



SIGMA

Support for Improvement in Governance and Management

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BOSNIA AND HERZEGOVINA

PUBLIC EXPENDITURE MANAGEMENT SYSTEM

ASSESSMENT MAY 2009

Summary

Main Developments since last year

The main developments in public expenditure management that have emerged in the period since the last assessment are as follows:

- There has been no change in the distribution of public service activity since the last assessment that would significantly affect the overall shares of public expenditure among the different levels of government.
- The most significant institutional change has been the establishment by law of the Fiscal Council. The main responsibility of the Fiscal Council is to co-ordinate fiscal policy. The Council, which was previously informal, appears to be developing into a substantive decision-making body. It has met five times since its establishment in October 2008. A further important development in 2008 has been that the Indirect Tax Authority (ITA) Governing Board has decided that final consumption is to be used as the basic economic criterion for the allocation of indirect taxes between entities.
- Efforts have been made to strengthen the capacity of the Ministries of Finance regarding public expenditure management in the following areas: improvements in budgeting and in particular the development of medium-term budgeting, the better integration of investment and current budgets, and some progress in the development of programme budgeting. The main benefits have been at state, Republika Srpska and cantonal levels. Less progress has been made at the Federation level. The project on strengthening public expenditure management (SPEM) was completed in the spring of 2008.

Main Characteristics (strengths and weaknesses)

One of the main characteristics of public expenditure management in Bosnia and Herzegovina has been the lack of co-ordination between the different levels of government. This applies not only to the budget-setting process (e.g. agreement on appropriate fiscal parameters) but also to the budget execution level (e.g. a lack of co-ordination in the development of treasury systems). However, the successful operation of the Indirect Tax Authority and the recent formal establishment of the Fiscal Council, coupled with the need to address a particularly serious financial situation in the Federation, could lead to better co-ordination in the future. If it does not, then the present difficulties, which could be exacerbated by the global economic downturn, will be more difficult to rectify.

Another characteristic of public sector management is the lack of delegation by ministers and other heads of budget organisations. The minister or head of the budget organisation is responsible for all decisions, even for those that appear to be the least important. For example, in the Federation the investment of overnight cash is the responsibility of the minister, whereas if clear strategies were developed (e.g. for the long-term management of cash), such decisions could well be taken by senior officials within a well defined strategic framework. This involvement in detail detracts attention from overall strategy issues and discourages the development of operational strategies within which officials can work.

Budget adjustment is a feature of public expenditure management in both the Federation and the Republika Srpska. This adjustment may occur because revenues are larger than expected or because of a revenue shortfall, or because expenditure rises above forecasts.

Although work is proceeding on the development of medium-term expenditure frameworks (MTEF), at this stage in their development they are not linked to the annual budgetary process.

Each level (state and entities) has a strong treasury system, and they all use the same software and basic approach, although they are “growing apart” as each level makes modifications to its system. These systems ensure that expenditure is managed against cash flow and that expenditure is also contained within budgetary limits. (However, the efficacy of this expenditure management is weakened because of the budget “adjustment” that occurs at entity levels.)

No evidence was found of the long-term financial stability of extra-budgetary funds or of the overall financial position of public enterprises or municipal enterprises; statistical publications such as Economic Trends, published by the State Department for Economic Research, do not refer to these activities.

