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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY LOAN

IN THE AMOUNT OF EUR 74.5 MILLION

(US\$80 MILLION EQUIVALENT)

TO

BOSNIA AND HERZEGOVINA

FOR THE

PUBLIC FINANCES DEVELOPMENT POLICY LOAN

February 23, 2017

Macroeconomic and Fiscal Management Global Practice
Europe and Central Asia Region

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BOSNIA AND HERZEGOVINA - AUTHORITIES FISCAL YEAR

January 1–December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of January 31, 2017)

| | |
|---------------|---|
| Currency Unit | Bosnia and Herzegovina Convertible Mark |
| US\$1.00 | 1.84 |
| EUR 1.00 | 1.96 |

ABBREVIATIONS AND ACRONYMS

| | |
|-------|--|
| BD | Brcko District |
| BiH | Bosnia and Herzegovina |
| CAD | Current Account Deficit |
| CBBiH | Central Bank of Bosnia and Herzegovina |
| CoM | Council of Ministers |
| CPF | Country Partnership Framework |
| DPL | Development Policy Loan |
| GDP | Gross Domestic Product |
| GRS | Grievance Redress Service |
| EU | European Union |
| FBiH | Federation of Bosnia and Herzegovina |
| FDI | Foreign Direct Investment |
| HIF | Health Insurance Fund |
| IFI | International Financial Institution |
| IMF | International Monetary Fund |
| MoF | Ministry of Finance |
| MOFT | Ministry of Finance and Treasury |
| MTDS | Medium Term Debt Strategy |
| PAYG | Pay as you go |
| PDIL | Pension and Disability Insurance Law |
| PEFA | Public Expenditure and Financial Accountability Assessment |
| PFM | Public Financial Management |
| PIMIS | Public Investment Management Information System |
| PIP | Public Investment Program |
| ROSC | Report on the Observance of Standards and Codes |
| RS | Republika Srpska |
| SAI | State Audit Institution |
| SCD | Systematic Country Diagnostic |
| SOE | State-owned Enterprise |
| STA | Single Treasury Account |

| | |
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BOSNIA AND HERZEGOVINA
PUBLIC FINANCES DEVELOPMENT POLICY LOAN

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**SUMMARY OF PROPOSED LOAN AND PROGRAM
BOSNIA AND HERZEGOVINA PUBLIC FINANCES DEVELOPMENT POLICY LOAN**

| | |
|--|---|
| Borrower | Bosnia and Herzegovina |
| Implementation Agency | Ministry of Finance and Treasury BiH, Ministry of Finance of Republika Srpska, Ministry of Finance of Federation BiH |
| Financing Data | IBRD Loan of EUR74.5 million (US\$80 million equivalent). Terms: Reference Rate plus Variable Spread; 32 years total repayment term, including 7 years of grace. |
| Operation Type | Stand-alone single tranche loan |
| Pillars of the Operation And Program Development Objective(s) | <p>The Program Development Objectives of the Development Policy Loan (DPL) are to support policy and institutional efforts of Bosnia-Herzegovina (BiH) authorities to:</p> <ol style="list-style-type: none"> i. Strengthen the medium-term management of public assets and liabilities for improved transparency of public finances; and ii. Enhance regulatory frameworks to lower medium-term fiscal pressures related to public employment, insolvency, and pharmaceuticals. |
| Result Indicators | <p>i. Strengthen the medium-term management of public assets and liabilities for improved transparency of public finances;</p> <ul style="list-style-type: none"> • Three-year projections of the total cost of prioritized PIP projects adopted in the respective FBiH, RS, and BiH Institutions medium-term budget framework documents <ul style="list-style-type: none"> ○ Baseline: No (2015) ○ DPL Target: Yes (2018 respective budgets) • Debt Information reporting against the MTDS-set debt management targets related to refinancing, interest rate, and foreign exchange risks made public annually on respective MoFs websites <ul style="list-style-type: none"> ○ Baseline: No (2015) ○ DPL Target: Yes (2017) • Reporting of budget users arrears to FBiH MoF <ul style="list-style-type: none"> ○ Baseline: No (2015) ○ DPL Target: FBiH MoF presents to the FBiH Fiscal Coordination body an analysis of the status of the FBiH arrears as of end-2017 (2017) • Reporting of health sector arrears by RS health facilities to the RS MoF <ul style="list-style-type: none"> ○ Baseline: No (2015) ○ DPL Target: RS Ministry of Health presents to the RS MoF an analysis of the status of the RS Health sector arrears as of end-2017 (2017) <p>ii. Enhance regulatory frameworks to lower medium-term fiscal pressures related to public employment, insolvency, and pharmaceuticals.</p> <ul style="list-style-type: none"> • Reduction in the BiH public wage bill (excluding wage arrears resolution) <ul style="list-style-type: none"> ○ Baseline: 11.5 percent of GDP (2015) ○ DPL Target: Not exceeding 11.0 percent of GDP (end 2017) • Decrease in severance pay (for an employee with 30 years of tenure) <ul style="list-style-type: none"> ○ Baseline: 10 times the average of the last three monthly salaries before termination of contract (2015) ○ DPL Target: not to exceed 6 times the average of the last three monthly salaries before termination of contract (2017) • Commencing resolution of public enterprise insolvency cases under the new legislation <ul style="list-style-type: none"> ○ Baseline: 0 (2015) ○ DPL Target: At least 3 cases filed by State Owned Enterprises (end 2017) • Reduction in the maximum wholesale price of top-20 prescription medicines by International Nonproprietary Names (INNs) as defined and published in the BiH Drug Agency Annual Report <ul style="list-style-type: none"> ○ Baseline: BAM 162 million (2015) ○ DPL Target: Not exceeding BAM 146 million for the same volume as in 2015 (2017) |
| Overall risk rating | Substantial |
| Operation ID | P149768 |

**IBRD PROGRAM DOCUMENT FOR A PROPOSED
PUBLIC FINANCES DEVELOPMENT POLICY LOAN
TO BOSNIA AND HERZEGOVINA**

1. INTRODUCTION AND BOSNIA AND HERZEGOVINA CONTEXT

1. **This proposed Public Finances Development Policy Loan (DPL) of US\$80 million supports the policy efforts of Bosnia and Herzegovina (BiH) authorities to improve transparency of public finances and lower fiscal pressures over the medium term in BiH.** The operation is central to the World Bank Group's (WBG) Country Partnership Framework (CPF) discussed by the WBG Board of Executive Directors on December 15, 2015, particularly to focus area 1 that supports the increase of public sector efficiency and effectiveness, and is complementary to related WBG operations and technical assistance. The operation aims to strengthen medium-term management of public assets and liabilities for improved transparency of public finances (Pillar I), as well as to enhance regulatory frameworks to lower medium-term fiscal pressures related to public employment, insolvency, and pharmaceuticals (Pillar II).

2. **This proposed DPL addresses weaknesses in public finances in BiH related to the size of public expenditures and transparency of public finances, while laying a foundation for tackling deeper structural reforms in the BiH public sector.** While BiH's fiscal deficits and public debt levels have been moderate (annual average of 2 percent of gross domestic product (GDP) in 2008–2016 and 33.1 percent of GDP, respectively), BiH faces challenges of inefficiencies and lack of transparency in its public finances. BiH has one of the world's largest public sectors relative to the size of its economy, with general government¹ expenditures at 43.7 percent of GDP in 2016 and public enterprises adding even more to the public footprint in the economy. Pensions, social transfers, and public wages together amount to nearly one-third of GDP and are the main causes for the excessive level of recurrent spending. Social transfers are poorly targeted and provide poor incentives for reducing informality and increasing labor force participation.² Not only is public spending structurally high, but importantly the quality of and control of spending is weak, leading to inefficient use of public resources and crowding out of private ones.³ Weaknesses in the fiscal reporting system at all levels and failure to recognize (and resolve) public arrears, the size and type of which remain undocumented, is interfering with prudent public financial management (PFM). Fiscal risks stem from the weak links among public investment, debt management, and medium-term budgeting, as well as from the presence of public arrears.

3. **The large and inefficient public sector is holding back BiH's growth and prosperity.** It crowds out the private sector and suppresses its development by capturing physical and human factors of production and using them in an inefficient way. The latest available poverty estimates (from 2011) show that the progress in poverty reduction experienced up to 2007 has been stalled by the 2008 global financial crisis—the poverty headcount remained roughly constant during this period at 14

¹ According to the Central Bank of Bosnia and Herzegovina (CBBiH), general government includes consolidated administrative data collected from Ministries of Finance (MoFs) of all levels of government, Social Security Funds of all levels of government, Entities' Public Company for Roads and Entities' Public Companies for Motorways. Annual data for consolidated revenues/expenses include local level of government (municipalities and towns) and Public Company for Roads of all levels of government of the FBiH, Public Company for Roads of RS, Public Company for Motorways of the FBiH, and Public Company of Motorways of RS.

² See World Bank. 2015. *Bosnia and Herzegovina Systematic Country Diagnostics*. In addition, World Bank. 2012. *Bosnia and Herzegovina Challenges and Directions for Reform. Public Expenditure and Institutional Review*.

³ See World Bank. 2014. *Public Expenditure and Financial Accountability Assessment (PEFA)*.

percent based on the World Bank definition.⁴ The post-crisis economic recovery has not been reflected in improved labor market performance, and poverty reduction continues to be constrained by the stubbornly high unemployment, particularly among youth, while real wages are expected to remain largely flat due to the substantial remaining slack in the labor market. Making public expenditures more efficient, transparent, and smaller, while maintaining macroeconomic stability, can save significant public resources, relieve the fiscal burden of the public sector on the economy, and at the same time improve the quality of the services that authorities provide to citizens. This will help not only improve the quality of public spending, but also release physical and human capital for the private sector and entrepreneurial activities, and in turn, boost economic growth and job creation.

4. This proposed DPL utilizes an opportunity to advance reforms in the area of fiscal policy. After years of policy stagnation, a new shared understanding has emerged among the authorities of the imperative to move forward with structural reforms. The BiH Council of Ministers (CoM) and the entity-level governments (Federation of Bosnia and Herzegovina [FBiH] and Republika Srpska [RS]) officially endorsed a medium-term Reform Agenda in July 2015, which serves as a blueprint of structural reforms. Detailed time-bound action plans are being implemented at all levels of authorities and with the support of international partners. The measures supported under the proposed operation are an integral part of BiH's ambitious program of critical policy and institutional reforms in the context of BiH's European Union (EU) Accession process. In February 2016, BiH submitted its European Union (EU) membership application. Most recently, in August 2016, an agreement has been reached on the adaptation of the trade provisions of the BiH-EU Stabilization and Accession Agreement and on putting in place an EU Coordination Mechanism. In September 2016, the International Monetary Fund (IMF) Board approved a three-year Extended Fund Facility for BiH. International Financial Institutions (IFIs) financing, including this DPL and other WBG support, is part of the international support of the policy and implementation efforts the authorities in BiH are pursuing to advance the Reform Agenda.

5. The risk assessment of the proposed DPL is substantial. Risks stem from complex and fragmented governance structures, which complicate coordinated preparation and implementation of sector policies and development strategies. In addition, head winds related to the euro area recovery and to domestic factors, such as the potential materialization of contingent liabilities and arrears, pose additional risks. The key mitigating factors include the agreement among different levels of authorities behind the Reform Agenda, broad support by the society of the reform path, and the support of the BiH reform efforts from the international community.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

6. Since the global financial crisis of 2008, economic growth in BiH has slowed, as has the rate of convergence to EU income levels. The global financial crisis affected all parts of the economy. Lower metal prices hit exports, foreign direct investment (FDI) declined as global capital financing conditions tightened, and remittance inflows dropped as growth in the EU suffered. Underlying structural weaknesses—including the bias toward consumption relative to investment, rigid labor market laws,

⁴ The World Bank methodology relies on the Living Standards Measurement Study poverty line (BAM 205/person/month). For details, see <http://documents.worldbank.org/curated/en/228531467999134102/Poverty-and-inequality-in-Bosnia-and-Herzegovina-2007-2011>.

high taxes, a poor business climate, and a weak transport infrastructure—were revealed. Following a double-dip contraction of the economy between 2008 and 2012, BiH experienced the beginning of a moderate economic recovery in 2013 when growth reached 2.4 percent (Table 1). This was interrupted by the floods of May 2014 which impacted almost all sectors of the economy and slowed growth to 1.1 percent in 2014. As a result of these dynamics, annual growth averaged only 0.6 percent in the 2009–2015 period and since 2008 the average income per capita on a purchasing power parity basis has remained stagnant relative to the EU average at 26–27 percent.

7. **While subdued since the global financial crisis, consumption remains the dominant driver of growth in BiH.** Consumption is slightly above 100 percent of GDP in 2015, fueled by remittances, public wages, and transfers. Net exports contributed 2.0 percent to overall growth in 2015. While remittances fell markedly after the crisis (from 12.3 percent of GDP in 2007 to 8.3 percent in 2015), growing public wages and social transfers continue to support consumption and overall growth. Investment’s contribution to growth, which was positive before the crisis (5.5 percent in 2008), turned negative between 2009 and 2015 (–0.2 percent on average). The bias toward consumption relative to investment remained.

8. **Following the floods of 2014 and supported by stronger net external demand, the economy recovered in 2015, achieving growth of 3.0 percent, and is expected to grow by 2.8 percent in 2016.** On a sectoral basis, growth in manufacturing and agriculture, along with services, were central to the recovery in growth from the impact of the 2014 floods. High-frequency indicators such as indirect revenue collection, industrial production, and the net trade balance exhibited positive trends. The latter was supported by a slow recovery in the EU and the dampening effect on imports of lower oil prices. In the first six months of 2016, consumption picked up, supported by rise in bank credits to households and evidenced in the pickup in consumer goods imports. However, investments stagnated, and the growth of long-term bank credit to private enterprises slowed down compared to 2015. Continued, but moderating, export growth is offset by a return of positive import growth. Overall, the growth contribution of net external demand is expected to be slightly negative in 2016.

