resistance from employees and trade unions.

2.6 Corporate restructuring has proceeded slowly and progress in strengthening corporate governance in BH has been more modest compared even with neighboring countries.⁴ Delays in completing corporate restructuring have limited scope for growth in output and government revenues to increase, keeping living standards low and tax rates high. In addition to delayed progress in advancing privatization and still timid use of bankruptcy mechanisms, two issues are at the core of these lagging reforms, namely the failed mass privatization program using vouchers and the concomitant rise of the Privatization Investment Funds (PIFs). Through the privatization programs, PIFs and insiders, followed by the state, have become the largest owner groups. Some 950 enterprises (4 of which are listed on the stock exchanges) are owned by 24 PIFs that, due to a flawed legislative framework and poor governance mechanisms, have failed to restructure the enterprises under their ownership.⁵

2.7 The restructuring of enterprises owned by the PIFs poses a major challenge to enterprise reform efforts but could yield the highest benefits to the long-term growth of the country if tackled properly and quickly. Weaknesses in the legislative and incentive framework have resulted in diffused ownership and deteriorating health of the enterprises, as neither owners nor investors can exercise effective control in the companies they own. This situation is exacerbated by the overall weakness in corporate governance in the country.⁶

Recommendations

2.8 Speed up restructuring of the remaining SOEs through privatization, bankruptcy or liquidation. The governments should move decisively with tenders for the viable enterprises and initiating liquidation procedures against non-viable SOEs. Write-offs of arrears and recapitalization without explicit change in ownership (“financial restructuring”) should not be pursued, because they tend to waste public money without producing results.

2.9 The operational independence of the privatization agencies should be ensured in both entities and transparent methods must be used for divestiture. To facilitate

³ A large number of these enterprises are not viable and therefore should be liquidated.

⁴ The EBRD rates BH’s corporate governance at 2 on a scale of 1 to 4+. BH’s rating is similar to that of Ukraine and Kazakhstan but lower than Serbia, Montenegro, Macedonia and Croatia, and well behind the countries that joined the EU in 2004 and 2007.

⁵ Market capitalization is equivalent to about 64 percent of GDP, but this is overstated due to valuation difficulties and inability to obtain proper market data for most assets in the PIF portfolios. At the Sarajevo Stock Exchange, PIFs account for 45 percent of share turnover, while in Banja Luka for 20 percent.

⁶ The assessment of compliance with OECD principles of good corporate governance has highlighted as key problems opaque ownership structures, a lack of accountability of boards and managers, and poor transparency and financial reporting.

divestiture, underlying social and political impediments need to be addressed, including the key issue of stopping the flow of additional pension contribution arrears and resolving the stock issue.

2.10 Efforts to reform the PIFs need to be redoubled. Both entities should approve the draft investment funds laws that follow the EU Directive for collective investment funds. It is recommended that the PIFs then be required to convert to either UCITS⁷-type funds or closed joint stock companies. At the same time, care should be taken against asset stripping or attempts to dilute minority shareholder interests. This will enable PIF management to consolidate ownership and affect necessary restructuring including closure of firms based on business requirements.

C. BUSINESS ENVIRONMENT

Key issues and challenges

2.11 There has been progress in improving the business environment, but that is yet to be borne out fully in survey results. According to the BEEPS 2005, improvements have been made in taxation, customs and trade regulations.⁸ Dealing with licenses, however, remains problematic, with BH ranked substantially below all countries in the region. Regulatory uncertainty and weaknesses in the legal and judiciary framework are also of concern.

2.12 New bankruptcy laws enacted in 2003-04 established the basis for a modern insolvency regime. Although the average length for resolving bankruptcy cases has dropped from between 3-5 years in 2003 to 2 years in 2005, the backlog of cases remains substantial, and the laws would benefit from improvements in the area of reorganization. Further, modern bankruptcy laws would be of little use unless the governments move with determination to speed the bankruptcy of unviable enterprises to enable, *inter alia*, the productive use of their assets.

2.13 In addition, progress has been made in bringing the accounting and auditing standards in the country in line with international standards, improving business registration and inspection practices and establishing a pledge registry. The challenge going forward, however, remains in building the capacity of government institutions to implement and enforce these laws and standards.

⁷ UCITS is an undertaking for the Collective Investment of Transferable Securities. This is a specific type of collective investment fund that allows financial institutions that invest money (raised from the public) in a spread of transferable securities to operate freely throughout the EU on the basis of a single authorization from one member state. UCITS correspond in general to open-end mutual funds in the United States.

⁸ The EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS).

Recommendations

2.14 Continue building the capacity of the bankruptcy system, including training of bankruptcy judges, trustees and court clerks and upgrading court facilities. Revise the RS law to take away the power of government officials to reject cases against SOEs.

2.15 Move ahead more forcefully with utilizing the bankruptcy mechanism for accelerating corporate restructuring, especially in the Federation. The governments will be well advised to set specific targets for clearing the bankruptcy backlogs and taking unviable enterprises to bankruptcy.

2.16 In the Federation, introduce the “guillotine approach” to reduce the regulatory burden on businesses and introduce regulatory impact assessment (RIA) mechanism as a prerequisite for proposing laws to the governments in BH. Continue with the guillotine approach in the RS to further reduce regulatory burden on businesses and formalize the RIA mechanism.

2.17 Continue with accounting and auditing reform through the implementation of the country Action Plan. Further, continue with inspection reform and implement the new business registration system. The authorities will be well advised to move and simplify the requirements for obtaining construction permits and licenses.

D. LABOR MARKET

Key issues and challenges

2.18 High wages compared to productivity in the formal sector, a large share of workers in the informal sector and high unemployment are the three main characteristics of the BH labor market. Urgent attention to tackle these issues is needed to help boost employment and living standards.

2.19 Wage levels in BH’s formal sector are high relative to value added in comparison with other countries in the region and often in the past have tended to rise faster than output growth. This trend now appears to have been contained in the RS, thanks to efforts to shed excess labor. In contrast to the formal sector, wage levels in the large informal sector are substantially lower and appear to have remained stagnant. This combines with absence of social protection to those employed in the informal sector.

2.20 The rigid legislative framework underpinning the labor market provides ample incentives for informality. In theory, the existing labor laws and collective agreements give the workers in both public and private sector a plethora of entitlements and protections. In practice, widespread non-compliance had rendered dormant many of these rules, especially in the private sector. High marginal contribution rates have resulted in rampant contribution evasion, which, together with timid enforcement, has engendered a vicious circle of a high tax and contribution wedge.

2.21 Outdated provisions governing employment impose additional burden on employers. The BH legislation does not allow for temporary layoffs, with a worker treated as either being in or out of full-time employment. In addition, stringent rules on laying off workers, including those who are not showing up for work, creates a pool of ‘fictitious’ workers for whom companies run up salary and social contribution arrears.

2.22 Unemployment remains very high. Skills mismatches and high minimal wages have contributed to this outcome, as has the low pace of business creation. Large inflows of remittances and generous untargeted social transfers, meanwhile, appear to deter individuals from taking available employment. Unemployment is particularly high among the young workers seeking jobs for the first time, as well as unskilled workers. High payroll contribution rates also discourage employment creation.

2.23 Besides limiting labor adjustment, the outdated payroll contributions system undermines the single economic space. Different contribution rates and bases across the two entities hamper labor mobility. Another factor is the system of workbooks used for tracking employees’ contribution histories, a system that is not geared toward temporary and part-time employment, especially with several employers at once.

Recommendations

2.24 The authorities are well advised to accelerate efforts to liberalize and modernize labor markets to facilitate labor adjustment and begin formalizing more strongly the large informal sector. Measures recommended include:

- Create a simpler but easier to enforce set of labor market regulations and develop an alternative to employee workbooks to promote labor mobility between jobs. To achieve this, consider allowing a gradual reduction of the minimum wage as a share of the average wage in the FBH, rationalize and simplify the system of coefficients and other aspects of wage and benefit determination in both entities.

- Separate collective bargaining for the public and private sector and limit collective agreements to those enterprises that are represented in the bargaining process.

- Reform the system of payroll contributions to strengthen employment incentives. As argued in Policy Note 1 and Chapter 6 of the Public Expenditure and Institutional Review, reduce payroll contribution rates and harmonize contribution bases and rates across the entities. In the FBH, integrate non-wage benefits into the taxable base.

- Abandon *ad hoc* measures for dealing with the existing pool of ‘fictitious’ or ‘waitlisted’ workers and implement measures that would systematically resolve this issue in a financially prudent manner that does not create imbalances elsewhere in the economy.

- Introduce legislation to address the issue of future temporary layoffs and remove all obstacles to temporary and part-time employment. Develop an alternative to workbooks as a means of keeping track of the workers’ social insurance history.

- Improve the statistical basis for labor market analysis. Continue with the Labor Force Survey and unify statistics on registered and paid employment. Increase the capacity of statistical offices in compilation and analysis of labor statistics.

POLICY NOTE 3: SOCIAL PROTECTION

A. INTRODUCTION

3.1 Outlays on social transfers financed from general government revenues are broadly in line with other countries in central and eastern Europe relative to GDP, but have little impact on poverty alleviation.⁹ These transfers include benefits to veterans and their families, as well as transfers for social welfare and child protection (SWCP). Veterans' entitlements are fairly generous, with the effect of crowding out other social protection benefits given the fiscal constraints. The systems for social welfare and child protection remain underdeveloped, underfinanced and unevenly distributed across the entities. As social protection benefits are predominantly rights-based and not targeted to need, they fail to provide adequate assistance to the most vulnerable members of society. By contrast, fragmentation of the social welfare system provides substantial scope for "double dipping," and that usually benefits recipients that are not among the poorest.

3.2 Taking into consideration fiscal constraints, the authorities are urged to focus on developing mechanisms that would channel resources toward the poorest citizens of BH. This implies reducing the overall spending on veterans' benefits by tightening eligibility, reducing opportunities to "double dip." Part of the savings thus achieved should be channeled to development and financing of social welfare and child protection systems. Assuming that the size of the overall budgetary envelope in either entity will not change substantially, the fiscal balance cannot be maintained with parallel substantial increases in outlays for both veterans and non-veteran related benefits. The remainder of this note examines existing policies and makes recommendations as to the proper policy directions towards achieving these goals.

B. KEY CHALLENGES AND ISSUES

3.3 Coverage of the social protection system in both entities is limited and varies considerably across the cantons and the municipalities. Almost half of BH's population lives in or on the verge of poverty. While the number of registered social welfare beneficiaries is large, only a fraction of those receive cash benefits due to lack of resources. Both coverage and benefit levels depend on the fiscal capacity of local authorities to provide benefits, resulting in large variations between cantons in the FBH and the municipalities in both entities.

⁹ Transfers for child protection are insurance-based in the RS, but funded from general government revenues in the FBH.

3.4 Social welfare benefits are not only small overall, but poorly targeted, with the negative consequence of ineffective use of even these modest funds in both entities. Targets are based on income, a variable that is hard to measure with confidence, especially given the large informalization of the economy. As a result, many beneficiaries receive small amounts that can barely have any impact in terms of poverty reduction. Benefits paid in 2006 to mitigate impact of the VAT introduction are just one example of poor targeting, with most of the recipients receiving KM10-15 per month.