Recommendations for Reform

- Most importantly, the emphasis should be on improving fiscal co-ordination. The Fiscal Council is key to this co-ordination. The Council should be supported in its role of establishing the fiscal parameters to be adopted at state and entity levels. It should also seek the harmonisation of budgeting and statistical methodologies and the establishment of a medium-term fiscal framework into which annual budgetary policies can fit. (In the Federation, where a similar council has been established to manage the fiscal consequences of the distribution of responsibilities between the Federation and cantons, the effective operation of its own Fiscal Council would be a positive development. In view of the problematic state of the Federation's finances, the success of this Federation Fiscal Council is highly important.)
- Enhanced co-operation to improve the technical operation of the treasury systems would provide important benefits.
- Extra-budgetary funds should be reviewed in order to establish their long-term solvency.
- Given the rising cost of transfer payments in the Federation and the Republika Srpska, special attention should be given to ensuring that those transfer payments are managed in the most efficient and effective way and that error and fraud are thereby minimised insofar as possible.
- The financial position of public enterprises and municipal enterprises should also be reviewed in order to establish their true financial position.
- In the planning and implementation of future reforms, it would be highly desirable to first of all focus efforts on strengthening the basic features of budget preparation and execution (including the introduction of financial impact analysis and the overall analysis of budget requests) and to then gradually move further to more sophisticated developments, taking into account the limited administrative capacity and general lack of technically qualified staff. The sequencing of various development activities in public finance should be thoroughly assessed and planned.

Donor funds should be focused on those activities and reforms that could apply to state and entity levels and not just to one entity. This overall approach would be particularly appropriate where IT developments are proposed, which should facilitate the exchange of data, and a common approach is more efficient from a value-for-money point of view. Therefore, creating proper overall co-ordination mechanisms and agreeing on regulations for managing foreign funds are crucial preconditions for managing foreign funds in a sustainable manner.

1. Overall Fiscal Situation

Bosnia and Herzegovina signed the Stabilisation and Association Agreement (SAA) with the EU in June 2008. The Central European Free Trade Agreement had been signed in 2007. These agreements have had some adverse effects on the revenues from customs and excise duties, with the most recent impact being an actual fall in customs revenue in 2008. The impact of this fall in revenue has been almost wholly on the Federation and Republika Srpska, with the state being relatively untouched, which is due to the funding distribution formula that provides a fixed cash sum to the state, with the two entities sharing the residual. This reduction in growth has had an adverse effect on forecast government revenue for the early months of 2009, and the situation in the Federation has been particularly serious.

These relative declines in customs and excise revenues have been offset by the continued growth in VAT revenue, which remained buoyant in 2008. However, the commentary in the full-year edition of *Economic Trends* (published by the State Department for Economic Research) suggests that, since a large proportion of VAT revenue is ultimately derived from international trade, Bosnia and Herzegovina may suffer in the future from the indirect consequences of the global economic crisis. The impact of any VAT declines fall most seriously on the state, as indirect tax is its main source of income. The entities also have direct taxes as a further source of revenue, and if necessary these taxes could be used as an additional source of funds. A further factor affecting economic activity is an expected downturn in remittances from abroad as the economic downturn affects the incomes of expatriates from Bosnia and Herzegovina.

The Federation in particular is in a very serious financial situation. At the time of preparing this report, staff in the public administration had not been paid for two months, and utility as well as other creditors had also not been paid. The Federation's financial crisis has its roots in legislation passed in previous years, which allowed for a significant expansion of transfer payments (increases have also occurred in Republika Srpska). However, the depth of the crisis in the Federation has led to co-ordinated action through the Fiscal Council to try to resolve these financial difficulties, with the view being taken that all three components of BiH would have to bear some of the strain. Funds are being sought from several sources, including borrowing from the IMF and from commercial banks as well as utilising resources of the former Federal Republic of Yugoslavia held in the Bosnian Central Bank.

Although in the Federation salary payments have been withheld, in the Federation and particularly in Republika Srpska in 2008 there have been significant increases in the salaries paid to public officials. Overall there was accelerated wage growth in 2008, with an increase of 16.6% compared to 2007. The largest contribution to that wage growth is attributed to the public sector and to the electric power supply sector (18% year on year). Wage increases in the public sector have changed significantly the ratio between public and private sector wages, especially in Republika Srpska, reversing the trend of the previous year. The net public sector wage in 2008 was 41% higher than the private sector wage. In Republika Srpska, average health care sector wages increased by 81%, education sector wages by 70%, and public administration wages by 15%. Overall, net wages in the entire public sector of Republika Srpska grew at the average rate of 55% year on year in 2008. In the private sector they grew at a rate of 11% year on year. In FBiH, health care, education and public administration also noted significant wage increases, but at a lower growth rate (around 18%), while the electric power supply sector increased the net employee income by 21%.