9. **A declining trade deficit led to a narrowing current account deficit (CAD) in 2015–2016.** The CAD fell from 7.5 percent of GDP in 2014 to 5.5 percent of GDP in 2015 but rose slightly to 5.8 percent in Q1 2016. Lower oil prices brought down imports of related products. Smaller funds inflow in primary and secondary income outweighed the continued narrowing in the goods trade deficit. The services surplus and remittances were relatively stable. While net FDI inflows were down by almost half in 2015 relative to 2014 at 1.4 percent of GDP, in Q1 2016 FDI inflows improved to about 2.3 percent, financing around 41 percent of the CAD. The remaining financing was from capital inflows and other investments (mainly new loans).

10. **The unemployment rate remains high, with the pickup in growth accompanied by only modest improvements in the labor market.** The unemployment rate fell by 2.3 percentage points in 2016 relative to 2015 but remains high at 25.4 percent (2016 Labor Force Survey). Part of this improvement was due to a fall in the activity rate (declining by 1 percentage point to 43.1 percent in 2016), but the employment rate also rose slightly to 32.2 percent (up 0.3 percentage points on 2015). In 2016, much of the improvement in employment originated in agriculture, wholesale, and food services, whereas the public administration employment was in decline. Unemployment among the youth (those between 15 and 24 years of age) is even higher, at 54.3 percent (58.9 percent for women and 52.0 percent for men).

11. **Imported deflationary pressures continue to push down consumer prices.** The Consumer Price Index dropped further in 2016 by 1.4 percent, from -1 percent in 2015. The biggest drivers of the fall were the prices of imported goods, reflecting lower oil, food, clothing, and footwear prices. Given the limited growth in nominal salaries (up 0.3 percent year-on-year in Q2 2016), declining consumer prices provided a small boost to real incomes.

Table 1. Key Economic Indicators and Projections for BiH

| | 2013 | 2014 | 2015 | 2016 Estimated | 2017 | 2018 | 2019 |
|---|--|---------|---------|-------------------|---------|---------|---------|
| Real Economy | Annual percentage change, unless otherwise indicated | | | | | | |
| Nominal GDP (BAM billion) | 26.7 | 27.3 | 28.5 | 29.5 | 30.4 | 32.0 | 33.7 |
| Real GDP | 2.4 | 1.1 | 3.0 | 2.8 | 3.2 | 3.7 | 3.9 |
| Per capita GDP (in US\$ Atlas Method) | 4,930.0 | 4,730.0 | 4,660.0 | 4,550.0 | 4,600.0 | 4,850.0 | 5,110.0 |
| Contributions: | | | | | | | |
| Consumption | -0.1 | 1.8 | 0.9 | 2.2 | 2.2 | 2.6 | 2.6 |
| Investment | 0.0 | 2.1 | 0.2 | 1.0 | 1.3 | 1.8 | 1.8 |
| Net exports | 2.5 | -2.8 | 2.0 | -0.4 | -0.3 | -0.7 | -0.7 |
| Exports | 2.4 | 1.4 | 1.0 | 0.7 | 0.8 | 1.0 | 1.0 |
| Imports | -0.1 | 4.2 | -0.9 | 1.1 | 1.2 | 1.7 | 1.7 |
| Unemployment rate (average, LFS Definition). | 27.5 | 27.5 | 27.7 | 25.4 | | | |
| GDP deflator | -0.3 | 1.0 | 1.4 | 0.6 | 0.0 | 1.4 | 1.4 |
| CPI (period average) | -0.1 | -0.9 | -1.0 | -1.4 | 0.5 | 1.0 | 1.0 |
| Fiscal accounts | Percent of GDP, unless otherwise indicated | | | | | | |
| Expenditures | 44.8 | 45.8 | 42.6 | 43.7 | 44.4 | 43.6 | 43.3 |
| Revenues | 42.7 | 43.8 | 43.2 | 43.1 | 43.8 | 43.3 | 43.3 |
| General government balance | -2.1 | -2.0 | 0.7 | -0.6 | -0.6 | -0.3 | 0.0 |
| General government debt | 37.7 | 41.8 | 41.9 | 41.5 | 39.7 | 37.4 | 35.3 |
| Selected monetary accounts | Annual percentage change, unless otherwise indicated | | | | | | |
| Broad money | 7.9 | 7.3 | 8.0 | 7.2 | — | — | — |
| Credit to non-government (eop) | 2.3 | 1.8 | 2.6 | 3.2 | — | — | — |
| Balance of payments | Percent of GDP, unless otherwise indicated | | | | | | |
| Current account balances | -5.3 | -7.5 | -5.5 | -6.2 | -6.1 | -5.6 | -5.6 |
| Exports of goods | 24.0 | 24.2 | 24.4 | 23.9 | 23.9 | 23.5 | 23.5 |
| Imports of goods | 51.4 | 53.9 | 50.5 | 48.4 | 48.3 | 48.3 | 48.3 |
| FDI (Net) | 1.4 | 2.6 | 1.4 | 1.1 | 1.1 | 1.1 | 1.1 |
| Gross official reserves (in months of imports) | 5.5 | 6.2 | 6.5 | 6.6 | .. | .. | .. |
| External debt | 73.8 | 76.9 | 76.6 | 76.2 | 74.3 | 72.1 | 70.0 |
| Exchange rate (average, per dollar) | 1.4 | 1.6 | 1.8 | — | — | — | — |
| Real Effective Exchange Rate | -1.8 | 0.2 | -0.8 | 0.01 | | | |
| Memorandum item | | | | | | | |
| GDP nominal (US\$ billion) | 18.8 | 17.0 | 15.9 | 16.9 | 17.6 | 18.5 | 19.5 |

Source: BiH Agency for Statistics, CBBiH, and World Bank staff estimates.

12. **The CBBiH maintains monetary stability through the operation of a currency board under which the BiH convertible mark (BAM) is fixed to the euro.** International reserves remained at a comfortable level in the first half of 2016, at around six months of imports. Given its linkage to the euro, the convertible mark has seen sustained depreciation against the dollar, but recent appreciation in relation to the currencies of some of its main trading partners. Overall, the real effective exchange rate depreciated by 0.8 percent in 2015 relative to 2014, and while appreciating slightly in the first half of 2016, remains down slightly (0.2 percent) on its 2014 average level.

13. **The financial sector's support to economic activity has been constrained by deleveraging and rising asset quality concerns.** While the banking sector remains stable and has reduced its reliance on foreign financing, many of the foreign-owned banks, which dominate the banking system, have been gradually deleveraging. This has contributed to the decline in the rate of credit expansion (averaging 3.5 percent a year in 2009–2015) relative to the pre-global financial crisis average (24 percent a year over 2003–2008). In addition, the share of nonperforming loans in commercial banks' portfolios is high, but it is gradually declining. At the end of Q1 2016, the nonperforming loan ratio was 13.2 percent, down from 13.7 percent at end-2015. Banks' profitability has deteriorated, partly due to high provisioning. Asset quality concerns make it hard to reestablish bank profitability mainly due to poor corporate resolution and insolvency frameworks, as discussed further in Section 4.2.2.

14. **Although overall fiscal deficits remain moderate, the highly fragmented fiscal sector remains characterized by a high tax burden and inefficient patterns of spending.** In 2015,⁵ on the back of smaller improvements in revenue collection and a strong decline in nominal expenditures, which declined by 2.7 percentage points of GDP, the fiscal balance was in surplus of 0.7 percent of GDP (Table 2). The fall in spending was mainly a result of low capital investment. With social benefits and capital spending picking up in 2016, fiscal deficit is expected to be around 0.6 percent of GDP with primary and current balance remaining positive.

15. **Revenue performance remains solid but at 43 percent of GDP, the burden of taxes and social contributions is high.** Indirect taxes provide roughly two-fifths of all revenues with social security contributions a further one-third. The performance of indirect taxes was the main driver of improved revenue collection in 2016. Led by higher custom duties, gross indirect revenue collections increased by 4.4 percent year-on-year in the first half of 2016, versus growth of 1.7 percent over 2015 as a whole.

16. **Efforts to curb current expenditure (dominated by wages, pensions, and social transfers) remain weak.** Public expenditures-to-GDP in BiH, at 42.6 percent, are higher than in most other European countries with 11.5 percent of GDP spent on wages and 16.6 percent on social benefits, including pensions and transfers. Fiscal consolidation efforts will not be effective if structural rigidities on the expenditure side remain unaddressed, for example, large public wage, sizeable and poorly targeted social assistance.

⁵ Consolidated fiscal data released by the CBBiH in July 2016.

Table 2. Key Fiscal Indicators, Consolidated General Government
(Percent of GDP, unless otherwise indicated)

| | 2013 | 2014 | 2015 | 2016 (estimate) | 2017 | 2018 | 2019 |
|-----------------------------|------|------|------|--------------------|------|------|------|
| Overall Balance | -2.1 | -2.0 | 0.7 | -0.6 | -0.6 | -0.3 | 0.0 |
| Primary balance | -1.4 | -1.2 | 1.6 | 0.5 | 0.5 | 0.9 | 1.3 |
| Total Revenues (and grants) | 42.7 | 43.8 | 43.2 | 43.1 | 43.8 | 43.3 | 43.3 |
| Tax revenues | 22.1 | 22.3 | 22.6 | 22.9 | 23.4 | 23.3 | 23.2 |
| Social contributions | 15.4 | 15.5 | 15.2 | 14.9 | 15.2 | 15.0 | 15.0 |
| Grants | 0.2 | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Other revenue | 4.9 | 5.8 | 5.3 | 5.1 | 5.0 | 4.9 | 4.9 |
| Expenditures | 44.8 | 45.8 | 42.6 | 43.7 | 44.4 | 43.6 | 43.3 |
| Current expenditures | 40.9 | 41.6 | 40.6 | 40.1 | 39.4 | 38.5 | 36.8 |
| Wages and compensations | 12.3 | 12.0 | 11.5 | 11.3 | 11.0 | 10.4 | 10.4 |
| Goods and services | 7.9 | 7.8 | 7.5 | 6.5 | 6.6 | 6.5 | 6.0 |
| Interest payments | 0.8 | 0.9 | 0.9 | 1.1 | 1.1 | 1.3 | 1.3 |
| Current transfers | 18.0 | 18.4 | 17.9 | 18.5 | 17.6 | 17.2 | 17.2 |
| Social benefits | 16.5 | 17.1 | 16.6 | 17.2 | 16.3 | 16.0 | 16.0 |
| Subsidies ⁶ | 1.4 | 1.3 | 1.3 | 1.3 | 1.3 | 1.2 | 1.2 |
| Other expenses | 2.0 | 2.5 | 2.7 | 2.7 | 3.0 | 3.2 | 1.9 |
| Capital expenditures | 3.9 | 4.3 | 2.0 | 3.6 | 5.0 | 5.2 | 6.5 |

Source: CBBiH and World Bank staff projections.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

17. **BiH's growth outlook is expected to improve over the medium term.** Supported primarily by growth in consumption, real GDP growth is projected to increase gradually from 2.8 percent in 2016 to 3.9 percent by 2019. The recovery in EU import demand will lead to a moderate rise in exports. However, net external demand will continue to be a drag on growth, given the relative strength of import demand. External conditions will support a stable inflow of remittances which, combined with sustained lower oil prices, will underpin a gradual pickup in consumption, which will remain a key driver of growth. Investments in energy, construction, and tourism will support investment growth. Inflation is expected to remain low.

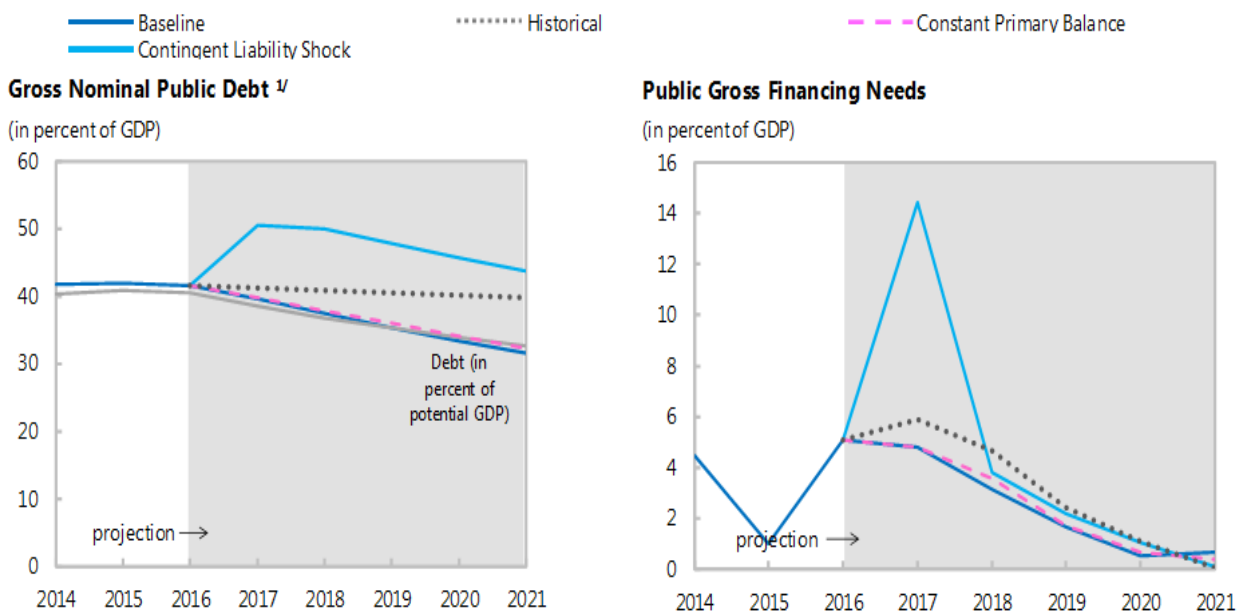
18. **Notwithstanding the positive growth outlook, unemployment is expected to remain high due to structural issues in the labor market.** Recent moves were undertaken to reform labor laws, as supported under this DPL and discussed further below (in section 4.2), but hiring is expected to remain constrained by the high tax burden (in particular social security contributions), while the substantial remaining slack in the labor market will contain real wages. As a result, the incidence of the US\$5 a day purchasing power parity poverty will improve marginally in the near term, staying above pre-crisis levels.