3.5 The separation between policy development and implementation engenders mismatches between legislative mandates set at the entity level and what can be afforded and implemented at the sub-entity level. In the FBH, the entity-level ministry is in charge of setting the overall policy, but is not in charge of benefit financing. Financing responsibility lies with the cantons, which also have the power to define specific benefits and allocate funding to either the cantonal or the municipal level (or both). This has resulted in a system where each canton essentially defines its own parameters for eligibility, benefit amount and benefit types. In practice, only the wealthier cantons actually provide a full range of benefits. For this reason, it is unfortunate that the efforts to introduce a comprehensive, FBH-wide child benefit in 2006 have failed. On the other hand, the introduction of a comprehensive, FBH-wide benefit for civilian victims of war signaled progress in the right direction since it ended the unequal treatment that these people faced across the FBH.

3.6 Centralization of social welfare and child protection in the RS is well advanced. The entity-level Child Protection Fund in the RS finances benefits uniformly across the entity. Disability benefits for civilian victims of war are also financed and administered at the entity level. Social assistance, by contrast, is provided at municipal level in the RS, resulting in variations in both coverage and benefit levels.

3.7 Generous spending on numerous veterans' benefits and programs has dominated the overall allocations for social protection since 1996. These include benefits for military war invalids, benefits for members of survivor families, career allowance and orthopedic aid, all financed by the entity level ministries. The cantons and the municipalities in the FBH and the municipalities in the RS finance additional benefits, such as subsidized housing schemes. The separation of the veterans' ministries from the welfare ministries enables this population to draw benefits from several sources at the same time, on different grounds. Moreover, the fact that in both entities half or more beneficiaries of veterans programs are survivor families is probably the most striking example of generosity of these programs. Recognition of new beneficiaries and beneficiary categories in the FBH from the start of 2006 paves the way for further increases in veterans' spending in the future.

3.8 Veterans' benefits are high relative to other disability benefits, pensions and average wages. For example, benefits for the first five categories of disability are higher than the average wage in both entities, with disabled veterans of the first category receiving three times average wage. By contrast, benefits for the lower categories of disability are very low, thus serving a role more as recognition of veteran

status, rather than a substantial income support. Because of the large number of beneficiaries, even these low benefits result in substantial outlays.

3.9 The tendency of most social protection benefits to gravitate toward the levels set by the veterans' benefits is worrying and potentially counterproductive. The recent adoption of the laws on the rights of civil victims of war and demobilized soldiers and their families underlines the concern, as in both cases, the FBH parliament, without any prior financial analyses, legislated a mixture of cash and fringe benefits whose potential cost runs into hundreds of millions of KM. The size of the potential obligations would require either tax increases or reduction of other, already underfinanced benefits. Rather than helping the most vulnerable citizens, the new measures threaten FBH's fiscal stability, the sustainability of social policies and will eventually hurt those most in need.

C. RECOMMENDATIONS

Social Welfare and Child Protection

3.10 The social welfare system in BH contains multiple programs that compete for scarce resources. It is recommended that the authorities start targeting benefits to need, in line with work carried out by the World Bank, DfID, and other donors over the last several years. The different schemes can be rendered more effective by improving the eligibility criteria and considering merging various social protection programs. Further, the authorities are encouraged to systematically reduce opportunities for "double dipping" by spelling out precise eligibility criteria for more than one benefit, and by strengthening an integrated beneficiary database to ensure effective monitoring.

3.11 Some of the recommendations to be put in place include:

- Centralize further financing for the core SWCP benefits to help narrow the gaps in coverage of basic social assistance in RS and social welfare and child protection on the FBH. Make financing of basic social welfare and child protection an entity level responsibility. Consider merging child allowance, social protection allowance and benefits for the refugees and IDPs into a single benefit.
- Introduce and utilize a coefficient-based rationing mechanism for social welfare, child protection, disability and civilian victims of war benefits, to avoid accumulation of arrears.
- Develop a more rigid method for benefit targeting. Progressively introduce means-testing and proxy means-testing to target benefits.
- Review financing arrangements for social protection between general revenue and payroll taxation financing; in the RS, move financing of child allowance to general revenue.

- Improve the existing comprehensive database connecting all centers for social work in BH thereby enhancing the identification and targeting of potential and existing beneficiaries.
- Improve and institutionalize the dialogue between the field-based service providers and policy planners in order to enhance policy planning and to put in place viable monitoring and evaluation mechanisms.

Veterans Benefits

3.12 The inability to impose restraint on the overall expenditure on veterans and war-related benefit schemes is the key challenge that authorities will continue to face. Proposed measures to help the governments tackle this challenge should help further focus veterans' programs to those most in need, while achieving savings to bring down the overall high general revenue financed social transfer expenditures and to reallocate resources to the basic social safety net. The proposed measures include:

- Adjust veterans' and family benefit levels downwards to align them more with benefit levels for civilian war victims and disability benefits. This can be achieved by either legislating lower benefits or utilizing the benefit rationing mechanism available in veterans' legislation in both entities.
- Introduce means testing to ensure that only the most vulnerable beneficiaries in groups VI-X (these groups include beneficiaries with disability of 50 percent or less) and family members of the fallen soldiers receive the benefit. It is estimated that savings could amount to about KM20 million in the FBH and about KM10 million in the RS.
- Amend the FBH law on the rights of holders of medals and special decorations to make the benefit payable subject to a means test.
- Conduct a comprehensive review of all cantonal and municipal veterans' benefits programs with a particular attention to free services, fringe benefits and benefits in kind. Make provision of these benefits conditional on a means test to ensure that only the most vulnerable are covered.
- Reduce double dipping opportunities by preventing the veteran and survivor family members' cash benefits from being used in conjunction with other sources of income such as old age pension.
- Review disability assessment rulebooks to allow for more consideration to work ability and create a single assessment and administration system for all disability benefits.

POLICY NOTE 4: HEALTH SECTOR POLICIES

A. INTRODUCTION

4.1 The BH healthcare system is fragmented and burdened with substantial duplication, excess employment and inefficient service delivery. The absence of a health policy agenda that addresses inadequacies in the organization and delivery of care and in health financing has led to fragmentation, duplication and sizable inefficiencies in the health sector. Health services tend to be implicitly rationed as a result, creating inequities as the poorer households typically suffer the most from such outcomes. Financial sustainability, moreover, is far from assured, even though BH spends more on healthcare than countries with similar income levels. All told, healthcare productivity and utilization are lower, while health outcomes are in general poorer despite the larger outlays on health.

B. KEY ISSUES AND CHALLENGES

Health Outcomes and Health Challenges

4.2 Despite progress achieved since the war, health outcomes in BH lag behind those other countries in the region. The health status has improved, but some key-outcome indicators raise concerns. Infant mortality is higher than in most CEE countries. The incidence of tuberculosis is four times higher than the EU average. Disability, posttraumatic stress, depression and chronic diseases rank highly on the burden of diseases. Accidents and injuries are at a high level and appear to be rising. The incidence of high-cost diseases of the heart and circulatory system, stroke and cancer has increased above European averages. Cancer is one of the leading causes of death, with BH reporting the highest mortality rates from lung cancer among the countries in central Europe and central Asia. Health policy measures require efforts to strengthen the capacity of primary health care and health promotion activities to prevent high-cost chronic diseases and ensure efficient use of secondary and tertiary care. In addition, quality services should be targeted to low-income groups to reduce the occurrence of communicable diseases.

Health Care Delivery

4.3 Utilization of primary and preventive health care (PHC) is substantially lower than in other countries in the region; these countries, in turn, lag behind the most efficient practices in Europe. Combined with over-staffed health facilities, low utilization

translates into low staff productivity. Relatively high referral rates by primary doctors to the more expensive secondary and tertiary care level points to unnecessary referrals. Efforts to improve PHC, resolve a large number of cases at the primary level, and adherence to standard referral protocols should help improve productivity.

4.4 The hospital sector is inefficient. BH reports twice as many hospitals than more efficient EU health systems and more hospital beds per population than many other lower middle-income countries. Many hospitals are small with small catchment areas resulting in extremely low utilization rates. Investment in high-cost medical technology (MT) occurs in different hospitals, leading to insufficient patient loads. Hospitals report low admission and occupancy rates but substantially longer average stays (ALOS) than neighboring countries. Hospitals are overstaffed leading to extremely low productivity. To improve hospital efficiency, BH would need to reduce a considerable number of beds and adjust infrastructure and the health workforce accordingly. Such restructuring requires implementing the hospital rationalization plan and human resource strategy; strengthening admission management and coordination among levels of providers; as well as substantial strengthening of the primary care system. With MT being a major cost driver throughout the world, controlling costs and ensuring quality requires the authorities to consolidate MT into one or two tertiary hospitals and ensure an efficient referral system. These are difficult reforms and will require substantial political will to implement.

4.5 Private providers are not regulated or subject to quality inspection. While private sector care is not covered by the public health insurance, the large number of private providers, combined with low utilization rates in public facilities suggests that many patients use private providers. Private sector participation needs to be an integral part of the broader health sector strategy.

4.6 Fragmented drug procurement and pricing add to inefficiencies, and increase the risk for corruption. Each health insurer in BH has its own drug procurement rules, procedures and positive lists. Decentralized procurement of small volumes results in higher cost and different prices and co-payment levels across the cantons/entities. Some cantonal health insurance funds (HIFs) are too poor to have even moderately innovative drugs on their lists. As a result, providers in the poorer cantons ration drugs, favoring patients who are able to pay informally. Although a system of reference prices is used in the RS, pharmacies sell drugs at a price about three times above the Ministry of Health (MoH) suggested prices. In the FBH, drug prices are set in a non-transparent way with preferred manufacturers and wholesalers, enhancing the risk for corruption. The higher costs caused by fragmented procurement are shifted to patients in form of higher co-payments, further hampering access to care.

4.7 The insurance benefit package, co-payment levels and purchasing power vary across the cantons and the entities, leading to unequal access to care. The fragmented benefit package results from different contribution rates for health insurance, different socio-economic situations across cantons and entities, poor collection of social security contributions, and risk-pooling in small insurance funds. The way providers are paid further amplifies inefficient service delivery. The HIFs are not active purchasers of services based on contracts but pay healthcare based on expenditures submitted by

providers, with little control over the level of spending or quality of care. To improve efficiency and access to healthcare, the benefit package, purchaser function and efficiency-enhancing provider payment should be defined at least on an entity level.

Financing Health Care

4.8 Health care is mainly financed through social insurance contributions collected by the HIFs. Collection has been poor due to a large informal economy, rampant evasion and substantial legal exemptions from paying contributions. Contribution rates and bases vary across the entities, and for some categories of contributors, even among the cantons. Administrative inefficiencies in collection are further exacerbated by fragmented pooling in the 13 HIFs. Although contribution rates are substantially higher than in other European countries, the HIFs report higher expenditures than revenues. The resulting deficits put substantial financial pressure on the HIFs, resulting in accumulation of payment arrears (notably in the RS), and in the implicit rationing of service.

4.9 At 5.7 percent of adjusted GDP, government health expenditures are above the average reported by CEE countries. Based on survey data, out-of-pocket payments amounted to some 2 percent of adjusted GDP; however, anecdotal evidence suggests that these payments could be higher mainly due to informal payments and bribes to providers. Overall health expenditures thus amounted to 7.7 percent of adjusted GDP in 2004, higher than in Poland and Hungary, among others. About one-half of healthcare spending is accounted for by wage outlays. As in other areas, the large share of wages crowds out investment in capital improvements and maintenance.

4.10 Inequity in health financing and the high share of out-of-pocket spending raise concerns about access to care. Regardless of their insurance status, more than 80 percent of patients pay out-of-pocket when using care. Health financing is inequitable. The health outlays of poor households account for about one-tenth of their overall expenditures, with the share falling to 5 percent for the richest households. Informal payments are common and substantially higher than official co-payments. Informal payments limit access to care, particularly for the poor.

