

# OFFICIAL DOCUMENTS

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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.

## 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.



Ministry,  
Vjekoslav Bevanda

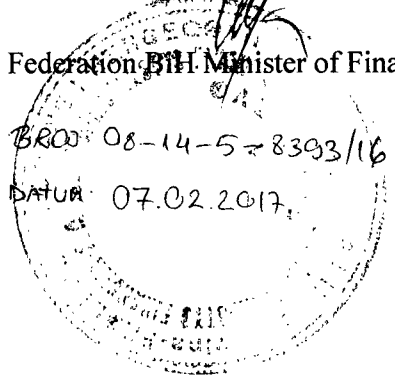
BiH Minister of Finance and Treasury

06-41-1-10485-11/17  
9.2.2017.

Jelka Miličević

Federation BiH Minister of Finance

BROJ: 08-14-578393/16  
DATUM: 07.02.2017.



Zoran Tegeltija

Republika Srpska Minister of Finance

06.08/322-864-3/16  
7.2.2017.