⁶ Refers to line 273 Government Finance Statistics severance pay to budget users per CBBiH panorama web portal data.

19. **Only a modest narrowing of the CAD is expected over the medium term, moving from 6.2 percent of GDP in 2016 to 5.6 percent of GDP in 2019.** Although exports will be supported by external demand, and by some recovery of global prices for BiH's main commodity exports (mineral fuels, oil products, metals, and wood products), the offsetting performance of imports means that the goods trade deficit is projected to increase gradually from 24.4 percent of GDP in 2016 to 24.8 percent of GDP in 2019. On the financing side, expected investments in energy (thermal plant Banovici) and tourism and the slow implementation of the Stabilization and Association Agreement support a stable FDI forecast of around 1.1 percent of GDP.

20. **The projected limited fiscal deficits and improved growth performance over the projection period contribute to a sustainable outlook for public sector debt.** The size and complexity of public debt have increased in recent years. The ratio of BiH debt-to-GDP has risen from 30.2 percent in 2010 to 41.9 percent in 2015. External BiH debt accounts for just under three-quarters of the total; BiH has limited domestic public debt with the first domestic bonds issued in 2007. Multilateral and bilateral sources account for the largest share of external debt, of which 60 percent is fixed rate. With the pickup in growth and constrained fiscal deficits, under the baseline projection, the BiH debt ratio would fall to 33.3 percent in 2020. A debt sustainability analysis conducted by the World Bank in January 2017 indicates resilience to different economic shock scenarios (see Figure 1). BiH risk of public external debt distress is considered to be of a lower scrutiny. Under a baseline scenario, the public debt-to-GDP ratio is expected to reach 32.4 percent by 2021. For example, a slowdown in the GDP growth rate starting in 2017 to around 0.6 percent annually would result in an increase in the debt-to-GDP ratio to 39.4 percent by 2021. Under a contingent liability shock (which assumes clearing arrears, an unexpected slowdown in GDP growth, or inadequate fiscal consolidation), BiH's debt-to-GDP ratio would reach 44.7 percent in 2017.

Figure 1. BiH Public Sector Debt Sustainability Analysis, Percentage of GDP



Source: World Bank staff estimates and projections.

21. **Despite the size of the CAD, the recovery in growth and projected FDI inflows result in a stable external debt under the baseline scenario.** External debt is expected to fall from 76.2 percent of

GDP in 2016 to 70.0 percent in 2019. Given the size of the CAD and amortization needs, external financing requirements are projected to remain high, falling slightly from 10.3 percent of GDP in 2016 to 10.1 percent by 2019 (Table 3). After FDI and portfolio flows, the estimated remaining financing gap in the period 2017 – 2019 is expected to be on average 1.2 percent of GDP, to be met by obtaining financing from the IFIs in support of the ongoing macroeconomic and structural reforms. Along with assumed disbursements under the IMF arrangement, this DPL contributes to closing BiH's financing gap in 2017.

Table 3. External Financing Projection
(US\$, millions, unless otherwise indicated)

| | 2015 | 2016 (estimate) | 2017 | 2018 | 2019 |
|--|--------------|-----------------|--------------|--------------|--------------|
| Financing needs | 1,530 | 1,742 | 1,960 | 1,934 | 1,962 |
| As percent of GDP | 9.6 | 10.3 | 11.1 | 10.5 | 10.1 |
| CAD | 879 | 1,048 | 1,078 | 1,036 | 1,093 |
| Amortization | 651 | 694 | 882 | 899 | 869 |
| Government | 235 | 313 | 404 | 412 | 370 |
| Non-government ^a | 416 | 381 | 477 | 486 | 499 |
| Financing sources (excluding IFI) | 1,530 | 1,742 | 1,676 | 1,692 | 1,799 |
| As percent of GDP | 9.6 | 10.3 | 9.5 | 9.2 | 9.2 |
| FDI (net) | 282 | 202 | 186 | 205 | 216 |
| Capital transfers | 206 | 220 | 231 | 238 | 240 |
| Foreign loans and other ^b | 1,532 | 1,850 | 1,674 | 1,410 | 1,594 |
| Gross international reserves | -489 | -530 | -415 | -160 | -250 |
| Financing gap (excluding IFI) | 0.0 | 0.0 | 284.2 | 242.2 | 162.5 |
| As percent of GDP | | | 1.6 | 1.3 | 0.8 |
| IMF | 0.0 | 0.0 | 204.2 | 192.2 | 112.6 |
| EU | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| World bank | 0.0 | 0.0 | 80.0 | 50.0 | 50.0 |

Source: IMF, World Bank staff estimates and projections.

Note: a. IMF estimate of nongovernment external debt amortization estimate; b. IFI financing, net errors and omissions and net portfolio flows included.

22. **The macroeconomic framework is considered adequate for the proposed operation.** Growth is projected to improve over the medium-term, with low inflation, and improvements in the fiscal and external balances. These outcomes are underpinned by prudent macroeconomic management and the implementation of structural reforms, some of which are supported by the DPL series. Nonetheless, the outlook is vulnerable to downside risks. External risks, given the CAD and external financing needs, are related to possible delays in Europe's economic recovery, which would affect exports, remittances, and capital flows because EU countries are BiH's largest trading partner. Improving competitiveness of export-oriented businesses can play a role in mitigating this risk and boosting the potential support to the economy from external demand. Internally, BiH's challenging political environment complicates structural reform implementation, including state-owned enterprise (SOE) restructuring. Moreover, materialization of contingent liability as well as arrears raises fiscal risks. Risks arising from natural disasters such as floods and droughts could also have a negative impact on economic growth.

23. **The twin pillars of future macro policy framework will continue to be: (a) adherence to the currency board with the euro and (b) a focus on fiscal consolidation and structural reforms to improve competitiveness.** As discussed in Section 3, the authorities are prioritizing fiscal stabilization and improved public finances under the Reform Agenda, supported by complementary IFI programs such as this operation and the IMF facility.

2.3 IMF RELATIONS

24. **The World Bank and the IMF have been closely coordinating their programs of support to help the authorities in BiH navigate the impact of various recent economic shocks, including the weather-related ones, and address key economic challenges.** The areas of coordination include entitlement reforms, labor market reforms, pension reforms, financial sector reforms, and measures to improve the business environment. In September 2016, the IMF Board approved a new program under a three-year Extended Fund Facility (equivalent to around EUR550 million) for BiH. The IMF program has three objectives focusing on (i) improvements in the business environment to support investment, job creation, and potential growth, (ii) fiscal consolidation while reducing the size of the public sector and improving the quality of spending, and (iii) safeguarding financial sector stability and reviving credit growth. The IMF and World Bank teams have worked closely in coordinating reforms under the IMF program and respective World Bank programs of support, including this DPL operation. More specifically, the structural reforms proposed under the IMF program rely on the technical assistance and complementary financing of this DPL

3. BiH PROGRAM

25. **With the support of the international community, the BiH CoM took important steps toward joint engagement with entity governments in defining the key pillars of a medium-term economic reform program.** In July 2015, the Reform Agenda document was agreed and endorsed by the BiH CoM and the FBiH and RS entity governments. Following the signing of the Reform Agenda document, the BiH CoM adopted a Strategic Framework for BiH for the period 2015–2018, and both entities developed detailed time-bound Action Plans to implement the Reform Agenda.

26. **The Reform Agenda aims to foster economic growth, create jobs, and improve the efficiency of social assistance, while setting a path toward fiscal consolidation and preserving macroeconomic stability.** The agenda targets six areas of reform. First, fiscal sustainability will be fostered through decreasing public debt, while creating room for public investment and reducing the size of the public sector in the economy. Second, business climate and competitiveness will be boosted through the elimination of barriers to investment, removing hidden subsidies, creating a more stable and accessible financial sector, improving bankruptcy procedures, and addressing inconsistencies in the regulatory and tax framework. Third, the labor market will be reformed to unleash the potential of the workforce. Fourth, targeting of social assistance will be improved and pension systems will be put on a sustainable financial path. It is noteworthy to mention that the authorities have already made significant progress on pensions' reform and are committed to further advance it. In 2016, the RS incorporated the Pensions and Disability Insurance (PDI) Fund in the Treasury Operations System and the FBiH is currently working to do the same. The new FBiH Pensions and Disability Insurance Law, which aims to establish a closer link between contributions and benefits, is in the process of being enacted. Fifth, the rule of law will be solidified through fighting organized crime, terrorism, and corruption. Sixth, public administration will be reformed to support the fiscal sustainability agenda, while ensuring the quality of public service delivery to citizens. EU accession and adherence to EU acquis will be the anchor for all

aforementioned reforms, and progress on the implementation of the Reform Agenda will be necessary for a membership application to be considered by the EU.

4. THE PROPOSED OPERATION

4.1 OPERATION DESCRIPTION AND LINK TO BiH's PROGRAM

27. **The Program Development Objectives of the DPL are to: (i) strengthen the medium-term management of public assets and liabilities for improved transparency of public finances; and (ii) enhance regulatory frameworks to lower medium-term fiscal pressures related to public employment, insolvency, and pharmaceuticals.** These two pillars complement and reinforce each other. In the absence of reforms supported under the proposed DPL, fiscal pressures will intensify in the medium term. In addition to achieving permanent reductions in public expenditures in the order of over 2.3 percent of GDP in the medium term, the reforms supported by this DPL unlock rigidities in public employment and enterprises, as well as pharmaceutical pricing, and as such directly contribute to lowering associated fiscal pressures and pave the way for deeper structural reforms in areas such as public financial management, and SOEs, among others. The operation is anchored on the BiH institutions' and entity-level governments' own development objectives related to the reforms envisioned under the public finance part of the Reform Agenda. The proposed DPL, in combination with financing provided by other IFIs, will help close BiH's financing gap for 2017. The policies supported under this DPL are complementary to those of other IFIs. They focus on areas of comparative advantage of the WBG, building on past or ongoing analytical and technical activities such as labor, health and pharmaceuticals, bankruptcy, and public finance management, among others. Without reforms in these areas, the fiscal stance of BiH would deteriorate over the medium-term.

28. **This DPL has two pillars seeking to improve transparency of public finances and lower fiscal risks over the medium term.**

29. **Under Pillar I, the DPL aims to strengthen the medium-term management of public assets and liabilities for improved transparency of public finances.** Fostering the links and complementarities of reforms related to medium-term debt management and public investment management, as well as documentation (and eventual clearance) of public arrears are among the policy measures through which the objective of the pillar is to be achieved.

30. **Under Pillar II, the DPL seeks to enhance regulatory frameworks to lower medium-term fiscal pressures** related to public employment and public enterprises through reforms of the labor law, bankruptcy procedures, and pricing of pharmaceuticals.

31. **The design of the operation recognizes the interlinked nature of the challenges in public finance.** While BiH's fiscal stance has improved since 2015, structural reforms are needed in order to ensure that fiscal pressures are lowered and do not threaten sustainability over the medium-term. By improving reporting and coordination in the planning and execution of fiscal policy among the different multiple layers of fiscal management in BiH, as well as by realizing spending efficiencies, both pillars ultimately contribute to reducing the fiscal risks and improving transparency of public finances in BiH. Reforms in pharmaceuticals pricing will yield direct savings to the budget. Effective public investment management (which delivers on the medium-term development priorities at the state and the entity level), as well as recognition (with the aim of clearance) of public arrears requires financing to be

incorporated in debt management strategies and its budgeting to be included within realistic fiscal frameworks. In addition, establishing effective procedures for insolvency and exit are critical actions for the financial and corporate restructuring of public enterprises. In the absence of reforms addressing public employment rigidities and severance payments, the financial health of the public enterprises could be at risk, leading to significant fiscal costs.

32. The design of the current DPL is informed by the experience of preceding policy lending, as well as the lessons learned from the Country Partnership Strategy implementation CY2012–2015. Relevant to this DPL, lessons include (a) wherever present, policy reform momentum should be utilized to support effective and timely implementation of focused (but not necessarily identical) policy and institutional measures at the entity and BiH levels; (b) policy lending informed by analytical and technical assistance work across the World Bank Group makes for effective DPLs, as evidenced by the last Business Environment DPL; (c) despite the medium-term nature of the policy agenda, stand-alone policy operations tend to be more effective over series in BiH because of the constitutional complexity of the institutional structure; allowing adequate time for preparation and implementation is critical, in particular for operations designed to support reforms involving both entities and BiH level institutions; and (d) client ownership, engagement, and open dialogue with a broad range of internal and international stakeholders play a pivotal role in successful design and implementation of the World Bank Group financing.

33. In addition to providing financing to meet the financing gap in 2017, the proposed DPL provides leverage for policy and institutional reforms. This proposed DPL provides a signal on the importance of the cross-cutting reform agenda in public finance, helping to foster collaboration among multiple stakeholders such as the EU and the IMF. Overall, the DPL takes into account factors such as projected future financing needs, structure of public debt and debt sustainability issues.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

4.2.1. PILLAR I: Improved Transparency of Public Finances

34. Measures to strengthen budget processes are critical to improving fiscal management and transparency in BiH. As highlighted in the 2014 PEFA, effective and transparent fiscal management in BiH faces the challenge of numerous fiscal institutions operating in a decentralized, complex structure, which contributes to a weak level of overall fiscal coordination in BiH. While the Fiscal Council of BiH is tasked with coordinating fiscal policy in BiH, almost all public functions are performed at the entity level, with many further decentralized to the local level of municipalities (particularly in the FBiH). This complex governance structure for managing public resources requires a close and transparent relation among different aspects of the medium-term fiscal management (identification of development needs, strategic planning of investment and their financing) at different levels of authorities in BiH. In addition, fiscal accounts should properly reflect the financial transactions and positions of the many public sector institutions or bodies, for example, through recognition (and eventual resolution) of arrears.