4.11 The fiscal sustainability of the healthcare system is far from assured. The key risks include the small risk pools of the 13 HIFs, pervasive contribution evasion, large exemptions from making health insurance contributions and generous benefit packages. Another key factor is the inefficient and costly hospital system that has resulted in substantial payment arrears. These financial challenges will further increase as the population ages rapidly, and considering the raising demand for high-cost treatment for chronic diseases.

C. POLICY STRATEGY

4.12 Systematic changes in the way health care is financed, organized and delivered are required to help improve health outcomes, provide access to quality care and

ensure the financial sustainability of the health care system. It is recommended that BH's health strategy focus on three main objectives: (i) more efficient resource collection and allocation; (ii) improved access to quality and efficient service delivery; (iii) improvements in governance and stewardship. The measures that would help deliver these results are summarized in the following paragraphs.

4.13 Reform health insurance. The rationale for access to free health insurance needs to be reviewed to help improve efficiency in resource collection, risk-pooling and allocation. Further, the collection and control of contributions, portability of insurance, strategic purchases of medication, and a common benefit package need to be ensured on at least an entity level. Strategic purchasing through provider payment should set an incentive to improve efficiency and quality in service delivery in all health facilities. In the FBH, for example, the insurance risk related to hospital and pharmaceutical care is advised to be pooled from the cantonal to the entity level. Subsequently, major insurance functions including contracting, purchasing and definition of benefit package and co-payment levels could be centralized and the operation of cantonal funds harmonized.

4.14 Rationalize the hospital sector and pharmaceutical procurement, and improve efficiency and equity in access to quality care. To improve access to better service delivery, hospitals should be restructured and merged to build efficient networks of facilities with day care, and the health workforce adjusted to increase productivity. Hospital planning should be centralized on an entity level and for tertiary care on a state level, and the referral system strengthened. A central drug procurement agency should ensure quality control, positive lists, pricing and regulations of public and private pharmacies. Drug procurement needs to be organized at least on an entity level and through competitive tenders. The delivery of preventive care should be emphasized to reduce the incidence of high-cost diseases; and low-income groups need to be targeted with services to prevent communicable diseases. Prices for care should be transparent and health workers who charge informal payments ought to be fined.

4.15 Improve governance and stewardship. To strengthen sector performance, it is recommended that the current fragmentation and duplication of functions in policy, strategy building, planning, financing and regulation be eliminated. Subsequently, the number of staff working in the MoHs and Institutes for Public Health needs to be reduced. To ensure evidence-based decision making in policy and planning and to comply with EUROSTAT, OECD and WHO requirements, National Health Accounts (NHA) should be compiled annually and institutionalized. The authorities will be well advised to verify the size of the arrears reported by the health insurance funds and health facilities and move ahead with measures to harden budget constraints to prevent further accumulation of arrears. The current arrears need to be resolved in a way that does not damage the financial viability of the system.

POLICY NOTE 5: TRANSPORT SECTOR

A. INTRODUCTION

5.1 Improving the transport system in Bosnia and Herzegovina (BH) must be a key priority for the new government. Users currently perceive the quality of the existing transport system in BH to be poor, ranking the country considerably lower than its neighbors in a recent survey.¹⁰ About 40 percent of the main and regional road network remains in poor condition despite significant expenditures over the last decade, and whilst the legacy of the former conflict has been, or is being, addressed, there has been little network development to meet the strong growth in road transport.¹¹

5.2 However, the development of the network must take place in a consistent manner, within a robust sector policy and strategy. There is currently no comprehensive sector policy and strategy and an associated action/investment plan consistent with the fiscal position of the country and agreed with all stakeholders, to achieve these objectives. This gap undermines the credibility of current development plans in the sector, as it appears that they are being proposed and developed independent of the development needs of the sector as a whole. It also raises concerns that spending priorities in transport are not decided on an objective basis, a concern reinforced by the current imbalance between capital and maintenance expenditures.

5.3 In addition, recent developments are a cause for concern. The parallel plans to develop the road infrastructure within corridor Vc and within the Republic Srpska, at a combined cost of Euro 5.5 billion, raises serious concerns. Whilst the involvement of the private sector will be crucial to the attainment of these aims, a substantially improved institutional framework is a key pre-condition for the successful operation of public private partnerships (PPP). Moreover, open and transparent competitive bidding is a pre-requisite to ensuring that best value is obtained for the public resources available. The overwhelming evidence suggests that inadequate preparation leads to failure.

¹⁰ Users' perception of quality ranked the railways 98th and the airports 94th out of 104 countries in the recent World Competitiveness Survey (2003/2004).

¹¹ A recent survey in Croatia revealed that only 32 percent of the road network was in a good condition, 46 percent in fair condition, and the remaining 22 percent in poor or very poor condition.

B. KEY ISSUES AND CHALLENGES

5.3 The demand for transport is growing markedly on most modes. Road traffic in and around the major urban areas is currently growing 5 percent a year, with one recent study estimating that it would increase threefold by 2025.¹² On the railways, heavy freight volumes are projected to increase markedly in the short to medium term. By contrast, passenger volumes on the railways have been broadly static since 2001 and are unlikely to increase substantially, reflecting significant and growing competition from road transport. Air traffic is forecast to also grow rapidly, tripling by 2025.

5.4 The lack of a National Policy and Strategy for the transport sector is a major problem. Currently, investment plans are prepared without sufficient regard for the overall fiscal envelope, or the priorities across the different sub-sectors¹³. There is also little use of formal project appraisal techniques, except in the road sector, raising concerns about the efficiency of spending. This gap undermines the credibility of the stakeholder institutions in terms of planning, budgeting and ability to prioritize investments. The cumulative impact weakens the efficiency of spending in the sector, undermines investor confidence, and exacerbates potential fiscal concerns.

5.5 Despite some improvements, the current institutional structure of the transport sector is unnecessarily complex, increasing transaction costs, atomizing responsibilities and resources, and inhibiting improvement. The transport sector in BH is currently administered and managed at the state level by the Ministry of Transport and Communications (MoTC) which is a new institution established early in 2003 as a part of the process of institution building at the national level. At the entity level, there are separate Ministries of Transport and Communications in both the Federation (FMTC) and the RS (RSMTC). At the operational level, there are three railway companies and six institutions in the aviation sector. In the road sector, there are now four Directorates, two in each entity, responsible for motorways and primary roads, respectively, combined with cantonal institutions responsible for the regional road network within the Federation (although there is a proposal to re-examine this delineation).

5.6 Part of the confusion stems from a legal framework that is unclear, or poorly defined. The state level MoTC has been developing plans to develop a motorway across the country on corridor Vc, part of the Trans-European Network (TEN), with significant private investment. However, the legal position remains unclear, as the State Roads Law has not yet been passed due to opposition from the entities, despite the state minister being endowed with responsibilities for international links under the Dayton Peace Agreement. In addition, both entity ministries have recently established additional Motorway Directorates to develop and manage nascent motorway networks within their domain, allowed under the respective entity Roads

¹² COWI, 2003, *The Regional Balkans Infrastructure Study (REBIS)*, a study undertaken for the EU.

¹³ The FBH government is procuring passenger rolling stock at a cost that does not appear to take fully into account either fiscal constraints or the technical suitability of the network. Lack of a strategy for the development of the transport sector and the railways, in particular, makes it hard to confirm these projects as a priority at this time.

Laws, and the RS is developing plans to develop a network of motorways and expressways of 400 km in length, costing an estimated Euro2.5 billion, over the next four years. The overwhelming evidence is that inadequate preparation leads to failure of any concession agreement, usually at significant additional cost to the public sector. There are also weaknesses in the different Concession Laws (which a recent survey described as only partly meeting best practice) and the Public Procurement Law.

The Road Sector

5.7 The condition of a large proportion (40 percent) of the road network is poor, although planned investments should address most of the concerns on the primary network.¹⁴ This is almost certainly an underestimate, as the data only cover two-thirds of the regional road network, with many of the worst sections, in terms of condition, excluded from the survey. The condition of the secondary and local road network is even poorer, and out of a total of 410 bridges and 160 tunnels inspected, 68 of the former and 17 of the latter were found to have serious safety issues.

5.8 But maintenance expenditure on the road network remains inadequate. The expenditure needs of the road sector are large, a legacy of conflict and neglect, and they are currently not being met. Over the next five years, maintenance is estimated to require about KM140 million a year on the main and regional road network. This amount includes expenditures necessary to return the existing network and structures to good condition, together with routine, winter and scheduled periodic maintenance. An additional KM24 million a year is required to maintain the local road network, excluding those additional outlays required to clear the maintenance backlog. In contrast to these estimates, the FBH allocated only KM49 million to the primary and secondary network in 2005, covering about one-third of expenditure needs with backlog maintenance included. The shortfall in the RS is similar.

5.9 The plans to develop Corridor Vc and a network of expressways in the RS would appear ambitious at this time. The authorities have just released a draft feasibility study of plans to construct a motorway along Corridor Vc. The high cost of this project, amounting to about 40 percent of annual GDP, raises serious concern about the fiscal implications, even if the project is taken forward with a significant capital contribution from the private sector. In addition, the economic return from the investment, reported to be 16 percent for the entire corridor¹⁵, is considerably lower than the economic returns from rehabilitation of the primary and secondary network, which range between 30 percent and 300 percent. The plans to develop 400km of motorway and expressway in the RS are at a much earlier stage of development, but the proposed implementation timetable is even shorter.

5.10 The institutional framework for private sector participation in the sector is currently underdeveloped. Given the fiscal constraints and sizable risks, BH's ability

¹⁴ As a comparison, a recent survey of the national road network in Croatia revealed that only 32 percent of the road network was found to be in good condition, a further 46 percent was found to be in fair condition, whilst the remaining 22 percent was in poor or very poor condition.

¹⁵ The Draft Feasibility Study reports returns between 8.4-24 percent for the individual sections.

to deliver the Corridor Vc project and other capital-intensive public works will require a significant involvement of private sector capital in some form of public-private partnership (PPP). This will require a substantially improved institutional framework as a pre-condition. Particular improvements are needed in strengthening the Concession Law and the passage of the new state-level Roads Law. Moreover, open and transparent competitive bidding is a pre-requisite to ensuring that best value is obtained for the public resources available.

5.11 Road safety remains a serious social and public health issue in BH. The state of the road network, driver behavior and limited education, poor or non-existent enforcement, all coupled with the significant growth in vehicle ownership and use, have contributed to a relatively high level of road traffic accident fatalities and injuries (436 and nearly 8470 respectively in 2004). Whilst this rate has declined in recent years, with the 2005 figure falling to approximately 8 fatalities per 10,000 vehicles, the rate of growth of car ownership and use will ensure that road safety remains a significant and growing problem that requires a comprehensive response across all stakeholders.

The Rail Sector

5.12 Much of the rail network is in poor condition, resulting in widespread speed restrictions. The railway infrastructure suffered extensive damage during the war, subsequently exacerbated by lack of maintenance and investment during the late 1990s. Projects supported by the EBRD, EIB and World Bank will continue to help improve the rail infrastructure along Corridor Vc, but critical gaps remain (e.g., 48 km of the rail network around Sarajevo).¹⁶ The importance of the freight sector suggests that addressing these gaps should be a higher priority than procuring new passenger rolling stock. There is also little use of formal project appraisal techniques, raising concerns about the efficiency of spending in the sector.

5.13 Financial and operational performance remains poor, with operating expenses exceeding revenues even after taking into account operating subsidies. Both the Federation Railway Company (ZFBH) and the RS Railway Company (ZRS) are loss making, with cost structures not supported by current traffic volumes and revenues. There is a danger that growth in freight revenues will be used to subsidize increasing losses from the inadequate and inefficient passenger sector.

