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A Fiduciary Update on Public Financial Management Bosnia and Herzegovina

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Acronyms and Abbreviations

BCB	Budget Coordination Board	NDP	National Development Plan
BFP	Budget Framework Paper	OBL	Organic Budget Law
BH	Bosnia and Herzegovina	OHR	Office of High Representative
BiH	The State of Bosnia and Herzegovina (the central State)	OBL	Organic Budget Law
CAFAO	Customs and Fiscal Assistance Office	OSCE	Organization for Security and Cooperation in Europe
CFAA	Country Financial Accountability Assessment	PAC	Public Accounts Committee
DfID	UK Department for International Development	PEIR	Public Expenditure Institutional Review
EC	European Community	PIFC	Public Internal Financial Control
EMSAC	The Economic Management Structural Adjustment Credit	PFM	Public financial management
Entities	The Entities refer here to the Federation of Bosnia and Herzegovina and the Republika Srpska	PIP	Public Investment Program
EPPU	Economic Policy and Planning Unit	PIU	Project Implementation Unit
EU	European Union	PPA	Public Procurement Agency
FBiH	The Federation of BiH (sometimes referred to as the Federation)	PRA	Public Revenue Account
GFS	IMF Government Finance Statistics	PRB	Procurement Review Body
GSO	General Services Office	PRSP	Poverty Reduction Strategy Paper
GTZ	Deutsche Gesellschaft fũr Technische Zusammenarbeit (German bilateral technical assistance)	RS	The Republika Srpska
IFAC	International Federation of Accountants	SAA	Stabilization and Association Agreement, negotiations with the European Union
IPSAS	International Public Sector Accounting Standards	SAI	Supreme Audit Institution
ITA	Indirect Tax Authority	SIDA	Swedish International Development Agency
LPP	The Law on Public Procurement (2004)	SNAO	Swedish National Audit Office
MoF	Ministry of Finance	State	The State (uppercase) refers here to the central state of Bosnia and Herzegovina, as established through the Dayton Peace Accords
MTDS	Medium-Term Development Strategy	TSAs	Treasury Single Accounts
MTEF	Medium-Term Expenditure Framework	UNDP	United Nations Development Program
NCB	National Competitive Bidding	USAID	United States Agency for International Development

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Preface

This report is based on the findings of a series of missions to Bosnia and Herzegovina in February/March 2006 and June 2006 by a Task Team that included Sanjay Vani, Task Team Leader, and Bernard Myers (ECSPE); Devesh Chandra Mishra, Yingwei Wu, and Nikola Kerleta (ECSPS-procurement); Andrew Mackie (consultant); Richard Williams, Edward Hedger, Martin Bowen, Rupinder Singh, Chris Vanderweele (DfID financed PKF consultants); Samra Bajramovic (data collection and logistics); and M. Ilyas Butt (report production). The findings were drawn from interviews with public authorities and a detailed analysis of the laws and other relevant information. Government counterparts fully supported the Fiduciary Update missions and engaged with the Fiduciary Update team in a comprehensive dialogue.

Purpose of the Report

The previous diagnostics for Bosnia and Herzegovina, Country Financial Accountability Assessment (CFAA), Country Procurement Assessment Report (CPAR), and the Public Expenditure and Institutional Review (PEIR) were published in 2002/03, but essentially carried out in 2001. These reports offered useful recommendations to Bosnia and Herzegovina (BH) authorities for strengthening the Public Financial Management (PFM) framework, including procurement. Some of these recommendations have been implemented and some have not. This report maps various developments since the previous assessments, identifies success factors in implementation of reforms, and provides a road map to implement remaining reforms.

In the recent past, there has been increasing demand for the use of "country systems" for implementing Bank-financed projects. This report reviews the capacity and risks of using "country systems" for implementing Bank-financed projects and suggests an approach for successful transition to the "country systems".

In addition, this report is intended to support the dialogue with the government/s and donors on strengthening the public financial management in BH, and help design programs to build financial management and procurement capacity. The Fiduciary Update may also help the authorities in assessing existing and future challenges and in identifying actions required to deal with them in a cost-effective manner.

Scope of the Fiduciary Update

This Fiduciary Update covers the State of Bosnia and Herzegovina (BiH) and the two Entities – the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS). In drawing up the scope of the report, consideration was given to available sector work in the area of public financial management, time, and resources. As agreed when the initiating concept paper was reviewed, the Fiduciary Update does not cover the third and fourth levels of governments, that is, the cantons in the Federation and municipalities in both the Entities. A separate fiduciary assessment for cantons and municipalities is expected to be carried out in FY 07.

The report presents a combined update on public financial management and procurement. In the area of financial management, the report covers both upstream budget management (including strategic planning, MTEF, and annual budget preparation) and downstream budget management (including treasury and cash management, internal controls and internal audit, accounting and reporting, external audit, and parliamentary scrutiny). In the area of procurement, the report focuses on soundness of the newly enacted procurement law and on the capacity of procurement agencies to implement the law. In addition, the report discusses fiduciary risks in Bank-financed projects.

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This report was sponsored by the country director for Southeast Europe, Orsalia Kalantzopoulos. This report was prepared under the overall guidance of Sunil Bhattacharya (Acting Director for ECSPS and Regional Procurement Manager), John Hegarty (Manager for Financial Management in ECA), and Dirk Reinermann (Country Manager for BH).

This report benefited from discussions and comments from colleagues—in particular, Siew Chai Ting, Pascale Kervyn de Lettenhove (ECSPS); Ivailo Izvorski, Irina Smirnov (ECSPE); and Srecko Latal (ECCBA).

The team also benefited from discussions with officials from the Central Bank, IMF, DfID, OHR, EC, USAID, UNDP, SIDA, SNAO, OSCE, CAFAO, and other organizations.

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EXECUTIVE SUMMARY

1. **Bosnia and Herzegovina (BH) hopes to successfully conclude the Stabilization and Association Agreement (SAA) with the European Union (EU) by the end of 2006, upgrading BH as a potential candidate for EU membership.** Entry into the EU will increasingly shape the future reform program of BH in several areas, including public financial management.

2. **Bosnia and Herzegovina has made good progress in establishing modern public financial management institutions and systems since the war ended in 1995.** Yet many challenges remain. BH inherited its institutions and systems from Yugoslav rule. Some were dysfunctional; and others simply did not exist and had to be created—for example, treasury and Supreme Audit Institutions. While international financial institutions, donors, and the Office of High Representative (OHR) played important roles in leading the reform process, the efforts and commitment of BH were critical to success.

3. **The State and both Entities—the Federation of Bosnia and Herzegovina and the Republika Srpska—have laid the foundation for sound public financial management, including independent external audits.** The reforms have been characterized by growing domestic ownership, particularly the finance ministries' efforts to improve the planning and execution of public finance. Recent amendments to budget laws have underscored this positive trend. Despite new or amended laws and improved institutional arrangements, however, technical assistance and training is still needed for the institutions to integrate new methods fully into practice.

4. **Fiscal policy remains fragmented among the State, the two Entities, and the Brcko District.** Fiscal policy in BH is still defined by the post-war outcome in the 1995 Dayton Peace accord, which gave overriding fiscal autonomy to the two Entities and the Brcko District. The establishment of an intergovernmental Fiscal Council is an important first step toward improving the level and quality of fiscal coordination among the governments. Going forward, the Fiscal Council must be vested with sufficient authority to make binding decisions.

5. **Enabling legislation for empowering the Fiscal Council is urgently needed.** The Fiscal Council should have sufficient authority to make timely fiscal policy decisions. The legislation should include a mechanism for resolving differences amongst the constituents. It should also include provisions for imposing penalties when agreements are breached.

6. **Strategic planning has improved, and ownership is more evident.** A key development was the country-wide Poverty Reduction Strategy Paper (PRSP), known as the Medium Term Development Strategy (MTDS), which was prepared jointly by the three governments. These efforts have helped to familiarize the governments with policy-based frameworks in a multiannual context, yet the link between policy and budget is still very weak. Externally financed technical assistance has helped to ameliorate the lack of capacity within the finance ministries. It is too early to say whether the medium-term expenditure framework (MTEF) will be sustained without

continuing external support although there are indications that it is becoming the starting point for the preparation of annual budget rather than remaining as a standalone document.

7. **Some preliminary steps have been taken toward transforming the traditional line-item-based budgeting process to a program-based approach within a medium-term expenditure framework.** In addition, significant institutional reforms have been introduced by the State and two entity governments through enactment of new or amendment of the existing organic budget laws (OBL). Although not particularly well articulated, the amended Federation OBL now requires some program budgeting type information across the Federation and canton levels of government. Additionally, an intergovernmental Budget Coordination Board (BCB) has been formed for coordinating medium-term budget development among the governments including aligning macro-fiscal assumptions. These reforms in the budget preparation area are critically dependent upon government implementation capacity. Realistically, completion will require many years of technical assistance.

8. **The key to improved budget execution and cash management since 2002 has been the automated treasury system in the State and the two Entities.** This has improved controls, brought discipline to the budget execution system, and improved overall cash management across the State and Entities. It is, however, important that extrabudgetary funds (particularly health insurance and pension funds) and municipalities be brought into the system, because these bodies command significant resources. Budget discipline must be uniform and consistent across the entire system of public resource management.

9. **The treasury system has greatly improved the availability and quality of financial reporting in the public sector.** The State and two entity governments have adopted full accrual-based accounting though it is not yet fully implemented. The Republika Srpska (RS) has adopted the International Public Sector Accounting Standards. Instead of the State and the two Entities issuing their own guidelines and instructions on public sector accounting standards, a joint Government Accounting Standards Board should be created. This would ensure uniformity across the entire public sector in BH, in turn enabling preparation of national consolidated financial statements.

10. **Public procurement remains weak in practice despite a common Public Procurement Law based on international best practice.** The law is applicable across the State and two Entities but compliance has been weak thus far. In a few instances, provisions of the law have been contravened, resulting in noncompetitive procurement. It is evident that knowledge and understanding of the law has not yet fully percolated down to the ministries and agencies. In addition, important institutions such as the Procurement Review Body have yet to be established, and the Public Procurement Agency is not yet fully functional. The challenge for BH is to fully implement the law, and for politicians and civil servants to then demonstrate sincere respect for its provisions.

11. **The unified indirect taxation system across the country presents a challenge.** The full effects of VAT are still uncertain. At the technical level of tax

administration, early indications are encouraging. At the political level, however, it has been less easy to manage a state-level institution charged with sharing a major source of revenue between various governments. While the issue is resolved at the political level, it is important that donors continue their support to stabilize the technical systems.

12. **Compliance with internal controls needs to be improved.** Audit reports from the Supreme Audit Institution (SAI) point to several instances of noncompliance with the rules and procedures. Internal controls are only as strong as the attention paid to them and it is undermined by continuous noncompliance. For rules and regulations to be meaningful, everyone in the environment must understand them and work together toward compliance. Moreover, current internal financial controls would need revision to better align with the EU prescribed public internal financial control (PIFC) framework.

13. **The legislative and organizational framework for an internal audit system does not yet exist.** Internal audits tell management whether controls really work as specified and whether they are being followed in letter and spirit. There is a common observation in external audit reports that compliance with rules and procedures is weak. It therefore becomes all the more important to establish a mechanism of internal audit whereby management can continuously ascertain the status of internal controls.

14. **The newly enacted Supreme Audit Institution laws unify key principles, and they eliminate contradictions among the old laws.** The new laws ensure uniform standards. They protect the autonomy of the SAIs while introducing parliamentary oversight; and they clearly specify the mandate of the three SAIs. However, a clear declaration of the SAI role needs to be included in the constitution of the State and Entities. This is required to help shield the audit institution from outside interference.

15. **The SAI Coordination Committee should develop a shared vision and prepare a joint Strategic Development Plan.** The strategic plan will facilitate further adoption of common approaches. It will keep the SAIs focused on the objectives and tasks ahead; and it should help to reduce the abrupt appearance of unfunded mandates. The plan should highlight the need to prioritize financial audits, including a concrete strategy for audit of information technology environments, revenue audits, and audit of local governments.

16. **Corruption is reportedly widespread.** The fight against corruption has mostly been carried out on paper, with political commitment lagging. Instead of yet another set of strategies and action plans, the right tone must come from the top. Basically, those in high places must completely eschew *any* activity that can even remotely be considered "corrupt." Barring this standard and example from the top, it is unlikely that any strategy or action plan will make any real difference. It is equally important that the governance in State Owned Enterprises (SOEs) be strengthened while simultaneously adopting transparent procurement practices, because most large-value procurement takes place in SOEs.

17. **Parliament has established specialized committees to review the budget, but its influence is extremely limited.** Its input on budget proposals and its oversight of budget execution are hampered: by inadequate qualitative budget execution data, lack of resources to recruit economic and sectoral experts who can provide research inputs, and the practice of adopting annual budget execution reports even before the SAI has submitted its audit report.

18. **It is important to calibrate reform measures in the light of the many lessons that have been learned in the implementation of reforms thus far.** Experience has taught, in particular, the importance of proper sequencing of reforms. Given the specific governance structure in BH, harmonizing policy decisions and reaching a consensus necessarily takes time. Building institutional capacity and strengthening coordination across governments will be critical to the sustainability of reforms in BH. Some reforms require good technical assistance. Some reforms require a proper legal framework. Some reforms have succeeded because a uniform, harmonized approach was applied across BH. However, without committed leadership, real progress is impossible.

19. **Despite these shortcomings, this Country Fiduciary Update found a good foundation for strong public financial management in Bosnia Herzegovina.** The treasury accounting system now provides reliable information; systems are in place to record, report, and track receipt and use of funds; and there is independent audit of the budget execution reports. However, weak compliance with the existing internal control rules and procedures is further compounded by the absence of a modern internal audit system thus weakening the internal control framework. Moreover, current public procurement practices are weak and fail to comply with the Public Procurement Law. This report therefore recommends that the use of country financial management systems in BH should begin with a pilot project subject to a separate project fiduciary assessment after progress has been made in setting up an effective internal audit function in the State and two Entities.

20. **The overall financial management risk to Bank development policy lending (DPL) funds is moderate.** Ample safeguards exist in the central bank to record and track foreign currency funds received under the Bank's DPL program. However, future DPL operations should include measures to develop public financial management capacity and to address the weaknesses and risks, particularly in the management of budgetary resources identified in this report. In doing so, it is important that conditions and triggers focus on results rather than inputs/processes while clearly stating the expected outcomes.

21. **The financial management risk to Bank funds in investment projects implemented in BH is moderate.** Until now, investment projects financed by the Bank have been implemented by standalone Project Implementation Units (PIUs). PIUs have been regular in submitting quarterly financial management and annual audit reports. Recent audit reports and management letters by auditors do not reveal serious internal control issues within the PIUs. In recent years, no procurement contract has been found to be misprocured in recent years.

22. **An overarching theme in this report is the need to build government capacity to implement laws and regulations.** All recommendations to address the issues identified in this report are summarized in Annex 1. The highest priority recommendations are as follows.

- Integrate government policy priorities into annual budget preparation. Fiscal Council members must be actively involved in the process. The Fiscal Council should establish a medium-term macroeconomic and fiscal strategy that sets out macroeconomic assumptions, the aggregate resource envelope, indirect revenue allocations, and size of the State and entity budgets, fiscal balance objectives, and sector expenditure policy priorities.
- Build capacity within the finance and line ministries in the area of fiscal management. The strengthening of technical skills is essential for improving upstream budgeting.
- Harmonize fully fiscal reporting systems and formats and introduce comprehensive and timely reporting for general government.
- Extend the treasury system to local government level and to extrabudgetary funds. In addition, online access to the treasury system should be extended to those line ministries and spending units that currently lack access to the system.
- Establish a procurement review body and make the public procurement agency functional. Focus on implementing the Procurement Law and train the line ministry and agency staffs in understanding its requirements.
- Establish a joint Government Accounting Standards Board and issue national public sector accounting standards.
- Continue to build capacity in tax audit and enforcement.
- Stipulate within the law explicit accountability that includes ministers, heads of departments, and managers.
- Adopt a legislative and organizational framework for a sound internal audit system.
- Develop a strategic development plan by the SAI Coordination Committee, focusing on financial audits. It should define a strategy for revenue audits, audit of local governments, and auditing within a modern information technology environment.
- Form a joint parliamentary research service providing analytical and research inputs for all the three parliaments in the State and two Entities.

23. **Monitoring the reforms.** The Economic Management Structural Adjustment Credit (EMSAC) is the Bank's major vehicle for monitoring ongoing reforms in public financial management. Donors such as EU, DfID, USAID, SIDA, and the Dutch bilateral programs are all expected to increase their technical assistance. They will therefore have a continuing stake in monitoring public financial management improvements. This Fiduciary Update will contribute to the Country Partnership Strategy in 2007 and to the preparation of new development policy loans.

THE PAST, PRESENT, AND FUTURE OF Public FINANCIAL MANAGEMENT REFORM IN BOSNIA and HERZEGOVINA

Governance after Dayton

Bosnia and Herzegovina (BH) has made substantial progress toward creating a growing economy since the Dayton Peace Accord ended the devastating 3½-year war in Bosnia in 1995. Underpinned by substantial post-conflict assistance and significant progress toward structural reform, real GDP has tripled, and exports have increased by a factor of ten. A shift has taken place from the accumulation of arrears to the repayment of debt. Combined with reduced defense spending, the general government deficit dropped from about 8 percent in 1999 to about 1 percent in 2004. Under the currency board arrangement introduced in 1997, the currency was pegged to the euro. Inflation subsequently declined to levels of most industrial countries.

Achievements notwithstanding, substantial challenges remain. Uneven progress with privatization and structural reform has limited the scope for acceleration in output growth, with scarcely a dent in the very high rates of unemployment and poverty. Moreover, the lack of a single economic space imposes substantial costs on the creation and development of business.

As a government, BH is complex, inefficient, and costly to operate. Indeed, there are 14 governments at three levels—the State (hereinafter referred as BiH), two Entities (the Federation of Bosnia and Herzegovina and the Republika Srpska), 10 cantons, and the self-governing Brcko District. Not surprisingly, unclear delineation of responsibility is related to competition for legislative authority. Public administration is weak and combines pre-war, war, and post-war institutions with frequently overlapping administrative authority. Decision-making is often controlled outside of formal government institutions. Corruption is widely reported to be rampant at all levels, particularly among the State Owned Enterprises (SOEs) and the extrabudgetary funds that typically handle large-value procurement.

Under the Dayton Peace Accord, the central State was granted few powers. These included foreign policy, enforcement of law between the two Entities, immigration, monetary policy, foreign trade, external debt, and inter-Entity transport and communications. Until 2001, BH had neither a countrywide system of administration nor a unified armed service. To sustain the fiscal viability of the central institutions, a major reform of the taxation system was initiated. Responsibility for indirect taxation was transferred from the Entities to the State. This resulted in a state-level Indirect Taxation Authority headquartered in Banja Luka. A unified customs administration was implemented in 2004 and began work in 2005. The new central VAT, introduced on January 1, 2006, has been accompanied by significant uncertainty as to its implementation. Despite recent changes to broaden its policy portfolio, the central state is constrained in its capacity to exert its authority and develop a consistent policy agenda.

Both Entities—the Republika Srpska (hereinafter referred as RS) and the Federation of BiH (hereinafter referred as FBiH, or the Federation)—were vested

with certain political, legislative, and judicial authority; **and the Brcko District was set up as a self-governing unit under the jurisdiction of the central state.** BH is a parliamentary democracy. In addition, the Office of the High Representative (OHR), headed by a senior foreign diplomat,[1] is charged with monitoring the implementation of the civilian portion of the peace accord on behalf of the international community. To date, OHR has wielded enormous power, including the authority to dismiss governments, ministers, officials, and to require enactment of laws.[2] The steering board of the Peace Implementation Council recently agreed that Bosnia and Herzegovina would assume full responsibility for its affairs; and to that end, the OHR is expected to close its operations by June 30, 2007.

The Federation and the RS have their own constitutions, presidencies, parliaments (bicameral in the Federation, unicameral in RS), and governments. The president is nominated by the parliament. The Federation is divided into 10 cantons, which are organized along ethnic lines. Each has its own government and parliament. The cantons are further divided into 84 municipalities. The RS is subdivided into 63 municipalities.

Several important events are coming up, and these will affect the future direction of PFM reforms in BH. The BH general (parliamentary and presidential) elections for the State and for two Entities were held in October 2006 and the process of forming new governments is in progress. Bosnia and Herzegovina hopes to conclude the Stabilization and Association Agreement (SAA) with the EU by the end of 2006, thereby upgrading BH as a candidate for EU membership.[3] EU entry will increasingly shape future BH reform in several areas, including public financial management. Successful conclusion of SAA may provide further impetus for strengthening of State institutions. As mentioned, the OHR is expected to close operations by June 30, 2007, which could ease pressure on the fight against corruption.

Scope of the Fiduciary Update

This Fiduciary Update covers the State and the two Entities. In drawing up the scope of the report, consideration was given to available sector work in the area of public financial management, time, and resources. As agreed when the initiating concept paper was reviewed, the Fiduciary Update does not cover the third and fourth levels of governments, that is, the cantons in the Federation and municipalities in both the Entities.

This report presents a combined update on public financial management and procurement. In the area of financial management, the report covers both upstream budget management (including strategic planning, MTEF, and annual budget preparation) and downstream budget management (including treasury and cash management, internal

[1] This position was held by Lord Paddy Ashdown from May 2002 through January 2006, when Christian Schwarz-Schilling, of Germany, took over as the fifth High Representative.
[2] The new High Representative of the OHR has adopted an approach that is more hands-off than that of his predecessor and allows local authorities more autonomy in determining policy.
[3] The first official round of the Stabilization and Association Agreement (SAA)—that is, the negotiations between BH and the EU—were successfully concluded in the final week of January 2006. However, the lack of progress towards the implementation of the October 2005 agreement on police restructuring could delay the conclusion of negotiations.

controls and internal audit, accounting and reporting, external audit, and parliamentary scrutiny). In the area of procurement, the report focuses on soundness of the newly enacted procurement law and on the capacity of procurement agencies to implement the law. In addition, the report discusses fiduciary risks in Bank-financed projects.