35. Pillar I of the DPL supports strengthening medium-term fiscal planning (specifically on public investment and debt management) and arrears recognition, necessary for improving transparency of public finances. The medium-term fiscal planning in BiH is underpinned by the annually adopted Global Framework for Fiscal Balances and Policies.⁷ However, improving the quality of medium-term fiscal

⁷ The Global Framework for Fiscal Balances and Policies is the key medium-term document as it outlines for each of the institutions of BiH, FBiH, RS, and BD the respective fiscal targets for next three years; the macroeconomic

management is needed—with the PEFA report rating all four authorities (institutions of BiH, RS, FBiH, and Brcko District [BD]) at only D+ in relation to the multiyear perspective on fiscal planning, expenditure policy, and budgeting.⁸ The DPL supports such improvements through actions on public investment management and debt management with a medium-term horizon. In relation to improving the transparency of fiscal management, this pillar also focuses on actions to improve arrears recognition.

36. Efficient public investment requires sound decisions on investment selection, portfolio management, and budgeting, linked to strategic objectives and medium-term budgeting and financing frameworks. All levels of authorities in BiH are under enormous pressure to improve public infrastructure, and generally undertake too many investment projects at once. Consequently, investments take too long to complete and end up costing more than they should. As a first step in strengthening public investment management, the BiH Ministry of Finance and Treasury (MOFT), in cooperation with the entity MoFs, have developed an online Public Investment Management Information System (PIMIS) to provide information on all public investment program (PIP) proposals and funded investment projects in a standardized format.⁹ Importantly, the PIMIS now provides information used for project prioritization in the budget planning process, including linkages of projects with strategic development planning, and for monitoring of financial implementation, reporting, and ultimately transparency of use of public resources. Project information from the entity level is electronically transferred twice a year to the central application of PIMIS and is publicly available. Each project entry contains actual and end start year, investment type, project type, status, total cost, total disbursement funds, area of development interventions, and strategic goal. Linking of the PIPs with the strategic planning and medium-term budgeting process supports the rationalization and realization of sector policies in the context of a transparent and predictable medium-term fiscal framework. Building on the progress, in 2016, the authorities established committees at the entity levels for the selection process of the PIPs as part of the medium-term fiscal planning. It will be important to continue to further improve the system in its scope, linkages with planning and budgeting, and monitoring and evaluation.

Prior Action #1: The BiH Council of Ministers and the governments of FBiH and RS have each adopted BiH's 2016 through 2018 Public Investment Program.

37. Sound medium-term fiscal planning entails clarity on strategies of funding the development priorities of BiH. As mentioned above, the scope, size, and complexity of public debt portfolios in BiH have significantly increased in recent years. While not very high by international standards, public debt has notably increased to reach 41.9 percent of GDP in 2015, compared to 37.7 percent in 2013 (Table 1). External debt stands at 72.6 percent of the total public debt, of which about 55 percent is allocated to or managed by the FBiH, 44 percent by RS, and the rest is divided between the DB and the BiH institutions.

38. Despite the rise in public debt, debt management has not been governed by medium-term strategies at any level of authorities before 2016. At the level of the institutions of BiH, regular publication of a debt management strategy is a legal obligation according to the Law on Debt,

projections; and the projections of total indirect taxes and their allocation for the coming fiscal year, as well as the upper limit of indebtedness.

⁸ Overall rating for PI-12. The ability of the government to manage and monitor its assets and ensure the transparency of asset disposal

⁹ See http://www.mft.gov.ba/pimis/pimis_bh.html.

Indebtedness and Guarantees of BiH from 2009, which was only met in April 2016 when the first BiH medium-term (three-year) debt management strategy was adopted. The Medium-term Debt Strategy (MTDS) enables the BiH institutions and the entities' MoFs to prepare, adopt, and publish such strategies that contain key risk indicators and their forward projection, including currency, interest rate, and refinancing risks. Table 4 shows the breakdown of public debt by entities and BiH institutions. These are important for internal planning purposes and the reduction of the cost and risk of debt, and for signaling to potential investors the strength and realism of national debt strategies and medium-term planning, especially as BiH prepares itself for accessing capital markets.

Table 4. BiH Public Debt in 2015

| BiH Public Debt (BAM, millions) | BiH Total | BiH Total (% GDP) | FBiH | RS | DB | BiH Institutions |
|---|------------------|-----------------------------|-------------|-----------|-----------|-------------------------|
| Public debt | 11,936.9 | 41.9 | 6,572.5 | 5,278.2 | 36.9 | 55.7 |
| External | 8,401.5 | 29.5 | 5,308.9 | 3,015.7 | 21.0 | 55.7 |
| Domestic | 3,535.4 | 12.4 | 1,263.5 | 2,262.4 | 9.4 | 0.0 |

Source: BiH MOFT report on Information on the state of public debt of BiH, as of December 31, 2015.

Prior Action #2: The BiH Council of Ministers and the governments of FBiH and RS have each adopted a Medium Term Debt Strategy (MTDS) to present their respective three year plans for the evolution of the public debt portfolio.

39. **The budget process in BiH is additionally burdened by the presence of arrears at each level of authorities in BiH.**¹⁰ Public arrears pose fiscal risks and hinder the ability of the authorities to execute fiscal affairs prudently. The underlying weaknesses in the PFM system, especially formulation of unrealistic budgets and poor cash flow management, weaknesses in fiscal reporting system, as well as weaknesses in the management of SOEs are among the causes of accumulating arrears. Arrears in public enterprises limit their potential restructuring or privatization. In the instances of known entity-level arrears, they often reflect the interaction of the incompatible structure of sectors (for example, the health sector) and their organization and financing.

40. **A full accounting of arrears does not exist in BiH and public arrears reporting and monitoring is very weak.** The documentation of overall arrears is limited. Neither cantonal MoFs nor SOEs and extra-budgetary funds (Health Insurance Fund [HIF], Pension and Disability Fund, and Employment Fund) report on arrears. In addition to collecting data on arrears from the entities, it is necessary to have reporting and monitoring of arrears incurred in budgetary funds, extra-budgetary funds, autonomous agencies, cantons, and SOEs on a regular basis.

41. **Different levels of authorities have increased focus on the need to improve the reporting mechanisms as well as to analyze and address the underlying causes of arrears.** The FBiH is making slow progress on this front at all levels of authorities. The first important step taken was to define the reporting format of arrears, through a Form 7. This form has been in use but with the assistance of the World Bank, it was modified in January 2016 to capture reporting of arrears to the FBiH MoF. At the same time, the FBiH introduced a reporting requirement on arrears for all budgetary users and the first such reports were submitted. Since then, the FBiH has produced a preliminary estimate on the

¹⁰ Arrears are payments overdue for more than 90 days.

outstanding stock and established a broad structure of the arrears of cantonal government budget users¹¹ based on information collected through the modified form.¹²

Prior Action #3: FBiH MoF has introduced reporting requirements on arrears for budget users in FBiH, designed to record all accumulated liabilities.

42. **Arrears in the health sector are among the biggest group of arrears in the RS.**¹³ Hospitals and health centers are accumulating substantial arrears, due to both inefficiencies and lack of management accountability and financial discipline. As of December 2015, health facilities had accumulated BAM 577 in liabilities, of which BAM 164 million were arrears (1.8 percent of RS GDP). The RS HIF reported an additional BAM 528 million in liabilities, of which BAM 313 million were declared as arrears.¹⁴ The sources of these arrears stem from disconnects in the annual budgeting process and health facility contracting; inefficiencies in the hospital service network; unnecessary referrals and admissions of cases that could be treated at primary levels; excess nonmedical staff; and limited accountability or autonomy by hospital managers to improve efficiency, quality, and stay within budgets.¹⁵ While BiH has made progress in primary health care reforms, hospital service provision remains inefficient. The authorities in the RS are concerned that the bulk of arrears are derived from unpaid taxes and social security contributions, resulting from a considerable overstaffing in primary and secondary health care. To collect quality data on RS health sector arrears and conduct an analysis of the main underlying causes, a working group has been formed and is working closely with the World Bank. In March 2016, the RS Government adopted conclusions related to reporting of public health sector institutions, including on health sector arrears (a detailed classification of expenditure arrears and monitoring of due days of such expenditure arrears).

Prior Action #4: RS Government has introduced reporting requirement on health sector arrears designed to set up regular reporting of accumulated liabilities in the health sector of RS.

43. The results under Pillar I are expected to contribute to improved transparency and predictability of medium-term fiscal policy. Specifically: (a) effective implementation of the medium-term PIPs would mean that direct linkages between investment and medium-term fiscal frameworks

¹¹ 'Budget users' (beneficiaries) mean ministries and other administrative bodies, and other entities that are financed from the budget.

¹² Arrears in the FBiH cantonal MoFs are classified by Government Finance Statistics Manual 2001 in seven broad categories such as compensation of employees, acquisition of goods and services, transfers, acquisition of nonfinancial assets, acquisition of financial assets, arrears recognized by courts related to entitlement legislation and salary regulation, and the others. The size of the cantonal MoF's arrears as of March 31, 2016 is BAM 349.5 million.

¹³ Preliminary evidence suggests that hospital arrears are present also in the FBiH, and hospital efficiency indicators are low. Officials in the FBiH acknowledge these concerns and wish to start diagnostics and developing strategy, and recently invited the World Bank to participate in a working group on health sector arrears.

¹⁴ Hospitals are responsible for 80 percent of liabilities. Nearly half of RS health facility liabilities are related to staff costs (including non-payment of pension and health insurance), with 40 percent late payments to suppliers. At least BAM 80 million (15 percent) liabilities are double counted by the HIF and facilities. In addition, facilities owed BAM 185 million (one-third of the liabilities) to the HIF for salary contributions, government debt and loans, and so on.

¹⁵ Further analysis is required to establish whether the HIF prices for health services correspond with the actual cost of those services. Reforms are needed in management, organization, and financing of hospitals.

are made. As a result, three-year projections of prioritized PIP projects are expected to enter the respective FBiH, RS, and BiH institutions' medium-term budget framework documents, starting with the 2018 budgets; (b) an effective implementation of the respective MTDS at the CoM and entity level would make debt information reporting against the MTDS-set debt management targets (such as currency, interest rate, and refinancing risks) will be made public annually on the respective MoFs websites; this public reporting is expected to commence in 2017; and (c) establishing and monitoring the stock of arrears is a first necessary step in their eventual clearance. The quarterly arrears reporting by the FBiH budget users and by RS health facilities will enable the preparation of an annual arrears analyses by the FBiH MoF and by the RS Ministry of Health, respectively. These analyses will track the status of arrears and present the information to the FBiH Fiscal Coordination body and to the RS MoF, respectively. As a result, a practice of generating regularly arrears information will be set to signal the authorities' commitment to establish a baseline, understand the root causes with the aim to start clearing arrears.

4.2.2 PILLAR II: Lowering Fiscal Pressures over the Medium Term

44. **Pillar II of this DPL supports the strengthening of selected regulatory frameworks which will lower fiscal pressures in the medium term through reducing expenditures and laying the ground for addressing structural issues in the public sector. With expenditures at close to half of GDP and public enterprises adding further burden on public finances, BiH has one of the world's largest public sectors.** Around one-third of formal workers in BiH work directly for the public sector that employs 37 percent of women compared to 30 percent of working men. The public wage bills accounts for close to 12 percent of GDP (the largest in the SEE6) and social spending at over 17 percent of GDP.¹⁶ The share of public sector employment would approach about a half of formal employment if SOEs were included. The policy measures in this pillar aim to permanently reduce fiscal pressures and the public sector burden on the economy over the medium term through releasing inefficiently used resources and crowding in private investment and resources. They will also contribute to establishing the foundations for tackling deeper structural reforms such as the reform of SOEs, the resolution of unpaid past pension contributions, arrears clearance, and health sector reforms.¹⁷

45. **Associated direct cumulative fiscal savings from the measures supported by Pillar II of this DPL are estimated to amount to at least 2.3 percent of GDP in the medium term.** The estimates refer to cumulative saving in the 2017–2020 period related to (a) pharmaceuticals at an annual average saving of €35 million starting in 2018; (b) public wages at estimated cumulative reduction of 1.1 percent of GDP (see Table 2); and (c) employer social benefits reduction of 10 percent annually.

46. **Limiting the duration of collective agreements to no more than three years will allow the authorities to regularly renegotiate salaries in the public sector, taking into account recent economic developments and fiscal constraints.** Not only is it important for the private sector that the current collective agreements, dating back to 2005, cease to exist, but also for the public sector this will be an opportunity to renegotiate salaries and benefits to reflect economic realities. The collective bargaining agreements of 2005 were not time-bound. Notably, the new regulations in the revised labor codes will limit the duration of collective agreements, so that social partners are able to renegotiate collective

¹⁶ The SEE6 are Albania, BiH, Kosovo, the Former Yugoslav Republic of Macedonia, Montenegro, and Serbia.

¹⁷ Transfer for unpaid past pension contributions will be determined by the Law on Settling the Unpaid Pension Contributions ('Law on Missing Contributions'), currently being prepared. Excluding the missing contributions transfer from the total transfer to the pay as you go (PAYG) system would show the actual savings achieved with the PAYG reform.

agreements on a regular basis. These regulatory changes extend support to a more flexible labor market, which in turn contributes to economic growth. Improved performance of the economy lends support to the fiscal position of BiH going forward.