5.14 Operating performance and productivity reflect the decline in traffic volumes with no corresponding reduction in network scope. The two railway companies currently employ 7,400 people, down from 14,000 before the war. With traffic volumes for both passengers and freight equivalent to just one-tenth of prewar levels, productivity per employee has fallen sharply, lagging well behind benchmark

¹⁶Railways Recovery Project financed by the EIB and the EBRD and the Emergency Transport Reconstruction Project financed by the World Bank.

European railways.¹⁷ Whilst, recent increases in freight traffic have improved the ratios, the underlying problem of excess staff and poor asset utilization remains.

The Urban Transport Sector

5.15 The growth in road transport in and around the major urban areas is placing considerable strain on the urban transport system. BH is experiencing rapid growth in private motor vehicle travel within urban areas, and also experiencing a rapid increase in the associated negative impacts in terms of growing traffic congestion, worsening road safety (especially for pedestrians), and rising pollution (particularly localized air pollution in Sarajevo). This phenomenon has been exacerbated by the poor quality of urban bus and tram services from the public sector operators. In addition, the condition of many municipal roads is poor.

5.16 The institutional framework, comprising policy, regulation and organizations are weak with limited capacities. Urban transport and urban roads is the responsibility of the respective municipalities, and capacities are low, with significant weaknesses in policy and practice on parking, traffic management, and contract management for civil works. There is also a lack of awareness of necessary instruments to promote a balanced, or sustainable, modal split in urban areas. In addition, consistent design standards for urban transport are missing currently, leading to inconsistent and incompatible approaches.

C. POLICY RECOMMENDATIONS

5.17 The substantial problems in the transport sector require a broad-based strategy. The following recommendations are proposed as the backbone of such a strategy.

- **Support the development of a comprehensive policy and strategy framework for the transport sector.** The MoCT, together with the entity ministries and with support from the World Bank and the EBRD, is now working to define a nationwide transport sector policy and strategy (covering aviation, roads, railways, urban transport and inland waterways). This process should also include the strengthening of capacity in the public sector institutions to facilitate: (i) the revision of a sound sector strategy; (ii) the use of formal project appraisal to assist in the identification and prioritization of projects; and (iii) the establishment of robust asset management systems in the operational agencies.

- **Further strengthen the institutional framework of the transport sector.** It is recommended that the MoCT be accorded greater responsibilities for the policy development and harmonization, planning and prioritizing in the sector. This would

¹⁷ Traffic units per employee are 57,000 for the ZRS (59,000 for the ZFBH), compared with 600,000 in Austria and Denmark. Traffic units per track equal 0.5 for the ZRS (0.8 for ZFBH) compared with 1 for the Croatian and Serbian railways, and 2.3 for benchmark railways in Denmark and Germany.

help clarify the split of responsibilities among the different levels at present, particularly in relation to the development of the strategic road infrastructure. Specifically, the adoption of the new state law on Roads and the law on Inland Waterways should be accelerated.

- **Improve the institutional framework for PPP and concessions and improve transparency.** The over-riding objectives should be to instill investor confidence and protect the fiscal stability by limiting the government's fiscal exposure wherever possible. Other objectives include the need to shift risk away from taxpayers and toward providers and users, and the need to improve the efficacy of agencies involved in financing of infrastructure. The World Bank is providing technical assistance, with funding from the Public-Private Infrastructure Advisory Facility, to assist in these aims.

- **Increase resources for the maintenance of the primary and secondary road network.** The recent World Bank PEIR proposes an increase in the share of resources allocated to the FBH road directorate (to 60 percent of the total from 40 percent at present) and a reduction in the share of resources allocated to the cantons and municipalities, reflecting better the maintenance needs of the different kinds of roads.

- **Support greater efforts to reduce the social and economic costs from road traffic accidents in BH.** Addressing this problem will require increased resources, greater co-ordination between stakeholders to improve road conditions, driver behavior and enforcement, and increased awareness of safety at each stage of the project cycle. The World Bank has obtained grant funding to undertake a Road Safety Management Capacity Review to provide a comprehensive review of the current status of road safety activities and stakeholder co-ordination in BH. The recommendations from this study should be considered carefully for prompt implementation.

- **The Law on Railways needs to be fully implemented,** together with a rational and functional organization structure. This would go a long way toward reducing the existing institutional inefficiencies and enhancing operational efficiency. Network and labor retrenchment, as currently introduced in Serbia, are also pre-requisites to ensure improved operational and financial performance from the railways companies, thereby reducing their burden on the public purse.

- **Greater efforts are required to improve urban transport in the main cities.** The key priorities (although this sub-sector will receive greater scrutiny in the Transport Sector Review being conducted by the World Bank and the MoTC), include: (i) review revenues and road management planning and civil works implementation in all municipalities and (ii) disseminate best practice in traffic management and parking policy to all municipalities.

POLICY NOTE 6: ELECTRICITY SECTOR POLICIES

A. INTRODUCTION

6.1 BH's power facilities have largely been restored to their normal status since the end of the war and the power sector is being restructured to reduce the outstanding inefficiencies and to comply with European Union regulations (designed to promote a unified, competitive, regional electricity market based on free and equal access to all participants). Power generation has returned to pre-war levels and the whole of BH has been resynchronized with the Union for Coordination of Transmission of Electricity in Europe (UCTE). The three Elektroprivredas (EPs) – the vertically integrated monopolies that operate the restored power system of BH - are technically competent and have improved their financial performance toward a largely satisfactory level.¹⁸ However, the fragmented operation of the country's power generation assets by the EPs according to their location in the present small, irregularly shaped geographical areas (service zones), limits cost-effectiveness. Entity governments need to expedite implementation of the Power Sector Restructuring Action Plans approved by their parliaments, strengthen the recently established Transmission Company and Independent System Operator, and harmonize regulatory practices at the state and entity levels.

6.2 A large policy agenda now dominates as the country strives to fulfill its commitments under the Energy Community of South East Europe (ECSEE). The authorities have expressed interest in expanding power generation and transmission capacity to meet growing domestic demand and increase exports within the emerging regional electricity market under the ECSEE. The emerging policy agenda should aim to create:

- **A stable electricity regulatory and market framework**, underpinned by implementation of the General Conditions for Electricity Supply (as under the EC *acquis communautaire* on energy).
- **A comprehensive, well articulated energy strategy** at the state level, which informs the development and adoption of a blueprint for harnessing the country's indigenous energy resources to strengthen the country's position as a net exporter of electricity.

¹⁸ The three vertically-integrated monopolies are the EPBH (Elektroprivreda Bosnia and Herzegovina), the EPHZHB (Elektroprivreda of the Croatian Community of Herzeg-Bosnia) and the EPRS (Elektroprivreda Republika Srpska). The EPBH has generating capacity of 1,672 MW (end-2005), the EPHZHB of 792 MW, and the EPRS of 1,348 MW. In 2005, EPBH served 635,000 customers, EPHZHB 177,500 customers and EPRS 481,000 customers.

- **A prioritized strategy for mobilizing public and private investment required for expanding power generation capacity**, taking into account fiscal constraints within the overall fiscal envelope, and the importance of spreading risk and limiting fiscal costs.
- **A coherent, coordinated, transparent authorization plan for development of new power generation and transmission projects** in BH, which is harmonized in both entities and in accord with EU Directives.

6.3 This note addresses these key issues and challenges and recommends a strategy to help tackle them in a comprehensive manner.

B. KEY ISSUES AND CHALLENGES

Completing Ongoing Power Sector Reforms

6.4 **Completion of the reform measures now implemented will enable BH to fulfill key commitments to the Treaty establishing the Energy Community of South East Europe Treaty (ECSEE), to which BH is a signatory.** While the reform process has clear goals and a well-articulated roadmap and there have been clear formal commitments from the various participants, several of the steps forward have occurred only after significant delays.¹⁹ Further progress will continue to require sustained commitment and perseverance by the state and the entity governments, especially to keep aging power generating and transmission facilities in operation (to assure secure and reliable electricity supply during the transition) until a new and regionally competitive power system emerges.

6.5 **As discussed in Policy Note 3 on social policies, the authorities need to set up comprehensive social safety nets to help protect the most vulnerable households against adverse shocks and help facilitate the next phase of tariff rebalancing measures in BH.** To reiterate, such protection mechanisms need to be provided by the entity governments and not by the EPs.

6.6 Thus far, the newly established Electricity Regulatory Commissions²⁰ have made significant progress in putting in place cost reflective electricity tariffs for the EPs. Nonetheless, further re-balancing of electricity tariffs will be needed amid the ongoing corporate unbundling of the EPs' generation and distribution/retail business lines and the introduction of bilateral power supply contracts between them. Moreover, private sector participation in the unbundled power generation businesses may also trigger further adjustments in electricity pricing arrangements to better eliminate cross-subsidization

¹⁹ A transmission company (Transco) and an Independent System Operator (ISO) have been created and are now functional. Since several important regional transmission lines pass through BH, these developments have fulfilled an important precondition for BH participation in the emerging regional electricity market of the Energy Community of South East Europe.

²⁰ Electricity Regulatory Commissions have been established at the state and entity levels: (i) the State Electricity Regulatory Commission (SERC) to regulate the Transco and the ISO; (ii) the Federation Electricity Regulatory Commission (FERC) to regulate generation and distribution functions in the Federation; and (iii) the Regulatory Commission for Electricity in Republika Srpska (RSERC) to regulate generation and distribution functions in the RS.

between segments of the power supply chain (generation, transmission, distribution, and retail supply), by voltage level and by the time-of-day of consumption.

6.7 The *acquis communautaire*'s General Conditions for Electricity Supply require elimination of cross-subsidies between suppliers and consumers. Based on experience elsewhere in the ECSEE, electricity pricing adjustments may result in substantial differences in end-user tariffs among different service zones of the unbundled EP distribution businesses due to different cost structures reflecting different consumption patterns. Joint action by the BH authorities is required to address the key challenges posed by such tariff rebalancing. It is important for all three Regulatory Commissions to follow a gradual approach in rationalizing and rebalancing tariffs and also coordinate the effective date for application of new tariffs so as to help avoid implementation difficulties and ensure that social and economic impacts are kept within reasonable limits and disruption is avoided.

6.8 Rehabilitation of Existing Power Generation Facilities: Despite substantial progress since the end of the war, there are still some power system facilities damaged during the war that have yet to be rehabilitated and there are continuing large investment needs because of aging facilities. While significant investments have been carried out to reduce pollution of air, water and soil at coal-fired thermal power stations, with others being implemented, more needs to be done. Particularly large investments will be needed to reduce SO₂ and NO_x emissions. BH's commitments to the ECSEE require eventual action to address these two pollutants. Action will also be desirable eventually to reduce emissions of CO₂ at coal-fired thermal power plants. An important issue concerns the desirability of restructuring the Federation coal sector with the objective of reducing unit costs of production, which in turn would reduce unit costs of production of electricity at EPBH's coal-fired thermal power plants. In 2006, the Federation government initiated the transfer of the Breza mine to EPBH, but it is not clear how this move fits into an appropriate overall restructuring strategy. There is less need for restructuring of the coal sector in the RS, where the existing mines are lower-cost, overstaffing is significantly lower, and the mines are owned by the two RS coal-fired thermal power stations.