Lessons learned from recent reforms

BH has made good progress in establishing modern systems of public financial management since the end of the war (a condensed timeline of the PFM reforms in BH is presented in Annex 2)**.** BH inherited its institutions and systems from the Yugoslav era. Many institutions and systems were dysfunctional. Others simply did not exist and had to be built from scratch —for example, the Treasury and the Supreme Audit Institutions. Without doubt, international financial institutions, donors, and OHR played major roles in the reform process; however, the efforts and commitment of BH was the key to success. A decade of experience establishing and reforming systems has taught many valuable lessons.

- *Sequencing is critical to public financial management reform.* An efficient treasury and accounting system is a precondition for successful budget reforms—to enforce discipline, to bring control over budget execution, to improve internal controls, to reduce arrears, to ensure timeliness in reporting, and to improve overall decision making. A treasury system serves as the backbone of the budget management system. Conversely, it is hard to imagine a successful budget management reform without one. With significant assistance from USAID and US Treasury, BH implemented a modern treasury system before attempting other major reforms.
- *Patience is necessary, because some reforms simply require time to build consensus gradually.* Given the specific governance arrangements in BH, harmonizing policy decisions across governments and reaching a consensus is necessarily a slow process. For example, preparing draft laws on external audit took more than 18 months through a process led by an expatriate technical adviser. Yet patience ensured active participation of all stakeholders.
- *Certain reforms can be implemented without external technical assistance if the leadership is committed.* In RS, implementation of international public sector accounting standards (IPSAS) was accomplished without outside assistance. The Oracle-based treasury system was of great help in implementing accounting reforms in RS; however, without committed treasury leadership, progress would have been doubtful.
- *On the other hand, external technical assistance played a significant role in several reforms.* USAID and US Treasury provided immense help in implementing the treasury system across BH. Similarly, the Swedish National Audit Office played a major role in building capacity in Supreme Audit Institutions, enabling them to move beyond compliance audits to financial and performance audits.
- *Certain reforms require a legal framework.* External audit reforms would not have succeeded in the absence of a legal framework that guarantees financial and

operational independence to the SAIs. BH has adopted modern laws on SAIs that conform to international standards. Similarly, a modern organic budget law is essential for ensuring budget discipline and for clarifying the role of multiple players in the budget process.
- *Some reforms succeeded because of a uniform and harmonized approach across BH.* The treasury system was implemented successfully across the State, two Entities, and 10 cantons in the Federation. They all adopted a uniform software system. This approach not only reduced the cost of technical assistance; more importantly, it enabled BH to prepare government-wide financial statements. A similar approach was adopted to train auditors from the three SAIs. Uniform training was provided, with several programs conducted jointly.
- *Certain reforms are yet to take off, largely because of inadequate commitment from the leadership.* Reforms in the area of internal audit are desperately needed. In fact, they are a component of Economic Management Structural Adjustment Credit (EMSAC) conditionality. Yet as described in Chapter 6, internal audit reform requires more than a law on paper. It requires full commitment from elected officials and civil servants. That means strong leadership. The same holds true for anticorruption measures.

Future reforms

The Economic Management Structural Adjustment Credit (EMSAC) operation[4] is World Bank's major vehicle for monitoring ongoing reforms in public financial management. As other donors (most notably EU, DfID, USAID, SIDA, and the Dutch bilateral) increase their technical assistance, they will need to monitor public financial management improvements. Success in the SAA negotiations will bring increased assistance from EU. This Fiduciary Update will contribute, first to the formulation of the new Country Partnership Strategy when the current Country Assistance Strategy[5] (covering 2005–07) is completed and, second, to the design of future development policy loans[6].

Organization of this report

This Fiduciary Update report references previous diagnostic assessments; it maps developments since those assessments; it identifies success factors in selected reforms; and it discusses the many challenges that remain. The report is structured as follows.

Chapter 1. Country background, explaining the complex governance structure emerging after the Dayton Peace Accords and a summary of key lessons learned from carrying out reforms in public financial management and procurement.

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[4] Closing date, December 31, 2006.
[5] Country Assistance Strategy for Bosnia and Herzegovina, August 12, 2004 (Report # 29196-BA)
[6] A new development policy lending operation is not expected before June 2007.

Chapter 2. An overview of upstream budgeting (strategic planning, medium-term expenditure framework, and annual budget preparation) includes the previous diagnostic, developments since 2001, the current scenario, and recommendations to meet remaining challenges in the area of upstream budgeting.

Chapter 3. Developments and the unfinished agenda in public sector accounting and reporting.

Chapter 4. Analysis of practices in budget execution and cash management area. Recommendations for further improvement.

Chapter 5. A review of accounting and controls in revenue administration, including alternatives for strengthening the system.

Chapter 6. Developments in internal controls and internal audit with respect to issues from earlier diagnostics. Recommendations to address remaining challenges.

Chapter 7. Developments in public procurement since the previous country procurement assessment. Recommendations to meet the remaining challenges in public procurement.

Chapter 8. Progress in reforming external audit in BH. Proposes measures to further strengthen external audit.

Chapter 9. Developments in parliamentary oversight over the budget process and external audit. Recommendations to make oversight more effective.

Chapter 10. BH ranking in corruption, as reported in various studies. A review of anticorruption efforts.

Chapter 11. A quick assessment of the use of country systems and fiduciary risks in Bank-financed operations.

Annex 1. Summary Action Plan.

Annex 2. Timeline of PFM reforms in BH.

Annex 3. Illustration of revenue composition for RS for the year 2004

Annex 4. Expenditure on procurement vis-à-vis budgeted expenditure.

UPSTREAM BUDGETING

Key issues identified in the previous diagnostic reports

The World Bank's October 2002 Country Strategy Progress Report for 2000–02 reported several weaknesses in the upstream budgeting process.

- The sustainability and impact of policy advice and reforms are impeded by poor analysis of problems and needs.
- Greater stakeholder involvement and grassroots participation in policy development and allocation decisions are required.
- Donor coordination needs to be strengthened despite the difficulties posed by the multilayered, fragmented government system.
- Capacity development is difficult to achieve where governance of public administration remains fragmented with ill-defined objectives and a duplication of roles.

The 2002 Public Expenditure and Institutional Review (PEIR) highlighted four key issues.

- Weak internal drive for harmonization and coordination hampers nation building and efficiency benefits of decentralization.
- The size and scope of public spending is not sustainable.
- The lack of proper fiscal decentralization has resulted in vertical and horizontal fiscal imbalances, overlapping responsibilities across governments, and inefficient mechanisms for financing and delivering services.
- Ongoing reform of budget planning and management is essential to meet strategic planning requirements, fiscal operation priorities, fiscal discipline and efficient public service delivery.

The 2002 PEIR and Country Financial Accountability Assessment (CFAA) reviewed the financial management and accountability frameworks. These diagnostics made a number of observations and supporting recommendations.

- Explicit risks to the fiscal position have resulted from contingent liabilities and deferred deficits at the entity level, which remain outside the budget.
- Fiscal adjustments tend to be forced and ad hoc, not strategically planned.
- Both Entities must address similar issues in rationalizing tax and expenditure policies.
- The level of public expenditures as a percentage of GDP is excessive, and spending on public sector wages and salaries is disproportionately high.
- The State's role as an integrative force and central authority needs to be strengthened, including its ability to coordinate vertical and horizontal fiscal policies.

- Major systemic obstacles exist in the preparation of a comprehensive resource framework, including the separation between investment and recurrent budget planning and a lack of consolidation of donor and off-budget domestic resources.
- Coordination is lacking between budgetary planning and overall government policy.
- Fragmented fiscal management and weak centers of government impede consensus and policy coherence.
- The effectiveness of the budget as a policy tool needs improvement, as well as the capacities for budget and sector planning, as well as the policy justification for spending units' budget proposals.
- The budget monitoring and evaluation functions need to be expanded to cover budget policies and programs.
- BH budget classification and chart of accounts need to be consolidated in a budget classification that is compatible with IMF Government Finance Statistics (GFS).
- The link between the macrofiscal framework and the budget should be strengthened by providing medium-term forecasts and the budget's main policy objectives.
- The link between the legal framework and its implementation should be strengthened.

The PEIR noted that the medium-term expenditure framework (MTEF) exercise met some of its objectives. These included raising awareness of the weaknesses in budget planning as well as the information, capacity building, and coordination requirements needed to improve the policy focus in allocating resources.

Developments and Reforms since 2001

Fiscal policy in BH continues to be governed by the postwar outcome defined in the 1995 Dayton Peace Accord. This gives overriding fiscal autonomy to the two Entities and the separate Brcko District that comprise BH. While the entire country's monetary policy is managed by the central bank, fiscal policy remains fragmented between the State, the Entities, and District Brcko.

Most upstream budgeting reform initiatives since 2001 have been driven by the international community and the OHR. Technical support has focused on developing the strategic planning and policy framework, and on strengthening the processes of medium-term budget planning and fiscal management. The World Bank, IMF, DfID, European Commission, and USAID have all assisted at the State, Entity, and canton levels. Numerous institutional and organizational reform initiatives have been undertaken. The BH governments have in general supported these initiatives as well as the associated technical assistance from the international community.

Strategic planning and policy framework

The key strategic planning development during the past five years was the combined countrywide Poverty Reduction Strategy Paper (PRSP) in 2003. All three governments participated. This process included the development of targets, performance measures, and an action plan to increase social and economic development and reduce poverty in BH. This PRSP was adopted by the governments as the Medium-Term Development Strategy (MTDS) for 2004–07. It represents the primary policy framework for BH. A consultative approach was used to develop this framework, involving sector working groups from all three governments and canvassing the views of NGOs and civil society. The MTDS achieved a degree of consensus among the governments in regard to development priorities for BH; however, the broad consultation and participation led to many compromises over objectives. The MTDS makes no reference to the financial or operational resources available, nor to the cost of the initiatives highlighted in the accompanying action plan.

The MTDS was updated in 2006. There are signs indicating improvements in strategic planning and ownership of the MTDS. This has been reinforced by the more focused bottom-up approach to the MTDS review, which involved stakeholders at all levels of society as well as 23 working committees at Entity and State levels. This process, which was completed in February 2006, was managed by the Economic Policy and Planning Unit (EPPU), an advisory body to the State Council of Ministers initially funded by the donor community. It has led to a streamlining of the MTDS. The new document contains clearer, more specific targets, though not all governments have adopted the document; and objectives have again been diluted in order to achieve consensus.

The development of the MTDS is helping government authorities at all levels to gradually become familiar with a policy-based framework in a multiannual context. However, there has been only limited development of interlinked sector strategies. In the disappointingly few cases where these do exist—for example, in the justice sector—resulting strategies have borne little resemblance to the broader national policy framework set out in the MTDS. This disconnect reflects in part the fragmented governance arrangement that constrains political commitment at all levels within the multilateral policy framework. It also reflects the weaknesses in the quality of the first MTDS, which rendered an insufficient platform for developing robust sector strategies.

Very limited progress has been made in linking the MTDS monitoring and evaluation framework to the performance measurement of government services in the context of the medium-term expenditure framework. The monitoring and evaluation functions measure compliance in the use of financial resources. They need to be expanded to cover budget policies and programs.

The EU Accession process has been a strategic driver of government institutional and organizational reforms. The EC carried out a feasibility study in 2003 to assess the status of BH against the requirements for a Stabilization and Association Agreement (SAA). The recommendations from this study shaped many of the subsequent reform objectives.

Medium-Term Expenditure Framework

In early 1999, both Entities embarked on a challenging reform program to introduce a MTEF aimed at an integrated multi-year approach to budget

preparation. The MTEF has primarily evolved as a standalone Budget Framework Paper (BFP), which is prepared before the detailed annual budget formulation process.

With DfID support, improvements have been made over the course of five budget cycles in building capacity of the Entity governments to formulate their rolling annual BFPs[7]. External technical assistance has been rolled out to the State (since 2005) and canton governments (since 2006) to develop their own BFPs. External technical assistance has focused on supporting the reform of budget planning process and the improvement of budget systems and procedures. Efforts at all three levels of government have involved:

- Enshrining the BFPs in the organic budget laws at the State, Federation, Republika Srpska, and canton levels
- Enhancing the economic policy-making and macroeconomic forecasting functions at the State level, including the establishment, under donor funding, of the EPPU as an advisory body to the State Council of Ministers
- Strengthening the revenue forecasting functions through the formation of the Macroanalysis Unit (MAU), the technical secretariat to the governing board of the Indirect Tax Authority (ITA)
- Improving the link between the policy planning process and resource allocation through the articulation of expenditure priorities within the BFP documents
- Managing foreign-financed investment through public investment programs and including related data in the BFPs at State and Entity levels
- Strengthening fiscal discipline and the link between the BFPs and annual budget through the introduction of budget user ceilings
- Introducing a program-based approach to budgeting.

In general, externally financed technical assistance since 2005 has been designed to build capacity. However, it is doubtful that improvements to date will be sustained without continuing external support.

Some significant legal framework reforms have been introduced since 2001. A new State Law on Financing of Institutions of BiH was adopted in 2004. This included articles requiring the presentation of comprehensive budget data as part of the BFP document and a detailed annual budget preparation calendar highlighting deadlines for budget users, the Ministry of Finance, government, and parliamentary approval. Before adopting the Law on Financing at the State level, there was no organic budget law. Instead, budget preparation was briefly described in a single article of the Treasury Law (dating from 2000). A revised RS organic budget law was adopted in 2005. The main amendment was the introduction and adoption of the BFP by June 30. However, the budget calendar was not fully harmonized with the State organic budget law. A revised Federation organic budget law was adopted in 2006, including a requirement for providing program budgeting type information across Entity and canton levels. It also harmonized the FBiH budget calendar with that in the State organic budget law.

[7] BFPs have been prepared for 2000–02, 2004–06, 2005–07, 2006–08 and 2007–09.

There is a lack of political engagement in setting budget parameters and policy priorities for the MTEF. To be effective, MTEF requires early decisions on budget parameters (including macroeconomic forecasts, revenue forecasts, size of state budget, revenue allocation) and broad policy priorities (ideally drawn from the MTDS). The governments, through the Fiscal Council, need to make such decisions early in the budget process.

Annual budget preparation

Until recently, little progress had been made in the reform of annual budget planning. Instead, external technical support concentrated on development of the BFP document. Since 2005, some progress was made by starting to transform the traditional line-item-based budgeting into program-based budgeting within a medium-term expenditure framework. Implementation of further reforms during 2005 and 2006 has focused on the following.

- An integrated, annual budget calendar and timetable based around a “ten step” approach to medium-term budget planning and preparation. This encompasses the detailed annual budget preparation process.
- The introduction of budget user expenditure ceilings as part of the BFP, which then form the basis for the preparation of detailed expenditure submissions by each budget user.
- Improving the transparency of budget requests through more comprehensive budget documentation
- Piloting program budgeting as an element of the annual budget planning and preparation process.

Intergovernmental fiscal harmonization. The level and quality of fiscal coordination among the State and the Entities has historically been poor. There has been a positive change since 2005 with the shift of indirect tax mandate from the Entities to the State level through the establishment of a countrywide Indirect Tax Authority (ITA). The need has gradually been recognized for coordinated fiscal decision making and an institutional mechanism to implement this coordination. The result has been a Fiscal Council that incorporates the key fiscal and public finance officials (prime ministers and ministers of finance) from the State, the two Entities, Brcko District, as well as an observer from the central bank. The Fiscal Council receives technical support from EPPU, the State, the two Entity finance ministries, and the Finance Department in Brcko District. However, the Fiscal Council lacks sufficient authority to make timely fiscal policy decisions. It remains to be seen whether the Fiscal Council will remain politically acceptable in this role—to the State, Entity, and Brcko District governments.

Budget coordination at a technical level has improved including harmonization and coordination of budget planning processes and working assumptions. In 2006, a Budget Coordination Board (BCB) was formed, comprising the assistant ministers for budget from the Entity and State finance ministries and the head of the Brcko District Department of Finance. The head of the EPPU and a representative from ITA also participate in the regular BCB meetings. It is expected that the BCB will receive official status as part of the proposed Law on the Fiscal Council. Through this framework the State and Entities, during the development of the 2007 budget, have utilized a number of common working assumptions and macroeconomic forecasts developed (for the first time) by the EPPU and indirect tax forecasts prepared by the MAU. At the political level, there has been some evidence of improvement in coordination of budget development, although agreements are not always adhered to. More needs to be done to improve political coordination among all levels of Government including enacting legislation to formally establish the Fiscal Council with appropriate operating procedures, deadlock breaking mechanisms, and sanctions for non-compliance with agreements.

Reasonable progress has been achieved in harmonizing the medium-term budget planning and preparation process as well as the associated calendar across the governments. However, the calendar is only partly reflected in the OBL. The budget calendars at State and Entity levels set out in the respective OBLs are similar during the first half of the annual budget cycle (to the end of the BFP preparation process), but they then follow divergent timetables for submission of detailed budget user expenditure requests. A harmonized calendar, such as that outlined in the proposed ten-step medium-term budget planning process, would allow more time for budget users to prepare budget submissions than is currently the case at the State and Entity levels.

While the institutional reforms are positive, the intensity of a shift toward greater interfiscal coordination is asymmetric. The Federation favors a shift toward harmonization of fiscal policy more than the Republika Srpska. Another constraint is the respective constitutions that emerged from the Dayton Peace Accord. These were primarily written with peace-building rather than economic cohesion and policy in mind. In this light, the ongoing initiative to draft and approve a constitution allowing a greater role for the State should be viewed as positive.

Budget classification. In terms of budget classification and reporting, consolidation has been facilitated by the adoption of an Oracle-based treasury management information system. A broadly consistent budget classification system has been applied across the State and Entities. The functional and economic classification is carried out generally in line with GFS requirements.

Parliamentary scrutiny, transparency, and accountability. USAID and OSCE funded projects currently provide technical assistance to BH parliaments. This includes training to enhance parliamentarians' knowledge of and involvement in the scrutiny of budgets.

Key Features of the Current System

This section describes the key features of the current strategic framework and budget planning and preparation processes. It highlights how reform policies and programs have affected these areas of government[8].

[8] The assessment of the current situation is based both on experience in 2006 and on the agreed 2007 budget cycle. As the 2007 cycle is yet to be completed, aspects of the assessment of the current situation are based on what is expected to occur. In some cases, these processes vary from previous years' experience and are based on the recommendations of international consultants.

Strategic planning and policy framework

The MTDS is the primary source of BH strategic policy objectives. Implementation of the MTDS Action Plan is monitored by EPPU with regular progress reports submitted to the Council of Ministers and published on the EPPU website. However, the action plan is not supported by systematic sector policy and program development. With the exception of a limited number of donor-assisted projects (for example, the Justice sector), individual strategic plans are not developed by sector ministries. Although sector working groups have been established to update the MTDS, policy priorities identified in the MTDS, resource availability, and budget allocations are poorly linked. Processes have been introduced to strengthen the link between the MTDS and budget allocations, particularly through the development of the BFP (Budget Framework Paper). In practice, these processes are yet to achieve full effectiveness. Budget users are not well informed on the MTDS and its impact on policies and programs that affect them. In addition, unfunded mandates are still common. Laws are still passed absent consideration of their budgetary impact, seriously affecting budget discipline, flexibility, and prioritization.

The strategic framework and public administration reform agenda are strongly influenced by the negotiations on a Stabilization and Association Agreement with EU that began in early 2006. The updated MTDS has been designed to lead into the development of a National Development Plan (NDP) in 2007, highlighting the need for change in light of SAA negotiations and eventual EU accession. Whether this potential is realized will depend on the authorities' willingness to press ahead with reforms.

Medium-Term Expenditure Framework

Three-year medium-term budget plans—Budget Framework Papers (BFP)—have been developed by the finance ministries of the State, the Entities, and cantons. These are in accordance with a simplified ten-step medium-term budget planning and preparation framework developed by the DfID Public Expenditure Management (PEM) project and endorsed by the ministries of finance. As of 2006, the BFPs are becoming more integrated into the annual budget planning process. They set out a preliminary draft budget and initial budget ceilings for the annual budget and two-year forward estimates. These ceilings form the basis for instructions to budget user issued at the start of the second part of the annual budget cycle. In accordance with the organic budget laws, BFPs must be submitted to the respective governments by June 30 of each year.

BFPs at the State and Entity levels follow a similar reporting format. The format includes chapters on macroeconomic outlook and assumptions; revenue forecasts; a draft fiscal strategy; analysis of expenditure by economic classification; consideration of sector expenditure priorities; and recommendations for sector and budget user expenditure ceilings. Working groups have been established within each Entity and State finance ministry to manage the preparation of the BFPs. The BFPs are developed at all levels with considerable technical assistance. This technical assistance has focused on improving budget systems and developing robust procedures and transferring skills to local staff.

Medium-term macroeconomic assumptions and projections are prepared by EPPU, using a macro model developed by international consultants. These projections and analyses provided a key chapter for the 2006 BFPs. Further, each Entity finance ministry now has dedicated staff responsible for providing the overall fiscal context for the budget documents. Some limited capacity for macroeconomic analysis also exists at the entity level. Fiscal data have improved considerably; however, major concerns remain about the quality and coverage of data for the large informal sector.

Fiscal forecasting capacity remains limited within all BH institutions. Attempts are being made to address this issue through technical assistance to EPPU, ITA, and Entity finance ministries. The macro-fiscal framework was prepared for the first time in 2006 by EPPU and ITA, rather than the IMF. Technical capacity is still very limited. Revenue projections are subject to new uncertainty caused by the introduction of the VAT in 2006. In RS, changes in wage and profit tax policies in 2007 will create forecasting challenges for the Ministry of Finance.