Overall, given the scale and rising costs of transfer payments, it is particularly important to ensure that those transfer payments are well targeted, that errors in administrative arrangements are minimised, and that fraud – an increasing problem in the transfer payment systems of most countries – is specifically addressed, with every effort being made to eliminate it.

The latest overall financial picture of the state of public finances in Bosnia and Herzegovina was provided in the IMF survey published in September 2008, which showed the following situation in percentages of GDP:

	2004	2005	2006	2007 Estimated	2008 Projections	2009 Projections
General government budget						
Revenue	44.2	45.5	47.5	48.7	47.9	47.3
Expenditure (commitment basis)	44.7	44.7	45.3	48.7	49.7	49.8
Overall balance	-0.5	0.8	2.2	-0.1	-1.9	-2.5

Source: IMF Report (September 2008), Table 1, page 31

The above table shows the overall deteriorating state of public finances in Bosnia and Herzegovina. Given the decline in revenue and the extremely difficult financial situation in the Federation, actual results for 2009 could turn out to be worse than those forecast here.

The most serious problem from a public expenditure management point of view is the financial weakness of the Federation and the overall potentially deteriorating flow of indirect taxation income, which would affect the state as well as the entities. At the present time there is a financial crisis that appears to be having adverse effects on the Federation in particular – on its staff and on the suppliers on which it depends. The scale and rising cost of transfer payments is also a debilitating factor and in the Federation these transfer payments are being given priority for payment. Every effort should be made to ensure an improvement in the quality of public expenditure, not least by specifically targeting fraud and error in transfer payments, as focusing only on the volume of expenditure is not enough.

2. Legal Framework

The State of Bosnia and Herzegovina and both entities – the Federation of Bosnia and Herzegovina and the Republika Srpska – each has its respective legislation regulating financial management in place. In addition, a number of aspects are covered in the annual Budget Execution Law, although sometimes there are periodic amendments to that annual Budget Execution Law during the financial year. The Law on Financing the Institutions of Bosnia and Herzegovina, adopted on 2 December 2004, regulates the preparation, enactment, execution, accounting, reporting and supervision of the budget, the Treasury Single Account, and the investment of public monies at state level. In Republika Srpska the Law on the Budget System, adopted in October 2003 and developed with assistance provided by DFID, lays down the regulations for preparation, planning, development, adoption and execution of the budget, as well as budget accounting, control and audit. The Law on Budgets of April 2006 regulates the planning, development, enactment and execution as well as debt management, accounting, reporting, supervision and revision of the budget in the Federation.

In both entities the laws provide regulations for all layers of the government, including municipalities, as well as for extra-budgetary funds. Despite this fact, the legal framework (regulating public expenditure management) in its substance differs substantially between the state and both entities. Among other issues, this means that currently each of the three governments has a different budget calendar and uses different budget preparation, accounting and reporting methodologies (different charts of accounts are also used).

The use of different methodologies has the effect, among others, of making the overall government financial statistics unreliable and making any comparison difficult as well as hindering the development of co-ordinated fiscal policies. However, the establishment of the Fiscal Council should allow for the co-ordination of a number of important elements, including harmonising budget calendars; establishing a comprehensive, timely and transparent reporting of budget and execution data; and requiring the state and entities to provide data on a uniform and consistent basis. The Indirect Tax Authority (ITA) is already collecting data on a consistent basis, but while harmonisation

of budget calendars and related information can be achieved relatively quickly, the likelihood is that broader statistical harmonisation will be a longer-term process.

The Law on the Fiscal Council was approved in August 2008. The Fiscal Council (FC) started to function in October 2008. The FC established by this new law is different from previous similar vehicles because it has the backing of the law and is therefore not an informal arrangement, as was the case previously. Membership of the FC consists of the three prime ministers and the three ministers of finance, with observers from the Central Bank and the District of Brcko. The Council is supported by an advisory group comprised of the Secretary to the Council of Ministers and experts from the ministries of finance and the District of Brcko.