Prior Action # 5: FBiH Parliament and RS National Assembly have each adopted changes to the labor legislation to cease the validity of the current collective bargaining agreements and limit the duration to three years of new collective agreements.

47. **Severance payments are an important component to help laid-off workers to smooth consumption during unemployment spells, but unemployment insurance should play the main role in social protection for the unemployed.** From an economic perspective, it is preferable to provide the larger part of support during unemployment spells through public risk-pooling instruments—like unemployment insurance—so as to not increase the costs of firing to levels that will impede economic efficiency. Severance payments that are set too high have negative implications for job creation and efficient labor reallocation. Hence, severance payments are preferably capped at a certain maximum. Up until now, in BiH, the severance pay formulas are overly generous: workers were entitled to one-third of the average of the last three monthly salaries for each year of service, with no cap. Reforms supported by this operation ensure that a cap is specified in line with international good practices. In parallel, authorities, with the technical and operational support of the World Bank, are considering to strengthen unemployment insurance benefits and the capacity of the public employment service as a mitigating measure.

48. **Capping the maximum amount of severance pay will help limit the fiscal impact of future public sector restructuring.** Many SOEs will need to be restructured or closed in the medium-term. Redundancies of long-serving employees in SOEs could significantly increase the fiscal costs of such reforms while failing to provide proper social mitigating measures in the form of monthly unemployment benefits combined with job search assistance. Limiting the maximum amount of severance pay at a socially appropriate level while strengthening unemployment insurance and employment services will decrease the fiscal burden of SOE restructuring and improve social mitigation measures.¹⁸

Prior Action #6: FBiH Parliament and RS National Assembly have each adopted changes to the labor legislation to introduce a maximum level of severance payments.

49. **BiH SOEs are plagued by inefficiencies which exert fiscal pressures.** According to data published by entity-level bodies that manage SOEs, most of the 574 BiH SOEs (174 in RS and 400 in the FBiH) are loss-making and unproductive, often requiring subsidies and burdened with difficult legacy issues (for example, missing pension contributions, weak corporate governance, and so on) that cannot be resolved through privatizations. Keeping such SOEs afloat is a diversion of resources away from productive activities, and it further increases recapitalization needs and solvency risks of these companies with direct implications for BiH's public finances. In addition, SOEs are accumulating arrears for unpaid taxes and contributions, generating large contingent liabilities and creating fiscal risks in the

¹⁸ The previous labor codes stipulated: (a) no severance below two years of tenure; (b) after that, one-third of the average of the last three monthly salaries for each completed year of service; and lastly (c) no cap on payments. Under the new labor codes, (a) and (b) were maintained but (c) was changed. A cap of six times the average of the last three monthly salaries was introduced. Therefore, not everyone with 18 years of tenure or more can gain further severance pay entitlements, other than through an increase in salaries themselves.

medium term. Finally, despite limited data, indications exist of interlinkages among some of the financially troubled SOEs and state-owned banks with increasing nonperforming loans, amplifying the potential pressure on public finances. In many cases, exit would allow for resources controlled by unviable SOEs to be put back to productive use.

50. **Authorities in BiH are working to reform SOEs, but the bankruptcy regime is fraught with a number of deficiencies which complicate the exit of firms.** In an effort to manage SOEs more effectively, BiH authorities are classifying them into three categories: (a) the first group is strategic companies, such as public utilities and railroads; these need restructuring and a better governance structure, but are likely to remain in public ownership; (b) the second group is companies that authorities could sell either directly or after restructuring; and (c) the third group is companies that cannot be salvaged and need to be liquidated. However, the bankruptcy regime is heavily weighted toward liquidations, and practice does not show a proper balance between liquidations and reorganizations (which are rare). A critical problem is the duration of the proceedings. A range of uncertainties remains related to the application of the insolvency moratorium, assets sales, and treatment of contracts. The claims resolution process is protracted, and issues remain with the priorities system.

51. **Legislative and regulatory changes supported by this DPL can contribute to improving the corporate resolution and insolvency frameworks and address some of the risks to public finances identified above.** The recent World Bank Implementation Completion and Results Report on the Observance of Standards and Codes for the Insolvency and Creditor/Debtor Regimes (ICR ROSC), identifies recommendations to improve the insolvency framework in each entity. The authorities have taken these recommendations closely by upgrading their respective bankruptcy legislation, which includes procedures for facilitating liquidation, reorganization, and cross-border insolvency. The RS authorities commenced the reform process early and as a result have already adopted the insolvency legislation and are now implementing it. The FBiH authorities started the process later, but are making rapid progress toward the adoption of the legislation.

Prior Action # 7: (a) RS National Assembly has adopted amendments to its insolvency legislation to align it with international best practice; and (b) the FBiH Government has approved proposed amendments to its insolvency legislation to align it with international best practice and sent the draft Insolvency law for parliamentary approval.

52. **Pharmaceuticals and medical supplies represent about 30 percent of health spending in BiH.** The pharmaceutical market is fragmented with more than 60 wholesalers, and BiH is the only country in the region that does not define maximum wholesale prices of pharmaceuticals. Average spending on pharmaceuticals is higher in FBiH than in RS due to cost-containment measures (for example, centralized procurement and negotiations for patented drugs by RS HIFs). In the FBiH, the price for the same medicine varies significantly among cantons. Both entities pay more for high-cost patented drugs, due to inadequate cost-benefit analysis in decisions to list high-cost drugs for reimbursement; outdated reference pricing; and inadequate use of more sophisticated negotiation approaches (such as price-volume agreements or risk-sharing agreements). For off-patent drugs, several factors contribute to high prices, including outdated external reference pricing (to set maximum wholesale prices); rebates from wholesalers and retail margins that incentivize dispensing higher cost drugs; inadequate competition in the generic market; prescribing according to brand names; and limited use of central procurement.

53. **Pharmaceutical procurement in BiH is inefficient, creating significant wasted resources.** As a result of fragmented purchasing and an unregulated pharmaceutical market, entities have little negotiation power in relation to wholesalers. On average, wholesale prices are 20 percent higher than maximum wholesale prices in comparator countries, resulting in poorly used health resources. Implementing an updated Rulebook regulating maximum wholesale prices for medicines could result in annual saving estimated at EUR35 million, of which three-quarters will be fiscal savings, and the remainder savings by households. The Rulebook stipulates that reference prices will be updated annually. In addition, implementation of more strategic purchasing, including increased use of competitive and pooled procurement in both entities, could further reduce costs of medication. As such, the reform improves access to medicines for the poor, elderly, and vulnerable groups, without any negative impacts on health access or quality.

Prior Action #8: BiH Council of Ministers has approved the updated rulebook designed to regulate maximum wholesale price of medications in BiH.

54. **Results under Pillar II are expected to relieve fiscal pressures relative to the baseline.** The policy measures are expected to introduce permanent fiscal benefits and reduce fiscal risks in BiH in the medium- to long-term. Moreover, taming the growth of the wage bill, lowering costs of top-prescribed drugs, and starting the process of resolution of public enterprise cases under good-international-practice-insolvency principles are all outcomes directly contributing to lowering associated fiscal pressures in the public sector. Specifically: (i) Renegotiating collective bargaining agreements every three years will contribute toward an expected 5 percent reduction in the public wage bill from its 2015 levels (excluding any wage arrears resolution); in addition, a cap on severance pay will decrease the maximum amount of severance pay for a typical employee with a 30-year tenure from, currently 10 monthly salaries (average of last three months) to 6 months salaries¹⁹, (ii) Given that the new insolvency legislation is to start being implemented in both entities only in 2017, filing under the new bankruptcy procedure by at least 3 SOEs will indicate commencement of the process in the public sector under the new improved rules, and (iii) Implementation of the rules of pharmaceuticals' pricing is expected to bring fiscal savings and permanently lower the cost of prescribed drugs. In 2017, the adoption of the Rulebook will lead to a reduction in maximum wholesale prices of the top-20 International Non-proprietary Names (INN) medicines as defined and published by the Drug Agency already in 2017. This is a first necessary step in the implementation of the Rulebook to bring drug prices down. Savings will be realized once the new 2018 framework contracts for procurement of drugs are signed and reflect the decreased prices of medicines.

55. **The DPL is underpinned by evidence-based analytical and advisory work and is complementary to other ongoing lending operations.** Table 5 summarizes the DPL prior actions and analytical underpinnings.

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WORLD BANK GROUP STRATEGY

¹⁹ The labor legislation stipulates no severance below two years of tenure; for each additional year of service one-third of the average of the last three monthly salaries for each completed year; and a cap of six times the average of the last three monthly salaries. Therefore, not everyone with 18 or more years of tenure can gain further severance pay entitlements other than through an increase in salaries.

56. **The proposed DPL is closely linked to the envisioned outcomes of the WBG Country Partnership Framework (CPF) 2016–2020 and the WBG’s twin goals of poverty reduction and boosting shared prosperity.** The proposed operation plays an instrumental role in influencing outcomes in focus area 1 of the CPF that supports the increase of public sector efficiency and effectiveness. It aims to support BiH in strengthening fiscal sustainability, reforming the SOEs’ role in the economy, and improving public service delivery (such as health, water supply, and sanitation). This proposed DPL, the ongoing technical assistance on pension reform and debt management, the planned work on SOEs, as well as the preparation of projects in the health sector (RS) and on financial management and control in the public sector complement each other to achieve the envisioned outcomes of the CPF. In addition, the planned study on the distributional impact of fiscal policy will shed light on the equity aspect of reforms, closely related to this proposed DPL.

Table 5. DPL Prior Actions and Analytical Underpinnings

| Prior Actions | Analytical Underpinnings |
|---|--|
| Pillar I Objective: Strengthening the medium-term management of public assets and liabilities for improved transparency of public finances | |
| The BiH Council of Ministers and the governments of FBiH and RS have each adopted BiH’s 2016 through 2018 Public Investment Program. | PEFA, covering BiH, FBiH, RS, and BD (FY14) Public Expenditure and Institutional Review (FY12) |
| The BiH Council of Ministers and the governments of FBiH and RS have each adopted a Medium Term Debt Strategy (MTDS) to present their respective three year plans for the evolution of the public debt portfolio. | Debt Management Performance Assessments, Reform Plans, and MTDS covering different levels of government |
| FBiH MoF has introduced reporting requirements on arrears for budget users in FBiH, designed to record all accumulated liabilities. | FBiH PEFA (FY14); Arrears Stocktaking and Reporting (ongoing) |
| RS government has introduced reporting requirement on health sector arrears designed to set up regular reporting of accumulated liabilities in the health sector of RS. | RS PEFA (FY14) Health Service Delivery Reform (FY15) |
| Pillar II Objective: Enhance regulatory frameworks to lower medium-term fiscal pressures related to public employment, insolvency, and pharmaceuticals. | |
| FBiH Parliament and RS National Assembly have each adopted changes to the labor law to cease the validity of the current collective bargaining agreements and limit the duration to three years of new collective agreements. | SCD (FY15) Labor Market Dialogue Technical Assistance (ongoing) |
| FBiH Parliament and RS National Assembly have each adopted changes to the labor legislation to introduce a maximum level of severance payments | SCD (FY15) Labor Market Dialogue Technical Assistance (ongoing) |
| (a) RS National Assembly has adopted amendments to its insolvency legislation to align it with international best practice; and (b) the FBiH Government has approved proposed amendments to its insolvency legislation to align it with international best practice and sent the draft Insolvency law for parliamentary approval. | SCD (FY15) ICR ROSC (FY14) IMF-World Bank FSAP (FY14) SOE Diagnostic Note for FBiH (FY15) |
| BiH Council of Ministers has approved the updated Rulebook designed to regulate maximum wholesale price of medications in BiH. | Rapid Assessments on Pharmaceuticals (FY13); Health Service Delivery Reform (FY15) SCD (FY15) BiH pharmaceutical policy note (FY16) |

Note: SCD = Systematic Country Diagnostic; FSAP = Financial Sector Advisory Program.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

57. **All legislative measures in BiH, including the ones supported by this DPL, are subject to a consultation process within and outside of authorities in BiH.** This includes a consultative mechanism with the groups that are likely to be affected by these legislative measures. The process is embedded in BiH's institutional setup and represents an integral part of the legislative process and consists of multiple filters to ensure valid checks and balances. Specifically, the process includes (a) drafts of new laws and those to be amended are prepared by working groups of officials from different ministries or agencies; (b) before regular authorities approval and parliamentary procedure, these drafts are subject to review and comment from the economic and social councils, as well as to clearance by the respective ministries of justice and finance and the legislative offices;²⁰ (c) since 2012, all draft legislations have to contain tables of concordance rationalizing compliance with respective EU legislation and commitments set in the Stabilization and Association Agreement; (d) once in parliamentary procedures, drafts are reviewed and discussed in a broader forum involving various interested parties;²¹ and (e) before final discussion and adoption, respective parliamentary committees review and provide feedback on proposed drafts, and ensure that the procedures were conducted appropriately, the relevant comments were addressed, and the entire supporting documentation is provided.

58. **In the preparation of this DPL, the World Bank has closely collaborated with the development partners and a range of stakeholders at all levels of authorities, civil society, academia, and private sector.** The consultations with stakeholders included, but were not limited to roundtables on pharmaceutical pricing and health care reforms, workshops on labor and debt management, and bankruptcy. They contributed to building broad support for the reforms in this DPL. In addition, the DPL benefited from public dissemination of complementing country economic reports and media interest and coverage of these issues which helped inform and shape public opinions. Furthermore, the priorities identified in the Reform Agenda document, including reforms supporting sustainability of public finances, were subject to discussions with the authorities, as well other IFIs and the EU. While each of these institutions of financial and technical assistance will negotiate its individual programs and monitor progress on its own priorities, the programs (including the ones related to public finances) are being closely coordinated and are contributing to the overall reform effort.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

59. **While the direct poverty and social impact of fiscal management reforms supported by the DPL is difficult to estimate, the reforms supported under Pillar I of the operation are expected to be beneficial to poverty reduction and shared prosperity over the medium term.** Policies aimed at strengthening medium-term public investment management, medium-term debt management, and arrears recognition should improve authorities' ability to manage risks, and improve its capacity to link

²⁰ The latter confirms constitutional and fiscal compliance of the proposed draft.