Under the ten-step medium-term budget planning framework endorsed by the ministries of finance, macroeconomic and fiscal projections will need to be approved by the Fiscal Council at an early stage in the budget process. In practice these forecasts are not being approved until late in the budget cycle and after the preparation of the BFPs. State and Entities use a number of macro-fiscal "working assumptions" pending fiscal council approval. These working assumptions are developed by the EPPU (macroeconomic forecasts), ITA (indirect tax forecasts) and the State and Entity ministries of finance with support from international consultants. The Budget Coordination Board meets regularly to discuss the working assumptions and its impact on the draft medium-term budget plans.

Budget users are requested to provide input to the BFP through preparation of Budget User Priority Review Tables. These tables require budget users to present and review existing resources and activities. The format identifies strategic and operational objectives and performance measures and targets. The tables also provide budget users with an opportunity to provide "bottom up" input to the BFP prior to the determination of budget ceilings**.** Budget users can put forward proposals for new or higher priority spending initiatives (and savings options) early in the annual budget cycle. This process strengthens the link between policy priorities and budget resource allocations, and it represents a first step toward program or results-oriented budgeting. Compliance at all levels has been encouraging to date, despite the poor quality of information. The finance ministries review the completed Budget User Priority Review Tables, making recommendations to the government on policy proposals and resource ceilings that are consistent with an aggregate fiscal target. The final decision on the policy proposals and resource ceilings is taken at the government level

BFPs set out sector and budget user ceilings. The initial budget user ceilings at each level are derived from the Budget User Priority Review Tables and analysis of overall availability of resources. The organic budget laws require each government level to adopt the BFP before the budget ceilings are transmitted to users; however, the current budget calendar allows insufficient time for the subsequent political process and in practice ceilings are issued by the MoFs before the BFPs have been adopted. The BFP and initial expenditure ceilings may also be submitted to each parliament for information.

Budget user ceilings provide the initial resource envelope for budget users to prepare their detailed submissions and forward-year estimates. This forward-estimate approach is still evolving and will take a number of years to fully integrate. Indeed, 2006 is the first year in which the process has been seriously attempted. It is too early to judge the robustness of the forward estimates as a starting point for the 2008 and 2009 budget cycles.

Annual budget preparation

The process and timetable for developing the annual budget are set out in the organic budget laws at the State and Entity levels. All three laws require detailed medium-term budgets. The legal requirements are supplemented by a medium-term budget planning framework, introduced at each level with support from DfID-financed consultants. The organic budget laws do not include the full requirements of the framework, so the State and Entity ministers of finance issue budget calendars and timetables at the start of each annual cycle. The calendar sets out the key reporting requirements and timetable for developing the BFPs and annual budgets.

The organic budget laws allow only 30 days for budget users in FBiH and the State to prepare detailed expenditure submissions (45 days in RS). This period coincides with peak holiday time. During the preparation of the 2006 annual budget, most budget users missed the deadline by more than a month, suggesting that a mid-September deadline might be more realistic. Once requests were sent to the finance ministries, budget users previously had little opportunity to clarify or revise their submissions. Technical assistance to the finance ministries is now helping to build rigor in the capacity to analyze submissions and to discuss the funding requests with users. Formal budget hearings took place at a technical level involving the State and RS finance ministries and their respective budget users for the first time in 2005. This step represents an important innovation, and this consultative process is expected to be repeated in 2006.

Budget allocations are still influenced by political considerations than agreed policy priorities. Anecdotal evidence suggests informal lobbying by ministers continues to undermine transparency in budget planning and to distort the initial ceilings developed in the BFP. The draft annual budget laws submitted to Parliaments in early November are more strongly influenced by political relations within the government than the quality of the budget submissions. Not surprisingly, the approved budgets are often considerably different from the draft submitted by the finance ministries.

Processes have recently been put into place to develop realistic annual budgets that are consistent with the MTEF. For instance, the draft 2007 budget instructions of the State, RS, and Federation all specify medium-term budget user ceilings taken from the BFPs. At the Federation and State levels, budget ceilings are issued to each budget user. At the RS level, ceilings are issued only to the line ministries, which are then responsible for consolidating the requests from all budget users within their jurisdiction. Budget users are required to prepare their submissions in accordance with these ceilings. Experience with ceilings is still limited, and strict adherence has yet to be observed. Despite the new medium-term expenditure framework, the budgeting process is still largely short-term and incremental.

Budget classification. The structure of the budget classification is broadly consistent across the State and Entities. The functional and economic classification is generally in accord with GFS 2001. The structure also maps the accrual-based GFS 2001 structure of expenses, revenues, assets and liabilities to the cash-based requirements of the BiH treasury system. A number of important categories (GFS 2001) are missing from the BiH structure. These include both expenditures and revenues including subsidies (25), social benefits (27), and other expenses (28). Notwithstanding the broad consistency of classification, there is no standardization of reporting formats or effective consolidation of fiscal data within or among the governments.

While formal budget requests are still based on economic classification, all three governments have made limited progress toward implementation of program budgeting. Budget users are required to use a program format when submitting initial proposals for the new high-priority spending initiatives. Program budgeting concepts are not yet well understood, and the quality of information provided by budget users is poor. The draft 2007 budget instructions for the State and Entities include additional tables requiring budget users to submit requests in a program format, in addition to the traditional economic classification. It is too early to assess compliance.

Budget comprehensiveness. The externally financed public investment process remains largely separate from the main budgetary processes at State and Entity levels. Externally financed projects are primarily implemented through project implementation units (PIUs), which negotiate directly with budget users outside the budget context. The finance ministries are therefore frequently unaware of the projects and agreed funding levels. In addition, the recurrent cost implications of capital expenditure are often not estimated or reflected by the budget users. This leads to unsustainable investment projects. Public investment programs (PIPs) were developed to address these weaknesses. However, at the State and RS levels, PIPs are currently managed by ministries separate from the ministry of finance, although there are proposal to merge these functions within the respective MoFs. Even at the Federation level, the PIP process, which is managed within the ministry of finance, is not fully integrated. The process of capital budgeting for public investment is also hindered by the approach of some financing agencies. Advice on or approval of externally financed projects is often provided late in the process, sometimes not until after the start of a budget year.

Several extrabudgetary social funds exist the Entity level. There are three in the Federation (health, pension, and employment) and four in RS (health, pension, employment, and child protection). Off-budget road directorates also exist within both Entities. These funds and agencies are funded outside the main budget process, either from their own source revenues or directly from the ITA Single Account. While these funds are not subject to the same procedures as the rest of government, each social fund must still submit a financial plan for the approval of the minister of finance of the Entity. Their financial plans are also discussed by the government and presented to the parliament as an annex to the main budget. After 2007, the same rules will be applied to the road directorates. So far, these have been completely off budget.

Revenues and expenditures of state-owned and public enterprises are generally off budget. For example, Sarajevo Airport, Air Bosna, and the main BH utility companies are off budget except when arrears are accumulated or subsides are paid. While those items are presented on budget, the funding mechanism is accompanied by limited scrutiny.

Intergovernmental fiscal harmonization. In the absence of a truly national fiscal policy function, BH depended heavily on IMF guidance to determine the overall level of State, Entity, and Brcko District expenditure ceilings, at least through the end of 2005. All parties know that reliance on IMF technical assistance is not sustainable in the long term. The donor community has reached a consensus on how to strengthen intergovernmental fiscal relations. In view of BH's political, historical, and constitutional legacy, a tripartite interministerial coordinating structure—the Fiscal Council—seems to be the only practical solution that can satisfy both Entities. In 2005, final aggregate 2006 resource envelopes were approved by the Fiscal Council and endorsed by respective governments.

Fiscal Consolidation. Currently there is no government agency responsible for systematically producing consolidated fiscal data and national accounts. The Central Bank produces some consolidated fiscal data on budget execution for submission to the IMF.

Fiscal strategy decisions are informed by data provided through the BFP process, following discussions with the IMF. However, the timing of IMF staff missions is typically not synchronized with the budget calendar. Officials generally delay decisions on budget parameters, allocations, revenue projections, allocations, and expenditure policy until after IMF missions. There appears to be little, if any, discussion within the Fiscal Council on long-term national strategic policy objectives and expenditure priorities. The budgets of the State, Entities, and Brcko District are currently not consolidated into a single "national" budget providing an overall budgetary picture, particularly because there is no legal requirement to make this to happen.

Historically, substantial variations in per capita revenues and expenditures have characterized BH. Yet arrangements for fiscal equalization have been limited. A revenue equalization mechanism in the RS places municipalities in one of four levels and adjusts the revenue allocation accordingly. With the exception of additional intragovernmental transfers to the three most vulnerable cantons in the Federation, there has been no mechanism for fiscal harmonization. As a result, significant differences in per capita revenue are observed among cantons.

Since the introduction of the VAT in 2006 and consequent changes in the laws on revenue allocation in RS and FBiH, some progress has been made toward fiscal equalization. The new model allocates indirect tax revenues within the Entities based on key criteria, including number of inhabitants, number of elementary and secondary schools and pupils, and total geographical area of the canton or municipality.

Parliamentary scrutiny, transparency, and accountability. Parliaments at the State and Entities levels are required to provide legislative oversight under the annual budget law. In practice, effective scrutiny is limited by analytical capacity, paucity of information on program and policy objectives in the budget documentation, and absence of information on performance and achievement of targets. Currently, the draft budget submitted to the parliaments uses an economic classification that lacks policy-based justifications for resources. The ten-step medium-term budget framework envisages submission of additional documentation using program-based budgeting.

Budget predictability. In-year adjustments and budget rebalancing are common at all levels, undermining budget predictability.

Engagement with civil society. Consultation has improved recently between finance ministries and budget users during the annual budget process. However, civil society still plays a negligible role in influencing the allocation of government resources. Several recent steps and suggested reforms could eventually make a difference. These include: discussion and formal adoption of the BFPs by the governments; dissemination of BFPs on the websites of finance ministries; publication of BFPs in official gazettes; and the presentation of BFPs to parliaments. Looking ahead the submission of comprehensive budget documentation to parliaments, particularly information related to the objectives and performance of budget funded programs, has the potential to facilitate much greater engagement of civil society in the budget process.

Technical skills and resource capacity of finance ministries and budget users. The levels of staff resources and technical skills of staff involved in budget development are limited. The scarcity of resources and skills leads to ineffective expenditure policy development, weak technical analysis, and continued reliance on adjustments to allocations by economic classification. A more systematic approach (yet still limited prioritization of expenditures) can increasingly be seen at the State and RS levels. Donors have provided technical assistance, but its effectiveness has necessarily been constrained by the lack of adequate staff to train.

Management of the budget process is frustrated by inflexible and outdated civil service laws. Resources allocated in upstream budgeting are dominated by wage and salary expenditures. The present civil service laws provide little if any incentive to improve program efficiency and service delivery. The rulebooks stipulate rigid staff levels. Reassigning staff and responsibility is no easy task. Similarly, there is little or no performance management of staff. Potentially, modest reform of the civil service laws could substantially improve the efficiency and effectiveness of upstream budgeting.

The recruitment of specialist staff is also hindered through outdated rules and practices specified under civil service legislation. Recruitment processes are inefficient and subject to considerable delays. Positions are typically filled based on years of service rather than competencies. This approach rewards "time servers" rather than civil servants who are dynamic, committed, and energetic. There a few incentives to attract talented new budget specialists.

Remaining Reforms and Recommendations

This section makes recommendations that would strengthen medium-term, policy-led budget planning and preparation.

Strategic planning and the policy framework

Government policy priorities.

- *Government policy priorities must be fully integrated into the budget preparation process.* This must start at the center and be endorsed by all governments through the Fiscal Council. Senior members of government must view budget formulation among its most important activities and as the key means to translate policy priorities into programs and services. The perception must be changed that the budget is simply an accounting exercise. Fiscal Council and government members must be actively involved in managing all aspects of the budget process—in particular, in prioritizing competing expenditure policy priorities.

- *The future development of the MTDS incorporating and reflecting SAA negotiations and implications, must be systematically linked to medium-term budget planning and preparation.* The MTDS and/or any subsequent National Development Plan (NDP) from 2007 must be fully endorsed and committed to by each level of government. Sector strategies should be developed across all levels of government, while retaining (within the existing constitution) the ability of the State, Entities, and cantons to determine the best mechanism for achieving the stated outcomes. MTDS proposals must be costed and prioritized to inform the budget prioritization process.

- *An objective and transparent reporting mechanism should be introduced to monitor and report progress against MTDS policy priorities.* The mechanism should be available for scrutiny by the government, the parliament, and the public. Reporting should focus on activities, and even more importantly, on results of activities. Line ministries and budget users should be responsible (and accountable) for reporting on achievements in respect of the objectives and priorities stated in MTDS for their organization.

New and existing legislated mandates.

- *All proposals for new or amended legislation should include a three-year financial impact statement (or table) that has been costed and verified by the ministries of finance.* By itself, this will not prevent unfunded mandates; however, it will draw the attention of legislators to the financial implications and affordability of their decisions. A plan to eliminate unfunded mandates should be developed. This can be done by amending or abolishing enabling legislation, or through reallocating budget resources.

MTEF and the annual budget cycle

Annual budget preparation—Timetable, process and fiscal harmonization.

- *The governments at all levels should be more engaged in establishing a clear fiscal strategy and in setting medium-term expenditure policy priorities.* Decisions relating to fiscal strategy—for example, the resource envelope, fiscal balance, as well as State and Entity allocations from the single treasury account—should be made early in the budget process. Budget users need time to submit and ministries of finance and governments need time to consider proposals for high-priority spending initiatives that are consistent with MTDS priorities and sector strategies. This should happen before the BFP is developed. To facilitate this process, the Fiscal Council should establish a clear medium-term strategy that sets out macroeconomic assumptions, aggregate resource envelope, indirect revenue allocations, as well as the size of State and Entity budgets, fiscal balance, and sector expenditure policy priorities.

- *A law on the establishment and operations of the Fiscal Council should be agreed and enacted as soon as possible.* The Fiscal Council should have sufficient authority to make timely fiscal policy decisions including budget parameters, policy priorities and the timely approval and publication of consolidated fiscal accounts. The legislation should include a deadlock breaking mechanism in circumstances where the Fiscal Council cannot reach an agreement. It should also specify appropriate penalties for failing to adhere to agreements reached at the Fiscal Council.

- *Responsibility for macroeconomic and fiscal forecasts, which are used in the development of State and entity annual budgets, should be integrated within the State MoF.* All BH budgets should be based on the same shared macrofiscal assumptions. The capacity to develop robust economic forecasts does not currently exist at the entity level, and the interdependencies between the economies of the two Entities would make such forecasts very difficult to prepare. Nevertheless, it is more appropriate that such a function be performed at the national level by the State MoF.

- *The governments should work with the IMF to ensure that staff missions to support budget development are harmonized with the budget cycle.* This will promote timely preparation of annual budgets and more effective budget ownership by the government.

- *BFPs should be renamed Preliminary Draft Budget Documents.* Under the medium-term budget planning framework, BFPs are intended to set out a three-year budget plan based on known economic and fiscal parameters and on a fiscal strategy endorsed by the Fiscal Council. Although BFPs have been prepared over the past few years, the process and documents are still marginal to budget preparation. Some officials perceive the BFP document as an end in itself rather than part of the work to draft a budget. Renaming the document as a *draft* budget would strengthen the importance of the BFP process. It would also be consistent with international good practice.

- *Budget calendars, processes, and legislation should be harmonized.* There is already a consensus within the Budget Coordination Board, in principle, around the concept of a harmonized budget calendar. DfID PEM project has been requested to prepare draft amendments to the relevant budget laws, reflecting the harmonized budget calendar.

Budget classification

- *GFS compliant budget classification should be simplified.* A set of codes more consistent with GFS 2001 needs to be developed. This issue was raised in the 2001 reports but is still unresolved.

- *Fiscal reporting formats should be standardized and agreement reached on the responsibility for preparation of consolidated fiscal accounts.* The lack of consolidated fiscal data continues to be an obstacle to effective budget management.

Program Budgeting

- *Program budgeting should be fully rolled out as the basis for budget preparation.* Budget decisions should be based on program objectives, priorities, and expected results. Increased responsibility, accountability, and incentives should be devolved to program managers for achieving program objectives. Program managers should be given the management and budgetary tools to encourage improvement in the efficiency and effectiveness of program and service delivery.

- *The governments should consider the introduction of systematic reviews and evaluations of programs and their impact.* Monitoring expenditures are now focused on economic categories. Instead, there needs to be a greater focus on monitoring outputs and evaluating outcomes of government programs. Emphasis should be on achieving policy objectives and value for money. Program reviews should be carried out internally by budget users and reported to finance ministries and parliamentary committees.

Budget comprehensiveness

- *Decisions on externally funded capital investment should be integrated into the main budget planning process by considering capital investment and its recurrent expenditure implications in the context of total resources availability.* Public investment must also be subject to the same level of prioritization as other budget funding. International donors providing externally financed projects should harmonize their activities and decision making with the budget cycle and the overall policy priorities of government.

- *Extrabudgetary funds and off-budget government agencies should also be brought "on budget."* Decisions on their policy and expenditure priorities should be made in the context of medium-term budget planning. In addition, budget comprehensiveness needs to be increased by including more information on arrears and contingent liabilities from State-owned enterprises. These obligations must be considered as part of the budget planning process.

Intergovernmental fiscal harmonization.

- *The new system for allocating revenues to cantons (within the Federation) and municipalities (within the Federation and the RS) will be phased in over the next six years.* This could provide an opportunity to review the functions allocated to each level of government, with the aim of reducing vertical and horizontal imbalances and duplication.

Parliamentary scrutiny, transparency, and accountability.

- *More comprehensive and transparent budget documentation should be made available to parliamentarians.* This should include budget documentation that clearly shows changes in annual budget vis-à-vis MTEF. Justification should be provided for these adjustments. Increased information and analysis will facilitate greater and more informed parliamentary and public debate. The initial steps toward program budgeting should be linked progressively to the inclusion of program and performance data in budget documentation submitted to the parliaments and their committees.

- *The role of parliamentary economy and finance committees should be strengthened in reviewing annual budgets.* These committees should publicly review and debate policy priorities, program objectives, and performance, as well as the overall value for money provided by government programs and services. Such scrutiny by the Economy and Finance Committee will promote political ownership and a commitment to results-oriented budgeting.

Technical skills and resource capacity of ministries of finance.

- *The reforms recommended here are critically dependent upon increasing the capacity within each government.* Realistically, this will require many years and considerable technical assistance to the ministries of finance and budget users at all levels.

- *Capacity building in fiscal management within ministries of finance should be a top priority.* This will enable the State and the Entities to develop more robust medium term budget plans and annual budget submissions, thereby improving the predictability of their respective resource frameworks and hence their budget performance.

- *The key to successful reform in upstream budgeting is to strengthen the staff resources and technical skills of the budget sectors of each ministry of finance.* Significant additional skilled staff will be required to improve management of public expenditure, monitor outcomes (not just expenditures), and analyze and prioritize budget policy proposals and alternatives. DfID PEM assistance has already prepared a range of recommendations for improving the staffing and structure of the budget sectors of all three ministries of finance, based on an international best-practice approach to budget development functions.

- *The technical capacity of budget users should be strengthened.* Program and policy managers need to be more accountable for developing and implementing sector strategies, programs, and services consistent with the policy priorities.

- *Factors that constrain capacity building of ministries of finance and budget users need to be addressed.* For example, civil service laws need to be modernized to facilitate managerial flexibility. Recruitment procedures based on competencies should also be introduced. Increased effort should be made to improve the quality and technical skills of staff through a continuous process of professional development.

Public Sector Accounting and Reporting

Key issues identified in the previous diagnostic reports

The 2002 Public Expenditure and Institutional Review and the Country Financial Accountability Assessment were prepared before full implementation of the treasury system in Bosnia and Herzegovina. Both diagnostics extensively covered the weaknesses in public sector accounting and reporting. The key findings are summarized below.

The budget classification and the chart of accounts were not synchronized. The State, the Federation, and RS had developed a new budget classification and chart of accounts along with detailed procedures; however, these were not fully harmonized. The detailed chart of accounts also needed to be systematically linked to the budget classification, which has been using functional, economic, and administrative classification compatible with 1986 Government Finance Statistics (GFS).

Budget execution reports were not comprehensive. The budget execution reports lacked consolidated information on externally financed projects and off-budget domestic resources such as privatization receipts and off-budget earmarked resources. Reporting on extra-budgetary funds also needed improved compliance with the organic budget laws.

The State and the two Entities had all adopted private sector accounting standards that were unsuitable for the public sector. Accounting standards based on private sector International Accounting Standards (IAS) were adopted by the State and the Federation and RS, but compliance was poor. Although this reflected the weak enforcement capacity within the three ministries of finance, more importantly the IAS-based system was unnecessarily complex for Bosnia and Herzegovina's public sector institutions. The CFAA recommended gradual introduction of International Public Sector Accounting Standards (IPSAS), which are more directly applicable to the country's budgetary institutions and other government agencies.

Many accounting functions were based on manual systems and procedures, and commitment recording was rudimentary. Before the treasury system was introduced, budgetary institutions used a pure cash bookkeeping supplemented by a fragmented, rudimentary, commitment tracking system that was not integrated with the overall accounting system. During this period, locally developed software packages were customized to handle the new budget classification and to automate certain aspects of financial reporting. However, many accounting functions remained semi-manual and paper based.

Development and reforms since 2002

Implementation of a common accounting system has been achieved through introduction of the treasury system. As part of the treasury automation, a common accounting system with a uniform chart of accounts has been established across the State, the two Entities, and the cantons in the Federation.