6.9 To help assure the competitiveness of BH's coal-fired power generation capacity within the emerging regional electricity market, the entity governments took initial steps in 2006 to attract private sector participation in joint ventures to rehabilitate, modernize and expand power generation capacity at existing coal-fired thermal power plants. The RS initiative focused on the Gacko and Ugljevik plants, and the Federation on the Tuzla and Kakanj plants. While these initiatives are generally in line with ongoing power sector restructuring action plans of the entities, BH's commitments to the ECSEE require that the BH authorities adhere to transparent and competitive procedures to solicit, select and authorize such joint ventures to develop large power generation projects.

6.10 Further, there are small water leaks at some of the dams at the hydropower stations that result in reduced power production and that may eventually pose a risk to the safety of the dams themselves. There are other safety risks at some dam sites (e.g. a landslide at one dam that will require rehabilitation investments and improved

monitoring). There is also a need to ensure that the authorities have appropriate procedures in place for regular monitoring of the medium and large dams in the country. The present fragmented ownership and operation of existing hydropower cascades is an impediment to addressing some of the above problems in a comprehensive and coordinated manner (for example, the existing allocation of the Neretva River cascade of six hydropower plants between the two EPs). While several of the problems identified are to be addressed under ongoing donor-financed investment projects, the required investments may turn out to be larger than can be covered under the existing projects. The key challenge for the authorities is to achieve more efficient, coordinated and sustainable utilization and management of hydropower resources to help BH remain competitive within the ECSEE

Statewide Blueprint for Developing New Power Projects

6.11 There have not been any significant investments in new power system facilities in BH since the war. Nonetheless, there is large interest in harnessing the substantial and relatively diversified energy resource base in BH to expand power generation capacity to meet growing electricity supply deficit within the ECSEE sub-region.²¹ Moreover, a large number of (thermal and hydro) power generation projects are apparently under consideration by the entity governments and the EPs, with most of the incremental electricity production being earmarked for export. Looking ahead, a central challenge for BH is to adopt and implement a comprehensive energy sector strategy to inform the development and adoption by the state and the entity governments of a unified blueprint for harnessing the country's indigenous energy resources to strengthen the country's position in the emerging competitive regional electricity (and gas) markets of the ECSEE. The strategy should also help mobilize private sector participation.

6.12 Given the significant generation investment needs in the region and the resulting competition among different countries to attract private (and public) sector financing, even one ill-advised undertaking that becomes controversial could have a significant negative impact on the perceived investment climate for such projects in BH, and thereby considerably reduce the prospects of attracting further investments. The BH commitments to the ECSEE Treaty require the authorities to put in place and adhere to transparent and competitive procedures for solicitation, selection and authorization of all new power generation projects, including small distributed-generation projects, such as mini hydropower facilities. The main challenge is to achieve harmonization of tendering and authorization rules to be put in place by the entity governments for new power generation projects. Such rules need also to be in accord with the relevant EU Directives.

6.13 Recognizing the constraints within the overall fiscal envelope, the authorities have begun to explore avenues for spreading risk and limiting fiscal costs through private sector participation. Although some of these initiatives have involved some

²¹ Refer to "Update of the Power generation Investment Study in South-Eastern Europe: Summary Report (Volume 1)", by Sustainable Development Department, Europe & Central Asia, World Bank (dated December 2006).

studies and a competitive process (primarily for some of the hydropower plants), several initiatives are linked to unsolicited proposals from the private sector. The comprehensive energy strategy referred to above should help define the avenues for mobilizing private sector participation in new power generation and transmission facilities.

C. POLICY STRATEGY

6.14 BH's energy sector has come a long way since 1995. The challenges identified in the previous section need to be addressed in a comprehensive and determined way to enable BH to reap maximum benefits from its abundant energy resources. Most of the key recommendations going forward have been articulated in the aide memoires (AM) that World Bank missions have prepared for the authorities during the Bank's continued support for the BH energy sector. A summary of these recommendations, with the details to be found in the AMs, is presented below:

- The authorities should develop and implement a national energy sector strategy taking into account the conclusions and recommendations of the energy sector study launched recently.
- The Federation and RS governments should take appropriate and necessary actions to expedite effective and coordinated implementation of the respective Power Sector Restructuring Action Plans. Efforts should continue to ensure the effective functioning of the Transmission Company and Independent System Operator.
- Adverse impacts on households from increases in electricity tariffs need to be treated the same way as any other adverse impact, thus mitigated through a comprehensive, general social safety net established by the entity governments. There should be no separate social safety nets solely for the purpose of mitigating increases in tariffs, nor should the EPs be burdened with cushioning the impact on vulnerable customers.

6.15 Looking beyond these challenges, the authorities need to work to meet BH's commitment to the ECSEE. This will involve continuing with market-oriented power sector reforms, in line with existing legislation and the EPs restructuring action plans, and continuing to give priority to the rehabilitation, refurbishment and expansion of aging power generation capacity. These measures should be accompanied by efforts to restructure the coal sector to reduce unit production costs for thermal power generation, and carry out dam safety upgrades at hydropower facilities. Additionally, the ongoing study to develop a comprehensive energy sector strategy at the state level²² should inform the preparation of a unified BH blueprint for strengthening the country's position in the ECSEE regional electricity market. Moreover, measures are needed to spread risks and limit fiscal costs of establishing new power generation and transmission projects, through private sector participation.

²² Under the Third Electric Power Reconstruction Project (IDA Credit 3534-BOS), the BH Authorities have launched the statewide "Energy Sector Study" (being executed by a joint venture of consulting firms, led by Energetski Institut Hrvoje Pozar).

POLICY NOTE 7: EDUCATION

A. INTRODUCTION

7.1 Inefficient education spending within an institutionally complex structure has resulted in unacceptably low education outcomes in BH. Forty percent of students do not acquire basic skills and knowledge, while many students enrolled in costly vocational schools receive insufficient general education and are ill-equipped to meet the challenges of today's labor markets. Students from poor families have the least chance of receiving quality education. Fragmentation in the institutional organization of the sector has enshrined significant regional differences in education spending and educational achievements, making it hard for the single economic space to take firmer hold. Moreover, this fragmentation is responsible for poor outcomes in tertiary (higher) education and puts at risk BH's participation in the European Higher Education Area.

7.2 Meeting the challenges faced by the education sector will require that systemic inefficiencies be tackled before new resources are dedicated. It is therefore important to implement measures to help improve efficiency over the medium term while raising education outcomes. Savings can be found from improving efficiency within the sector, and are estimated at about KM770 million over five years, resources which could be used to finance a package of reforms urgently needed to begin meeting the identified challenges.²³

7.3 The agenda summarized in this note is undoubtedly ambitious. However, the priorities identified are deliberately few in number (and significantly fewer than in government documents) and almost all of them are included in existing policy documents adopted by governments. What remains is the political will to carry out the reforms that are central to the future welfare of the country.

²³ For the full background of this note, consult chapter 5 of the World Bank's *BH Public Expenditure and Institutional Review, 2006*.

B. KEY ISSUES AND CHALLENGES

Education Spending

7.4 BH education spending is larger than in all other countries in the region and only modestly lower than the average for the OECD countries. Within this high spending, wage costs consume 80 percent of resources, slightly higher than in comparator countries. There is substantial scope for improving the efficiency of teacher use in primary and secondary education, thereby increasing student-teacher ratios, as a way to reduce the share of the budget spent on wages. While countries exhibit a wide range of student-teacher ratios in tertiary education, BH's ratio is low. Moreover, the trends in BH are in the wrong direction, with the number of both primary and secondary teachers falling by less than the number of primary students in the FBH during 2002-2004. In the RS, the number of secondary teachers actually increased, even as the number of students decreased.

Education Coverage

7.5 The share of children attending primary schools is similar to other countries, although coverage is still not complete. Secondary and tertiary education coverage (73 percent and 24 percent) tends to be lower despite some improvement of late. Enrollment rates are much lower for children from poor households and with relatively uneducated parents, limiting scope for escaping from poverty. The direct costs of attending school reduce school attendance for poor children. The cost of education is the second most prevalent reason for non-continuation of schooling beyond the compulsory level. The private costs of schooling increase sharply after the primary level.

7.6 There will be a sharp decline in the secondary and tertiary school-age cohorts over the next decade due to past fertility declines and outward migration, followed by a partial recovery during the following ten years. Over the next decade, the primary school-age cohort is projected to increase by 8 percent, while the secondary and tertiary education cohorts to shrink by one-third. This pattern is fortunate for education spending because the cohort declines are projected to occur at levels of education having low coverage rates at present.

Education Quality

7.7 Exacerbating coverage issues, student performance in a number of areas is substandard, while geographical differences are substantial. In 2003/04, at least 40 percent of eighth-grade students across the country failed to obtain a satisfactory score on the mathematics assessment. This number rises to more than one-half of the students in the Central Bosnia and Una Sana cantons, with an even greater difference among the

average performance of individual schools. This assessment was based on what BH experts thought students should be able to do at the end of primary education. BH's performance on international assessments is similarly poor.

7.8 Levels of funding are positively associated with student achievement, but more resources will not necessarily lead to improved educational outcomes. Both average levels of public financing per student and student performance vary widely by region. Within the FBH, at least, cantons that spend more on education tend to have higher student achievement but these cantons also tend to have higher incomes per capita and higher levels of parental education, both of which result in better student achievement. Raising learning achievement in the poorer cantons would require spending more on interventions such as tutoring and subsidized provision of textbooks in order to offset the handicaps of lower parental education and lower household income. At present, most spending is on wages and a substantial part of the rest of the budget is on utilities and heating. This leaves little for educational materials, teacher training and other measures that directly support improvements in the teaching and learning process.

7.9 Graduates of secondary vocational programs earn far less on average than graduates of general secondary schools, and little more than primary-school graduates. Despite this, the majority of students attend vocational education courses. Moreover, secondary vocational and technical education programs disproportionately attract students from low-income households, exacerbating the socio-economic differences in family background.

7.10 There are no good measures of quality of tertiary education as BH does not have a system of quality assurance or accreditation. But there are other dimensions that demonstrate that tertiary education performance is weak. Efficiency is very low, with only three percent of students graduating from the University of Sarajevo in 2003 doing so on time. These inefficiencies are in large part caused by the highly autonomous faculties within universities, resulting in duplication and lack of institutional strategy and management. BH has signed the Bologna Declaration that commits it to establishing a system of quality assurance, restructuring and modernizing degree programs and courses, and enabling the mobility of professors and students within BH and with other countries. BH's slow progress to date in fulfilling these commitments places it at the bottom of a ranking of participating countries.

C. POLICY STRATEGY

7.11 The recommended policy strategy involves a restructuring of the education system to yield savings that could be used to tackle directly the causes of poor educational performance. This approach should help improve efficiency while also tackling equity and raising quality.

Improving efficiency

7.12 The paragraphs below propose a set of measures designed to create substantial room to redirect spending towards priority areas. Overall, the measures to improve efficiency proposed in this section are estimated to save KM770 million over the next five years. However, given the breadth of the change needed, and the structural weaknesses that exist, priorities for immediate action are identified (which might consume approximately half of the savings). Once these initial changes have been made, the authorities could consider further investments warranted. While the policy recommendations apply to all jurisdictions, the potential for savings will vary; no attempt has been made to produce sub-national estimates. However, the responsibility for action lies with the sub-national governments.

7.13 As a matter of first priority, governments should adopt policies to ensure that teacher numbers decline in relation to any future decline in enrollments so that resources can be released for reform priorities. Moving to the *recommended* average class size for primary education in both entities could lead to budget savings on teacher costs of about KM35 million per year without degrading education quality. Achieving these potential savings would require major changes in the school management and financing framework.

