



## **SIGMA**

### **Support for Improvement in Governance and Management**

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## **BOSNIA AND HERZEGOVINA**

### **PUBLIC EXPENDITURE MANAGEMENT SYSTEM**

#### **ASSESSMENT MAY 2008**

#### **Introduction**

The state-level Government of Bosnia and Herzegovina still represents the smaller part of the consolidated budget of BiH. It has continued to progress significantly in recent years. In 2000 the central government accounted for only 1.3% of total expenditure, compared to 11.3% in 2006 (the figures for 2007 have not been published yet). In this regard, the Federation (FBiH) in 2006 accounted for 55.4% of total expenditure, compared to 71.0% in 2000; the Republika Srpska (RS) was 27.3% in 2000 and 30.2% in 2006; and Brčko district in 2000 was 0.4%, compared to 3.2% in 2006. In comparison to the estimations for 2006, the budget execution figures showed a budget share increase for Republika Srpska (approximately 1.4 percentage points) on account of a slight decrease of the shares of the state, the Federation and Brčko district.

The transfer of the defence function to the state level from the entities in 2006 and the planned gradual transfer of the police, and associated expenditures, will further increase the share at state level. It is assumed, for instance, in the 2006-2008 budget framework document for BiH that state-level expenditures will increase by 10% over the next three years.

#### **1. Legal and Institutional Frameworks**

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 issues in place. As is common in countries that were part of former Yugoslavia, a number of aspects are covered in the annual Budget Execution Law. 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 the 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 of Bosnia and Herzegovina.

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 very unreliable, if not impossible to prepare at any kind of an acceptable quality level, thereby limiting the possibilities of setting any reasonable fiscal goals. If the current financial situation is unknown, it is impossible to assess it and to set a goal for future years based on that assessment; in addition, setting a goal that is not really possible to monitor later on is an exercise of very little added value.

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As co-ordination mechanisms are also lacking, the allocation of budgetary resources is inefficient (e.g. investment planning is carried out by one government without knowing what kind of investments the other governments are planning to undertake). However, some steps have been taken to improve the co-ordination of activities. The exercise to harmonise budget preparation calendars has been initiated (but currently not legalised) in the framework of a technical assistance project. Also, a draft Law on the Fiscal Council has been prepared. The basic role of the Fiscal Council is to improve the co-ordination of fiscal policies. The council is to be composed of the three prime ministers and the three finance ministers as well as representatives of the President and of central government as observers. The council will be responsible for preparing proposals concerning fiscal targets, macroeconomic projections, indirect taxes and their distribution, the ceiling for public debt, etc. While the initiative to create such a council is worthwhile, care should nevertheless be taken in developing the working procedures of the council so as to create all possible preconditions to motivate and enable this body to reach agreements.

### *State level*

The Ministry of Finance and Treasury (MFT) at state level has a limited policy role in the public finance system. The current “systematisation” contained in the internal rulebook plans for more than 100 positions, but many of these positions are currently vacant. The draft new systematisation foresees a total number of 230 staff in the ministry. The new systematisation also foresees the establishment within the MFT of a new sector responsible for the co-ordination of international assistance – which would consist of two departments, dealing respectively with the public investment programme and foreign assistance.

The public investment programme is currently being prepared and implemented by the Ministry of Foreign Trade, among other issues, for drafting a document related to the investment programme, which was part of the budget framework. The main problem related to the preparation of this investment programme was the impossibility of setting objective priorities, and the programme was therefore prepared without taking into account financial impacts, including the possibilities to finance the projects planned. Therefore, the decision that has now been taken to transfer the responsibility for the preparation of the public investment programme to the Ministry of Finance and Treasury is very rational and practical. Even though it has been decided to set up a separate unit in the MFT for that purpose, close co-operation with the budget sector in the ministry is crucial. In a medium-term perspective, it would be rational to re-assess this allocation of responsibilities so that the budget sector has full control over both current and capital expenditures.

The new department of foreign assistance in the MFT is to be responsible for managing all foreign funding except IPA. It is also foreseen to create a unit for financing and contracting within the Treasury sector, and an embryo of the National Fund is in place. The ministry is currently also making efforts to create a database on foreign assistance. Although very worthwhile steps have been planned with the new systematisation with respect to the use of foreign funds (including EU funds), considerable challenges remain in terms of creating conditions for the effective, transparent and sustainable use of these funds. In many respects these issues relate to the current existence of three independent bodies (the state and the two entities), without proper co-ordination mechanisms, which makes it very problematic to ensure proper responsibilities for the management of projects. For example, 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 bodies as common systems would be more practical. Another issue that emerges is that of ensuring the possibility of later development of IT systems and determining where the responsibility for this 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.

In the budget sector of the MFT a new unit for budget analysis will be 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 that would support the budget preparation process.