The automated treasury system has led to timely availability and improved quality of financial information in the governments. The treasury system produces a range of financial reports that are now used by budget spending units and the ministries of finance. The treasury system can produce reports on demand so that budget spending units and the ministries can access budget execution data on a timely basis, which greatly facilitates decision making.

The RS government has adopted International Public Sector Accounting Standards (IPSAS). Since 2001 the International Federation of Accountants (IFAC) has made significant progress in the development of International Public Sector Accounting Standards, which are being adopted in a number of countries. The RS government has recently adopted accrual-based IPSAS. It is noteworthy that the Republika Srpska Ministry of Finance is financing its own capacity building to implement the standards. Considering that many countries struggle even when preparing cash-based financial statements, the progress by RS Ministry of Finance has been laudable. Although the automated system helped to produce proper financial statements, the dedication and effort of treasury staff was no less important. This suggests that solid commitment and hard work can implement certain reforms successfully without recourse to extensive external technical assistance. With donor support, both the State and the Federation are developing work plans for implementing IPSAS-based reforms.

Work has begun on consolidated countrywide financial statistics. Currently, variation in reporting formats makes it difficult to easily consolidate fiscal statistics. Moreover, authorities tend to depend upon the IMF to consolidate the fiscal data. A system is being developed so that budget data can be classified, aggregated, and consolidated into summary GFS aggregates for all government levels, except for municipalities. Simultaneously, ongoing work will link GFS codes with the treasury accounting systems.

Key features of the current accounting system

Bosnia and Herzegovina has a single public sector accounting system. The treasury maintains the official financial accounting records and prepares financial statements. Unlike countries where line ministries maintain an accrual-based financial accounting system and the treasury maintains a cash-based financial accounting system, BH has only one system of accounting. This helps to avoid duplication and the need for periodic reconciliation. This classic division of function between budget spending units and treasury enables strict control of accounting transactions.

Bosnia and Herzegovina has adopted a "dual" system for budgeting and accounting using a cash-based approach for the budget and an accrual-based approach for accounting. Judging from the experience of Australia and the UK, immediate replacement of a cash-based budget with an accrual-based budget would demand enormous resources from both government and parliament. These resources are not readily available. The solution—maintaining the current cash-based system for the budget while changing government accounting—is a progressive, realistic approach that is consistent with orderly development and implementation. Switchover to accrual-based budgeting must be viewed as a longer-term objective.

Budget spending units use the treasury system as the basis for their accounting. Budget spending units are required to follow rulebooks on detailed accounting and reporting procedures. While primary accounting documents are prepared by budget spending units, general ledger and other accounting books are held on the treasury system. Larger budget spending units have direct access to the treasury system and can retrieve information using standard report preparation software. Smaller budget beneficiaries lack access to the treasury system and receive periodic paper reports from the treasury.

The treasury system can capture commitments and liabilities. The treasury system can capture commitments by budget spending units and track them against appropriations. By keeping track of liabilities, the system has built-in controls to ensure that budget commitments do not exceed available funds. By making it easier to keep track of unpaid liabilities, the system helps control the build-up of arrears.

Fixed asset registers are maintained by budget spending units. In addition, the General Services Office in the Federation maintains a register of all fixed assets owned by the Federation government. Records are reconciled annually with the physical inventory taken by the budget spending units.

The Republika Srpska has adopted accrual-based International Public Sector Accounting Standards. The RS government adopted accrual-based IPSAS effective January 1, 2006. The RS treasury held a series of seminars in 2005 to support implementation of the standards. It also developed a detailed guidance note that was circulated in the local language with a copy of the IPSAS to all public sector accountants. RS is currently transitioning to the full accrual system and is yet to bring natural and heritage assets in the books of account. The State and the Federation have adopted accounting and financial reporting rulebooks that budget spending units must follow. Present accounting policies are comprehensive, but the present standards in the State and the Federation do not fully conform to international standards.

Reporting modules in the automated treasury system have improved the timeliness and accuracy of financial reporting. The treasury system prepares standard budget execution reports and other financial management reports.[9] The system is capable of generating reports on an as-when basis and also enables the user to query the databases for particular information. Notwithstanding the financial information available in the treasury, budget spending units are required to submit quarterly and semi-annual reports. In addition to the financial information, which is extracted from the treasury system, the budget spending units provide nonfinancial information such as variances in their expenditure plan, staffing, and other topics. The accrual-based financial information generated by the treasury is used by line ministries to manage its finances, while cash-based financial reports conforming budget structure are presented to the parliaments.

[9] The system has over a hundred standard reports, and the USAID project provided over 80 custom reports to meet local regulatory requirements. The system provides users with the ability to query data, export results to Excel spreadsheets or HTML, and use third-part reporting tools to develop complex ad hoc reports.

Internal management reporting within budget spending units has also improved. Besides reporting to the finance ministries, the treasury system has enabled many budget spending units to generate detailed financial reports for their own management. These internal reports vary in structure and timing but typically focus on the availability of funds, commitment data, and unpaid obligations.

The annual budget execution reports of the State and the two Entities are submitted to their parliaments in a timely manner. Treasuries prepare consolidated final reports for the governments. Annual execution reports include the following information:

- Budgeted and actual revenues and expenditures for the fiscal year, showing differences between the approved budget and actual execution
- Opening and closing balance on the treasury single account
- Opening and closing balance for assets and liabilities
- Data on borrowing, debt, and guarantees provided during the fiscal year
- Data on the use of the budget reserves.

The annual budget execution report submitted to Parliament must contain information on corrective measures. These include the implementation of recommendations from the previous year's audit report. This requirement applies to the State and the Federation, but not to the RS.

Annual budget execution reports must be audited by the Supreme Audit Institutions. The laws mandate audits of annual budget execution reports and submission of audit reports to Parliament.

Unfinished agenda and future challenges

Introduction of the treasury system has significantly affected how budget execution is managed, accounted for, and reported on. Legislation on budget execution reporting is comprehensive and has improved transparency in both the State and the two Entities. In addition, the automated treasury system, with a unified chart of accounts, has improved access to financial information at all levels of government. The following additional measures would facilitate the development of public sector accounting in BH:

- **Finish implementation of the accrual accounting system**. The government has adopted accrual-based accounting. However, valuation of existing assets (including heritage assets) and depreciation policies are yet to be worked out. Full transition to accrual accounting represents a major undertaking for any government, involving complex issues such as gain and loss from foreign exchange. Like any large-scale project, a shift of this complexity requires careful planning and management. Governments have adopted accrual accounting over a wide range of timeframes, and implementation seems to work best when done in stages.[10] For example, the United Kingdom produced its first accrual accounts for

[10] For more information, refer to the IFAC publication "Transition to the Accrual Basis of Accounting" (December 2003) at http://www.ifac.org/Store/Details.tmpl?SID=102026702640546.

individual departments in 1999–2000. It consolidated central government accounts using generally accepted accounting principles in 2003–04, and it will prepare whole-government accounts for 2005–06.

- **The State and the Federation should implement IPSAS in a phased manner, following the lead taken by the Republika Srpska.** The RS government has made good progress on developing public sector accounting; however, as noted above, compliance represents a long-term challenge needing support from the Finance Ministry training organizations, accounting institutes, public sector auditors, and the donor community. The State and the Federation should commit to develop their public sector accounting based on internationally recognized standards. A starting point for that effort would be to learn from the RS experience in adopting IPSAS.

- **Train users of accrual-based financial statements.** The Ministry of Finance, particularly the RS treasury, has made significant efforts to train public accountants across the country. Accrual-based financial reporting is not an end in itself but provides useful information for multiple purposes. Accrual-based accounting statements are difficult to understand, especially for non-accountants. For accrual-based financial statements to be fully useful as management decision-making tools, it is therefore important that end users, including heads of departments and program managers, be extensively trained in how to interpret and apply accrual accounting statements.

- **Establish a joint Government Accounting Standards Board and issue national public sector accounting standards.** Public accountability of government is demonstrated in part by accounting standards that require fair presentation and full disclosure. Instead of the State and the two Entities issuing their own public sector accounting standards, a joint Government Accounting Standards Board should be formed. This would ensure adoption of uniform accounting standards across the entire public sector, enabling preparation of national consolidated financial statistics.

- **Provide all budget spending units with access to the treasury system.** Currently, treasury allows only select budget spending units to use its system. However, since budget spending units should not maintain separate accounting records, all budget users should have unhindered access to the system. This will enable them to better monitor the financial performance of their units.

- **Implement full commitment accounting.** The treasury system is capable of tracking commitments. However, not all commitments are entered into the system. Recording all commitments is necessary to ensure budget discipline and avoid accumulation of arrears.

- **Ensure wide availability of financial information.** Informing the public about financial operations of the government is a prerequisite for better accountability. Several countries post annual budget appropriations and allocations, monthly budget execution information, and an annual budget execution report, including performance reports, on the website of the ministry of finance. The State and the two Entities should regularly make such information available on the official websites of their finance ministries. In addition, line ministries should be encouraged to post their performance targets, performance reports, financial statements, and SAI audit reports on their websites.

BUDGET EXECUTION AND CASH MANAGEMENT

Key issues identified in the previous diagnostic reports

The 2001 CFAA observed that payment bureaus and the finance ministries, in both the Entities and the State, had limited budget execution functions until their closure in January 2001[11]. The report highlighted several issues.

- The system was unable to support sound budget execution. While the finance ministries allocated the budget, they did not monitor spending. As a result, budget-spending units exercised considerable discretion over allocated resources. The finance ministries provided little oversight.
- Predictability of funds and prioritization for carrying out budget activities were weak. As a result, funds were frequently reallocated during the year.
- Cash management and tracking of arrears were rudimentary. This made monitoring difficult for the finance ministries. Budgetary institutions adopted pure cash-bookkeeping. The supplementary commitment tracking system was rudimentary, fragmented, and not integrated with the accounting system.
- Large expenditure arrears marked by cash shortages ensued.
- Budgetary reports were erratic and incomplete. Delays in budgetary reporting and a general lack of transparency resulted in a weak control environment. Inefficiencies and abuse were difficult to uncover.

The PEIR and CFAA both welcomed the new automated treasury system. However, several issues were flagged.

- The treasury system needed to be extended to the third and fourth levels of government (that is, to cantons and municipalities) to ensure uniform standards for accounting and reporting countrywide.
- Budgetary institutions located away from treasury offices maintained separate checking (giro) accounts.
- The treasury system had not yet established a system to report extrabudgetary funds.

Developments and reforms since 2001

An automated treasury system was the key development in improving budget execution and cash management[12]. This was set up in the State and the two Entities in 2002. The payment bureaus were closed. Budget beneficiaries are now financed through Treasury Single Accounts (TSAs), which are held in commercial banks and operated

[11] The weaknesses of the budget execution process before the treasury system in 2002 are extensively documented in the 2003 PEIR, pp. 124–25.
[12] Use of the singular treasury system is **not** intended to convey that there is one treasury serving the State and two Entities. In fact, the State and two Entities have separate treasury systems. Although the three treasury systems use the same Oracle® Financials Software, the systems are operated and maintained on separate servers owned by the respective governments ensuring confidentiality of the data.

exclusively by the treasury. All separate bank accounts of budget beneficiaries were closed. New accounts are allowed only in exceptional cases with prior approval of finance ministries. The State and the two Entities operate their own treasuries, though all use the Oracle financial software implemented under the USAID-financed project.

The automated treasury system has improved budgetary controls, brought discipline to the budget execution system, and improved overall cash management across the State and Entities. The treasury system addresses many weaknesses highlighted in the CFAA.

- A general ledger with a chart of accounts is shared across all levels of government. It standardizes the framework for managing all types of financial transactions.
- Finance ministries are now able to monitor budget execution through information available in the treasury system. Controls are built into the treasury system to ensure that spending units do not exceed their monthly allocations.
- The banking arrangements are well organized. All treasuries have reporting systems so that balances can be reconciled and aggregated daily.
- The system enables budget beneficiaries to manage the purchase cycle. They can track commitments and unpaid liabilities. System controls ensure that liabilities are managed and arrears are controlled.
- Information on the execution of the budget has improved at all levels of government, increasing transparency. The environment is far more conducive to informed decision making.
- Timely budget execution reports are now available. Decision makers can make ad hoc queries for real-time information.

A comprehensive legal framework for budget management was introduced with the enactment of the state law on financing in late 2004. The budget laws were amended in the RS in 2005 and in the Federation in 2006. As discussed, there was no organic budget law before the law on financing at the State level. Key aspects of budget execution and cash management were not clearly defined earlier. Similarly, the amendments to budget laws in the two Entities have led to improved clarity on provisions relating to budget execution.

Key features of the budget execution and cash management system

Major provisions relating to budget execution are enacted annually. Parliaments enact annual budget execution laws to stipulate how budgets will be executed during the year. The laws set requirements in relation to cash flow management. Spending units are required to prepare monthly and quarterly budget-execution plans. For 2004, the State annual budget execution law also specifies how liabilities will be created and assets utilized. See Box 4.1 for a description of the procedures for cash flow management under the law.

Box 4. 1 Procedures for Cash Flow Management in the 2004 State Budget Execution Law

- All budget users must submit their annual expenditure plans to the ministry of finance—divided by months, no more than 15 days from publication of the budget in the official gazette of BiH. Information must be provided with account codes for current expenses, special purpose programs, capital expenses, and so forth.
- Using these submissions, the Ministry of Finance prepares a dynamic plan of revenues and expenses for budget execution while harmonizing cash inflows and outflows.
- Thereafter, budget users prepare and submit revised monthly operating budgets to the finance ministry, including outstanding liabilities.
- The finance ministry conveys approval to the budget users.

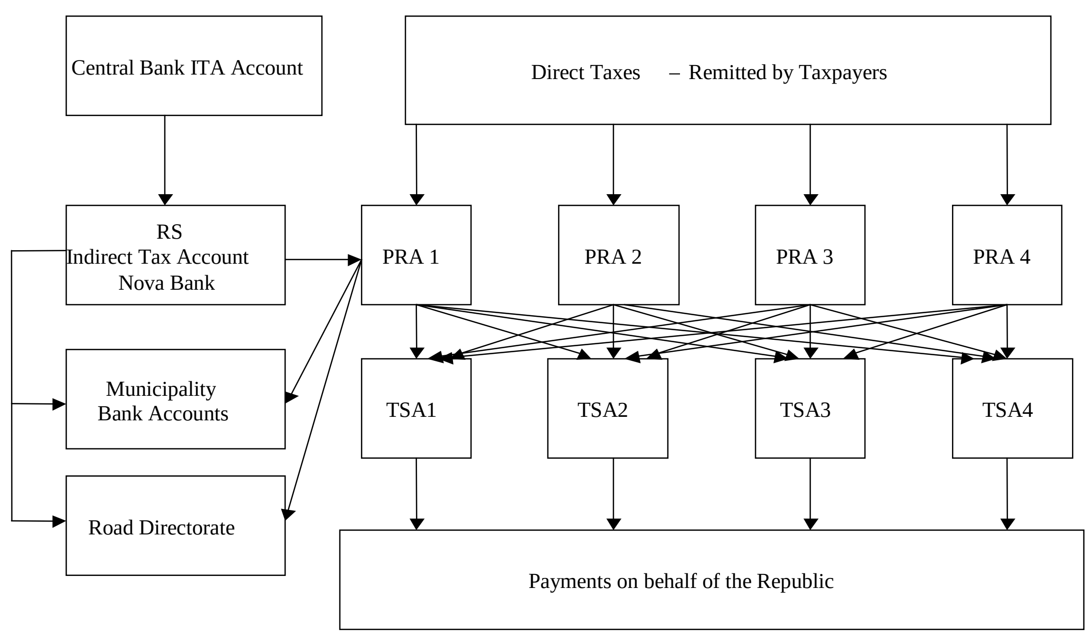
Budget execution rules specify procedures for appropriations and monthly allocations. Budget beneficiaries submit detailed monthly operating budgets each year based on the aggregate budget allocations. Based on these plans, the finance ministries prepare the aggregate plan of revenues and expenses for budget execution. The finance ministries inform budget beneficiaries of their approved monthly operating budgets. These are entered into the automated system by the treasury department. Inbuilt system controls ensure that no payments are made without an appropriation or adequate allocation.

Several budget beneficiaries have direct access to the treasury system. Larger budget beneficiaries have been granted direct access to the treasury system by equipping them with computer terminals, while smaller beneficiaries present documentation directly to the local treasuries, as they do not have computer terminals to access the treasury system. Access to treasury data is controlled. Users can access information relating to their entity only. Segregation of duties is built into the purchase and payment cycles. Budget users authorize commitments, and they verify that purchase invoices are eligible for payment under the internal control procedures documented by their organization. Only treasury staff can process payment orders. Supporting documents are usually required for large or unusual items. Because larger line ministries and budget beneficiaries have access to the system, they can see when payments are made. Smaller budget beneficiaries bring their requests and supporting documentation physically to local treasuries. They receive regular reports generated by the treasury system.

The rules for reallocations of approved budgets are transparent. Within budgeted current expenses, a budget user can initiate a request for reallocation of funds by the ministry of finance. This flexibility is subject to further restrictions. For example, the State Budget Execution Law for 2005 states that reallocations within current expenses should not result in increase in salaries beyond those approved by the Council of Ministers. Reallocation between two budget users is generally discouraged and requires approval by the ministry and the Council of Ministers in the State. The organic budget laws in the Federation and RS make no provision for reallocations between budget users. However, the RS annual budget execution law provides that the RS government can—exceptionally and upon request of the Ministry of Finance—reallocate among budget users subject to an overall ceiling of 5 percent of the approved budget of that user.

All separate bank accounts of budget beneficiaries were closed. Budget users now make payment through treasury single accounts. The State and the Entity mechanisms are similar. To illustrate, Figure 4.1 shows how funds flow in Republika Srpska.

Figure 4.1. Funds Flow Diagram for Revenue and Expenditure in RS



Note: The balance on the four PRAs is allocated to the STA, Municipality, and Road Directorate. However, to simplify the diagram, only flows from PRA 1 to municipalities and the Road Directorate are shown. In addition, each PRA maintains subaccounts to track direct taxes.

Several features of this system should be noted.

- All public revenues (for the Republic as well as for local governments in the RS) are collected by the Direct Tax Authority. They are paid into Public Revenue Bank Accounts (PRA). These are held in four commercial banks. This avoids the risk of placing all the funds in one commercial bank in light of the size of commercial banks in BH. The revenue accounts are swept at the end of each business day. Revenues are allocated to the Republic and to municipalities in accordance with revenue-sharing agreements.

- The RS allocation of the revenues for indirect taxation is received from the Indirect Tax Authority (discussed in Chapter 5).
- Each PRA has subaccounts to track direct taxes.
- Daily statements of revenues are received by the treasury from the commercial banks. These are consolidated into a single report, which is consolidated on a daily basis to manage the cash flow requirements of the government.
- Four Treasury Single Accounts (TSAs) are held with the same commercial banks as the PRAs.
- Revenues are allocated from the PRAs to the TSAs of the Republic, or to bank accounts opened by the finance departments of municipalities.
- Payments for the Republic are made through the TSAs.

Until recently, the State and two Entities faced persistent cash-flow difficulties. These resulted in cash rationing. The situation has recently improved. The annual budget execution laws clearly specify priorities in how payments should be made in the event of cash rationing. If a shortfall occurs, the first three State priorities are external debt service, salaries and payments to employees, and payments to suppliers. The Federation priorities are financing for the army, disability benefits, and payments to displaced persons and refugees. The RS priorities are foreign debt, transfer to State for common institutions, and contributions and taxes on employee payroll. Although cash flows improved in 2005, the treasuries adopted conservative approaches in cash release. For example, RS budget beneficiaries were allocated only 22 percent of the total annual budget in the first quarter. This cautious cash-flow management puts pressure on the procurement process in the last quarter, when most resources are made available. It should come as no surprise that compliance with the procurement law is weak.

The treasury system requires budget users to make "batch payments." In RS for example, treasury payments are combined by economic classification, and payments are sequenced across the month. Social contributions are paid between the first and tenth of the month. Net wages are paid between the twenty-first and thirtieth of each month. The finance minister and an assistant minister of finance must authorize the batch sheet in order to release payments.

Unfinished agenda and remaining challenges

The treasury system needs to be extended to local governments and to extrabudgetary funds. As funds are increasingly routed through local governments, it becomes even more important for local governments to have a robust treasury system. In the Federation, the cantons have already implemented the same automated treasury system. In RS, the treasury system has been piloted in 18 municipal treasuries. Budget discipline must be uniform. Extrabudgetary funds (particularly health insurance and pension funds) must be brought into the treasury system.

Online access to the treasury system should be extended to other line ministries and spending units. As discussed above, the treasury system has enabled budget spending units to better manage their budgets and accounting. It is important that these benefits be extended to spending units that currently lack direct access.

ACCOUNTING AND CONTROLS IN REVENUE ADMINISTRATION

Key issues identified in the previous diagnostic reports

The 2001 CFAA did not specifically discuss revenue accounting and controls in tax administration. However, the PEIR noted that the BH tax burden was high despite rapid recovery of tax revenues during the postwar years. Several issues were highlighted.

- The complex tax laws included numerous tax shelters and exemptions.
- There were too many types of taxes, especially indirect taxes. Excessive fragmentation created incentives for evasion and noncompliance.
- Significant smuggling of excisable goods, such as alcohol, cigarettes, and coffee, resulted in tax evasion.

Prior to 2001, tax administration was inefficient and fragmented in the Entities. Taxpayer assessment and enforcement were carried out directly by tax officials in branch offices that were operated as standalone systems. Interoffice communications scarcely existed. Data could not be shared between the head office and branch offices.

Developments and reforms since 2001

A number of donor-financed initiatives have been implemented. These cover all aspects of tax administration, with subsequent improvements in revenue control and accounting. Several initiatives were implemented in tandem with the new treasury system. The Entities have received significant support from USAID, US Treasury, GTZ, and the European Union. This work has been well coordinated across the State and two Entities.