7.14 Capitation financing would yield substantial savings. This would help provide an incentive for a more efficient deployment of teachers and use of schools, and could also help improve quality, as schools compete with each other to attract more students. Even if secondary enrollment coverage were to increase by 1 percent a year, cumulative savings from capitation financing would amount to about KM125 million in the first three years of implementation. Capitation financing could be combined with setting aside centrally financed initiatives to raise teaching effectiveness in the lowest-performing schools. These funds could either come from budget savings or from setting per-student allocations in the formula at a level below the current average per pupil spending and using the remainder to finance targeted interventions.

7.15 Reducing or moderating the growth of teacher salaries could provide the most important budget savings over the medium term (as much as KM200 million over five years). Average teacher salaries in BH are double per-capita income, which is very high compared to all OECD countries except South Korea. High staffing ratios amplify the fiscal cost of these high salaries. With school cohorts projected to decline in size, teacher salaries could be gradually lowered in real terms and the number of teachers could be reduced without compromising the needed supply of teachers. Increasing real GDP growth, of course, remains a key priority for boosting the incomes of all citizens, including teachers.

7.16 Restructuring secondary education by moving away from vocational programs, especially those of only three years in duration, would help reduce costs and improve the relevance of education. The main reform would be to convert some secondary vocational and technical education programs to general education. This reform is promoted by the Education Restructuring Project, supported by the World Bank, and

could potentially be amplified. Hungary and other transition countries are revamping a large number of occupation-specific programs by strengthening training in mathematics, science and languages. Cumulative savings from this measure could amount to KM65 million over the next five years.

7.17 Unified higher education management has provided major savings in Tuzla University, and could do so for other universities. Apart from Tuzla University and more recently Zenica University, all universities in BH are agglomerations of separately managed faculties and institutes, limiting course choices for students and increasing administrative costs because each faculty has separate accounting, budget and support staff. Since it unified management five years ago, Tuzla University has reduced total public expenditures by 20 percent, while doubling staff, tripling enrollment, improving laboratory and library facilities, and diversifying financing. In the process, it also offered more student choice and flexibility across programs and better access to professors by eliminating over-programming of teaching staff. Based on the experience of Tuzla University, budget savings from moving to unified management for other universities throughout the country are estimated at KM60 million over the first four years of implementation. It is encouraging to see that there is now consensus for changing the legal structure of universities across BH, though action remains to be taken.

7.18 Increasing fees for repeating students in higher education would lead to improved efficiency and additional revenues. Students currently take 7.2 years on average to complete a four-year degree program in the FBH. Students with budget support who repeat an individual year more than twice have to pay fees and fee-paying students have to pay slightly increased tuition; in the absence of effective quality assurance mechanisms, this creates an incentive to fail students (and opens up avenues for corruption). But these students still pay far less than the full cost of their programs. Raising fees for repeating students to the full budget cost of their programs would generate about KM145 million over the next five years.

Improving equity and quality

7.19 At a minimum, any credible effort to improve attendance and quality of primary and secondary education would require three elements. Firstly, improve the classroom environment for effective teaching and learning, including by improving the availability of textbooks and other teaching and learning materials. Secondly, improve teachers' effectiveness through in-service training, and thirdly, provide additional incentives and penalties to encourage school attendance by children from the poorest households.

7.20 A limited program to address these immediate needs in primary education is estimated to cost about KM100 million over five years. These costs would include spending for improving availability of classroom teaching and learning materials, including textbooks in all primary schools in BH; spending for teacher training, including the costs of developing training programs and materials in the core subjects; and conditional cash transfers to offset the cost of school attendance for children in very poor households.

These transfer programs have a well-documented record of success in many countries around the world.

7.21 Similar considerations apply to secondary schools, where a five-year program of reform might cost KM150 million. This spending could include the cost of providing a similar program of training over a three-year period for all secondary teachers, funds to improve teaching and learning materials for general education in all secondary schools and materials and updated equipment for secondary vocational and technical courses. Funds could also be used to provide grants to defray the larger private costs of secondary education for students from poor families.

7.22 Implementing these ideas would result in a substantial overhaul of BH education system and would yield quick results in terms of improved student attendance and learning conditions in schools. These, in turn, would generate improved learning outcomes. This package of measures would cost about KM370 million, about one-half of the projected savings.

7.23 Additional reforms and investments would be needed to tackle other problems identified in this note, but the costs of these changes are more difficult to assess without more extensive study than has been possible to date. In order of priority, these need to include reforming the management of universities (including management and professor training) and restructuring degree programs to modernize curriculum. Further, there is need to introduce quality assurance and accreditation systems to provide a level playing field for public and private providers, and invest in facilities, starting with a focus on health and safety issues and on investments that would support the core reforms (such as expanding general education schools to enable increased enrollments in four year secondary programs).

POLICY NOTE 8: PENSIONS

A. INTRODUCTION

8.1 Substantial reforms have been undertaken in the entity pension funds that comprise the BH pension system. Nonetheless, critical problems still exist and will only worsen with time unless tackled early. The key problems include high contribution rates and acquired rights, sharply declining contributory coverage and differential implementation of the revenue constraint imposed by the OHR. The latter will result in lower future benefit rates in the FBH and higher current budgetary costs in the RS. Furthermore, there are parameters in both systems that encourage shorter working careers and overuse of benefits. Pension system parameters also differ across the two entities, limiting scope for workers to move between the FBH and the RS and contributing to fragment the labor market. Finally, the high labor market informality results in lower revenues and lower protections for workers. It will also have future impact as fewer of the elderly get a right to a pension.

B. KEY ISSUES AND CHALLENGES

8.2 The key issues facing the pension system are the functioning of the coefficient mechanism imposed by the OHR, the high contribution rates, and the disincentives for making pension contributions. **These are discussed in turn below.**

The coefficient mechanism

8.3 The OHR imposed in 1998 a revenue constraint on pension expenditures, limiting the total pension outlays to the revenue collected. The purpose of this ruling was to avoid building of pension arrears at a time when revenues were severely limited. This ruling was subsequently formalized in laws in both entities. However, the implementation across the two entities differs considerably. The Federation has implemented the ruling rigorously, and with revenues rising rapidly due to higher wage growth in recent years, average pensions have increased substantially faster than inflation. As wage growth slows, however, and as the population continues to age, scope for sustaining such a pace of pension increases will be limited. Benefits will ultimately begin to decline in nominal terms given the binding revenue constraint. Another factor contributing to lower pensions is the burden on the pension fund to pay benefits to individuals that have not paid contributions, and for whom the budget has not made the promised compensatory transfers to the pension fund. The RS, on the other hand, has

opted to finance a substantial share of pensions through budgetary support to the pension fund, thus loosening the impact of the revenue constraint on expenditures. It is likely that demand for such support will only increase with time.

8.4 The use of this revenue constraint has been reasonably effective in preventing the accumulation of pension arrears. In the Federation, the coefficient has been above 1 for some time (implying higher pensions than legally mandated). In the RS, a political decision was made to raise the coefficient to 1 in 2006, financed with larger budgetary transfers. The difference in applying the coefficient mechanism in the two entities arises from the different rates of growth in output and employment, and a higher contribution rate applied in the Federation. Pensioners in RS are interpreting the years in which the coefficient was below 1 as years in which arrears were accumulated, despite the prohibition on such arrears accumulation by law. In addition to its current heavy reliance on budgetary support, the RS government needs to take a strong position against pressures to recognize arrears.

8.5 The implementation of the coefficient mechanism has led to a quasi-indexation of pensions in payment. The nominal value of a pension is calculated at the time of retirement and this value is multiplied by the coefficient in any given year to determine the amount of the pension. Thus, if the coefficient is 1.15, all pensions are raised by 15 percent above their nominal value at the time they were awarded. For the oldest pensioners, the accumulated inflation since they began receiving pensions may well exceed 15 percent, thus even a coefficient of 1.15 does not allow pensions to keep pace with the cost of living. For those who retired only a year before, a coefficient of 1.15 results in a substantial bonus. Instead of protecting the consumption basket of the elderly, this system actually lowers the real pensions for the oldest pensioners. This effect will increase substantially when the coefficient actually begins to fall.

High contribution rates

8.6 Contribution rates set at 24 percent of gross (net) wages in the Federation (RS) are relatively high by OECD standards. Benefit rates are also more generous than in the OECD, with individuals accruing at the pace of 2 percent of net wage per year of contribution for the first 20 years of making contributions. On the other hand, the retirement age has been raised to 65 years in both entities, although a large share of new retirees continue to retire much earlier. Pensions are already based on full career earnings in the RS, in line with international best practice, and are rapidly moving in that direction in the Federation.

Disincentives for making pension contributions

8.7 A number of design features in both systems provide incentives for short contribution careers, increasing the prevalence of informal labor markets. Firstly, accrual rates in both systems are significantly higher for the first 20 years than for the following 20 years. After 40 years of contributions, no increases in benefits are permitted. Individuals thus are encouraged to contribute 20 years just to gain eligibility and then to move to the informal sector, or more commonly, to spend the first 20-25 years of their

career in the informal sector and then transfer to the formal sector just before retiring to qualify for a pension.

8.8 Similarly, the eligibility standard for receiving disability payments includes inability to perform in the last job. Internationally, by contrast, disability is often defined as inability to perform any job. Furthermore, disability payments are more generous than old-age pensions. If an individual has contributed for the 19 years prior to retirement and can claim a disability before reaching retirement age, the individual is eligible for a higher pension than if the person contributes an additional year and qualifies under the old age pension.

8.9 These disincentives, together with lack of strong enforcement have contributed to high informality. For a pensioner, informality implies a loss of potential revenue to the pension funds and thus a lower pension, given that pension levels are constrained by revenues. In the long run, those who have not contributed will not have rights to collecting old-age pensions. While formal labor force participation has been lower in BH compared with other transition economies, the broad range of benefits available to veterans and their families, and to other special groups suggests that most elderly currently have access to some public support. Furthermore, many firms still keep on their books a large number of workers who are no longer actually working in the company and earning a salary. Contributions for these workers have not been paid during this period of no salary. As these workers reach retirement age, governments are likely to come under political pressure to deal with these gaps. Through the medium term, governments are more likely to acquiesce and grant pension rights. Over the longer term, however, those without contributions will be unable to collect benefits.

C. POLICY STRATEGY

8.10 As a first step, the entities should consider harmonizing the parameters of the pension systems, removing the disincentives for making contributions and aligning all remaining parameters with international standards. Recommendations to be considered for immediate implementation include:

- Unify contribution rates at 24 percent of net wages, a measure that will result in a reduction in the Federation contribution rate.
- Remove the option for women to retire at the age 60 in the RS
- Lower the annual accrual rate to 1.5 percent for all years of contribution from the current higher level applied to the first 20 years and remove the limits which penalize those who might try to contribute for more than 40 years
- Move from the current coefficient system to an indexation of pensions to inflation

- Introduce administrative constraints on new disability and survivor pensions to reduce the number of recipients by one-half over the next 20 years.

8.11 While these short-term measures will help improve the fiscal outlook for the RS pension fund and in the level of benefits in the Federation, the pension funds will still experience significant deficits in the longer term. The number of elderly covered in the future, moreover, will continue to decline.

8.12 Additional and fundamental reforms are needed to help assure the fiscal sustainability of the pension systems. Rather than continuing to subsidize those who previously contributed to the pension system and leaving those who were unable to contribute with no public assistance, the governments could choose to further reform the parameters of the existing schemes to make them financially self-sufficient and use government resources to provide a social pension for all elderly, irrespective of whether they also receive a contributory pension. Measures to achieve financial sustainability in the contributory system include further reductions in the accrual rate and an increase in the retirement age. Pensions would become more modest, but if people want additional pension, they can always choose to save more through a voluntary system. The fiscal resources freed could then be allocated to providing a social pension for all. Such a level will clearly not provide for a comfortable living standard, but will be sufficient to guarantee a minimum assistance to the elderly.