²¹ For example, chambers of commerce, industry associations, unions, local authorities representatives, and civil society organizations.

public resources with strategic development goals. These reforms should also lead to better measurement of the impact of spending over the medium term, which should translate into improved service delivery for all, including the bottom 40 percent and those socially excluded.^{22,23}

60. The introduction of reporting requirements on arrears overall in the FBiH and in the health sector in the RS would help improve service provision to the population. The prevalence of arrears at all levels of entity authorities, including social sectors such as health, creates not only an overall fiscal burden, but also constraints service provision to the population. The introduction of reporting requirements on arrears would establish baseline information to start addressing the issue of arrears as part of a medium-term strategy. This would allow, over time, support to reforms helping health facilities remain within their allotted budget without having to resort to volume control through rationing of services, and this would benefit the population overall, and low-income households in particular.

61. Reforms of collective bargaining agreements are expected to improve job creation by improving the ability of the public sector to adjust to changing market conditions. The reforms supported by this DPL align the duration of collective agreements in BiH (previously indefinite) with those from other countries in the EU (the majority of which range between two and four years).²⁴ While the direct effects of this reform are difficult to determine, the elimination of indefinite duration of collective agreements will likely benefit households in the lower part of the income distribution, because indefinite collective agreements (a) imply a higher wage premium in the public sector (relative to private) where incidence of poverty is considerably lower;²⁵ (b) make informal (and less secure) arrangements more attractive to employers; and (c) may lead to poor performance and job losses due to low ability of firms to adjust to negative shocks.²⁶

62. The introduction of maximum levels of severance payments for public sector employees will improve the efficiency of labor reallocation and is not expected to have adverse poverty impacts. Maximum caps to severance payments are part of a broader process of transferring the support for the unemployed to public risk-pooling mechanisms (unemployment insurance)—a more comprehensive

²² The ‘channels of transmission’ from budget reforms to share prosperity are likely to be (a) accountability (authorities become accountable for their uses of public funds) and (b) awareness (authorities improve efficiency and effectiveness by feeding the lessons of performance assessments back into strategies and plans). See for instance, Overseas Development Institute Briefing Paper (April 2003), *Results-Oriented Public Expenditure Management: Will It Reduce Poverty Faster?* (www.odi.org.uk). When accompanied with a strong medium-term fiscal framework, budget reforms could also be a useful tool in implementing ‘dash-for-growth’ policies that squeeze untargeted transfers in favor of economic infrastructure.

²³ Existing evidence from Latin American and other countries suggests that fiscal discipline, in turn, is beneficial to pro-poor growth through a number of pathways, including (a) improved fiscal space for public investment in roads, schools, and health care that the poor and those in the bottom 40 percent rely on heavily; (b) by improving the authorities ability to deploy counter-cyclical measures during episodes of economic downturn; and (c) by minimizing volatility which hurts those at the bottom of the income distribution in particular. Birdsall, N. 2007. “Reflections on the Macro-foundations of the Middle Class in the Developing World.” Center for Global Development Working Paper No. 130.

²⁴ ILO (International Labour Organization). 2015. “Collective Bargaining in the Public Service in the European Union” Working Paper No. 309.

²⁵ Bosnia and Herzegovina Agency for Statistics (BHAS), Federation Institute for Statistics (FIS), Republika Srpska Institute for Statistics (RSIS), and World Bank .2015. “Poverty and Inequality in Bosnia and Herzegovina 2007–2011.”

²⁶ See IMF .2015. *Bosnia and Herzegovina: Selected Issues*. IMF Country Report No. 15/299.

income protection system that does not suffer from challenges like nonpayment of severance packages.²⁷ Furthermore, severance payments only apply to permanent contracts, that is, the group directly affected by the changes is one where poverty incidence is low (according to Household Budget Survey 2011 data the poverty rate was 8 percent among those with permanent contracts, compared to 19 percent for those with no contract and 21 percent for the unemployed). Over 80 percent of those in professional occupations (International Standard Classification of Occupation 1–3) had permanent contract arrangements, compared to only 48 percent of non-skilled professionals.

63. **The reforms aimed at improving the efficiency of pharmaceutical procurement would benefit low-income households through lower prices and greater availability of all medicines.** Lower drug prices will allow (a) new medicines to be included in the reimbursement drug lists, and (b) revision of copayment policies to decrease copayments of most frequently prescribed drugs for chronic diseases. Individuals' costs for drugs would decrease. This will be particularly beneficial to elderly households. Just under 2 percent of population reported out-of-pocket payment in excess of 25 percent of household budget. However, among elderly only (and single elderly), this was over 7 percent (30 percent of elderly report out-of-pocket expenses in excess of 10 percent of household budget). However, low-income households reported lower than average visits to the doctor, general practitioner, gynecologist, or dentist over the past 12 months, which may be due, in part, to issues of affordability; households in the bottom quintile having much lower rates of private health insurance, making health shocks more difficult to deal with. Lower cost pharmaceuticals and greater availability of medications, would be particularly beneficial for poor and elderly households.

64. **Several actions supported by the DPL should help address issues faced by women in particular.** The labor market reforms supported by the DPL that aim to improve job creation and streamline support to the unemployed, should benefit women who have much higher unemployment rates (30 percent compared to 22.5 percent among men in 2016) and lower activity rates (32.1 percent compared to 55.1 percent among men in 2016). Indeed, low labor force participation among women has been identified in the SCD as one of the key distinguishing characteristics of the bottom 40 percent in BiH. Likewise, reduced drug prices following adoption of the Rulebook on maximum medicine prices, will benefit elderly persons, particularly single women, affected by out-of-pocket payments for medicines.

5.2 ENVIRONMENTAL ASPECTS

65. **The policies supported by the proposed DPL are not expected to have significant effect on BiH's environment, forest, and water resources.** All prior actions were screened and the team's conclusion is that they pose no significant or adverse environmental effects. Moreover, in all levels of authorities the new PIP screening criteria take into consideration environmental aspects of proposed projects, while the existing sets of environmental laws in RS (2002) and the FBiH (2003) ensure all activities with potential environmental impacts are subject to Environmental Impact Assessment, and environmental permitting that sets forth adequate mitigation and monitoring measures.

5.3. PFM, DISBURSEMENT, AND AUDITING ASPECTS

66. **BiH has made good progress in establishing modern PFM institutions and systems.** The PFM system and authorities' commitments to reform are adequate to support this operation. The reforms

²⁷ For details, see Kuddo, Robalino and Weber.2011. *Balancing Regulations to Promote Jobs: From Employment Contracts to Unemployment Benefits*. Washington, DC: World Bank.

this DPL support under its Pillar I directly contribute to policy and institutional measures to strengthen PFM practices in the areas of medium-term public investment and debt management, as well as reporting of arrears. But further progress is needed to ensure that budget discipline is uniform and consistent across the system of public resource management and to counter weak compliance with procurement law and internal controls, weak internal audit capacity, weak governance in SOEs, and widespread corruption.

67. **Comprehensive medium-term macro-fiscal strategies are lacking at all levels of authorities, despite recent efforts such as the adoption of medium-term debt strategies.** As such mid- to long-term policy planning is not based on clearly costed in overall/sectoral strategic documents and integrated in the budget planning process.²⁸ Instead, medium-term expenditure frameworks are prepared each year and adopted in early summer, serving as a pre-draft of annual budgets, which are prepared in the fall and adopted by the Parliaments by year-end. At all levels, budgets include economic and organizational classifications. As such, budgets are available in both hard copy and online. Only at the BiH-level program, budgeting information exists, including program performance measures, a part of the budget documentation that accompanies the annual budget law in the adoption procedure.²⁹

68. **Arrears are problematic not only because of their amounts, but also because comprehensive, good-quality records on arrears are not publically available yet, and treasury systems only started monitoring the payment due dates as of end 2013.** Generally, social fund management and fiscal sustainability constitutes a growing risk for the overall solidity of the PFM system. The entities differ on the interconnectedness of their single treasury accounts (STAs): extra-budgetary funds, cantons, and local self-governance units are not integrated into the FBiH Government STA and in fact not all local self-governance units in the FBiH have treasury systems, making arrears monitoring difficult. By contrast, in RS, all local self-governance units have been integrated into one STA since January 2013. This DPL directly contributes to tackling obstacles to reporting and eventual resolution of public arrears.

69. **The current Public Procurement Law was adopted in April 2014, and its implementation started in November 2014.** This legal framework was prepared in accordance with the 2004 EU Procurement Directives, as well as other legal acts in BiH. The effects of application of the new legislation remain to be evaluated in the coming period given the implementation start date. The main goal of the new legislation was to improve some of the key areas of the public procurement system in BiH as well as to tackle some of the problems of the old procurement law. Unlike with the previous legislation, the new law is expected to strengthen governance, enhance transparency, and bring procurement practices in BiH in line with those in the EU. The new law was prepared with assistance from the EU and the Organization for Economic Co-operation and Development (OECD), and is generally aligned with EU standards. As of February 2014, two new EU directives were adopted, and BiH is expected to introduce them gradually and fully in the coming years. The Procurement Strategy had been prepared, was approved by the Public Procurement Agency Board in August 2016, and is pending approval by the BiH CoM.

70. **All levels of authority have their own State Audit Institution (SAI), each with its own laws and regulations and the four SAIs are independent of the legislature and the executive.** In the FBiH, at the BiH institutions level and at the BD modified cash bases of accounting is used, whereas in the RS full

²⁸ BiH PEFA report, May 2014 available at <https://www.pefa.org/en/assessment/ba-bih-may14-pfmpr-public-en>

²⁹ BiH PEFA report, May 2014 available at <https://www.pefa.org/en/assessment/ba-bih-may14-pfmpr-public-en>

accrual basis of accounting is in force. Some of the SAIs' audits have led to court proceedings against officials, and SAI reports receive considerable public interest. All four SAIs have formally adopted the standards of the International Organization of SAIs. Several performance audits were carried out, but the application of performance audits across authorities has been uneven. Following the establishment of Committees for Audit in all three Parliaments (BD excluded, where audit reports go directly to the Parliament instead of through Committees), which are specifically dedicated to the examination and follow-up of SAI audit reports, there has been an improvement in the use of audit reports and in Parliament's recognition of the roles of SAIs. The committees seem to review SAI reports carefully, and hearings are mostly held with those budget users whose audit reports indicate most issues. However, at all levels, the follow-up on these hearings is low.

71. The CBBiH has ample safeguards to record and track proceeds of the Development Policy Operation. The latest updated safeguards assessment of the Central Bank was done in August 2014 under the IMF Stand-By Arrangement. All recommendations from this previous assessment (March 2013), including strengthening of the audit mechanism and legal functions, have since been implemented.³⁰ As a result, using the Central Bank to channel the Development Policy Operation funds to the BiH institutions, and then further to the entities, is assessed acceptable. Additionally, the Central Bank auditors Deloitte d.o.o. Sarajevo have issued an unmodified auditor's report for the year ended December 31, 2015.³¹ Ample safeguards exist in the Central Bank to record and track foreign currency funds received under the World Bank's Development Policy Operation program.

72. Disbursement arrangements. This operation is a stand-alone single tranche loan, between the borrower (BiH) and the International Bank for Reconstruction and Development (IBRD). The loan proceeds would be made available to the borrower upon the effectiveness of the Loan Agreement between IBRD and BiH. The borrower will submit a withdrawal application to IBRD within a defined drawdown period. IBRD will deposit the proceeds of the loan into a foreign currency deposit account designated by the borrower to be held at the CBBiH. This account forms part of the official foreign currency reserves of BiH, and it will be managed by and subject to control of the MOFT. The borrower shall ensure that upon the deposit of the loan into said account, an equivalent amount is credited in local currency to the two STAs, one for the FBiH and another for RS, also kept in CBBiH and that is available to finance budgeted expenditures of the relevant entities.

73. Accounts, auditing, and closing date. The BiH MOFT will be responsible for the loan accounting and administration and for preparing the withdrawal application, and maintaining the withdrawal application as required. The MOFT and the entity MoFs, with the assistance of CBBiH, will maintain records of all transactions under the loan in accordance with sound accounting practices. Given the positive IMF assessment of CBBiH, an audit of the deposit account for the proceeds of the loan is not considered necessary. The MOFT will provide the World Bank, within 30 days, a confirmation letter stating that the DPL funds have been received and deposited into the designated account assigned by the borrower that forms part of the borrower's budget management system.

5.4 MONITORING, EVALUATION, AND ACCOUNTABILITY

74. The World Bank continues to work in close cooperation with authorities in BiH to monitor and assess the implementation of the reform agenda supported by this DPL. The BiH MOFT, as well as

³⁰ October 2015, IMF Staff Report, <http://www.imf.org/external/pubs/ft/scr/2015/cr15298.pdf>.

³¹ The audit report for FY 2015 was available at the Central Bank's website. (<http://www.cbbh.ba/Content/Archive/36?lang=bs>)

RS and the FBiH MoF will be responsible for implementation of the proposed operation and for coordinating actions among other concerned ministries and agencies in their jurisdictions. The BiH MOFT will perform together with RS and the FBiH MoF the overall monitoring and evaluation of the implementation of the suggested operation. The BiH MOFT together with RS and the FBiH MoF will track the baseline and result indicators provided in the policy and results matrix (annex 1) based on the economic and legislative data provided by authorities and disclosed in the official sources.