The main developments relating to indirect taxation are as follows. (Note that indirect taxes on goods and services, customs, and excise generate the bulk of BH tax revenues.

- Creation of the Indirect Tax Authority (ITA), that is, a single State-level customs and indirect tax administration.
- A new Value Added Tax (VAT) with a uniform rate of 17 percent came into effect in January 2006. The new VAT addresses many weaknesses of the previous tax structure. The VAT law was drafted with donor support and is in accordance with EU and international standards.
- A single account for receipt and distribution of revenues became operational January 2006. All indirect taxes for which ITA is responsible are collected into this account, including import and export duties, as well as taxes chargeable on goods and services such as tax on excisable sales items and the road tax.
- A tax administration system under the EU Customs and Fiscal Assistance Office (CAFAO) program has been developed and integrated with the State treasury system. This has improved revenue accounting and controls.
- An internal audit unit within ITA, consisting of a chief of internal audit and 36 staff members.

The following significant developments had a positive impact on direct taxation revenue accounting and controls: (It should be noted here that direct taxation generates only modest revenues for BH and does not constitute a significant source of revenue. By way of an illustration, Annex 4 provides composition of revenues for RS for 2004.)

- The creation of direct tax authorities in the two Entities, subordinate to the respective finance ministries. These authorities have developed a modern organizational structure that has improved coordination and efficiency while addressing many weaknesses inherent in the previous arrangements.
- The introduction of modern self-assessment tax system that places the burden of compliance on taxpayers.
- A single account system for payment and distribution that is linked to the treasury system in the two Entities.

Key features of the indirect taxation arrangements

A single State-level customs and indirect tax administration (ITA) was formed in 2004 by merging the custom agencies of the Entities. The governing board of the ITA, which is chaired by the OHR representative, comprises finance ministers of the State and two Entities. ITA has a sanctioned strength of 2,200 staff members of whom 2,060 were in place as of February 2006. The head office is in Banja Luka. The four ITA regional centers are located in Sarajevo, Tuzla, Mostar, and Banja Luka.

The ITA has developed a modern computerized tax administration system. With World Bank support[13], ITA developed a customs administration system using ASYCUDA[14]. With EU support, a VAT system was built onto the ALICE (A Logical Integrated Computerized Environment) system. A third system (RACUN) is used to support other taxes. ITA plans to graduate the customs and excise system to ALICE in 2007.

Introduction of the countrywide VAT was well organized. The ALICE management information system became operational on July 1, 2005, when BH enterprises were required to register for VAT. The system is an integrated database that is installed at headquarters and at all four regional centers. Registration of taxpayers was completed on time. Compliance with the deadline for the submission VAT returns in the first few months has been encouraging.

The ITA manages the receipt of indirect taxes through a single account. The account comprises several sub accounts with one or more banks—both commercial banks and the central bank. The ITA governing board has authorized 60 sub accounts to be opened in 12 commercial banks and 2 accounts to be opened in the central bank. Tax receipts

[13] World Bank support was provided under the Trade and Transport Facilitation in Southeast Europe (TTFSE) project.
[14] The acronym ASYCUDA stands for Automated System for Customs Data. It refers to a computer software package used extensively in developing countries by customs administrations—to process export and import documentation, accounting for revenues, and compilation of trade statistics.

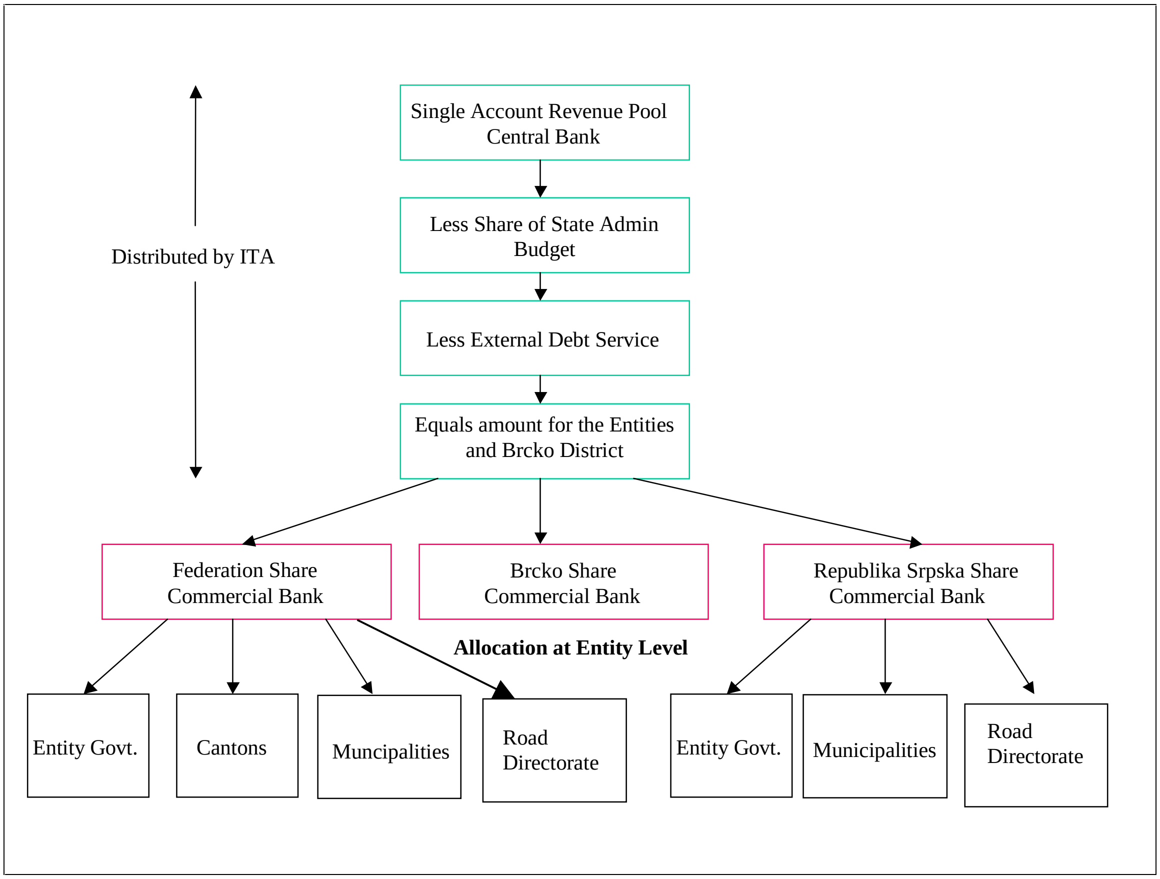
collected through the 12 commercial banks are transferred to the central bank at the close of each working day.

ITA reconciliation procedures ensure completeness and accuracy of indirect tax receipts. Collection files received from commercial banks are reconciled to the aggregate amount transferred to the central bank. Unrecognized receipts are insignificant and are credited to a separate suspense account. ITA staff is specifically assigned to clear suspense items. Once the collection files have been validated, they are uploaded into the taxpayer system. Individual payments are credited to the taxpayer account.

The single account is integrated into the treasury system of the State. The collection data received from the commercial banks is also used to update the treasury system.

Revenue allocations, accounting, and reporting of indirect taxes are handled through the treasury system. Based on total daily collections, the treasury system calculates the revenue allocations to the State and two Entities using a predetermined coefficient. A report on the daily allocation of indirect tax revenues is reviewed and verified within ITA. Thereafter, the central bank issues an order for transfer of revenue to the State, and the two Entities. Figure 5.1 depicts the distribution of ITA revenues from the single account.

Figure 5.1. Distribution of Indirect Tax Authority Revenues from the Single Account



The law requires that revenues to be distributed must first be used to finance an agreed-upon portion of the State administration and foreign debt service. The balances of revenues are split amongst the Federation, RS, and Brcko District.

Distribution systems in the two Entities are able to further allocate revenues. In the Federation, revenues are shared among the Entity government, cantons, and the Road Directorate. Under a recently adopted law in the Federation, municipalities (in Federation) get a prescribed share of the single account revenue pool available to the Federation instead of the previous system under which the municipalities received funds through the cantons. In RS, the revenues are shared among the Entity government, the municipalities, and the Road Directorate.

Key features of direct tax administration

In 2002, the two Entities formed direct tax authorities within their respective finance ministries. The directors of the tax authorities report directly to the finance ministries. The direct tax authorities have been organized at three levels. Roles and responsibilities have been clearly defined. Headquarters in Banja Luka and Sarajevo house the central processing center and has overall responsibility for coordination. Seven regional centers in RS and 10 in the Federation are responsible for tax collection, follow-up with taxpayers, and taxpayer services. Regional units are spread throughout the Entity. They are responsible for registering taxpayers, receipt of tax declarations, and answering general inquiries.

The direct tax authorities administered indirect taxes too until ITA took over indirect taxes in January 2006. This transfer of responsibility has significantly reduced the volume of transactions and the workload of the direct tax authorities.

Several measures simplified the tax administration system. These include (a) restructuring the organizational structure of tax administration; (b) simplifying tax forms and educating taxpayers, and (c) establishing central processing centers to handle data entry for tax declarations and to generate notices related to liabilities.

Revenue collection is through the treasury system. Taxpayers make remittances through the banking system into accounts held at four commercial banks that manage public revenues. There is a separate bank account for each tax. The tax collection accounts in commercial banks are emptied at the end of each business day. Funds are remitted to the Treasury Single Accounts (TSAs) that are held in commercial banks.

An effective process for accounting and reconciliation exists in RS. The banks provide electronic files on a daily basis, which allows the direct tax authority to update the taxpayer ledger and to monitor tax arrears. It also enables the tax authority to reconcile its records with the data submitted by the treasury. Errors in data transmission (for example, with respect to tax type or beneficiary) are investigated and corrected by the tax authority. While treasury accounts for revenues on a cash basis, the DTA maintains accounts of all taxpayer obligations and can thus provide data on tax arrears.

Reconciliation procedures are weak in FBiH. The treasury data is not systematically reconciled with collection data received from the commercial banks. A primary reason is that treasury data reflects only Entity amount without information on revenues transferred to cantons and other beneficiaries. It is thus difficult for DTA to reconcile aggregate tax collections with treasury receipts.

Unfinished agenda and remaining challenges

It is too early for a comprehensive evaluation of the unified indirect taxation system. Uncertainty remains on the full effects of the VAT. Early indications at the technical level of tax administration have been encouraging. Similarly, indicators have improved on the number of taxpayers registered and the amount of VAT collected. However, the management of a State-level institution charged with sharing a major source of revenue among governments poses a significant political challenge. This will only accentuate after the OHR, which currently chairs the governing board of the ITA, is closed. It is important that donors continue their support to stabilize the technical systems.

ITA needs to be sensitive to overarching complexities. The integration of the Entity customs administrations involved absorption of existing customs staff, which turned out not to be a painless process. Similar challenges continued with the introduction of the VAT, which required recruitment of a new administrative team. This proved difficult for reasons ranging from low quality of applicants to lack of transparency in the process. The difficulty was compounded by the need for an acceptable ethnic mix at the head office as well as increasing pressure to cut public administration costs.

Current computerized systems need to be integrated so that taxpayer information can be fully accessed. All taxpayers have a unique tax identification number for indirect taxes; however, the present systems are not interlinked, so a composite picture for each taxpayer cannot yet be provided. This issue will be addressed in 2007 when ITA migrates the current customs and excise system to the new ALICE software, which is already used for VAT.

Additional capacity needs to be built in tax audit and enforcement. Tax evasion and smuggling continue to plague and challenge the BH authorities. Past initiatives have laid significant groundwork for developing a transparent, professional, tax service. Yet revenue enforcement and audit capability necessarily take time to develop. Staff members are needed who are willing and able to adopt new approaches. Training and modern technology can help; but the fundamental reality is that capacity building will be a long-term endeavor. Political will to enforce laws and pursue tax evaders is equally important.

The FBiH Direct Tax Authority needs to address underlying weakness in control and accounting for tax revenues. Weaknesses in the ability to manage errors, reconcile suspense accounts, or reconcile the treasury and tax systems mean that major discrepancies could go undetected, with tax revenues then potentially used to “float” the banking system. FBiH DTA should review its control processes in detail. Structure and control procedures could be significantly improved, which would go long way toward address many shortcoming that are identified in this report.

Internal Control and Internal Audit

Issues identified in the previous diagnostic reports

The 2001 CFAA Report observed that BH inherited a set of socialist institutions that preserved the mentality of bureaucratic control but lacked real checks and balances. These institutions maintained the old administrative formalism but lacked the substance to carry out necessary tasks. The result was fragmentation and overlapping authority. Despite pervasive "controls" that focused heavily on budget allocation and payment stages, confidence in the internal control of public funds was seriously lacking. This problem significantly affected capacity to implement the budget as approved by the parliament. The CFAA highlighted several issues.

- Although financial controls formally existed on paper, they could easily be circumvented. Decisions to release funds in line ministries were often communicated informally. Decisions often violated statutes—for instance, payments without delegated authorization. There was generally little or no follow-up to ensure that funds were spent as intended. Accounting records and supporting documentation were incomplete. They did not allow for an appropriate audit trail. In general, procurement methods were neither appropriate nor properly enforced.
- The lack of capacity and proper orientation were compounded by the lack of "control consciousness'' within governments. In the absence of such consciousness, individuals can easily override nominal controls
- Modern internal audit functions were lacking at all tiers of the BH administrative structure.
- Until closed in January 2001, the Payment Bureau exercised only quasi-financial control and reporting on budget transactions.

Developments and reforms since 2001

The treasury system has improved budgetary controls and brought discipline to the budget execution system. As described, an automated treasury system has been implemented together with the treasury single account. This enables the ministry of finance to exercise better control over the implementation of the budget. Unlike countries such as Turkey and Ukraine, however, the treasury does not verify every single payment with supporting documentation (except for small-budget spending units, which do not have access to the treasury system terminals and therefore submit payment orders with supporting documentation to the treasury in order to process and make payments). Instead, the budget spending unit enters the payment order into the treasury system, which is accountable for the accuracy and legitimacy of the payment; and payment is made by the treasury without reviewing supporting documentation for each payment. Treasury asks for supporting documentation mainly for large or unusual payments.

The State and Federation have developed a centralized employee database and payroll system. Because employee costs constitute a significant portion of the annual budget, a strong and robust employee payroll system is indispensable. Creation of a central database of employees and a payroll system in the State (except for the armed forces) and the Federation has improved controls over payroll processing. In fact, the recently enacted state law on financing mandates maintenance of a centralized payroll. Wages are paid through the banking system by crediting employees' account, further strengthening the internal control framework. In addition, the treasury system has built in controls to limit payroll expenditures. In RS, however, each budget spending unit manages its own payroll.

The recently amended or enacted organic budget laws in the State and Federation mandate an internal audit function. The State Law on Financing stipulates establishment of an internal audit function to be regulated by the Ministry of Finance (Article 23). The law provides an option to establish centralized (within the ministry) and decentralized (within each budget spending unit) internal audit functions. Similarly, the Federation Law on Budgets envisions an internal audit function and provides both the options insofar as organization of the internal audit function is concerned(Article 63). The RS Law on the Budget System, however, lacks specific provisions relating to internal audit. The RS law provides for internal control units within budget spending units (Article 65) and a budgetary control unit within the treasury department (Article 66).

A new procurement law has been enacted, and a public procurement agency has been established. A modern law on procurement was enacted, paving the way for transparency, openness, and fairness in procurement of works, goods, and services. Proper implementation of the new law will contribute to better controls and lead to more efficient procurement. (See Chapter 7 for details).

Formal rulebooks have been prepared on control procedures and organizational structure. Ministries have begun developing their own rulebooks on control procedures and organizational structure, providing a frame of reference and transparency. For example, the Federation Ministry of Education has developed its own rulebook to on accounting policy[15], cash-box procedures, allowances to the staff, and so forth.

Key features of the internal control system

Duties regarding authorization and payment functions are properly segregated. Clear delineation of roles helps to strengthen internal controls—the budget spending unit approves and authorizes the payment, and the treasury executes it. Moreover, all payments within the budget spending unit are routed through its General Affairs and Accounting Department, helping to ensure that those who receive goods and services do not also process the payments.

The automated treasury system ensures that no payments are made without a corresponding budget appropriation and a monthly allocation. The problem of

[15] It is important to note that accounting policy and other policies in the rulebooks are just restatements of policies set in the laws, rules, and regulations. The rulebooks simply provide elaboration.

payment arrears has been brought under control since the automated treasury system was introduced. The system is also capable of tracking commitments.

The minister (in a line ministry) approves all requests for payment that are submitted to the treasury. Presently, the line minister must approve all payment requests each comprising payments to different suppliers before the request is forwarded to the treasury. This requirement necessarily involves highest-level officials in the payment process. It is unclear whether this involvement has improved controls or simply introduced another bureaucratic layer. Large organizations require delegation of authority with corresponding responsibility for decision making as well as a sense of personal responsibility and commitment among managers.

The payment requests of second-tier budget-spending units must first be approved by their respective ministry headquarters. In RS, for example, the Ministry of Education must approve payment requests for schools before the treasury can make the payment. This effective control mechanism reinforces budget discipline and helps reduce the risk of excessive payments.

The treasury is the final accounts keeper for the government. Since the treasury operates and maintains the automated treasury system, financial accounts prepared by the treasury are authoritative. This helps to ensure the integrity of financial data.

A fixed-assets register is maintained by a separate department, which also verifies the inventory. In the Federation, the General Services Office (GSO) maintains a register for all the fixed assets owned by the government, thus ensuring integrity of the record. The GSO also reconciles the book records with the annual physical inventory carried out by the budget spending unit.

There are other effective internal controls. First, the treasury requires documentation for capital expenditure payment requests—for example, a copy of the invoice and the completion/acceptance certificate. Second, all payments are directly credited to the supplier's bank account, eliminating unnecessary handling of cash (except for petty cash expenses). Third, all revenue is collected into deposit accounts in banks from which no payments can be made.

In the Federation, treasury data is not well reconciled with direct tax receipts. Several banks collect and transfer direct taxes to the Treasury Single Account, which is maintained in selected commercial banks. The tax collections are shared among cantons and municipalities according to a predetermined formula. Errors in the data forwarded by the collection banks are often not resolved expeditiously. Moreover, the Direct Tax Authority lacks a robust mechanism to reconcile data transmitted by collection banks with the treasury data from the Treasury Single Account. (See Chapter 5 for details)

Unfinished Agenda and Remaining Challenges

Compliance with internal controls needs to be improved. The SAI audit reports point to several instances of noncompliance with the present internal control rules and procedures. For example, the 2004 SAI report on the Federation Ministry of Veterans Issues and Disabled Veterans of the Defensive Liberation War observes, "Budget funds are not used in accordance with the Law on the FBiH Budget and the Law on the FBiH Budget Execution for purposes determined by the budget and amounts determined in its special part." Similarly, the 2004 SAI report on the State Ministry of Justice observes failure to meet rules in the field of accounting relating to inventory and funds. The strength of internal controls is not a matter of how strong they look on the paper. They depend upon people. Controls will succeed or fail depending on the extent to which people pay attention to them. Controls are effective when people in the context of the surrounding environment assume and work together toward compliance.

Align internal financial control framework with the EU prescribed model of Public Internal Financial Control (PIFC). The EU model provides a structured model for establishing a state-of-the-art control environment in revenue centers and spending units. A key element of this model is clarity on ministerial and managerial accountability. As a first step, the ministries of finance should take the lead in drafting a PIFC policy paper providing gap analysis between the current internal control environment and the intended state-of-the-art internal control environment.

Adopt a legislative and organizational framework for a sound internal audit system. Internal audit provides an assurance to management on whether specified controls really work and are being followed in spirit as well as letter. Given the general observation in audit reports that compliance with rules and procedures is weak, a mechanism for the management to continuously ascertain the state of internal controls is all the more important.[16] As mentioned, the organic budget laws envision an internal audit function. RS has prepared a draft law on internal audit, which the Bank has reviewed and found to mirror good-practice internal audit legislation elsewhere in the region. However, before this new law is enacted, a general understanding and consensus must be built among stakeholders (especially the Ministry of Finance and line ministries) on the role and functions of internal audit. Line ministries will be implementing parts of the legislation and will also be most affected by it. Lack of proper dialogue at the outset will put effective implementation eventually at risk. In addition, an internal audit function will require new appointments. Taking into account the larger objective of reducing public employment in BH[17], a broader discussion on internal audit would go a long way in building consensus and ensuring commitment among legislators, the finance ministries, and line ministries. Another issue that will need consideration is the availability of qualified auditors willing to take on the internal audit job in the public sector. These issues reinforce the necessity of broad discussions among stakeholders.

Implement centralized employee database and payroll in RS. Payroll constitutes a significant portion of the budget expenditure in BH. The State and Federation have already implemented a centralized payroll system that strengthens internal controls over the payroll processing. RS should also consider centralizing the payroll processing for all employees and similarly the State for army personnel.

Stipulate how ministers, heads of departments, and managers will be accountable under the law. Many countries in the region are now explicit in stating the accountability

[16] It should be acknowledged that no system of internal control can provide absolute assurance against loss or fraud

[17] Please refer to the 2006 Public Expenditure and Institutional Review

of ministers and other officials under their laws. This is a key element of the EU PIFC model referred to earlier. For example, the recently enacted Public Financial Management and Control Law in Turkey clearly articulate the accountability of the ministers and other senior officials in the budget process. In general, presumed responsibility or dispersed responsibility translates to no one being held accountable.

Ensure that audit recommendations are implemented. Auditors can be effective when there is constructive dialogue between the budget spending units and auditors. The budget spending units must pay proper attention to the recommendations made by the auditors. Continuous disregard for good recommendations breeds cynicism among auditors and weakens the public financial management system. It is important that managers be held accountable for timely implementation of agreed-upon audit recommendation.