The basic responsibility of the FC is the co-ordination of fiscal policy. In terms of procedures, the FC has adopted a policy document setting out the fiscal framework for the next three years, i.e. 2009-12. There are three main elements to this framework, namely fiscal objectives, macroeconomic analysis and policy on indirect taxes, and upper limits of debt. The policy document has been signed as an agreement between the parties. Based on these rules, the annual budget and a three year MTEF will be prepared for each constituent entity. Arrangements have been incorporated into the legislation to prevent any "blocking action" by one party to the agreement.

However, the FC has not been able to influence the 2009 budgets because it started its work too late. At the time of this assessment, the FC had had five meetings. The fiscal problems now facing the Federation were discussed in the FC. The view was that these problems were not limited to the Federation. Republika Srpska has also been affected to a degree (because of the loss of revenues) and these difficulties had to be dealt with collectively.

In terms of budget execution, each level of government has laws that govern the operation of treasury systems. These systems have underlying similarities, but in operational terms they are moving apart. These differences do not help to ensure the most efficient and effective use of resources for improving the management and development of those systems, so that they are able to meet new circumstances and respond to additional demands (see also section 3 below).

In the past there has been a considerable lack of co-ordination in the area of public expenditure management. Greater co-ordination is needed (both formal and informal) in all aspects of public financial management and execution (as well as in public internal financial control). The existence of the Fiscal Council creates the opportunity to bring new discipline to a weak budgetary formulation process through the strengthening of fiscal co-ordination and related activities. The establishment of an effective fiscal council at Federation level would be of great assistance as well, especially at the present time of fiscal stress. The fact that the FC takes the view that the current fiscal problems have to be dealt with collectively seems to reflect a considerable improvement in co-operation, but at the time of this assessment no decisions had been made about the actions to be taken and by whom. Increased co-ordination in terms of budget formulation ought to encourage greater co-ordination in other areas, where there could be considerable benefits.

3. Institutional Framework

3.1 Budget Planning – Adjustment

In both the Federation of Bosnia and Herzegovina and Republika Srpska, the Law on the Budget System requires budget resources and budget expenditures to be balanced. An additional requirement is that in the event of a decrease or increase in budget revenues or expenditures during a fiscal year, the balancing of the budget is to be conducted through a budget adjustment, applying the procedure of budget adoption. Budget laws tend to be passed at the end of the previous fiscal year or even in the first quarter of the actual year to which the budget applies. Also, delays in the adoption by governments of their draft budgets shorten the amount of time during which the draft budgets can be considered by parliament. This has a significant impact, as the Ministries of Finance are reluctant to distribute the Budget Instructions with final ceilings until these have been approved by the respective

government. The later the drafts are adopted, the later the Budget Instructions are distributed and the less time parliaments have to scrutinise the draft budgets. This lateness of timing, whatever the factors causing it, together with the adjustment process, makes the careful planning of expenditure and its management, other than at the cash control level, very difficult.

Budget adjustment seems to have been a regular feature of public expenditure management in 2008 and early 2009 in the Federation and in Republika Srpska. BiH State has not found this adjustment to be necessary, which is partly due to the different structures of expenditure within the state compared with those structures in the entities, with the state not having the same degree of responsibility for transfer payments.

In the Federation the government's budget has increased considerably in the past three years (the budget adjustment for 2008 was 11% as compared to the 2007 budget). This budget increase resulted from increased indirect tax revenues, which were mainly used for transfers between social categories, debt servicing (increased by 44.5%, largely to settle internal debt), and employee costs (increased by around 22% as compared to 2007). The FBiH Government faced difficulties in 2008 with budget liquidity due to unrealistic revenue planning (including the planned 2007 surplus transfer of around 150 million BAM – 78 million EUR, which did not actually occur) and an increase in the number of persons entitled to receive assistance from the FBiH Government's budget.