75. **Grievance redress.** Communities and individuals who believe that they are adversely affected by specific BiH policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible BiH authorities, appropriate local/national grievance redress mechanisms, or the World Bank’s Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank’s independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank’s attention, and Bank Management has been given an opportunity to respond.³²

SUMMARY OF RISKS AND MITIGATION

76. **The overall risk to the operation is Substantial.** Complex governance structures, political tensions, and a weak track record in implementing structural reforms all pose a risk to this operation (Table 6). In addition, there are risks related to the macroeconomic outlook, stemming from the external environment (in particular, in the euro area), as well as the domestic environment (related to the realization of contingent liabilities and in particular arrears).

Table 6. Risk Ratings

| Risk Categories | Rating (H, S, M or L) ¹ |
|---|------------------------------------|
| 1. Political and governance | H |
| 2. Macroeconomic | M |
| 3. Sector strategies and policies | S |
| 4. Technical design of project or program | M |
| 5. Institutional capacity for implementation and sustainability | S |
| 6. Fiduciary | M |
| 7. Environment and social | L |
| 8. Stakeholders | M |
| Overall | S |

Note: 1/ Ratings are high (H), substantial (S), moderate (M) and low (L).

77. **Political and governance risks remain high.** Fragmentation of political structures exists in both entities. For example, recent disputes over the census results publication show the potential for political developments to slow the implementation of reforms. Sustained efforts are required to tackle

³² For information on how to submit complaints to the World Bank’s corporate GRS, please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org

governance issues, such as a weak rule of law, which could undermine, for example, the arrears clearance process. A mitigating factor is that the different levels of authorities have achieved a broad-based unprecedented level of agreement behind the Reform Agenda document and the action plan behind it. Moreover, the society at large has been supportive of the content of key reforms. Recent reforms related to labor, bankruptcies, and strengthening of the public administration are encouraging. These reforms (in essence, the key elements of the BiH Reform Agenda document) present requirements for reaching the EU candidate status. The support of the BiH reform efforts from the international community is another important mitigating factor of these risks.

78. **Substantial risks are associated with sector policies and institutional capacity.** BiH's complex and decentralized governance structure complicates coordinated preparation and implementation of development strategies and programs. These risks are managed through policy dialogue and extensive advisory and technical assistance to strengthen strategic and capacity development of the key aspects of public finances. This is imbedded in the preparation of this operation (for example, the stocktaking of arrears at the cantonal level).

ANNEX 1: POLICY AND RESULTS MATRIX

| Prior Actions | | Results |
|--|---|--|
| I: Strengthen the medium-term management of public assets and liabilities for improved transparency of public finances | | |
| 1. | The BiH Council of Ministers and the governments of FBiH and RS have each adopted BiH's 2016 through 2018 Public Investment Program. | Three-year projections of the total cost of prioritized PIP projects adopted in the respective FBiH, RS, and BiH institutions medium-term budget framework documents. Baseline: No (2015) DPL Target: Yes (2018 respective budgets) |
| 2. | The BiH Council of Ministers and the governments of FBiH and RS have each adopted a Medium Term Debt Strategy (MTDS) to present their respective three year plans for the evolution of the public debt portfolio. | Debt Information reporting against the MTDS-set debt management targets related to refinancing, interest rate, and foreign exchange risks made public annually on respective MoFs websites Baseline: No (2015) DPL Target: Yes (2017) |
| 3. | FBiH MoF has introduced reporting requirements on arrears for budget users in FBiH, designed to record all accumulated liabilities | Reporting of budget users arrears to the FBiH MoF Baseline: No (2015) DPL Target: the FBiH MoF presents to the FBiH Fiscal Coordination body an analysis of the status of the FBiH arrears as of end-2017 (2017) |
| 4. | RS Government has introduced reporting requirement on health sector arrears designed to set up regular reporting of accumulated liabilities in the health sector of RS. | Reporting of health sector arrears by RS health facilities to the RS MoF: Baseline: No (2015) DPL Target: RS Ministry of Health presents to the RS MoF an analysis of the status of the RS Health sector arrears as of end-2017 (2017) |
| II: Enhance regulatory frameworks to lower medium-term fiscal pressures related to public employment, insolvency, and pharmaceuticals. | | |
| 5. | FBiH Parliament and RS National Assembly have each adopted changes to the labor legislation to cease the validity of the current collective bargaining agreements and limit the duration to three years of new collective agreements. | Reduction in the BiH public wage bill (excluding wage arrears resolution) Baseline: 11.5 percent of GDP (2015) DPL Target: not exceeding 11.0 percent of GDP (end 2017) |
| 6. | FBiH Parliament and RS National Assembly have each adopted changes to the labor legislation to introduce a maximum level of severance payments. | Decrease in severance pay for an employee with 30 years of tenure Baseline: 10 times the average of the last three monthly salaries before termination of contract (2015) DPL Target: not to exceed 6 times the average of the last three monthly salaries before termination of contract (2017) |
| 7. | (a) RS National Assembly has adopted amendments to its insolvency legislation to align it with international best practice; and (b) the FBiH Government has approved proposed amendments to its insolvency legislation to align it with | Commencing resolution of public enterprise insolvency cases under the new legislation Baseline: zero (2015) DPL Target: at least 3 cases filed by SOEs (end 2017) |

| | | |
|----|--|--|
| | international best practice and sent the draft Insolvency law for parliamentary approval. | |
| 8. | BiH Council of Ministers has approved the updated rulebook designed to regulate maximum wholesale price of medications in BiH. | Reduction in the maximum wholesale drug price of top-20 prescription medicines by International Nonproprietary Names (INNs) as defined and published in the BiH Drug Agency Annual Report Baseline: BAM 162 million (2015) DPL Target: not exceeding BAM 146 million for the same volume as in 2015 (2017) |

ANNEX 2: LETTER OF DEVELOPMENT POLICY

BOSNA I HERCEGOVINA
MINISTARSTVO FINANCIJA/
FINANSIJA I TREZORA



БОСНА И ХЕРЦЕГОВИНА
МИНИСТАРСТВО ФИНАНСИЈА
И ТРЕЗОРА

BOSNIA AND HERZEGOVINA
MINISTRY OF FINANCE
AND TREASURY

Mr. Jim Young Kim
President
The World Bank
1818 H Street, N.W.
Washington, D.C., 20433

REF: Letter of Development Policy

Bosnia and Herzegovina for Public Finances

Dear Mr. Kim:

This is to request, on behalf of Bosnia and Herzegovina (BiH), a Public Finances Development Policy Loan (DPF) of EUR [] million equivalent to US\$ 80 million to support our public finance reform program. This letter summarizes the critical aspects of the program that the authorities are committed to undertake over the short and medium term to implement reforms for the improvement of BiH public finance transparency and the containment of fiscal pressures. To that extent we have strengthened management of public assets and liabilities, as well as are tackling structural rigidities in pensions, public employment, insolvency and pharmaceutical policy.

This program supports the objectives of the Reform Agenda -- a medium term time-bound reform plan endorsed in July 2015 by the BiH Council of Ministers (CoM) and the entity-level governments (Federation of Bosnia and Herzegovina (FBiH) and Republika Srpska (RS)).

Overall Reform Agenda

Building on the Compact for Growth work and supported by the international community we drafted in July 2015 the Reform Agenda document. The document was agreed and endorsed by the BiH Council of Ministers (CoM), Government of Republika Srpska and Government of the Federation of Bosnia and Herzegovina. Following the signing of the Reform Agenda document, the BiH CoM adopted a Strategic Framework for BiH for the period 2015-2018. Republika Srpska and the Federation of Bosnia and Herzegovina developed detailed Action Plans to implement the Reform Agenda. The Reform Agenda aims to foster economic growth, create jobs, and improve the efficiency of social assistance, while setting a path towards fiscal consolidation and preserving macroeconomic stability. The Agenda targets six areas of reform. First, *fiscal sustainability*, will be fostered through decreasing public debt while creating room for public investment and reducing the size of the public sector in the economy. Fiscal consolidation is part of the fiscal sustainability agenda, and it will be carried out by reducing public spending and increasing public revenues. Second, *business climate and competitiveness*, will be boosted through the elimination of barriers to investment, removing hidden subsidies, creating a more stable and accessible financial sector, improving bankruptcy procedures and addressing inconsistencies in the regulatory and tax framework. Third, the *labor market*, will be reformed in order to unleash the potential of the workforce. Fourth, *targeting of social assistance*, will be improved and pension systems will be put on a sustainable financial path. Fifth, the *rule of law* will be solidified through progress in fighting organized crime, terrorism, and corruption. Sixth, *public administration* will be reformed to support the fiscal sustainability agenda, while ensuring the quality of public service delivery to citizens. This blueprint of structural reforms is being implemented with the support of international partners, including by the EU and the IMF which has in September 2016 approved a three-year Extended Fund Facility for BiH.

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www.mfi.gov.ba

Macroeconomic framework

Eight years after the onset of the global financial crisis, which triggered a prolonged recession, and the adverse impact of the 2014 floods, the BiH economy is experiencing a renewed, fragile recovery. Real growth in 2015 was 3 percent, mainly driven by agriculture, manufacturing and services. Lower commodity prices, particularly for oil, continued to affect the economy through a number of channels, most notably the trade balance and the impact on domestic prices. Taken as a whole, the economic impact seems to be net positive because lower prices supported real disposable income, reduced real input costs, and reduced net imports. The growth recovery continued in 2016, likely reaching 2.8 percent by year-end. Yet, unemployment remains high (at 25.4 percent) with youth being at considerable disadvantage. Expected medium-term growth at on average 3.6 percent by 2019, supported by the Reform Agenda, should make a dent to the stagnant labor market and support the private sector-led employment growth.

The currency board operated in BiH maintained the monetary stability, but has also contributed to the moderation of fiscal policy. BiH's fiscal deficits have been moderate throughout 2008-2015 (annual average of 2 percent of GDP) while public debt amounting to 41.9 percent of GDP in 2015, but there are concerns with the quality and efficiency of spending and high tax burden that is reducing the country's potential growth. Fiscal deficit for 2016 is estimated at 0.6 percent of GDP that would lead to a decline in public debt.

The Fiscal Council adopted the Global Fiscal Framework for the medium term to underpin the preparation of the 2017 budgets. The authorities are working at ensuring sustainability of the fiscal policy also through an ongoing dialogue with the IMF team. The implementation of the necessary fiscal measures and structural reforms will be underpinned by a strong partnership which we are seeking with the World Bank and the IMF. We are targeting the maintenance of close to balanced budget with primary surplus aiming to support public debt reduction. Given the risks to our macro-fiscal framework, stemming from volatile external environment, large financing needs, and challenging internal political environment, we are working on implementing the structural reforms which will ensure adherence to the currency board with euro, support fiscal consolidation and strengthen competitiveness, and bring the country closer to a fully functioning market economy.

Program for Reforming Public Finance

Anchored in the broader Reform Agenda, our goal is to implement fiscal consolidation that will gradually reduce the budget deficit and put the public debt on a downward medium-term trajectory. While we are tackling the budget deficit issue, there are concerns with the efficiency and quality of public spending, as well as with the management of public resources and transparency. The large public sector spending at 42.6 percent of GDP in 2015, coupled with public enterprises, add to a large state footprint on the economy. Pensions, social transfers, and public wages together amount to nearly a third of GDP and are the main causes for the excessive level of recurrent spending. Social transfers are poorly targeted and embody poor incentives with respect to informality and labor force participation. Not only is public spending structurally high, but importantly the quality of and control of spending is still weak. Until recently, the size and type of public sector arrears was undocumented, which we are now addressing with the support from the World Bank.

Improved transparency of public finances

International partners of BiH, including the World Bank Group, the IMF, and the EU among others, have been instrumental in helping us advanced the broader Reform Agenda, including in the area of public finances. This also includes meaningful efforts in improving transparency of public finances and containing fiscal risks, policy areas which this DPF directly supports.

Public investment program (PIM). We aim to strengthen a system for investment selection, based on the strategic objectives and within the medium-term budget and financing frameworks. As a first step in strengthening public investment management, the BiH Ministry of Finance and Treasury, in cooperation with the entity Ministry of Finances, have developed an on-line Public Investment Management Information System (PIMIS) to provide information on all public investment project proposals and funded investment projects in a standardized format. The PIMIS provides information which can be used for project prioritization in the budget planning process, including linkages of projects with strategic development planning, and for monitoring of financial implementation, reporting, and ultimately transparency of use of public resources. Linking of the PIPs with the strategic planning and medium-term budgeting process supports the rationalization and realization of sector policies in the context of a transparent and predictable medium-term fiscal framework. We are glad to report that the BiH Council of Ministers and the entity governments of FBiH and RS each have already adopted their respective Public Investment Program for 2017-2019

in 2016. We will continue to use this instrument and adopt annually such programs with additional improvements to be made to the system in terms of scope, linkages with the planning and budgeting, as well as monitoring and evaluation of the implemented projects.

Public Debt program. While our public debt almost doubled since 2008, we did not develop a medium-term strategy at all level of authorities until 2016. We are glad to report that entity government of FBiH and the BiH Council of Ministers each adopted Medium Term Debt Strategy in 2016, while government of RS adopted it on December 2015. At the level of the Institutions of BiH, regular publication of a Debt Management Strategy is a legal obligation per the Law on Debt, Indebtedness and Guarantees of BiH from 2009, but it was only met in 2015/2016 when the first BiH medium term (three year) debt management strategy was adopted. The MTDS contain key risk indicators and their forward projection, including currency, interest rate and refinancing risks. These are important for internal planning purposes and the reduction of the cost and risk of debt, and for signaling to potential investors the strength and realism of national debt strategies and medium-term planning, especially as the country prepares itself for accessing capital markets. The process of development of strategic debt documents at the BiH Institutions and entities level has already improved the exchange of debt data and information among debt management professional as well as with market participants, it has also eased the preparation of medium-term fiscal documentation consistent among different part and levels of government and helped assess the degree of sustainability of public debt, understand the depth of the domestic capital market and develop benchmark yield curves for mid-to-long term sovereign borrowing. Most notably, the transparent and regular publication of debt auction calendars and borrowing plans have helped to build the investor in domestic debt, supporting government financing objectives. The entity Ministries of Finance has started the publication of the quarterly auctions calendar on a regular basis. We are grateful to the support received by the World Bank, including through the Debt Management Facility.