8.13 Proposals to move toward a mandatory funded system (second pillar) or as a voluntary supplement to the existing scheme (third pillar), need to be carefully evaluated. Successful implementation of a second pillar would require that governments cover the shortfall in the pension fund generated from shifting revenues to private accounts. Privatization proceeds could help finance this transitional gap, but they will typically suffice for a relatively short period, while the transition period is likely to last 20-40 years, depending on how the reform is designed. A second area to consider before introducing funded pillars is the state of the financial markets. Are there sufficient financial market instruments that offer reasonable returns without undue risk in which pension funds can invest? Is the regulation and supervision of financial markets such that unsophisticated investors can safely invest their lifetime savings and expect to receive a reasonable pension in 30-40 years? Is there a stable enough macroeconomic framework that the financial market can even provide long-term instruments? Without these financial market and macroeconomic preconditions, the funded pension system will not provide adequate pensions and result in implicit liabilities for a government unwilling to abandon its elderly, but without access to the resources provided by worker contributions to a public pension system.

8.14 At the same time, the public pension system will clearly have to pay less generous benefits in the future. Reforms that enhance the financial market structure will enable individuals to save additional resources to augment the reduced pensions that the public system will pay. These reforms need to involve improvements in the full range of financial market instruments, including housing finance. The marketing of unregulated pension products while the financial market structure is evolving can often result in substantial losses to unwitting savers, making it more difficult to rely on products like these

for some portion of retirement savings. The governments are strongly encouraged to create the legal and institutional framework to ensure development of a healthy nonbank financial sector, rather than allowing unregulated schemes to proliferate.

8.15 In the absence of reform, the RS pension system will continue to require substantial fiscal resources and the Federation will soon begin to see falling pensions. Any structural reform will require additional resources from the governments. The governments are urged to focus on the short-term pension reform measures that can help create fiscal room for more substantive future reform. Moreover, the governments are advised to improve the information databases of the pension funds and tighten collection.

POLICY NOTE 9: AGRICULTURE, FORESTRY AND NATURAL RESOURCES

A. INTRODUCTION

9.1 Agriculture and forestry are important economic sectors in Bosnia and Herzegovina (BH), accounting for about 10 percent of GDP and 21 percent of employment.^{24,25} Low productivity in agriculture and inefficient management of the country's natural resources have limited scope for higher rural growth and development, however, and sustained dependence on agricultural imports. Rural livelihoods have come under increasing pressure and the poverty of those working in the natural resources-based economy has remained little changed near 20 percent.

9.2 The opportunity is ripe for the agriculture and forestry sectors to undergo a significant transition, and pre-accession assistance from the EU would be an effective vehicle to facilitate this process. The transition should help turn producers and processors with commercial potential into a vibrant part of the economy. It will also help provide for a new future for the small subsistence farmers without commercial potential, including by diversifying income sources through rural development programs and social protection programs. This transition can be moved forward by adjusting and strengthening agricultural and forestry policies and institutions while simultaneously advancing EU integration and taking advantage of the opportunities associated with pre-accession.

9.3 Improved natural resource management can maximize the contribution of forests, water resources and biodiversity to rural growth and development, and help reduce rural poverty. Most pressing is the need to improve the governance structures so that these resources are managed to optimize all benefits including public goods. Strengthened environmental policies and institutions will help facilitate BH's EU integration process.

²⁴ Official statistics are likely to underestimate the role of agriculture, given the significant role it plays in the informal economy.

²⁵ Data refers to 2005 GDP and the 2006 Labor Force Survey. The 21 percent employed in agriculture under the latter are to be compared with the 4 percent of the labor force registered as employed in agricultural enterprises and other organizations.

B. KEY ISSUES AND CHALLENGES

9.4 A vibrant future for BH's agriculture and forestry can be assured only if they begin to produce high quality and value specialty products. Agricultural producers and processors have the potential to supply such products, but at present they cannot compete successfully either domestically or abroad. In order for the small-scale farmers who currently dominate the agriculture sector to match the price and quality levels of competing agricultural products, they must invest in productivity and quality enhancing technology. Likewise, producers and processors of forest products need to better respond to market demand by improving efficiency and involving transparent, competitive supply chains.

9.5 There are structural and institutional obstacles to increasing the productivity and quality levels of BH's agriculture and forestry. Structural obstacles include the slow land consolidation process, deteriorated rural infrastructure and underdeveloped rural credit markets. The main institutional obstacles include the absence of a well-articulated rural development strategy, unpredictability in agricultural support programs, and the lack of a modern food quality (including safety) system. Regarding forestry institutions, BH recently separated the regulatory and production functions into separate agencies, and its relatively new parastatal forest management companies now need to further develop their business planning, marketing, and other management capacity.

9.6 Uncertainties regarding ownership, land fragmentation and the absence of a well-functioning land rental market contribute to the underperformance of the agricultural sector. About half of arable land remains unused due to a combination of uncertainties regarding land ownership and lack of access to capital. Agricultural land is very fragmented with a large number of farms with plots of about 2-3 ha, each dispersed in 6-8 plots. Land consolidation is complicated by the lack of enabling state-level legislation to replicate small-pilot land consolidation initiatives countrywide and the unregulated process of converting high-quality agricultural land to urban uses.

9.7 Deteriorating rural infrastructure, including roads, electricity, and village water supply and irrigation, constrain rural development. Costs for agricultural and forest producers are increased, as a result. Further rehabilitation of existing irrigation schemes and improved drainage and management of land could enhance the development of high-value crops in the north and east of BH.

9.8 Improving long-term rural financing opportunities can help increase investment in agricultural productivity and processing as well as non-farm activities. Although reduced of late, interest rates charged primary agricultural producers and processors continue to be high, as commercial banks tend to perceive rural lending as a high risk. Risks primarily reflect the long-term nature of agricultural investments and problems farmers have using their property as collateral because of uncertainties regarding land ownership. Some private banks are participating in subsidized credit schemes set up by the entity ministries of agriculture to address this issue. However, subsidized credit schemes may ultimately delay the development of a sustainable rural finance by discouraging banks from undertaking proper risk assessments.

9.9 The absence of reliable statistical data and comprehensive national agricultural strategy hampers the development of BH's agriculture sector; the lack of an updated state forest inventory (SFI) constrains forestry planning. Available information on ownership, size and operational structures of agricultural farms, number of livestock, and labor in agriculture is outdated. In addition, data is not systematically collected. Reliable information would help improve the targeting of public resources in agriculture and the design of an EU compatible agriculture and rural development policy. The lack of an SFI since the 1960s prevents BH from knowing the extent and location of its forest assets for potential private investors in wood-processing industries. It also impedes sound decision making on forest-related public expenditure and revenue policies, and national reporting on international conventions that are important to the EU. The recently designed and tested SFI methodology, which covers 12 percent of forest land, is a step in the right direction.

9.10 BH's agricultural subsidies are unpredictable and do not send consistent signals to agricultural producers and processors. Existing programs include a range of production and interest subsidies that often change from year to year, introducing a significant degree of uncertainty and resulting in higher costs in the long-term investment planning process. Merging the subsidy programs into a single instrument that is decoupled from production and prices, and can be efficiently targeted to those with the highest potential would help improve the sector's competitiveness. It is also important to direct some of these resources towards rural development programs to diversify the income sources of the poorest segments of the population. This approach will also be consistent with the guidance under the Instrument for Pre-Accession in rural development and eventually EU's common agricultural policy.

9.11 Food safety, veterinary and phytosanitary systems need to be improved to ensure that BH's agricultural output is of high quality. Producing high quality and safe agricultural products is largely a private sector responsibility for which the public sector must provide an enabling environment. While steps have been taken to improve the legal and institutional framework for sanitary, veterinary and phytosanitary services, the capacity of the recently established Food Safety Agency, State Veterinary Office and Phytosanitary Agency are underdeveloped. Moreover, there is a need for greater cooperation and coordination between the state and entities and careful consideration of the role of the private sector in providing inspection and laboratory services.

9.12 Improving water resource planning, water quality, and water waste management are key challenges that must be addressed in the near term. BH is a water-rich country with significant potential for hydropower generation and irrigation. However, management of river basins to maximize electricity generation has impacts on other uses (such as tourism, environmental services, and irrigation). Most of its rivers are shared with other countries and some areas face localized water shortages, all of which must be addressed through improved water management planning. The new Water Law, which was adopted to regulate many areas of water resources management in accordance with the EU Water Framework Directive, still needs to be implemented.

9.13 BH's substantial forest and biodiversity resources require better governance. Government forest offices, police, customs officials and local and central government need

to become more effective in fulfilling their oversight roles. Further, while the extent of corrupt practices and illegal activities in forestry are not precisely known, there is general consensus among stakeholders that the problem deserves special attention. As a result, the government has moved to develop an action plan to combat illegal activities. Improved biodiversity conservation could substantially assist the development of nature-based tourism and lead to improved management of water, forest, and other land-based ecosystems.

C. POLICY STRATEGY

9.14 It is recommended that public institutions related to agriculture be strengthened to promote a more productive and quality-oriented agricultural sector. To this end, immediate action is needed to improve agricultural statistics. Advisory and extension services need to be modernized, and the land consolidation process accelerated so that farms can produce on a more viable scale and with better access to credit. A modern, risk-based food safety and management system needs to be introduced to help improve quality of agricultural output and help producers seize opportunities for growth.

9.15 Agricultural support programs can be decoupled and made more predictable to reduce uncertainty for farmers. Decoupling support from specific crops should help induce farmers and agro-processors to make investments to improve productivity and competitiveness. In addition, this would pave the road for potential EU pre-accession funds for rural development and rural landscape management that should help make the best use of BH's natural assets and ease the transition towards non-farm activities and rural development for the non-commercially oriented farmers.

9.16 Carefully targeted support for forestry would optimize the sustainable economic benefits of BH's rich forest assets. This could include completing the state forest inventory and the associated analysis, further developing the forest management information systems and providing other institutional support. Such support could comprise implementing strategies for human resources development, new timber pricing mechanisms and forest management company business planning. Improved governance in the sector, together with improved communication and transparency, will also be crucial for achieving optimum results.

9.17 Improving environmental management will also be important, particularly in the water sector. Support for water resources could include improving water management practices and developing a strategy for irrigation and drainage. Particular attention needs to be paid to improving multi-purpose management of BH's river basins for power generation, irrigation, tourism, and water and waste water services. Environmental capacity building is critical for the further development of the country's tourism sector. It should also help prepare BH for absorption of possible EU pre-accession funds for environmental investments and help meet the EU accession requirements in the field of environment.

POLICY NOTE 10: LOCAL GOVERNANCE AND MUNICIPAL DEVELOPMENT

A. INTRODUCTION

1.1 A decade after the Dayton Peace Agreement (DPA), the municipalities are among the most uncontested and accountable government institutions. Local authority and legitimacy is far less challenged compared to any other level of government. Federalism and decentralization was considered fundamental to the successful post-conflict reconstruction, with the layer of municipal governments a key building block for service delivery and post-conflict institution building. However, the current decentralization framework is characterized by a lack of clarity and mismatch between responsibility for service provision and funding among various levels of government. As a result, municipalities are frequently caught between the need to match limited resources with large needs to improve local infrastructure and service delivery. Since 1995, there has been continuous reform and the introduction of the VAT in 2006 is the most recent example that directly affected the municipalities. But, much more needs to be done to reap the full benefits of decentralization.