In Republika Srpska in 2008 the government conducted a budget adjustment (third in the last three years), increasing the budget by 75 million BAM (39 million EUR), as compared to the initially adopted amount. Revenue from indirect taxes increased by 44 million BAM (22 million EUR) or 4%, income tax revenues increased by 28 million BAM (14 million EUR) or 23%. Debt repayment was reduced by 18 million BAM (9 million EUR) or 45%, and planned credits were reduced by 11 million BAM (5.5 million EUR) or 46%, compared to the initially adopted budget for 2008. On the expenditure side, the adjustment increased wages and other compensation by 94 million BAM (49 million EUR), material costs were reduced by 8 million BAM (4 million EUR), individuals' transfers increased by 29 million BAM (15 million EUR), enterprise subsidies increased by 24 million BAM (12 million EUR), while other expenditures were reduced.

This demonstrates that adjustments occur for a variety of reasons. One reason is to absorb increased revenues, which would suggest that expenditure may not be as well planned as it should be, because spending decisions then become ad hoc rather than planned, with an implicit policy aim being to ensure that available resources are spent. A second is that unrealistic revenue planning leads to overoptimistic expenditure assumptions, a risk that may be accentuated if revenues from indirect taxes become less buoyant. A third is that because of a lack of analytical budget resources or an inability of a ministry of finance to secure parliamentary recognition of the costs of expenditure proposals or the cost of legislation, expenditure forecasts can be out of line with the reality of actual costs.

The way in which budget adjustment occurs suggests that weaknesses exist within the budget-making processes. For example, constraints on administrative capacity may make it difficult to evaluate new legislation and amendments and to carry out essential budget analysis of expenditure proposals so as to ensure a rational allocation of resources.

3.2 Other Budgetary Preparation Issues

Federation BiH

In the Federation there are two key budget sections, one responsible for budget preparation and the other for budget execution (the Treasury). There appears to be a particular problem in developing the capacity of the Federation's Ministry of Finance. Analytical capacity is limited (see the section above on "adjustment"), and ministry staff are unable to meet the needs of the 62 budget organisations in the Federation. In addition, there seem to be some morale problems, which may be partly associated with difficulties that the ministry has had in persuading the government and parliament of the poor state of the Federation's finances and partly because of difficulties in hiring appropriately qualified staff. The civil service personnel appointment policy has apparently also resulted in a significant mismatch between the skills required and those of appointees. Whatever the reasons for the weaknesses of

personnel policies, the problems arising from them do need to be addressed, which may mean reviewing the process and obtaining information from senior officials about the suitability of the appointments that have been made.

Another problem concerns the relationships between the Federation and cantons and municipalities, which are financed according to a formula – the criteria for allocation of resources are the same each year, but certain variables differ from year to year. The main and very basic problems regarding budget planning are the unreliability of the revenue prognosis and the uncertainty of the allocation of revenues to the entity as well as the problematic relations between the Federation and the cantons, as evidenced by the apparent difficulty in establishing the effectiveness of the Federation Fiscal Council. Unstable budget arrangements are likely to accentuate these problems.

The Federal Ministry of Finance (along with the other ministries of finance) is preparing a Medium-Term Expenditure Framework (MTEF) with assistance from the World Bank and DFID. The MTEF, which includes both the federal and cantonal budgets, aims to introduce fiscal sustainability and to reduce the overall very high levels of public expenditure. However, given the serious difficulties that the Federation is facing at present and the very limited staff capabilities, the preparation of an MTEF that would link with the annual budgetary process and create a policy framework for the annual budget will be difficult to achieve.

Republika Srpska

In Republika Srpska information was difficult to obtain. As far as can be established, no changes have occurred in legislation that would affect the budget planning and execution arrangements.

The Ministry of Finance of Republika Srpska (RS MoF) is organised for budgetary purposes in two sectors: the Budget Planning Sector, responsible for budget preparation, and the Treasury Sector. A third sector has recently been established to deal with accounting and audit issues concerning the private sector and, as it also has responsibility for public sector accounting policies, its role is likely to impact on the Treasury. RS MoF also suffers from a lack of technical capacity (for example the new accounting and audit department has a staff of only five compared with an establishment of 12), although staff have benefited from increases in salary along with other public officials. The Budget Planning Sector is composed of four departments – planning, macroeconomics, budget inspection and a department dealing with the budgets of cities and municipalities. No IT systems support budget preparation.