Arrears. Public sector arrears pose fiscal risks and hinder the ability of the authorities to execute fiscal affairs prudently. Therefore, better understanding and resolving the arrears issue is central to improving the execution and transparency of fiscal policy as well as the quality of medium-term budget planning in BiH. By 2016, there was absolutely no arrears reporting requirement existent at cantonal or central levels of government. In addition to collecting data on arrears at the level of central governments, it is necessary to have reporting and monitoring of arrears incurred in budgetary funds, extra-budgetary funds, autonomous agencies, subnational governments, and state-owned enterprises on a regular basis. We are glad to report that we have introduced reporting requirement on arrears for all budget users in FBiH, as well as health sector arrears in RS. The first reports were already submitted by all budget and extra-budgetary users in FBiH in March 2016 and we have also started collecting data on the health sector arrears in RS. Under our reform agenda, we envisage that the World Bank, through a DPF, will support the reorganization of our health sector, particularly, the settlement of outstanding liabilities. As agreed the World Bank will continue to provide technical assistance in order to build capacity on reporting public sector expenditure arrears in general, as well as analyze the main underlying causes behind their incurrence.

We would also like to note that the authorities in FBiH will continue to work on improving the transparency of public finance. We are currently working in FBiH on the Law on Contributions and the Amendments to the Law on Personal Income Tax, all with a view to encouraging employers, but with the neutral fiscal impact on the funds. We are therefore striving in FBiH to broaden the tax base along with proportional rate reduction. Furthermore and in addition to all of the above that is supported by this DPF program, FBiH also implemented a Register of Fees and Charges in FBiH. This Register is available on the website of the Ministry of Finance of FBiH. We would also like to highlight that the work is currently in progress on development of a register of public sector employees and that we will finalize already in early 2017 a Public Finance Management Strategy, which is currently in the final phase of preparation.

Containing fiscal pressure

Labor. The culture of collective bargaining and social dialogue is underdeveloped and often burdened by unrealistic demands of the social partners and this needs to change. The collective bargaining agreements under the previous labor codes were not necessarily time-bound. As a result, the labor markets of Bosnia and Herzegovina have been governed by the same collective bargaining agreements since 2005. With the consensus of our social partners we have adopted the amendments to the labor act in 2016 which ceased validity of the existing collective agreements and limit new collective agreements to a duration of at most three years. In addition, capping severance payments at a maximum multiple of monthly salaries will enhance efficient labor reallocation throughout the economy and help limit public expenditures on such social benefits. Although severance payments play an important tool to support workers after a job loss, it is more efficient to shift this support to risk-pooling

instruments like unemployment insurance and strong public employment services that can help workers to retrain and find new employment opportunities.

Bankruptcy. Bringing the insolvency regime in BiH to international best practice would bring the following benefits to the economy: (i) create an insolvency and debt resolution system that will assist creditors and debtors to engage effectively and on fair terms, in a bankruptcy or restructuring procedure that will allow for debt recovery, access to credit and investment, or salvaging/continuation of a viable business; (ii) help reduce the levels of NPLs through an efficient insolvency or restructuring process, or an out-of-court workouts. We expect this new insolvency regime will make BiH more attractive to investment – a key ingredient for future growth and prosperity. It will also contribute to reducing the fiscal pressures from keeping non-viable public (and private) agents afloat, through direct or hidden subsidies. In the past, bankruptcy processes would last long and usually end in liquidation, while reorganization has been rarely used. Taking into account the recommendations of the ICR ROSC for FBiH and acknowledging the importance of insolvency procedures for a successful SOE restructuring, we can report that the RS has adopted amendments to an insolvency law following good international practice in 2016, while the FBiH legislation is expected to be adopted in 2017.

Pensions. We recognize in our agenda that pensions systems also need to be put on a sustainable financial path if the accumulated rights of workers are to be met over the medium term. Current pension system in FBiH needs to be reformed to provide old age security in a fair and financially sustainable manner. The new FBiH Pension and Disability Insurance Law, is in Parliament procedure. The Law intends to establish a close link between contributions and benefits by introducing a point formula which proportionally awards length of service and contributions paid in pension benefit calculation. The new valorization and indexation pattern assures intergenerational fairness in determining new pensions and preserves real purchasing power and social security of old pensions. It also discourages early exit from the labor market by tightening early retirement rules and eligibility for disability and survivor pension. In the RS, during 2017, the government will re-examine the need for parametric reforms of the pension system. Both entities will intensify the work on implementing voluntary-pensions schemes.

We would also like to highlight that the RS incorporated the Pension and Disability Insurance (PDI) Fund in 2016 in the Treasury Operations System, and that FBiH also intends to do the same. Our expectations are that as a result of this we would ultimately have as a final outcome the stability in payout of pensions before all other benefits.

Pharmaceuticals. Pharmaceutical wholesale prices in BiH are 20 percent higher on average than in comparator neighboring countries due to fragmented purchasing and inadequate regulation of the market. In 2011, the Council of Ministers adopted a Rulebook to regulate maximum wholesale prices of pharmaceuticals, but it was not implemented for minor technical reasons. As a result, BiH is the only country in the region not regulating maximum pharmaceutical prices. The adoption of a revised pharmaceutical Rulebook in November 2016 will result in up to EUR 35 million in savings, of which about EUR 26 million will be fiscal savings for the entity health insurance funds, and the remainder for households. We further aim to pursue complementary reforms that will reduce costs and improve availability of medicines, including increased use of pooled and competitive procurement; revised health insurance reimbursement policies; revising retail margins to incentivize dispensing of lower-cost drugs; and introducing innovative purchasing arrangements for high-cost medicines, and strengthening evidence-based criteria to decide which high-cost medicines should be reimbursed by social health insurance.

In closing, we kindly seek your endorsement of this Development Policy Loan and hope that the World Bank will extend its support for the BiH Reform Agenda in the future.

**ANNEX
3: FUND
RELATIO
NS**

Press
Release
No.
16/522
Novembe
r 22, 2016

An
Internatio
nal
Monetary
Fund
(IMF)
mission,
led by
Nadeem
Ilahi,
visited
Bosnia
and
Herzegov
na (BiH)
during
Novembe
r 9-22,
2016 to
conduct
discussio
ns on the
first
review of
BiH's
Extended
Fund
Facility



Sincerely,

Vjekoslav Bevanda
Vjekoslav Bevanda

BiH Minister of Finance and Treasury

06-21-1-10485-11/17

9.2.2017.



Jelka Miličević
Jelka Miličević

Federation BiH Minister of Finance

BR03 08-14-5-8803/16

DATUM: 07.02.2017.



Zoran Tegeltija
Zoran Tegeltija

Republika Srpska Minister of Finance

06.08/322-864-3/16

7.2.2017.

(EFF). At the conclusion of the visit, Mr. Ilahi made the following statement:

“Bosnia and Herzegovina’s economic program remains on track. IMF staff and the BiH authorities have reached agreement, subject to approval by the IMF Executive Board on the policies needed to complete the first

review
under the
EFF.
Considera
tion by
the Board
would
follow
the
impleme
ntation of
a number
of
measures

“The
economy
continues
to
recover.
Growth is
expected
to
accelerat
e to
above 3
percent
in 2017,
following
estimated
growth of
2.6
percent
in 2016.
The
consumer
price
index is

expected to drop by almost 1 percent this year, but inflation is expected to turn positive in 2017 reflecting the Euro area inflation forecast imported though the currency board arrangement. The unemployment rate remains unacceptably high, especially among the youth. While the banking system is liquid and adequately

capitalized at the aggregate level, vulnerabilities remain.

“Improving the business environment to attract investment, create private sector jobs, and raise the growth potential is of paramount importance. The authorities are in the process of improving the functioning of the labor market by

shifting
the tax
burden
away
from
labor and
by
continuin
g to
impleme
nt new
labor
legislatio
n.

Restructu
ring and
privatizati
on of
state
owned
enterpris
es will
help
improve
economic
governan
ce and
competiti
on.

Raising
excise
taxes on
fuel will
generate
resources
to
construct
highway
Corridor

Vc, which will improve connectivity, competitiveness, and thus raise growth.

“Fiscal performance in the third quarter of 2016 was broadly in line with program targets. The authorities have prepared 2017 budgets that are consistent with improving the quality of public spending and reducing the public

debt to GDP ratio over the medium term. It will be critical to continue to strengthen tax administration and to strictly limit expenditures to meet program targets. We support the authorities' efforts to harmonize tax laws to lower the administrative burden on businesses.

“Financial stability

has been maintained. International reserves held by the Central Bank of Bosnia and Herzegovina provide strong backing to the currency board arrangement. Credit growth is recovering but remains low, affected by high-non performing loans and subdued credit demand. Banking sector

agencies have taken actions to address vulnerabilities in banks and strengthen cooperation among them. The mission welcomes the authorities' plans to enact new banking legislation at the entity and BIH levels that is in line with international best practice. The Executive Board of the IMF is expected to discuss

the first review in the first quarter of 2017. Approval of the review would enable the disbursement of SDR 63.4125 million (about €80 million). Bosnia and Herzegovina's 36-month EFF arrangement was approved on September 7, 2016

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS

1. **As required by the World Bank's OP 8.60, the team has carried out an assessment of the expected impact of this operation on the environment, on forests, and natural resources and analyzed the broader context of environmental policy making in BiH.** Specific policies supported by the operation are not likely to have significant effects on the environment and natural resources in BiH. The measures contemplated under the loan are primarily geared toward supporting the policy and institutional reform efforts of BiH authorities to improve transparency of public finances and lower fiscal pressures over the medium term. Currently, none of the sectors included in the operation are expected to have any direct significant links to the environment. The legislation in place and functioning at the entity level will provide adequate identification, mitigation, and monitoring and evaluation of environmental impacts, if any.

2. The environmental legislation in BiH, as delineated in the Constitution of BiH (Dayton Peace Accord) is enforced at the entity levels and BD and is predominantly aligned with the EU acquis, although enforcement and full implementation still need strengthening. The key laws on topics as related to this operation include Environmental Impact Assessment, waste management, air quality protection and protection of nature, as well as international treaties. Environmental oversight in BiH is delegated to the Ministry of Spatial Planning, Civil Engineering, and Ecology of RS, Ministry of Environment and Tourism in the FBiH, and the relevant cantonal ministries within the FBiH. The coordination role and all participation and representation that needs to be done for the whole of BiH is carried out by the responsible departments within the Ministry of Foreign Trade and Economic Relations of BiH. All entity and district laws have been in place since 2003 (2002 in RS), and the ministries are most experienced with environmental permit procedures. In addition, there is an overall need for capacity development, particularly in the light of the very limited numbers of environmental inspectors and officials who can supervise the stipulations of the regulatory framework.

3. **While the direct poverty and social impact of fiscal management reforms supported by the DPL is difficult to estimate, the reforms supported by the operation are expected to be beneficial to poverty reduction and shared prosperity over the medium term, as discussed in section 5.1.** Table 4.1 summarizes the assessment.

Table 4.1 Summary of Environment and Poverty and Social Analysis

| Prior Actions | Significant Positive or Negative Environment Effects (yes/no/to be determined) | Significant Poverty, Social, or Distributional Effects Positive or Negative (yes/no/to be determined) |
|--|--|---|
| I: Strengthen the medium-term management of public assets and liabilities for improved transparency of public finances | | |
| 1. The BiH Council of Ministers and the governments of FBiH and RS have each adopted BiH's 2016 through 2018 Public Investment Program. | There are neither positive nor negative environmental impacts associated with this action, or anticipated, at this stage. Proposed investments that may have environmental impacts (not known at this stage) would be adequately addressed through the RS and the FBiH laws on environmental protection and environmental permitting procedures. | No |
| 2. The BiH Council of Ministers and the governments of FBiH and RS have each adopted a Medium Term Debt Strategy (MTDS) to present their respective three year plans for the evolution of the public debt portfolio. | No | No |
| 3. FBiH MoF has introduced reporting requirements on arrears for budget users in FBiH, designed to record all accumulated liabilities | No | No |
| 4. RS Government has introduced reporting requirement on health sector arrears designed to set up regular reporting of accumulated liabilities in the health sector of RS. | No | No |
| II: Enhance regulatory frameworks to lower medium-term fiscal pressures related to public employment, insolvency, and pharmaceuticals | | |
| 5. FBiH Parliament and RS National Assembly have each adopted changes to the labor legislation to cease the validity of the current collective bargaining agreements and limit the duration to three years of new collective agreements. | No | No |
| 6. FBiH Parliament and RS National Assembly have each adopted changes to the labor legislation to introduce a maximum level of severance payments. | No | No |

| | | | |
|----|---|----|----------|
| 7. | (a) RS National Assembly has adopted amendments to its insolvency legislation to align it with international best practice; and (b) the FBiH Government has approved proposed amendments to its insolvency legislation to align it with international best practice and sent the draft Insolvency law for parliamentary approval. | No | No |
| 8. | BiH Council of Ministers has approved the updated rulebook designed to regulate maximum wholesale price of medications in BiH. | No | Positive |

BOSNIA AND HERZEGOVINA

- | | | | |
|---|------------------|-------|-----------------------------|
| ◻ | SELECTED TOWNS | — | MAIN ROADS |
| ⊙ | NATIONAL CAPITAL | — | RAILROADS |
| — | MAIN RIVERS | ⋯ | INTER-ENTITY BOUNDARY LINES |
| | | - - - | INTERNATIONAL BOUNDARIES |

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