Have uniform internal control standards for rulebooks. Currently, every ministry prepares its own rulebooks without uniform standards for internal controls. This is understandable given that internal control must be responsive to the nature and needs of individual ministries. On the other hand, certain common standards must also be adopted. In this regard, it would be worth reviewing the uniform internal control standards for the entire federal government in the United States. (See http://www.gao.gov/special.pubs/ai2131.pdf.)

Implement public procurement law. As described in Chapter 7, a general observation is that weak capacity across the board has prevented effective implementation of the new public procurement law. Despite enactment of a good law, public procurement continues to suffer from uneconomic and inefficient procurement that further constrains already tight budgetary resources. There is an urgent need to create capacity within budget spending units; to strengthen the public procurement agency and making it functional; and establish complaint-handling mechanism envisioned in the law. Without a functional public procurement agency, control and oversight over public procurement will continue to be ineffective.

Separate bank accounts operated by some secondary budget spending units should merge with the Treasury Single Account. Secondary budget spending units such as secondary schools, universities, and cultural institutions operate bank accounts that do not form part of the Treasury Single Account. This practice defeats the fundamental rationale of bringing all public funds under the control of single treasury account. Efforts must be made to merge such accounts.

Systems controls documents should be developed and updated regularly. BH has implemented state-of-the-art database systems for treasury operations. It is now important to develop systems control document that include access control requirements, password protection and change requirements, back-up procedures, offsite back-up storage procedures, a systems maintenance log, and so forth. Moreover, the systems control document needs to keep pace with the ever-changing technology and sophisticated means adopted by hackers to perpetrate technological fraud.

Strengthen the tax collection reconciliation mechanism in the Federation Direct Tax Authority. The Federation Direct Tax Authority should set up a mechanism to ensure that errors in transmission of collection data by collection banks is resolved in an agreed timeframe. Issues not resolved within a reasonable period of time should be brought to the notice of senior management, including the minister. In addition, DTA should establish a robust mechanism to reconcile and aggregate individual tax collection entries with the total tax collection amounts appearing in the Treasury Single Accounts.

PROCUREMENT

Key issues identified in 2002 CPAR

The 2002 CPAR point to shortcomings in all the areas of public procurement in BH. These referred to the legislative framework, performance of regulatory functions, enforcement regime, capacity of public sector institutions, and corruption in procurement. Major weaknesses were identified as follow.

- *The absence of a law on public procurement harmonized across entire BH.* The FBiH Decree on Procedure of Goods, Services, and Contracts, as well as the RS Law on Procedures for Procurement of Goods, Services, and Works provided a less-than-comprehensive framework. They failed to provide clear rules for public tenders, and they afforded public officials with too much discretion in making decisions about contracts. Further, compliance with the legislation was low in both Entities and at all levels of administration. The need for a harmonized set of procurement rules throughout BH, in line with EU legislation, was identified.
- *Procurement not viewed as a core function of government.* Procurement did not merit specialized staff or a dedicated organizational unit, despite public expenditure of KM 670 million (US$300 million) spent at all levels of administration in 2000. In fact, procurement of goods, services, and capital investments accounted for about 15 percent of budgeted expenditures—just over 7 percent of GDP (see Annex 4 for details). Procurement capacity was weak at all levels of administration. It was managed, often improperly, by untrained nonspecialist staff.
- *Many instances of bad or abusive practices. Examples included***:** (i) insufficient time to submit bids (the legislation vaguely stipulated "a reasonable period"); (ii) a bid evaluation process that was highly susceptible to manipulation; (iii) legislative provisions not requiring procuring organizations to pre-disclose their evaluation criteria - an essential element of transparency.
- *Inadequate arrangements for holding public officials accountable.* Complaints were reviewed in Ministry of Finance rather than by an independent review body. Further, because of the ineffectiveness of the court system, bidders rarely sought judicial review. Given the prevailing lack of redress, public officials were not held accountable for breaching the rules.
- *Procurement-related corruption.* One survey indicated that 73 percent of respondents believed that unofficial payments were required to win a public contract, usually around 4 percent of the contract price.
- *Little faith in the fairness of public tender.* The private sector complained about bids being frivolously rejected and the pervasive lack of transparency in evaluation. Many believed that winners were actually determined in advance.
- *A generally high-risk environment.* This overall perception reflected weak overall legislative framework, ineffective regulatory institutions and enforcement regime, scant institutional and human resource capacity, and the threat of corruption.

Developments and reforms since 2002

Some reforms and developments have occurred since 2002. These relate primarily to improvement in the legislative and regulatory framework. However, despite the Law on Public Procurement (September 2004) and publication of implementing regulations (January 2005), implementation has been limited by knowledge of the new law among procuring organizations. The Public Procurement Agency (PPA) is yet to become operational.

Legislative and Regulatory Framework

A new harmonized Law on Public Procurement (LPP) for Bosnia and Herzegovina was enacted in September 2004. The law applies to all administrative authorities of BiH, Entity, Brcko District, cantons, municipal bodies, public organizations, and public enterprises as defined in Article 3 of the law. This represents a major achievement as unified law has not achieved in other areas—for example, in the areas of national audit and organic budget laws. LPP was drafted with technical assistance from the European Union public procurement program. The LPP is based on international best practices but might need alignment with EU directives. The World Bank provided extensive comments and recommendations before enactment of the law and issuance of implementing regulations. Several recommendations are yet to be implemented, including the need for standard forms and standard bidding documents. An implementing regulation came into force in January 2005. These regulations elaborated upon certain articles, as listed in Article 53 of the LPP.

An implementing regulation came into force in January 2005. These regulations elaborated upon certain articles, as listed in Article 53 of the LPP.

Institutional Framework and Management Capacity

A country level Public Procurement Agency was formed as an independent administrative organization in accordance with LPP (Article 48) on September 29, 2005. Notification for appointment of a director was issued on November 23, 2005. EC provided critically needed support to establish the office. The law required that PPA begin work within three months of LLP entering into force. Appointment of the director was delayed by about a year, and subsequent staff recruitment has been slow. It is expected that PPA will require 10 staff in Sarajevo, 5 in Mostar, and 5 in Banja Luka. Their mandate is to: (i) propose amendments to legislation; (ii) reinforce awareness of LPP among contracting authorities and suppliers; (iii) publish procurement manuals and guidelines; (iv) establish systems for monitoring compliance; (v) collect, analyze, and publish information about procedures and awarded contracts; (vi) develop a nationwide electronic information system to supplement the *Official Gazette* in publishing tender documents; (vii) initiate and support electronic procurement; (viii) publish training manuals and maintain a list of accredited trainers; and (viii) submit an annual report to the Council of Ministers. Current staffing is considered adequate for the time being, with a total of 12 at headquarters and the branch offices. Nine more positions are to be filled when budget funding is available.

The Law on Public Procurement required the Procurement Review Body (PRB) to be functional as an independent administrative organization within three months of LPP effectiveness (Article 49). The purpose of the review body is to handle bidder complaints at a country level.

Procurement training was provided under the EU Project by way of one-day workshops for over 2,000 participants. The EU Project provided further training for about 90 trainers from January through May 2006. PPA keeps a list of certified trainers and nominates suitable trainers when a request is received from government institutions or potential bidders.

A beginning was made on a nationwide electronic information system as required by Article 48 of LPP. The current website of PPA (http://www.javnenabavke.ba/Home.aspx) is maintained by the EU–Public Procurement Program. It contains laws on public procurement, implementing regulations, standard documents for public supplies, public works and public services contracts, guidance for award of contracts, standard letters, and templates. The website is very user friendly. The current website will merge with the *Official Gazette* and publish tender invitations (but excluding bidding documents or requests for proposals), contract awards (including those by negotiated procedures), and provide Q & A. In 2005, the *Official Gazette* published 11,634 tender invitations on paper and electronically.

Procurement Operation and Market practices

Progress has been uneven in implementing the law. Operational effectiveness and efficiency of procurement system was lacking among ministries in the State and two Entities, while only a few State Owned Enterprises demonstrated good procurement practices. This may partially be due to the scale of procurement. At the level of the State and the two Entities, procurement is limited mostly to purchase of items such as office stationary and furniture, while most large value procurement takes place at utilities, SOEs, and Road Directorates. As a result, these organizations have relatively better capacity in managing public procurement. Good practices are illustrated in Box 7.1.

Box 7.1 Example of Good Procurement Practices

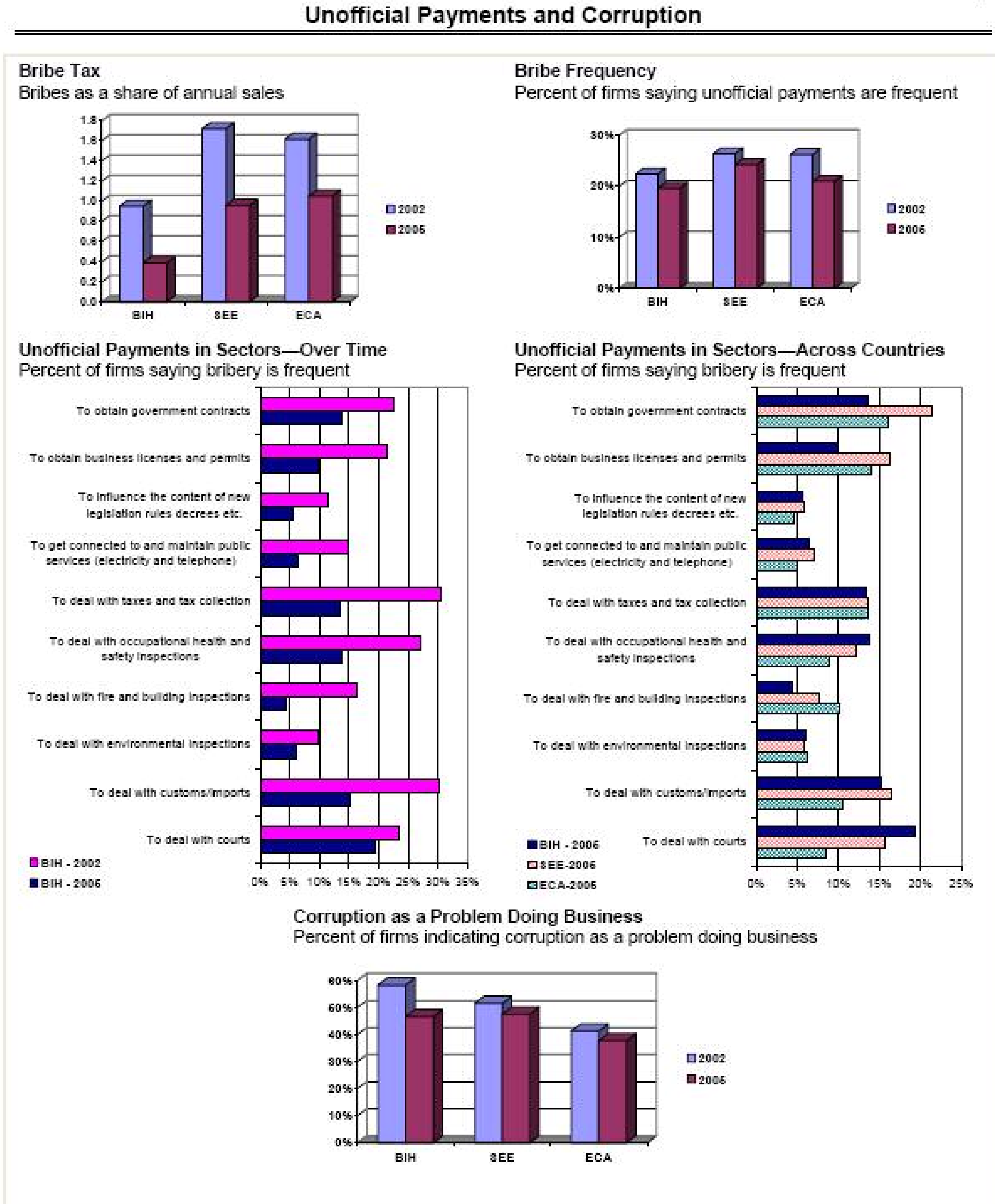
Telekom Sprska (TS), a majority owned government company, has employed better procurement procedures. Approximately KM135 million was spent on purchases during 2005. Major procurement included a GSM base station and other associated equipment, which were procured using EBRD procedure, which is similar to the Bank's procurement procedure. TS has developed internal procurement procedures, including tender documents, which not only are consistent with the new Public Procurement Law but incorporates several best international practices.

Integrity and Transparency of the Public Procurement System

The Supreme Audit Institution of the State reported several instances of violation of the LPP in 2004 audit report. These included: (i) non-compliance with the bid submission deadline stipulated under the law, (ii) acceptance of bids after the bid submission deadline, (iii) disregarding the qualification criteria specified in the bidding documents, and (iv) prolonging bidding procedure.

The BEEPS survey, as shown below in Figure 7.1, shows reduction in corruption. The percentage of firms stating that unofficial payments are required to obtain government contract declined from 22 percent in 2002 to 13 percent in 2005. On the other hand, Transparency International's index of corruption perception for the past three years shows increased level of perceived corruption.

Figure 7.1. Unofficial Payments and Corruption



(Source: http://info.worldbank.org/governance/beeps/)

The unfinished agenda and challenges

An independent Procurement Review Body should be made functional. As per the law, PRB should have been operational about 1½ year ago. Members should be quickly appointed. PRB should be provided with the necessary resources and staff to be functional. This would help instill confidence among bidders in matters related to complaints and fairness of the system.

Criteria for evaluation of tenders (works and goods) should be changed to monetarily quantifiable criteria. The current practice of assigning weights and points to different criteria is too arbitrary and is prone to manipulation and misuse. It is possible that in the current point system a supplier could be selected who offers insufficient period of warranty or unacceptable delivery period. The determination of a responsive bid should be based on pass/fail criteria (instead of point system), and the lowest evaluated bidder should fulfill the minimum specified criteria. Factors such as delivery and payment terms could be evaluated by adjusting the offer price with a pre-disclosed loading percentage.

Procurement of consultancy services of intellectual nature should be treated differently in LPP. Annex II of LPP on services treats labor-intensive works and consultancy assignments alike. For example, maintenance works and architectural services are treated equally requiring same procurement procedures. Consultancy services of intellectual nature, such as management consultancy assignments, should be procured based on a restricted procedure. This procedure requires a specified number of qualified candidates to be first short-listed and who are then invited to submit proposals.

The limitation period for bidder complaints is too long and should be shortened. LPP (Article 51) currently provides to the bidders a period of one year to submit their complaints. This is too long and needs to be modified. Several procuring organizations pointed out that this provision is bound to be misused by losing bidders and has the potential to put enormous strain on procuring organizations in dealing with complaints received long after the contract itself is executed. The complaint period should be shortened to a reasonable period, say fifteen days from the date of contract award.

Clarity is required regarding exemptions from the application of LPP. There is a need to clarify circumstances under which Article 5 of the LPP permits exemption to contracts awarded pursuant to an agreement with international financial institutions or donor organizations. The following example illustrates possible misapplication of exemption provisions under Article 5: FBiH railway has reportedly awarded a large contract pursuant to an agreement signed with a foreign export credit agency. The award of contract does not appear to be in compliance with the provisions of the LPP, which requires international competitive bidding for all contracts over KM 700,000. International financial institutions require borrowers to apply more transparent and competitive bidding procedures as compared to borrower's own procurement procedures, which generally tend to be more restrictive. In recognition of the more open and transparent procurement procedures required by international financial institutions, the LPP provides such an exception from its applicability. As such, it would not be in the spirit of Article 5 to apply a restricted instead of a competitive procurement procedure required by the LPP. The government therefore should immediately consider issuing appropriate clarifications in respect of Article 5.

The Public Procurement Agency should issue secondary regulation to guide efficient procurement in certain utilities. For example, "GRAS" (the tram/trolley/bus company) purchases spares, fuel, and consumables for 30 different types of buses following the Open Procedure. Frequently it happens that the same type of a spare when required for a different type of a bus costs differently causing large price variations. As a result, GRAS is required to undertake rebidding. In the case of procurement of traffic lights by the FBiH Roads Directorate, bids are often received from one supplier only, requiring the Directorate to undertake rebidding. It is recommended that PPA issue secondary legislation to regulate exceptional procurement.

The standard bidding document needs revision. It should include general conditions of contract, special conditions of contract, and a contract agreement form. Inclusion of these is essential from a bidder's perspective, which needs to consider these terms while calculating the price. The bid document further needs to contain tender security and performance security forms. These inclusions are also envisioned in the LPP.

Provisions in respect of joint ventures should be modified in the bidding document. In the case of joint ventures (Clause 6 of the bidding document for Public Supplies Contract–Open Procedure), the bidding document needs to clearly specify that the joint venture partner firms shall have joint and several responsibility for execution of the contract. The bidding document should also require each partner firm to fulfill certain minimum qualification requirement specified in it.

PPA should engage into dialogue with the private sector. The chamber of commerce and industry and other private sector organizations were not consulted while drafting the procurement law. These organizations have pointed out several shortcomings in the practical implementation of the law. Since private sector will have major share in public procurement, it is important that PPA establishes a mechanism to consult representative private sector organizations, such as chamber of commerce, to elicit their views, while drafting secondary legislation or amending documents.

Procurement capacity needs to be strengthened. This requires training not only in understanding the LPP but also practical aspects of procurement. Such training should adopt a case-study-based approach. In addition to training staff directly involved in procurement, it is important that people connected indirectly with public procurement, for example, members of the tender evaluation committee, should also receive training. It will be useful to engage local institutions (such as universities) and private sector organizations (such as chambers of commerce) in the delivery of training programs.

Finally, reforms will not succeed unless there is commitment by the government and political parties in making the procurement process more equitable and transparent. It is difficult to sustain procurement reforms just through external pressures. In order to build a momentum and convey a message of commitment, the government of the State and two Entities should establish a high-level joint steering committee, ideally chaired by the State Minister of Finance, to monitor the progress.

External Audit

Key issues identified in the previous diagnostic reports

The 2001 CFAA report identified several shortcomings in external audit arrangements. The report noted that the Supreme Audit Institutions (SAIs) in BH had become operational only in 2000. Most of the difficulties encountered were attributable to the nascent developmental stage of public sector auditing. However, some were due to the legislative framework and the general environment in which the SAIs operated, including the following:

- No provision in the Constitution mandating audits by the SAIs
- Weaknesses in the legislative framework, with several provisions in the audit legislation diverging from the original uniform legal framework or inadequately inserted during final enactment of the three audit laws
- Need for substantial skill enhancement and capacity building in all three SAIs
- Poor public sector accounting and financial reporting, severely hindering the proper and timely auditing of government finances when several budget beneficiaries and institutions could not provide financial statements to the SAIs
- Unclear provisions for resolving conflicts between auditors and auditees
- Weak institutional relationship and collaboration between SAIs and their respective parliamentary committees.

Developments and reforms since 2001

The Supreme Audit Institutions in BH have prepared new public sector auditing laws to replace the previous legal regime. RS was the first to enact the new law, followed by the State and the Federation. These laws were prepared through consultations among the three SAIs and donor partners, including the World Bank. The process was led by the Swedish National Audit Office (NAO), which has been providing onsite technical assistance to the SAIs. Amendment of the existing laws or enactment of new laws was a condition for the Economic Management Structural Adjustment Credit (EMSAC).

The new laws[18] are an improvement. The new laws unify key principles and eliminate contradictions among the three laws they replaced; ensure uniform auditing standards; protect the autonomy of Supreme Audit Institutions while introducing parliamentary oversight; and clearly specify the mandate of the three SAIs. Financial independence is ensured by restricting the right of the Ministry of Finance to decide SAI budgets, granting that power instead to the Economy and Finance committees of the three parliaments. The new laws explicitly mandate the SAIs to carry out financial, performance, and other specified audits while barring them from ex ante controls and pre-audits.[19] The new laws

[18] This collectively refers to the SAI laws recently enacted by the State, Federation, and RS.
[19] Pre-audit refers to an audit activity carried out before a transaction occurs. Such an activity is generally integral to the approval procedure and is normally carried out within the department and not by external auditors.

require the Supreme Audit Institution to make public all audit reports upon submittal to Parliament. There is also a statutory requirement for auditing of SAI financial statements by an independent auditing firm or by a commission appointed by the parliamentary oversight committee. The selection process and criteria for appointment of an Auditor General and two deputies at each SAI is clearly defined in the new laws.

The SAIs have an ongoing twinning arrangement with the Swedish National Audit Office. Since 2002, SNAO has stationed an onsite senior officer in Sarajevo to manage and supervise the cooperation. Under this project,[20] SNAO has conducted training in financial audits, performance audits, human resource management, information technology strategy, communication policy, international cooperation and networking, steps to combat fraud and corruption, and English language skills. The project also funded IT equipment and software purchases for audit offices. The twinning project has been important for getting the Supreme Audit Institutions on their feet and running during the early years of their operations. SAI staff benefited from training in modern audit practices and exposure to international auditing standards in order to prepare quality audit reports. A key factor in the success of SNAO's partnership has been the tight coordination among the three SAIs to facilitate a common training program. This makes sense since all three Supreme Audit Institutions share the same history, face similar constraints, and have similar objectives. It also stretches scarce resources since SNAO had limited budget funds from which to carve individual, tailor-made training programs.

Key features of the external audit arrangements

There are three public sector external audit agencies in BH. The international norm is for each country to have one SAI. In Bosnia and Herzegovina there are three—one operating at the State level, and one for each entity government. Although, this arrangement obviously is not very cost effective, the political realities make it inevitable. The focus then shifts toward the working level to harmonize policies and procedures adopted by the three SAIs. All three participated in drafting the new laws, and share a common understanding of the principles and objectives of public sector audits. The Supreme Audit Institutions have established an interagency committee—comprising their respective auditor generals and deputy auditor generals—to ensure consistency in agency manuals and guidelines, exchange professional experiences, and facilitate and coordinate training and development activities. Having a common technical assistance provider, SNAO, has facilitated greater harmonization in audit methodology and procedures.