1.2 Robust municipalities are critical for growth and poverty alleviation in BH. Well-functioning local infrastructure and municipal services along with sound urban management will be of even greater importance to maintaining robust growth. While agriculture's contribution to GDP has been declining, the share of services, including construction, has grown, indicating a growth of urban service sector. BH is urbanizing at a rate faster than before the war, with the urban population amounting to 46 percent of the total population at present, projected to increase to 62 percent by 2030 as a result of migration from the rural areas and smaller towns. With increased urbanization, economic activities will be taking place increasingly in cities, accounting for a larger share of GDP.

1.3 Municipalities and local governments are the main and de facto provider of essential services to citizens. BH municipalities have the specific responsibility to deliver infrastructure service like local roads, water, waste water and solid waste and social services like housing and housing related services. In addition, municipalities play a critical role in facilitating access to health and education services. Municipalities also face the challenge of re-integration of returnees and internally displaced persons, including a decisive role in facilitating cooperation and trust at the local level which cannot be achieved by higher levels of government.

B. KEY CHALLENGES

1.4 There is a need for major improvements in local infrastructure and services.

Due to a lack of funding for rehabilitation and further investment, much needed infrastructure has only been partly rebuilt and there has been a visible decay of infrastructure. Most local level utilities need reform and investments. Utilities are generally in a perpetual financial crisis due to low collections, low tariffs and lack of maintenance. As a result, many Utilities are in arrears to suppliers, contractors, Government agencies and power companies. Organizational fragmentation at the municipal level resulting from post-war split up of municipalities added to inefficiencies. As a consequence, service quality and reliability are lagging compared to countries in the region. A vicious circle is created where deteriorating service makes consumers reluctant to pay the tariffs and where the lack of tariff revenue, in turn, prevents maintenance and causes service to deteriorate still further.

1.5 Responsibilities are defined poorly and too broadly among levels of government.

The decentralized government structure created by the DPA was intended to ensure political stability (motivated predominately by ethnic criteria) and promote democratic representation in the decision-making process. However, unclear specification of the division of functions across levels of government has resulted in duplication or under-provision of essential public services, and a proliferation of unfunded mandates.

1.6 Resource allocation is strikingly disconnected from responsibilities, which are unnecessarily split between municipalities and next higher unit of government.

Decentralization is unbalanced and incomplete in that public spending is predominately undertaken at entity and cantonal levels, leaving only small percentage of the total budget executed at the municipal level. Delegated responsibilities have been pushed back and forth between municipalities and higher government levels. Although the RS in its constitution and the Federation in its local government law guarantee funds and resources to carry out mandatory and delegated tasks at the municipal level, municipalities in both Entities often step in to provide services that higher levels of government failed to provide, due to funding shortage and/or ill-specified criteria for financing. For example, municipalities in the federation often have to allocate funds to support schools though education is a cantonal level function.

1.7 Municipalities in both entities lack the ability to influence the size and quality of the tax base used for both local taxes and shared taxes.

In both Entities municipalities depend highly on shared taxes (sales taxes and personal income tax, and more recently the VAT), often representing more than 80% of their total revenue. On average, own source revenue – revenues imposed and collected by the municipalities - contribute around 10% of municipal budgets (though the exact size of local tax revenue is often unreported). Few of these local revenue instruments are regulated by the Cities/municipalities themselves (e.g. property tax), except for user charges on utility provided services. As a result, local authorities have little incentive and scope to improve the tax base through economic development or greater mobilization/collection efforts.

1.8 Absence of rule-based intergovernmental transfers worsened fiscal imbalances among levels of governments (vertical) and across regions (horizontal). There are substantial regional variations in per capita revenues and expenditures, with Municipalities witnessing the largest horizontal fiscal disparities in both Entities. Uneven regional distribution of the economic basis and the revenue allocation being solely reliant on an origin based tax sharing principle has resulted in the poorest and stagnating regions being left behind. Vertical fiscal imbalances basically run against the State level government and the municipalities because of their very limited own revenues as a source for financing their current responsibilities.

1.9 The new VAT allocation mechanism seeks to address, at least partially, both the vertical as well as horizontal imbalances in intergovernmental fiscal transfers; however, its real impact is still unknown. The rules that govern distribution of the revenue collected by the new Indirect Tax Authority (which includes the VAT) allows predictable and increased revenues for the state level and the municipalities, hence, addressing the core issues of vertical imbalances in fiscal transfers. The formula that guides the distribution of this revenue among the municipalities includes, to a limited extent, demographic variables, hence, addressing the horizontal imbalances in fiscal transfers among municipalities. Last year, 2006, was the first year of implementation of this new mechanism, and the whole policy will be implemented gradually over the next few years. It is imperative that the impact of this new initiative on municipal budget is closely monitored and analyzed to evaluate the extent to which this initiative is able to address the horizontal and vertical fiscal imbalances. Some of this analysis is currently in progress.

1.10 A confusing regulatory regime for local borrowing limits infrastructure investments and service expansion. Due to the need for infrastructure investments, and the limited capital investment budget, access to capital markets for sub-national governments has been considered as a potential alternative source to finance fixed public capital formation. However, existing rules governing municipal level borrowing are excessively restrictive. Conventional institutions for facilitating and regulating municipal borrowing – clear rules guiding municipal and utility borrowing, an agency with the authority and capacity to regulate, a mechanism to deal with possible default and a monitoring apparatus – do not currently exist in BH. Both entities have responded to this situation by overtly restricting municipal level borrowing. In RS, existing laws allow local level borrowing, however, each transaction needs to be approved by the entity finance ministry. Overall, very few transactions have actually taken place. In the Federation, though local government laws allow municipal level borrowing, each annual budget laws have effectively forbidden such transaction. New laws governing local level borrowing are being considered/ processed, but their passage and implementation time frame remains unclear.

1.11 Institutional capacity at the municipal level varies greatly, affecting the effectiveness of current decentralized system in BH, especially at the local level and in the smaller municipalities. There is a great variation in institutional capacity among the municipalities in BH. While few large municipalities have competent staff and robust governance structures, most do not. Both elected and non-elected parts of the government have similar capacity issues. A professional civil service is not yet in place. Staff

members often do not have the skills, knowledge, and professional training to work in a modern public administration system. This deficiency is sometimes demonstrated in their lack of development strategies, their poor coordination with higher levels of government on budget parameters and absence of expenditure prioritization criterion. Many qualified staff have left for the private sector for higher paying jobs or left the country, leading to a lack of innovation in service provision.

C. POLICY STRATEGIES

1.12 Clarifying roles and responsibilities within the decentralization framework would minimize inefficiencies and leverage the full potential of municipal governance.

Though numerous legislative initiatives have been passed to support decentralization, a coherent overall framework for decentralization is critically needed. Such a framework will clearly articulate the political, social and economic goals of decentralization. It further needs to identify and empower the agency that is responsible for implementation of the framework through coordination across various sectors and across various levels of government. A well articulated decentralization framework will also allow policy makers to quickly identify the legislation and institutions that are missing or need augmentation to meet the overall goals and help focus their efforts. Reduction of overlapping responsibilities among various levels of government will improve quality of public goods and shrink the room for inefficient use of resources by raising accountability. Under given fiscal constraints, strategic policy actions need to be taken to specify expenditure responsibilities at each level of government. Mandates need to be clarified and well defined service standards to be set at the local level. It is critical to develop a clear vision of the role of municipalities, especially in the Federation where the relationship between cantons and municipalities needs to be further clarified. However, many small municipalities will depend on cantons/entity to pool resources to reach economy of scale in service provision; municipalities can associate or collaborate to perform certain functions jointly. Where appropriate, re-assignment of certain functions from municipalities to higher level governments should be considered, as for instance in redistributive measures as an essential factor for social stability.

1.13 Taking full advantage of the available fiscal space can expand the scope of municipal finance, reduce chronic under-funding of infrastructure and service utilities and significantly improve public service delivery.

There are four possible strategies that could be pursued by each municipality to increase their overall fiscal space for development expenditure. They include: lobbying higher levels of government to increase their share of intergovernmental transfers, increasing their own source revenue, more efficient expenditure of the existing budget envelope and local borrowing. Especially in BH, there is plenty of potential to widen the fiscal space of municipalities within the overall fiscal envelope. Current transfer schemes have to be adjusted in order to meet the financial needs of municipalities according to their assigned mandates. Furthermore, they have to take into account horizontal fiscal imbalances. Losses due to inefficiencies will minimize, once the re-assignment of functions leads to more economies of scale. With the right incentive structure in place, municipal tax revenues are expected to increase

significantly, offset by reductions at higher levels and, therefore, without adding to the overall government burden on the economy.

1.14 A comprehensive policy needs to be developed that will enable individual municipalities to pursue customized fiscal space expansion strategies, including one or more strategies listed above, that best suit their needs. The following initiatives need to be included in such a policy. First, tax policy, tax assignment/sharing, tax administration, and local utility tariffs have to be realigned within a balanced intergovernmental fiscal system. The issue of own sources revenue and local revenue autonomy as a whole needs to be examined critically, with the goal of increased incentives for own resource mobilization and tax collection at the municipal level. Second, the design of intergovernmental transfers should include the criteria for expenditure needs based on clearly articulated minimum standards for public service provision. Development of minimum standard of service delivery has proven instrumental in ensuring a uniform minimum level and quality of public services in other countries. Third, open access to responsible borrowing for investment from domestic and international capital markets (without sovereign guarantee) will help expand capital expenditure. While embracing the reforms that create the conditions for a rules-based domestic capital market, it should be recognized that such conditions take time to come to fruition. Municipal authority to borrow should be clarified through legislation. At the same time, the financial management skills at the local level and regulatory capacity at the state/entity level need to be developed and strengthened.

1.15 A clear municipal level capacity building strategy has to be a core element of a decentralization framework. A successful decentralization framework has to include initiatives that can address the great variation in governance capacity among the municipalities. Given the different economic and demographic dynamics of municipalities, as well as the various capacities at the local level, municipalities will need tailored and demand driven local capacity building support. Many international agencies have focused their support on municipal level capacity building. This support has included inclusive planning and allocation methods, budgeting, financial management, public procurement, streamlining of selected services, utility management reform and to some extent training for elected officials. Some of these initiatives are very innovative and are much appreciated by the municipal leadership. However, this capacity building support is based on individual projects which include a subset of municipalities and each following a fairly distinct methodology. To move forward in municipal governance reform, the decentralization framework has to include a clear vision on a local capacity building strategy which includes minimum practice standards on basic municipal function, e.g. planning, budgeting, financial management, public procurement and transparency. International agencies can use such a strategy as guide to develop their capacity building program ensuring a more coordinated development of the sector.

1.16 Municipal performance benchmarking, monitoring and widespread dissemination of performance outcomes needs to be a key part of the overall decentralization framework. The desired goal for BH's municipal development agenda is better and more responsive municipal services leading to a better quality of life for its citizens. Significant improvements in service quality are dependant on reforms at all levels of government. The imperative for this reform comes from many directions, e.g. from

users and citizens, from higher levels of government and from a peer group of other municipalities. However, for these groups to be effective in pursuing reform and bringing change in municipal governance, they need to know how well municipalities are performing over time and in relation to other municipalities. Today in BH, there is no systematic collection and dissemination of municipal performance data at any level. This gap in the decentralization framework needs to be addressed immediately for the municipal reform agenda to gather needed momentum. Various methods of municipal performance benchmarking have been used in other countries successfully and a body of knowledge is readily available to develop a system suitable for BH. A regular publication of comparative municipal performance in service delivery for all municipalities in BH will empower municipal leadership, citizens and higher levels of government to pursue reform of the sector with a new understanding of real results.