BiH State

At BiH State level, the Ministry of Finance and Treasury (MFT) has responsibility for the public finance system.

A department of foreign assistance in the MFT is responsible for managing all foreign funding except EU's Instrument for Pre-Accession Assistance (IPA). The MFT is currently also making efforts to set up a database on foreign assistance.

In the budget sector of the MFT a new unit for budget analysis has been established. The initial plan is to recruit an analyst for every five or six budget beneficiaries. The budget sector currently has 12 staff and in three years' time the plan is to increase the number of staff by 15 (i.e. a total of 27 staff in the sector). Although there are plans to increase the number of personnel in the budget sector, there is currently no capacity to evaluate the impacts of new pieces of legislation or amendment proposals. With respect to direct budget preparation activities, no IT system is currently in place to support the budget preparation process.

A fully integrated macroeconomic forecasting capacity does not really exist at the moment at the state level. This function is performed outside the MFT, and for the revenue side only, by the macroeconomic unit of the Indirect Taxation Authority.

For the first time, as part of the preparation process of the 2008 budget, BiH State was able to carry out a multi-year review of capital investments, which has continued for 2009. Further reform in the public finance area includes the development of programme budgeting.

Emphasis has been placed on developing an overall approach to the establishment of a Medium-Term Expenditure Framework (MTEF), with similar methodologies applied across the state and entities. The MTEF has been developed at state and entity levels with the support of a long-term technical assistance project. At the moment, this process is still not sufficiently connected to the normal annual budget preparation procedure.

All BiH components (state and entities)

The DFID-sponsored project “supporting public expenditure management” (SPEM) was completed in the spring of 2008. This project was concerned with a number of improvements to budgetary processes at state and entity levels and in the cantons. In particular, it was concerned with improving the consistency between government policy objectives, expenditure allocation and budget execution through the strengthening of budget processes. In particular, the project assisted the ministries of finance in implementing a medium-term budgeting planning framework designed to improve consistency of the governments’ overall policy objectives and expenditure with the governments’ economic policies and fiscal strategies. Although public investment programmes are still prepared separately from the main budget preparation process, the project resulted in progress towards better integration of capital and budget planning, with the agreement to transfer of Programme Investment Planning (PIP) functions to the respective ministries of finance from other parts of the governments. In addition, this project has encouraged the governments at state and entity levels to develop programme budgeting. A new project (SPEMIII) will extend support in this area to 2011.

Although the improvements achieved under the SPEM project are important, given the very considerable capacity shortages that exist and the current difficulties requiring regular budgetary adjustment, some of the more advanced features of the project, such as programme budgeting, may be of questionable value at this point in time.

Generally, little delegation from ministers and heads of budget organisations seems to occur. This lack of delegation is undesirable from many points of view and not least because it diverts ministerial attention towards details and away from key issues and it reduces the morale of staff.

While some efforts have been made to increase administrative capacity and in particular analytical capacity in ministries of finance, there still appears to be inadequate staffing as there are numerous vacant posts or (especially in the Federation) the staff appointed do not have the necessary skills or technical knowledge. In view of the current financial crisis it will be difficult to improve that capacity in the near future. Therefore, better utilisation of existing resources is essential and may involve rethinking the roles of ministers and other budget organisation heads.

Whatever the reason for the inability of governments to build expert capacity, a review should be made of personnel policies to ensure that appropriate staff are appointed and that staff motivation is enhanced. These problems exist at a time when more sophisticated and complex tasks have to be completed, such as the development of the Medium-Term Expenditure Framework (MTEF) and programme budgeting. The development of the role of the Fiscal Council will add an impetus to these demands. This may mean that priority will need to be given to some developments at the expense of deferring others. For example, it is not clear how the introduction of programme budgeting will improve public expenditure management when it is so difficult to ensure the preparation of stable, traditional budgets and when the capability to perform budget analysis and assess the financial impacts of planned activities is very limited.