Supreme Audit Institutions are independent from the legislature and the executive. Although establishment of SAIs is not grounded in the Constitution of the State or the Entities, existing legislation shields their financial and operational integrity. SAIs do report to their respective Parliament, which has oversight responsibility and a role in selecting the audit institution's senior officials, but independence from legislative and executive branch interference has taken root. Soon after their establishment, SAIs faced a barrage of criticism from politicians, including threats of criminal investigations.

[20] The first phase of the project started in June 2000 and had a budget of SKr 10 million; the second phase started in June 2002 with a budget of SKr 36.2 million; the third phase will begin in June 2006 with a budget yet to be finalized.

However, the pressure has lessened as parliaments gained a better understanding of the role and functions of Supreme Audit Institutions, and as those agencies acquired the capacity to meet their responsibilities under the law. The auditor general and deputy auditor generals are appointed by Parliament for nonrenewable seven-year terms. SAIs have their own staffs, which are not subject to civil service laws. Although the laws permit Parliament or a parliamentary committee to request a special audit from an SAI, the audit institution has the right of refusal. The laws explicitly state that the audit institutions shall not be subject to the direction/control of any person or institution. In practice, undue influence by the government and the legislature is not apparent in SAI operations.

SAIs enjoy financial autonomy. The Supreme Audit Institutions prepare their own budgets (adhering to terms set out in the Law on Budget and guidelines issued by the Ministry of Finance), which are submitted to a parliamentary committee for approval instead of the Ministry of Finance. Discussions with the SAIs reveal no serious constraints in preparing their annual budget requests, although it is important to note that the audit institutions typically have been fiscally responsible given the general resource constraints. The auditor general of an SAI has sole authority over expenditures from the institution's budget, leaving no room for either legislative or executive bodies to interfere with spending. In practice, SAIs have not recently been subjected to any cash rationing measures.

SAIs have a very broad and unrestricted mandate. This mandate covers all public institutions, including Parliament, the office of the presidency, ministries, all extra-budgetary funds, and companies in which the government ownership share exceeds 50 percent. An SAI audit of an agency or institution has purview of all financial, administrative, and other activities, including all the programs and projects being managed by the auditee. The SAIs can carry out financial audits, performance audits, and special audits requested by Parliament or a parliamentary committee. However, no Supreme Audit Institution has responsibility for the Brčko District.

SAIs report to their respective parliaments. All audit reports are submitted to Parliament, with a copy forwarded to the council of ministers and the president. The audit institutions also prepare annual activity reports, including a summary of highlights from that year's financial/performance/special audit reports, for submission to Parliament. The laws also empower the SAI to table a special audit report in Parliament during the year.

SAI audit reports generally are open to the public. The laws specifically require the Supreme Audit Institutions to release audit reports to the public immediately after their submission to Parliament. The only exception is when the information in the report is confidential as defined in the laws and regulations governing the audited entity. All three SAIs have established Web sites[21] where audit reports are posted for public dissemination. The media is taking greater interest in SAI audit findings, which often

[21] State SAI Web site: http://www.revizija.gov.ba/en/news;
Federation SAI Web site: http://www.saifbih.ba/en/predst-ureda;
RS SAI Web site: http://www.gsr-rs.org/english/index.htm.

receive extensive coverage in the press. This is a welcome development since greater civil society engagement is an important prerequisite for a well-functioning government.

SAIs now carry out financial audits. Unlike many Supreme Audit Institutions, most notably those in the Commonwealth of Independent States (CIS) region, that still predominantly conduct compliance audits, new laws in Bosnia and Herzegovina require SAIs to carry out financial audits—that is, the auditing of financial statements. Financial audits require different techniques and skills, and as previously mentioned the Swedish National Audit Office has played a key role in strengthening the SAIs to handle this responsibility. A review of selected financial audit reports indicates progress is being made by the SAIs in conducting financial audits. SAIs have also begun to carry out performance audits[22].

The laws provide budgetary "teeth" for taking action on audit findings. The organic budget laws oblige public institutions to include information, in their annual budget execution reports, on corrective actions taken to address problems highlighted in the previous year's audit. Based on findings from that annual audit, Parliament may reduce an institution's budget request for the new fiscal year. This provision was intended to ensure that audit findings would be taken seriously by auditees. Thus far, however the parliaments and their committees have yet to develop adequate capacity to digest and use the audit reports. Moreover, political considerations have tended to sidetrack substantive discussion of audit reports in committee or in the Parliament (see Chapter 9 for more detailed discussion).

Staffing/Resources of SAIs. To partially meet the increasing workloads from new responsibilities under the law, all three Supreme Audit Institutions plan to hire additional professional staff. Their relative competitive advantage in working conditions has meant that SAIs have not had a major problem in retaining trained personnel thus far. However, the growing financial sector and the entry of new foreign banks have spurred demand for accounting and auditing professionals. Doubtlessly the public sector will have to keep pace with employment market trends to attract and retain talented accountants and auditors. In assessing the resource envelope for the Supreme Audit Institutions, one cannot overlook the sizeable funding provided by the Swedish National Audit Office for training and equipment. The current SNAO project closed earlier this year, and a new phase began recently in June 2006. If this external technical assistance ends or is curtailed, essential training of current and newly recruited auditors may suffer.

[22] Performance audit refers to an examination of a program, function, operation or the management systems and procedures of an entity to assess whether the entity is achieving economy, efficiency, and effectiveness in the employment of available resources.

Figure 8.1. SAI Staffing and Resources

	State SAI	Federation SAI	RS SAI
Staff			
Professional	16	33	28
Support	8	9	6
FY 2005 budget	KM 1.6 million	KM 2.0 million	KM 1.9 million
Office locations	Head Office in Sarajevo	Head Office in Sarajevo and three branch offices	Head office in Banja Luka and one branch office

The unfinished agenda and future challenges

The new laws create a sound basis for development of public sector audits in Bosnia and Herzegovina that are attuned to modern governmental auditing theory and accepted international standards. It is important that the new laws be implemented quickly at the State, Federation, and RS levels. The following additional measures would facilitate transformation of the SAIs into strong and able institutions:

- **Anchor the role of the SAIs constitutionally.** As discussion on drafting new constitutions continues, the role of the Supreme Audit Institution needs to be considered. Current constitutions, prepared in the immediate postwar climate of uncertainty, do not mention SAIs. The Lima Declaration of INTOSAI[23] states that a provision for establishment of independent Supreme Audit Institutions should be in the constitution, while details for implementation can be set out in statutory legislation. A clear declaration in the constitution of the audit institution's role not only helps shield the audit institution from outside interference, it also provides necessary respect for the auditing process.

- **Focus on financial audits.** Countries often display great enthusiasm for performance audits. Yet for such audits to be useful, a system of performance planning must be set up, followed by systemic performance monitoring and reporting. Without these systems, the audits would be judgmental and lack objectivity, rendering them less useful if not useless. Performance audits also are resource intensive, requiring auditors to spend scarce time developing a fuller understanding of the auditee agency's technical systems. The SAIs should therefore give first priority to financial audits and conduct only pilot performance audits until the ministries develop proper performance planning and monitoring systems.

- **Prepare a common Strategic Development Plan.** The interagency SAI Coordination Committee should work on developing a common vision and

[23] See the International Organization of Supreme Audit Institution's Web page at http://www.intosai.org/Level2/2_LIMADe.html.

prepare a joint Strategic Development Plan that outlines short- and medium-term objectives and specifies priorities, tasks, and responsibilities, and a time frame for implementation. The strategic plan will facilitate further adoption of common approaches; keep the Supreme Audit Institutions focused on the objectives and tasks ahead; and reduce the chances of introducing abrupt unfunded mandates that distract from achieving agreed-upon goals.

- **Prepare an audit methodology and guidelines for implementing it.** The coordination committee also needs to standardize audit methodology and prepare detailed guidelines for auditors to use in doing their work. As financial and performance audits are relatively new in the region, auditing standards need to be supported by a detailed audit methodology and guidelines.

- **Form a secretariat for the coordination committee.** The coordination committee currently works ad hoc, without any support from a permanent secretariat to craft an agenda, take action on common issues such as preparation of a uniform audit methodology, or assist the committee in discharging its functions. The committee agenda is ambitious and the need to harmonize policies and procedures is real—formation of a secretariat, with appropriate budget and defined procedures in the form of a rulebook, is urgently needed.

- **Clarify the role of the SAIs in the audit of Indirect Taxation Authority.** The current Law on ITA prescribes annual audit with the participation of the State, Federation, and RS but it is not clear whether the SAIs will have a role in the audit of ITA. In order to ensure that all public funds are audited by the SAI/s, it is important that SAI's have the primary role in the audit of ITA.

- **Devise a strategy for auditing local government.** Local government audits are part of the SAIs' jurisdiction. There are 10 cantons in the Federation, and more than 125 municipalities in the country, but only a few are audited each year. The increasingly important role being played by local administrations, and the growing complexity and size of their activities, requires rethinking audit policies for this sector. Depending on which strategy is chosen, the role of SAIs might take several forms. For example, local administrations might be grouped based on population size, with each group audited differently; or a new local government audit service might be created; or private sector auditors could be hired to do the audits.

- **Develop expertise to close gaps in auditing information technology systems and tax revenues.** As described earlier, Bosnia and Herzegovina has implemented a state-of-the-art Oracle treasury and accounting system in the State, Federation, RS, and canton governments. Traditional auditing techniques are unable to adequately identify and assess risks in IT-based systems, which require different audit skill sets. Supreme Audit Institutions will need to hire new staff with IT skills, train existing staff, and develop methodologies and guidelines for auditors. It also generally has been observed that SAIs in the region have made less progress in auditing revenues than expenditures. Audits of revenues[24] require different approaches, and the appropriate institutional skills and methodology need to be developed.

- **Develop a robust quality assurance system.** Lessons can be learned from recent developments in the private sector audit profession. Private sector auditing firms have struggled to keep up as business processes and technology grows more complex, throwing a spotlight on weak internal controls. This has led to increased scrutiny of quality assurance mechanisms within the audit firms to ensure that they meet the new challenges. Given the lack of experience with public sector audits in Bosnia and Herzegovina, establishing a strong quality assurance system, incorporating periodic peer reviews, is vital.

- **Ensure adequate review of audit reports by parliamentary committees.** Although the laws state that Parliament may reduce the budget of an institution criticized in its annual audit report, this provision is yet to be invoked. Invoking the provision presupposes that the parliamentary committee will thoroughly discuss the audit report, allowing the auditor and auditee to present their cases before the committee. Unless auditees are held to account for their actions and auditors for their audit through rigorous examinations in committee, the SAI will lack the incentives to regularly produce quality audit reports.

[24] Revenue audits should not be confused with inspections/audits carried out by tax authorities. Rather these audits deal with the internal control environment in the levy and collection of revenues and how these funds are stated in the financial statements.

LEGISLATIVE OVERSIGHT

Issues identified in the previous diagnostic reports

The 2001 report did not specifically assess the role of the parliament in budget preparation or execution. However, the report noted that parliaments at the State and Entity levels lacked functional public accounts committees (PACs).

Key features of the legislative scrutiny

The Committee for Economy and Finance in respective parliaments oversees the budgetary process. The committee is generally chaired by a member of the ruling party and is comprised of nine parliamentarians. This committee also reviews SAI audit reports.

The Committee for Economy and Finance had little influence over overall budget size. Budgets were prepared annually within the broader economic program agreed upon with the IMF.[25] Despite limited influence, informal discussion among members of the parliament, the committee, and the government is common in the budget process. Limited qualitative discussion occurs in the committee for several reasons. First, the budget calendar leaves little room for discussions. More time for discussion permits analysis to identify and support amendments. Second, the composition of the committee, including its chair, is predominantly comprised of ruling party coalition members. Third, the fragmented nature of parliament, with a coalition of parties forming a government, requires that multiple demands for scarce budgetary resources be catered to. Moreover, there is hardly any discussion regarding the MTEF, either within the parliament or the committee.

The Committee on Economy and Finance lacks resources to recruit experts who can provide research inputs and advise on macroeconomic and sectoral policies. In many countries, research and analytical institutions are attached to the parliaments, providing expert advice and enhancing debate on the relative merits of proposed measures—for example, in Germany, Australia,[26] and the United Kingdom. Parliament's ability to affect amendments depends on detailed scrutiny, requiring analysis by specialized research staff. In the absence of independent expert inputs, discussions in the parliament and parliamentary committees are likely to narrowly reflect the political agenda, with parliamentarians acting primarily as advocates or claimants.

Neither the parliament nor the commission receives qualitative data pertaining to budget execution. The half-yearly and annual accounts to parliament include large quantities of numeric data, but scant detail that would help to interpret program implementation, outcomes, or outputs. The reports are not conducive to constructive

[25] The IMF played this role through expiration of the second Standby Agreement in early 2004.

[26] In the German Bundestag, the Budget Committee has a secretariat that consists of about 5 people. In Australia, the Joint Committee on Public Accounts and Audit examines the auditor general's reports, and has a secretary and 10 dedicated staff members.

discussion. Provision of annual accountability reports, including detail on costs and program achievements, would go a long way toward advancing the quality of debate in the parliaments.

Scant technical discussion takes place in the parliament and the Economy and Finance Committee on SAI audit reports. Presently, the parliament adopts the annual budget execution reports submitted by the government, even before the SAI has submitted its audit report to the parliament, thus dissipating whatever interest the parliamentarians may have had in the audit findings. Occasionally discussion on audit reports is crowded out by other important issues which take precedence in the parliamentary discussions. For example, there were significant delays in adopting the annual SAI audit report for RS in fiscal 2004. As noted in Chapter 8 (External Audit) too much lip service on the importance of audit reports—but not actually using them—engenders cynicism and ultimately undermines the audit institutions. On a more positive note, the legal framework requires the government to describe actions on previous year's audit in its annual budget execution report. Yet much depends on how much importance is attributed to audit findings in the first place.

The unfinished agenda and challenges

An independent parliamentary research service should be created. Parliamentary discussion is necessary on the draft budget and the audit report. However, such discussion needs to be backed by strong independent research. Analytical input would help guide the parliamentary and committee discussions along more productive lines. It will be worthwhile to consider a joint parliamentary research service to provide analytical and research inputs to all the three parliaments. Most macroeconomic data will be common across the State and two Entities, and a joint initiative with consolidated resource availability might be able to attract and retain better talent. It is recommended that an analysis of the options and costs associated with an independent parliamentary research service and dedicated committee research support be carried out.

Accountability and performance reports to the parliament should be considered. There is a need for comprehensive review of the budget documentation, including systematic output and outcome information. This, of course, would need to be part of a broader agenda to introduce performance budgeting and reporting. In the parliament, financial information coupled with output and outcome data would greatly facilitate qualitative discussion. In this regard, it would be useful to study reforms in Turkey, an EU accession candidate country that now requires each ministry to prepare accountability reports. Performance is mapped against targets and the use of resources. Such reports facilitate discussion of each ministry's use of budget resources.

Discussion on the annual budget execution reports in the parliament should be simultaneous with the discussion on annual audit reports. This would ensure that audit reports are not prioritized as an after-thought in the parliamentary discussions. To be meaningful, audit findings must be considered at the same time that budget execution reports are actually discussed.

Regular meetings between line ministries and Economy and Finance Committees should be held. They should focus on progress in implementing the current budget and development of the new budget. Brief year-end meetings to discuss budget proposals often fail to sufficiently engage the members of the Economy and Finance Committee. They are pressured from the other direction to get the annual budget quickly to the plenary session of the parliament. Regular meetings would foster dialogue and engagement between the committee and the ministries. This could concretely improve parliamentary oversight over the executive branch.

Corruption

Key issues identified in the previous diagnostic reports

The 2001 CFAA report noted that corruption is a major problem in Bosnia and Herzegovina. Citing the Anticorruption Diagnostic Survey conducted by the World Bank in 2000, the report stated that malfeasance was widespread and that politicization of the public sector was a contributing factor. The report also warned that corruption presents a significant barrier to attracting foreign direct investment and domestic private sector investment.

The 2001 CFAA report recommended that sincere efforts should be made in implementing anticorruption strategies and action plans for combating corruption. At the same time, the report recommended increased participation and scrutiny from citizens and civil society, introduction of consultation requirements, and timely dissemination of relevant public financial data.

Developments and reforms since 2001

The Strategy for Combating Crime and Corruption is an integral part of the 2004 Medium-Term Development Strategy. The strategy is complemented by an Anticorruption Action Plan. The strategy is largely a descriptive document, in which the Bosnian authorities pledge to pursue legislative, institutional, and educational remedies. It broadly outlines concerns about corruption and recommends waging a fight against it through investigation and prosecution, and strengthening the judiciary and law enforcement agencies.

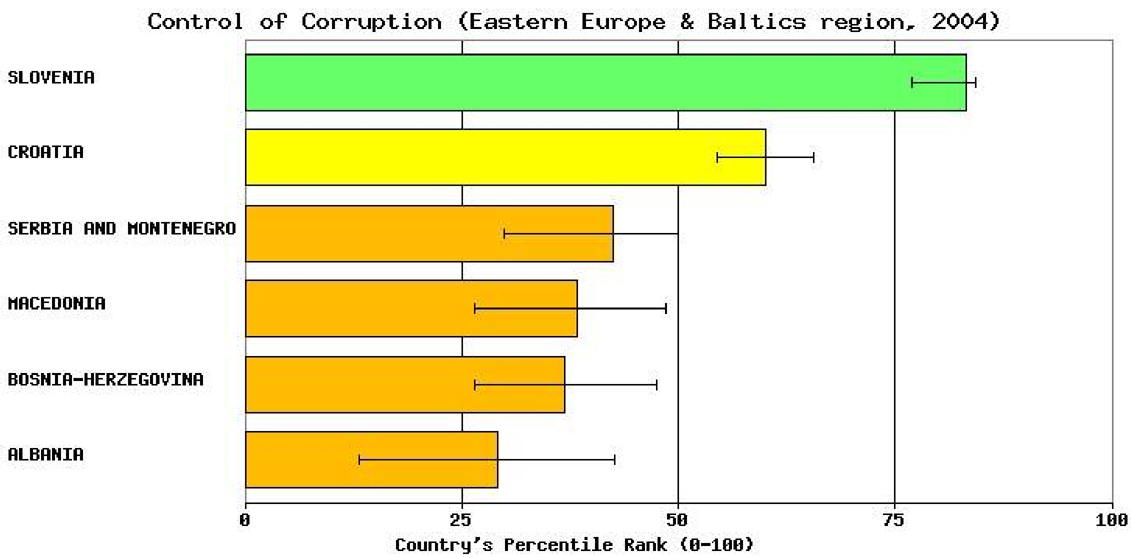
Reforms have targeted establishment of a national legal framework and the restructure of judicial and law-enforcement institutions. A State Law on Conflict of Interest in Governmental Institutions was imposed by the High Representative in 2002. It contains a Code of Conduct for elected officials, executive officeholders, and advisors in the exercise of their duties. Article 16 of the Civil Service Law regulates conflict of interest by public employees. The Law on Freedom of Access to Information (enacted in 2000) and a new Law on Public Procurement have been notable additions to the legal framework though implementation has generally been weak. The State Prosecutor’s Office has seven international prosecutors, and is supported by four Anti-Crime and Anticorruption Units that are headed by additional international prosecutors.[27]

Transparency International’s Corruption Perception Index for the latest three years indicates increased level of perceived corruption. The 2005 Corruption Perception Index (CPI) ranked Bosnia and Herzegovina at 88th in a survey covering 158 nations. Bosnia and Herzegovina scored 2.9 out of 10 (0 is highly corrupt and 10 is highly clean). Regionally, Slovenia at 31st, Slovakia at 47th, and Croatia at 70th were ranked ahead of Bosnia and Herzegovina; whereas Serbia at 97th, Macedonia at 103rd, and Albania at

[27] See CMI 2005 Report on Corruption in Bosnia and Herzegovina at http://www.cmi.no/pdf/?file=/publications/2005/rep/r2005-8.pdf.

126th trailed behind. Comparison of results from 2003 to 2005 reveals that the score for Bosnia and Herzegovina has been deteriorating—dropping from 3.3 to 2.9 respectively, indicating greater perceived corruption. (While it is important to note that the survey measures perception rather than actual incidence of corruption, the indicator is internationally accepted as a barometer of corruption among countries.) Yet another indicator, the World Bank's Governance Research Indicator, places Bosnia and Herzegovina in the bottom third of the countries in the Eastern Europe and Baltic region (see Figure 10.1).[28]

Figure 10.1. The World Bank Governance Indicator—"Control of Corruption"



Source: World Bank Kaufmann D., A. Kraay, and M. Mastruzzi (2005) Governance Matters IV: Governance Indicators for 1996–2004.

The High Representative has removed from office a number of politicians who have been openly exposed as being corrupt. Since 1998, thirteen politicians and officials were removed from office by the OHR specifically for corruption and/or fraud. The reasons for removal from office (which also included ban for holding of any other public office) varied from person to person, including evidence of direct involvement in organized crime and other criminal activities, evidence of misuse of funds, and tax evasion.

State Owned Enterprises are plagued with weak corporate governance and opaque procurement practices. SOEs continue to be managed by political appointees rather than by professional managers. SAIs and OHR auditors have highlighted serious

[28] The figure depicts the percentile rank for the governance indicator "Control of Corruption." Percentile rank indicates the percentage of countries worldwide that rate below the selected country. Countries are presented on the chart from "best" (top of the chart) to "worst" (bottom of the chart) during 2004.

governance issues in some SOEs – for example, the audit reports[29] for RS Sume (forestry company) has highlighted the need to strengthen corporate governance and control framework.