Even with functions that are still not very well developed, the current number of staff of the MFT is quite insufficient to carry out the tasks of the ministry in a smooth manner. This situation is not uncommon at the state level in Bosnia and Herzegovina, and it is aggravated by a high level of staff turnover. One of the

consequences of this situation is that a number of key functions are still carried out by, or in the framework of, assistance projects. However, this situation may be changing now, as a recruitment campaign was launched last year with the opening of 40 staff positions, and a new systematisation should result in a substantial increase in the total number of people employed by the Ministry of Finance and Treasury, which follows in particular the recommendations by technical assistance projects to strengthen some key sectors (e.g. it was recommended to increase the budget and public expenditure sector by a total of 11 positions). This process might nevertheless prove to be a very long one. . All structural increases should also be looked at in perspective, taking into account the impacts arising from the activities related to improving co-ordination (e.g. impacts of the Law on Fiscal Council once approved and other similar initiatives).

### ***Macro-economic prognosis***

A fully integrated macroeconomic forecasting capacity does not really exist at the moment at the state level. This function is performed outside the Ministry of Finance, and for the revenue side only, by the macroeconomic unit of the indirect taxation authority.

The Law on Payments into the Single Account and Distribution of Revenues of 2 December 2004 entrusted the Indirect Taxation Authority (ITA) with the collection and distribution of VAT as well as other indirect taxes, revenues and fees. VAT was introduced at state level as from 1 January 2006, replacing the former sales tax collected by the entities. Other indirect taxation comprises customs duties and road tax, which will provide the state level with a substantial and stable revenue source of its own. The ITA is also responsible for the preparation of fiscal projections for the medium-term fiscal envelope.

Revenues are allocated by the Governing Board of the ITA. According to the Law on the Indirect Taxation System, this board is composed of the Ministers of Finance of the state and the two entities as well as three experts in the area of indirect taxation. It is chaired by an additional member, who has been appointed – since the effective establishment of the Board in 2004 – as an “international expert” by the High Representative; the Board chair is renewed on a yearly basis.

Revenues are supposed to be allocated according to the Law on Allocation of Revenues from the Single Account. However, this set-up is currently being negotiated by the Governing Board of the ITA. The issue is how the formula is applied and how it changes based on historical data on revenues collected in each entity and in the Brcko district.

In addition to the establishment of the ITA Governing Board, to strengthen the co-ordination of budget policies between state and entity levels, a National Fiscal Council was created in May 2005. The National Fiscal Council comprises Prime Ministers and Ministers of Finance of the state and the entities, and the President of the Central Bank serves as an observer. The National Fiscal Council was created in 2005, on the basis of an ad hoc agreement, but in practice it has not been operational for two years now. As mentioned in section 1 above, a draft Law on the Fiscal Council has been developed and the concept of the Council will therefore probably be revived and procedures created to regulate its work. Initially, the creation of the National Fiscal Council in 2005 made it possible for the first time to set overall public deficit goals and other budget targets in 2005 (for the 2006 budgets). However, these targets were abandoned by the Republika Srpska (RS) in March 2007. New spending commitments were made through legislation in both entities, without taking into account the targets and their projections.

A technical level of co-ordination was established in 2006 with the creation of the Budget Co-ordination Board, comprising the assistant ministers for budget and representatives of the ITA and of the Unit of Economic Policy Planning in the Council of Ministers of BiH (EPPU). This body is expected – with four to six meetings per year – to become a more permanent forum for operational co-ordination, but it lacks the necessary legal foundations. With the draft Law on the Fiscal Council a similar body acting as secretariat for the Council was foreseen, but the location of the secretariat has not been decided yet.

### ***Budget planning***

The number of common institutions funded by the state budget has constantly increased recently. They now include the Ministry of Defence and the State Border Service, and a gradual transfer to a fully unified police system at state level is foreseen. Contributions from entities were abolished with the introduction of the single account direct funding for the state.

For the first time, within the preparation process of the budget 2008 the administration was able to carry out a multi-year review of capital investments. Further reform steps in the public finance area include the development of programme budgeting. The emphasis has been placed on an overall approach to the operational establishment of a Medium-Term Expenditure Framework (MTEF), with similar methodologies applied across the state and entities. The MTEF has been developed at all levels of government with the support of a long-term technical assistance project. Budget Framework Papers (BFP) similar for all levels of government, which have been prepared by the project, are to be submitted by 30 June to the governments. At the moment, this process is still not sufficiently connected to the normal annual budget preparation procedure.

The annual budget preparation is initiated rather late, leaving limited time for discussions in parliament. According to the Law on Financing the Institutions of Bosnia and Herzegovina, the annual budget preparation process starts with the distribution of a circular to all budget-users no later than 1 July. All budget-users are requested to submit their proposals by 1 August; the draft budget has to be submitted by the Ministry of Finance and Treasury to the Council of Ministers by 1 October and to parliament by 1 November.

### ***Budget execution and accounting***

The Ministry of Finance and Treasury (MFT) began as the State Treasury and worked closely with USAID to introduce a treasury system, which led to the establishment of a Treasury Single Account (TSA). Both of these elements have been fully functional since 2003. Although the system is in place, there is still room to further benefit from the existence of the TSA. For example, currently there is no functioning cash management covering both the state level and entities, and furthermore, according to the Law on Financing the Institutions of Bosnia and Herzegovina, all budget-users may request the MFT to open a supplementary account for the collection and use of donations as well as own revenues.