3.3 Budget Execution

Budget execution and accounting are the responsibility of the Treasury at state and entity levels. Increasingly each Treasury is seeking to improve the operation of its treasury systems, and detailed reference to these reforms has been made in Sigmas’ PIFC assessment update. These reforms include extending the treasury system to most institutions in the public sector. An important improvement at all levels of government would be to link the budget system with the treasury system, although some

work has been done in this regard in the Federation. Such a link would not only be more efficient but would also reduce the risk of error.

Cash management and forecasting are the responsibility of each Treasury, at state level and in both entities. In preparing cash flow forecasts the Treasury may consult with budget organisations, but in BiH State and in the entities the forecasts are essentially those of the Treasury. The cash flow forecasts take into account monthly forecasts of expenditure and quarterly forecasts of income. The effect of those forecasts is to provide a limit on the amount that may be spent in the month. In the Federation those limits are based on aggregated expenditures (i.e. not line-by-line), and the calculations relate to types of transactions (such as fuel or salaries), not to the expenditures of budget-users. Thus there are about 30 lines for which cash flow calculations are made.

In the Federation, bank reconciliations are made daily and bank accounts holding cash are cleared daily. In Republika Srpska, again daily bank reconciliations are made and cash funds are managed on a daily basis. The Treasury in both entities calculates expenditure profiles, and those profiles take into account quarterly expectations of revenue and monthly expenditure forecast cash flows. These are then allocated to budget-users as monthly expenditure profiles. The system would stop a payment in excess of the budget profile for that month and therefore on an annual basis should ensure that the annual budget was not exceeded. Profiles are prepared for each budget line (i.e. in Republika Srpska about 2000-3000 budget lines in total are controlled by the system and in the Federation many fewer because of the way in which control is exercised.)

At state level, the treasury system works in much the same way as in the two entities, and in BiH State a development of the system has been to introduce a stocks module and a fixed assets module, at the request of the Ministry of Defence. This development could have value elsewhere in Bosnia and Herzegovina.

Each Treasury provides regular reports to budget organisations on expenditures to date.

Given the way in which the treasury system works at state level and in each entity, the annual budgets are in effect executed on a monthly basis and the budget laws specify the priorities for payment in the event that cash resources are insufficient to meet all requirements. Those priorities reflect the political policies of the government. For example, in the Federation, where high priority is given to transferring payments to certain categories, the priority list reflects this, i.e. for 2009 these priorities are listed as follows:

1. Payment of foreign debt;
2. Transfers for the disabled and war veterans;
3. Agriculture;
4. Transfers for displaced persons and refugees;
5. Salaries for employees;
6. Transfers to lower levels of government, enterprises and capital investment;
7. Other business, which itself is also prioritised.

The scope for co-operative development, and eventual harmonisation, of the different treasury systems is substantial and should be considered.

3.4 Accounting System

The state and the entities use a form of commitment accounting; it is described as modified accrual accounting, but in practice it would be more appropriate to describe it as a form of modified cash accounting. There is no reference in the law to the development of accounting policies to accompany the accounting standards, and such policies would be an essential feature of even modified accrual accounting. Thus, for example, accounting policies would be required to define asset lives and depreciation schedules, to record and value assets, and to value future liabilities, such as those relating to pensions and contingent liabilities.

The way in which commitments are recorded is to be commended. All MoFs considered that they were already using accrual-based accounting because of the introduction of commitments into the treasury system. To go further and to adopt a full accrual system, or even a modified accrual basis of accounting using the International Public Sector Accounting Standards (IPSAS) would be a major step and would require the employment of expert staff, the development of accounting policies and a widespread training programme, which would be inappropriate given the present level of development of public financial management in Bosnia and Herzegovina. Ideally such a move should also require a degree of independence in the standard-setting process, which does not appear to currently exist in Bosnia and Herzegovina. The supreme audit institutions (SAIs) would also need to be trained so that they would be able to provide an appropriate opinion. An argument that was also put forward was that such a move was desirable anyway in order to facilitate completion of IMF statistical returns. However, given the other priorities in Bosnia and Herzegovina as well as the lack of technical resources and lack of strong independent institutional structures, such a reform would be inappropriate at present.