The unfinished agenda and challenges

A prerequisite for fighting corruption in BH is not developing another set of new strategies. The right tone must be set at the top. Unless people occupying high positions eschew activities that can be even remotely deemed corrupt, no strategy and action plan will have any measurable impact on corruption.

Reforms have focused excessively on passing legislation without paying sufficient attention to implementing it. Efforts to depoliticize enforcement, judicial, and oversight bodies and insulate them from outside interference have been only partly successful. Capacity building and training for enforcement agencies is also lagging. For example, the Public Procurement Agency established by the new Public Procurement Law is yet to become fully operational because it lacks sufficient capacity to perform its duties. The challenge facing these institutions is to build sustainable capacity by systematic training of staff and leaders, by providing political support through adequate budget allocations, and by shielding operations from political interference by appointing highly qualified people to head these institutions with a secure term of office.

In its fight against corruption, Bosnia and Herzegovina should strengthen public procurement agency, establish Procurement Review Body, strengthen internal controls, and establish internal audit departments. Procurement is generally recognized for its susceptibility to corruption. A strong and independent public procurement agency could provide effective oversight over public procurement in the country. Similarly, weak internal controls widen the opportunities for illicit activities. An effective internal audit function would provide management with ongoing assurance that internal controls were operating properly.

This report recognizes that several other measures could be taken to fight corruption. Since the focus of this study, however, is not on anticorruption, a comprehensive discussion is not provided.

[29] The RS SAI has opined in the audit report that consolidated financial reports of RS Sume do not give a fair and true presentation of the financial status as of 31 December 2004 and results of business operations of the company for 2003 and 2004.

Fiduciary Risks and Use of Country Systems

Key issues identified in the previous diagnostic reports

The 2001 CFAA report concluded that the environment for project implementation in Bosnia and Herzegovina was high risk. The key findings of the study—weak institutional capacity and extensive perceived corruption—justified the rating. The report indicated that there were instances of diversion of grant proceeds through nontransparent fund flows that exploited the complex patterns of cross-ownership among recipient agencies, commercial banks, and political parties. The CFAA cited the 2000 U.S. General Accounting Office (GAO) report, which had highlighted the absence of controls over most grants and loans provided by the U.S. government in direct budgetary support to the governments in Bosnia and Herzegovina.

The CFAA spotlighted the prevalence of multiple Project Implementing Units (PIUs) within one sector or in one ministry working for different donors. Several factors were listed as responsible for limited success in fully integrating externally financed projects into the budget: location of PIUs outside the government structures, little communication between PIUs and aid coordination units in the government, and ill-defined lines of reporting from the PIUs to government ministries.

Developments and reforms since 2001

Since 2003 no new PIUs have been created outside the ministries. All projects financed by the Bank are now implemented by existing PIUs or project units created within the responsible ministry.

There is greater emphasis on integrating PIUs within ministry structures. Several recent efforts—for example, the Land Registration Project, the Education Restructuring Project, and the Urban Infrastructure Project—have implementation structures within the responsible line ministries. These implementation units are headed by senior ministerial staff. However, certain specialized jobs, such as fiduciary tasks, are filled by short-term consultants since ministries lack enough skilled personnel. FBiH has issued a Decree on Establishment of a Coordination Mechanism which provides for an institutional framework for implementation of projects with foreign financing; regular reporting on ongoing projects; establishment of unified reporting formats for FBiH Government; planning public investment within the Public Investment Program preparation process.

Special Accounts are now held in local commercial banks rather than banks in foreign countries. The banking sector has undergone consolidation, following entry of several foreign banks and the privatization of several government-owned banks. Banking supervision, carried out by separate oversight agencies in the Federation and RS, has stabilized and improved. Considering these positive developments and based on an assessment of a small sample of local private sector banking institutions, special accounts for Bank-financed projects are now held in local commercial banks, which allow PIUs to access special accounts more quickly.

Key features of current arrangements

PIUs have established satisfactory financial management and procurement arrangements. All existing PIUs have gained solid experience in implementing Bank-financed projects. PIUs regularly submit quarterly financial management reports and annual audit reports. Recent annual audit reports and the management letters prepared by auditors indicate no serious internal control issues in PIUs. In the past several years, no contract has been found to be misprocured. While outside-ministry PIUs have the advantage of avoiding red tape and carrying out their work smoothly and efficiently, their existence limits the role of line ministries in implementing sectoral programs. Moreover vast and useful project implementation knowledge and experience is being accumulated outside the ministries that cannot be readily accessed to better carry out regular budget-financed public programs.

Awarding a three-year global audit contract (renewable annually) to an international auditing firm is best practice. This policy has consolidated work assignments, reducing costs and eliminating delays in submission of audit reports.

Externally financed projects are still not integrated in the annual budget. Externally financed projects, such as Bank-financed projects, implemented by outside PIUs are not included in the annual budget on the revenue side with estimated loan receipts and on the expenditure side with estimated project expenditures. The annual budget only reflects counterpart funds made available for project implementation. This practice distorts reporting on the amount of public investments in various sectors.

The overall financial management risk to Bank funds in the ongoing investment lending projects is moderate. This assessment takes into account satisfactory financial management and procurement arrangements in ring-fenced PIUs while factoring in the risk of widespread corruption in BH.

Fiduciary Risks[30] in the Use of Country Systems[31]

There are six key prerequisites that need to be satisfied before attempting routine use of country systems for Bank-financed projects in Bosnia and Herzegovina. To use country systems for Bank-financed projects, the following Public Financial Management (PFM) components are essential:

- **Reliable accounting and timely reporting systems.** The Country (the State, both Entities, and the cantons in the Federation) has implemented a state-of-the-art treasury accounting and information system capable of timely reporting financial and accounting data. Moreover, the accounting system is accrual-based, and

[30] Fiduciary risk refers to the possibility that funds provided will be misused or stolen. But in the context of development aid even a narrow conception of fiduciary risk must also include the possibility that actual expenditures will diverge from authorized expenditures (as reflected in the borrowing country's budget), whether because of misappropriation or misallocation. (*Assessing and Reforming Public Financial Management A New Approach* by Richard Allen, Salvatore Schiavo-Campo, Thomas Columkill Garrity)

[31] Country systems connotes use of country's legal and institutional framework, consisting of its national, sub-national, or sectoral implementing institutions and applicable laws, regulations, rules, and procedures.

movement is under way to adopt financial reporting standards based on international best practices. This prerequisite is met satisfactorily.

- **Robust internal controls with clearly defined accountabilities.** Although good internal checks exist on paper, compliance is weak. For example, SAI audit reports point to several instances of noncompliance with existing internal control rules and procedures. This prerequisite is partially met

- **An efficient treasury system capable of managing funds, tracking collections, and making payments.** A well-established treasury system is now in place that uses an online network to collect revenues and make payments. A Treasury Single Account consolidates all public funds, enabling the treasury to exercise control over all funds. This prerequisite is met satisfactorily.

- **A functioning internal audit system to detect weaknesses in the internal control framework.** Absence of a modern internal audit system weakens the internal control framework. This is an area requiring serious attention in coming years. This prerequisite is not met.

- **Independent and competent external auditing agency to conduct financial audits.** The Supreme Audit Institutions are independent, and have wide jurisdictions that cover the entire range of public funds. SAIs have received extensive technical assistance from the Swedish National Audit Office, including training in financial audits. The external audit situation is partially satisfactory.

- **Transparent and fair procurement system**[32]**.** A new Public Procurement Law has been enacted and a new public procurement agency has been established. However, significant capacity building is required in the line ministries and in the public procurement agency to make government procurement effective and efficient. In addition, a Procurement Review Body has yet to be set up to adjudicate disputes. The prerequisite for procurement is not met.

Overall, Bosnia and Herzegovina has met two of the six prerequisites, partially met two, and has yet to make progress in two. A pilot initiative using country financial management systems should be limited at first to a selected project, subject to a separate project fiduciary assessment, and only after progress is made in setting up an effective internal audit function in the State and two Entities.

The World Bank policy for the use of country systems for procurement is still evolving. However, thresholds for national competitive bidding (NCB) and for prior review are gradually being increased in Bank-financed projects provided the NCB procedures meet certain minimum requirements (see the following paragraph).

NCB procedure is acceptable for use in Bank-financed projects, provided it meets certain minimum requirements. National competitive bidding procedures should be based on the Open Tendering procedures defined in the Law of Public Procurement. The following additional conditions must be fulfilled to meet the Bank’s requirements: BH

[32] The Bank’s policy on Use of Country Systems is still evolving for procurement, so it is not yet possible to conclusively define the minimum benchmarks in this area.

government-owned enterprises shall not be allowed to participate unless they are legally and financially autonomous, operate under commercial law, and are not a dependent agency of the implementing/contracting ministry; tender documents shall be acceptable to the Bank; and evaluation of bids shall be made in a monetarily quantifiable criteria.

For projects implemented by local governments, such as cantons in the Federation and municipalities in both Entities, use of country systems must be assessed case by case. There are 10 cantons in the Federation and more than 125 municipalities in the country as a whole, each of varying capacity. In general, local financial management is characterized by fragile internal controls, problematic financial procedures, and low compliance with set rules, poor financial transparency, and weak organizational capacity, including human resources. A project funded by USAID and the Swedish Development Cooperation Agency (SIDA), with a budget of US$20.5 million, has been under way since August 2004 to strengthen financial management systems and improve governance in municipalities. A separate general fiduciary assessment for cantons and municipalities is expected to be carried out in FY07.

Externally financed projects should be integrated into the annual budgets. The Oracle-based treasury accounting system, which is accrual-based, can account for journal entries of expenditures incurred by outside-ministry PIUs on various projects while recording equivalent loan proceeds. The treasury should begin piloting entry of such data in its accounting system to ensure that externally financed projects are reflected properly in the annual budget.

Fiduciary Risks in Development Policy Lending Operations

The World Bank has two primary fiduciary concerns in providing direct budget support to a country[33]—overall use of foreign exchange and management of budget resources. Financial management in development policy lending (DPL) operations focus on two major issues: (a) whether fund flow arrangements give reasonable assurance that the foreign exchange from loan proceeds are deposited into an account with the Central Bank that forms part of the country's foreign exchange reserves, while an equivalent amount is credited to a government account to finance budgetary expenditures; and (b) whether management of the country's budget resources through the country's PFM system is appropriate.

The Central Bank has sound fiduciary management procedures to handle foreign exchange proceeds under the DPL program. The Central Bank is audited by an international auditing firm based in the Czech Republic, and has received unqualified opinion on its most recent financial statements for 2004 and 2005. The Central Bank has established a strong internal audit department. Foreign exchange reserves are invested as cash deposits with foreign banks of acceptable rating, in accordance with the guidelines on investing foreign currency reserves and based on recommendations of the Investment Committee. More than 70 percent of the total investment portfolio of the Central Bank in FY 2004 was in time deposits with banks rated AA+ and AAA.

[33] This conclusion is based on the Bank's Operational Policy 8.60 and other relevant material.

Aspects of public financial management that are important for DPL program include the following: budget comprehensiveness and transparency, reliable and efficient systems for budget implementation and monitoring, fiscal transparency (reliable information on fiscal results and position), and financial accountability for use of public resources.

As indicated in earlier section, weak governance and opaque procurement practices in SOEs presents a major risk. SOEs command a significant proportion of the overall public sector resources and strengthening governance and financial management in SOEs is an urgent need.

The overall financial management risk to Bank funds in the development policy lending program is moderate considering improving public financial management systems in BH while factoring in weak compliance with procurement laws and internal controls, absence of internal audit, weak governance in SOEs, and widespread corruption

Future DPL operations should include measures to develop country PFM capacity and address key weaknesses and risks identified in this report. In doing so, it is important that PFM conditions and triggers should focus on results rather than inputs/processes, spelling out what outcomes are expected. The following key results should be considered in designing a future DPL operation. Simultaneously, it will be important to ensure that appropriate arrangements in place to support implementation of these public financial management reforms, including for example, training and technical assistance, especially in areas of intensive need like internal audit.

- An effective and functioning internal audit
- An effective and functioning Public Procurement Agency
- An effective and functioning Procurement Review Body
- Uniform internal control standards across all levels of government
- Implementation of a centralized payroll system in the RS
- Preparation of a strategy for external independent audits of local governments

Summary of Recommendations		
OBJECTIVES	**MEASURES**	**TIMEFRAME**
	2. UPSTREAM BUDGETING	
To have a comprehensive budget process closely linked to policy goals	1. Government policy priorities must be fully integrated into the budget preparation process.	**Priority**
	2. The future development of the MTDS incorporating and reflecting SAA negotiations and implications, must be systematically linked to medium-term budget planning and preparation	Short term
	3. An objective and transparent reporting mechanism should be introduced to monitor and report progress against MTDS policy priorities.	Short term
	4. Budgets should be developed on a program basis with clearly specified objectives and linked to the MTDS priorities.	Medium term
	5. All proposals for new legislation should include a three-year financial impact statement (or table) that has been costed and verified by the ministries of finance.	Short term
To ensure fiscal harmonization across BH	6. The Fiscal Council should receive recognition and sufficient authority, through a legislation, to make timely fiscal policy decisions.	**Priority**
	7. Fiscal Council should establish a clear medium-term strategy.	Short term
	8. Responsibility for macroeconomic and fiscal forecasts used in the development of State and Entity budgets should be	Long term

Summary of Recommendations		
Objectives	**Measures**	**Timeframe**
	given to the State MoFT.	
	9. Empower a national level agency to prepare consolidated fiscal accounts.	Short term
	10. Budget calendars, processes, and legislation should be harmonized	Short term
To better align budget classification with 2001 GFS	11. GFS compliant budget classification should be simplified.	Medium term
To cover all budgetary and extra-budgetary activities of government to allow a complete picture of financial operations and status	12. Decisions on externally funded capital investment should be integrated into the main budget planning process by considering capital investment and its recurrent expenditure implications in the context of total resources available.	Medium term
	13. Extrabudgetary funds and off-budget government agencies should also be brought on budget.	Medium term
To ensure better parliamentary scrutiny	14. More comprehensive and transparent budget documentation needs to be made available to parliamentarians.	Medium term
	15. The capacity and role of Parliamentary Economy and Finance Committees in reviewing annual budgets should be strengthened.	Medium term
To build sustainable capacity to implement the budgetary reforms	16. Strengthen the resources and technical skills of the budget sectors of each ministry of finance.	Ongoing
	17. Strengthen staff resources and technical skills within budget users in strategic planning, MTEF, program budgeting, and monitoring	Ongoing

Summary of Recommendations		
Objectives	**Measures**	**Timeframe**
	and evaluation.	
3. Public Sector Accounting and Reporting		
To ensure reliability and comparability of financial reporting	1. Finish implementation of the accrual accounting system.	Short term
	2. The State and the Federation should implement IPSAS in a phased manner, following the lead taken by the Republika Srpska.	Medium term
	3. Establish a joint Government Accounting Standards Board and issue national public sector accounting standards.	**Priority**
	4. Implement full commitment accounting.	Medium term
To ensure easy accessibility of financial information to the general public	5. Ensure wide availability of financial information.	Ongoing
To ensure decision makers benefit from the accounting and reporting reforms	6. Train users of accrual-based financial statements.	Short term
4. BUDGET EXECUTION AND CASH MANAGEMENT		
To improve the budget execution and cash management	1. The treasury system needs to be extended to local governments and to extrabudgetary funds.	Medium term Priority
	2. Online access to the treasury system should be extended to other line ministries and spending units.	Medium term Priority
5. ACCOUNTING AND CONTROLS IN REVENUE ADMINISTRATION		
To strengthen tax revenue accounting, reporting, and controls.	1. Current computerized systems need to be integrated so that taxpayer information can be fully accessed.	Medium term
	2. Additional capacity needs to be built in tax audit and	**Priority**

Summary of Recommendations		
OBJECTIVES	**MEASURES**	**TIMEFRAME**
	enforcement.	
	3. The FBiH Direct Tax Authority needs to address underlying weakness in the control and accounting for tax revenues.	Short term
6. INTERNAL CONTROL AND INTERNAL AUDIT		
To strengthen internal controls and increase efficiency and effectiveness in the use of public resources	1. Compliance with internal controls needs to be improved.	Ongoing
	2. Adopt a legislative and organizational framework for a sound internal audit system.	**Priority**
	3. Implement centralized employee database and payroll in RS.	Short term
	4. Explicitly provide for the accountability of ministers, heads of departments, and managers in the law.	**Priority**
	5. Have uniform internal control standards for rulebooks. 6. Separate bank accounts operated by some secondary budget spending units should merge with the Treasury Single Account.	Medium term Short term
	7. Systems control document should be developed and updated regularly.	Short term
7. PROCUREMENT		
To ensure efficient public procurement system that is fair and transparent	1. An independent Procurement Review Body should be made functional.	**Priority**
	2. Criteria for evaluation of tenders (works and goods) should be changed to monetarily quantifiable	Short term

Summary of Recommendations		
OBJECTIVES	**MEASURES**	**TIMEFRAME**
	criteria.	
	3. Procurement of consultancy services of intellectual nature should be treated differently in LPP. 4. The limitation period for bidder complaints is too long and should be shortened.	Short term Short term
	5. Clarity is required regarding exemptions from the application of LPP.	**Priority**
	6. The Public Procurement Agency should issue secondary regulation to guide efficient procurement in certain utilities.	Medium term
	7. The standard bidding documents should be revised.	Short term
	8. Provisions in respect of joint ventures should be modified in the bidding document.	Short term
	9. PPA should engage into dialogue with the private sector. 10. Procurement capacity needs to be strengthened.	Ongoing Ongoing
	11. Establish a high level joint steering committee monitor the progress in procurement reforms.	Short term
8. EXTERNAL AUDIT		
To strengthen the external audit function to provide better assurance on the use of public resources.	1. Anchor the role of the SAIs constitutionally.	Medium term
	2. SAIS should focus on financial audits.	Medium term
	3. Prepare a common Strategic Development Plan.	**Priority**

Summary of Recommendations		
OBJECTIVES	**MEASURES**	**TIMEFRAME**
	4. Prepare an audit methodology and guidelines for implementing it. 5. Form a secretariat for the coordination committee.	Short term Short term
	6. Devise a strategy for auditing local government	Short term
	7. Develop expertise to close gaps in auditing information technology systems and tax revenues.	Medium term
	8. Develop a robust quality assurance system.	Medium term
9. LEGISLATIVE OVERSIGHT		
To improve public financial accountability and transparency.	1. An independent parliamentary research service should be created.	Medium term Priority
	2. Accountability and performance reports to the parliament should be considered.	Long term
	3. Discussion on the annual budget execution reports in the parliament should be simultaneous with the discussion on annual audit reports.	Medium term
	4. Regular meetings between line ministries and Economy and Finance Committees should be held.	Medium term
10. CORRUPTION		
To strengthen the enforcement capacity to fight corrupt practices.	1. Ensure a total commitment in fighting corruption at the highest levels of government	Ongoing
	2. Ensure sufficient resources are devoted in building capacity in enforcement agencies.	Ongoing

(Short Term measures generally refer to the timeframe of 1 to 2 years, Medium Term 3 to 5 years, and Long term beyond the 5 year period. Ongoing indicates continued implementation.)

Key Milestones in the Bosnia and Herzegovina's Public Financial Management Reform Journey

Establishment of SAIs	Late 1999
MTEF process introduced in Entities	1999
Closure of payment bureaus	Early 2001
Implementation of an automated treasury system	Early 2002
Establishment of Indirect tax authority at the State Level	Late 2004
Enactment of procurement law	Late 2004
Enactment of modern organic budget laws	Late 2004/2005
MTEF process expanded to the State and integrated with the annual budget process	2005
New laws on external audit	2005/06

Future Milestones

- Enactment of internal audit laws
- Functioning internal audit function
- Proper compliance with laws, rules, and regulations
- Mainstreaming MTEF
- Implementation of IPSAS
- Centralized automated payroll system (In the RS)
- Performance and accountability information

Revenue composition for Republic Srpska for 2004 (Actual)

Revenue Type	(KM millions)	% to total Revenue
Direct Taxes	**143.3**	**13.4**
Income Tax	2.4	
Payroll Tax	96.3	
Company Tax	19.7	
Property Tax	21.2	
Other	3.7	
Indirect Taxes	**663.6**	**61.8**
Sales tax	271.1	
Excise	200.2	
Custom Duties	112.9	
Other	79.4	
Other tax and non-tax revenues including borrowings	**266.3**	**24.8**
Total Revenue	**1073.2**	**100**

Expenditures on Procurement Compared with Budgeted Expenditures

Level of Administration	Total budgeted expenditures			Amount allocated to procurement of goods and services and capital spending			Procurement as a share of Total budgeted expenditures(in percent)		
	2002	**2003**	**2004**	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**
State	400	389	425	35	42	56	9	11	13
Federation									
Federation Government	1,241	1,126	1,092	114	131	129	9	12	12
Cantons	1,169	1,207	1,300	238	250	277	20	21	21
extrabudgetary funds	1,308	1,363	1,509	465	594	657	36	44	44
Municipalities	301	344	402	99	113	144	33	33	36
Total Federation	**4,019**	**4,040**	**4,303**	**916**	**1,130**	**1,263**	**23**	**28**	**29**
Republika Srpska									
RS Government	1,117	1,085	1,098	234	206	151	21	19	14
extrabudgetary funds	566	675	725	238	288	281	42	43	39
Municipalities	250	302	344	118	148	166	47	49	48
Total RS	**1,933**	**2,062**	**2,167**	**590**	**642**	**598**	**31**	**31**	**28**
Brcko District	**212**	**213**	**172**	**145**	**127**	**82**	**68**	**60**	**48**
Grand Total	**6,564**	**6,704**	**7,067**	**1,506**	**1,899**	**1,943**	**23**	**28**	**27**

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