All ministries of finance should concentrate on the effective utilisation of existing accounting systems to ensure that they not only facilitate the management of cash but also ensure the control of expenditure against the budget. Accounting systems can also be used to improve the quality of financial management through a greater emphasis on value-for-money and by evaluating the costs of activities and functions through the development of management accounting information. Moving towards more sophisticated systems, such as accrual accounting, would require much more experience and capacity than the ministries seem to be able to provide at the moment.

3.5 Extra-budgetary Funds and Public Enterprises

There has been no change in the range of extra-budgetary funds (EBFs) since Sigma's last assessment. At the Federation level the main EBFs include the Pension Fund, Health Fund and Employment Fund. These funds are financed by restricted taxes and non-tax revenues, such as contributions. Such funds also exist in Republika Srpska, where they include the Pension and Invalid Insurance Fund, the Health Insurance Fund, the Public Child Care Fund and the Employment Bureau.

It is not clear whether any attempt has been made to identify the liabilities that have been created by these funds and therefore whether they are financially solvent in the long term.

Again, the financial position of public enterprises and of municipal enterprises is also not clear. Significant deficits represent a considerable potential risk to the owner entity or municipality.

The economic crisis highlights other vulnerabilities that ought to be examined, such as the financial status of extra-budgetary funds. The reliability of current funding arrangements, including personal contributions, will depend on the state of their solvency. Again the financial position of public and municipal enterprises is unclear. Overall financial vulnerability would add to the burden placed on these various funds and activities and reduce the ability of the relevant authorities to manage the overall economy effectively.

4. External Assistance

Assistance to the Ministry of Finance and Treasury (BiH State) from external donors is now developing, in contrast to the period when assistance was mostly provided to the two entities. For other components of BiH, the main assistance in the area of budgeting has been provided by the UK's DFID. This assistance started in 2004 with support to the introduction of the Medium-Term Expenditure Framework (MTEF) at state level and to the strengthening of the budget preparation process. This project aimed to unify the budget processes at state and entity levels of government and to create a unified calendar. The harmonisation of budget calendars has been achieved, but it has not yet been formalised. Currently a third project/stage is being planned, focusing on the elaboration of a comprehensive, medium-term budget planning process linked to government policy priorities at canton, entity and state levels.

The USAID/SIDA Governance Accountability Project has provided support to both entities in the implementation of legislation on the allocation of revenues and in the introduction of new models of revenue allocation. The EU had provided support to the National Fiscal Council and to the Macroeconomic Unit (MAU) of the ITA Governing Board. One US Treasury advisor has worked with the Fiscal Department of the Federation's Ministry of Finance on tax legislation and on the modernisation of tax administration in the Federation. The Public Administration Reform Co-ordination Office (PARCO) as well is planning to support public finance reforms; a project is currently being developed to include IT developments.

It would be preferable for donor funds to focus on activities and reforms that could apply at state and entity levels, and not just at a single level (in one entity, for example). Again, issues of a very practical nature arise with regard to the financing of IT development projects, as it obviously would not be rational to develop different IT systems supporting the development of public services for each of the three main components of BiH, as common systems would be more practical. Another issue that emerges concerns the possibility of ensuring further development of IT systems and determining where the responsibility for such a task would lie. Therefore, creating proper overall co-ordination mechanisms and agreeing on regulations for managing foreign funds are crucial preconditions for managing foreign funds in a sustainable manner.

What is also very important is to refrain from encouraging through donor funding the adoption of advanced techniques until, first of all, basic systems and management arrangements are in place and operating effectively and, secondly, ministries of finance have demonstrated the capacity to adopt and implement those techniques.