According to the Law on Financing the Institutions of Bosnia and Herzegovina, the MFT is required to record budget revenues and expenditures by using the modified accrual basis of accounting and to promulgate a rulebook on accounting and financial reporting, which is to include a chart of accounts and a budget classification framework in accordance with internationally recognised standards.

### ***Federation of BiH***

The Ministry of Finance (MoF) has a very limited administrative capacity in performing its functions. For example, as the Budget Sector of the MoF has only seven staff, it is doubtful that the ministry is able to perform its activities effectively. Compared to the other government components of Bosnia and Herzegovina, this might have less impact than one would expect, since the portion of the cantons in the total of public revenue and expenditure is overwhelming.

### ***Budget planning***

The cantons and municipalities in the entity are financed according to a formula – the criteria for allocation of resources are the same each year, but variables differ from year to year. The main and very basic problems regarding budget planning lie in the unreliability of the revenue prognosis and the uncertainty of allocation of revenues to the entity.

However, the Federal Ministry of Finance (MoF) has started the Medium-Term Expenditure Framework (MTEF) process 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.

According to the Law on Budgets, the budget of the Federation consists of general and special parts, as well as the development programme plan. The general part of the budget contains the revenues and expenditures account and the financing account. The special part of the budget consists of the budget-user expenditure and cost plan, divided into current and development programmes for the current budget year and the following two years. The development programme plan comprises the development programmes of budget-users, as defined in the medium-term development plan document, by special laws or other regulations. The overall classification of revenues and expenditures according to economic classification is enacted in the Law on

Budgets. It is also stated in the Law on Budgets that the budget must be balanced and that total revenues and incomes must cover total expenditures and costs.

There also exist extra-budgetary funds, which are legal bodies established on the basis of the law and which are financed from restricted taxes and non-tax revenues (namely contributions). These funds include the pension fund, health fund, employment fund, as well as other funds established by the Law on Budgets.

### ***Budget execution and accounting***

The budget is executed on the basis of a monthly plan of allocation of available budget funds for each budget-user. The plan is approved by the Minister of Finance, on the basis of cash-flow plans, which are used for projecting payments to and from the Treasury account. In the event that some of the funds are not used by the end of the fiscal year, there exists a possibility to transfer the remaining funds over to the next budget year (which is not the case, for example, at the state level). According to the Law on Budgets, appropriations can be transferred to the following fiscal year for financing capital projects by using financing from special funds, as well as for financing projects of special importance for economic development or improved efficiency. Appropriations for the purposes of financing several year-long capital projects are transferred to the following fiscal year, in accordance with the amounts and time schedule determined in the capital budgets that have been approved for several years.

The Treasury Single Account (TSA) dates back to January 2001. The MoF has an Oracle Treasury Ledger System (TLS), established with technical assistance from USAID. Users are satisfied with the system, which is being extended to the cantons so that every canton now has a treasury system in place.

The introduction of treasury systems has had a positive impact on cantons, which have been able to better control their expenditures, and this has had an impact on their deficits. Despite the existence of the TLS, the Treasury continues to implement expenditure control at the point of payment, deferring payments whenever there are insufficient funds available in the TSA. However, the introduction of the treasury system has helped the FBiH MoF to deal with arrears and to establish spending discipline.

The Law on Budgets does not lay down the accounting methodology used – it is stated that the Federation Minister of Finance is to make sure that the unified accounting procedures are used, and he/she also determines the bookkeeping regulations and the regulations on content and method of financial reporting for all ministries, budget users, off-budget funds, as well as for cantons, cities and municipalities.

In general the regulations fixed for budget preparation, execution and accounting differ rather remarkably from the rules agreed at the state level, even though some initiatives (such as a common budget calendar) have been launched to harmonise the regulations currently in place.

### ***Republika Srpska***

The Ministry of Finance of the Republika Srpska (RS MoF) is organised in two sectors: the Budget Planning Sector, responsible for budget preparation, and the Treasury Sector. As for equivalent institutions in Bosnia and Herzegovina, the RS MoF suffers from a lack of capacity.

The Budget Planning Sector currently has 21 staff, and it is planned to reach a total of 32, according to the draft amendments to the systematisation. The new posts are foreseen mainly so as to be able to start performing the budget analysis function; a sort of career system will be put in place, starting with the help of volunteers, then moving further on to interns, and finally to the appointment of full-time civil servants. The Budget Planning Sector is composed of four departments – planning, macroeconomics, budget inspection, and a department dealing with the budgets of cities and municipalities. At present the main administrative constraints lie in the macroeconomics unit, where none of the posts has been filled. Moreover, no IT systems support budget preparation.

The Treasury Sector is also composed of four departments – responsible for distribution of public revenues, accounting, payment of salaries, and management of balances. The total number of posts is currently 66, but not all of the posts have been filled (10-15 vacancies at the moment). The largest department is currently the accounting department, which also has subsidiaries in 12 cities, a set-up that is likely to be reconsidered.

## ***Budget planning***

The annual budget preparation process starts in mid-June with the preparation of the preliminary budget memorandum. Budget requests are submitted to the Ministry of Finance by 1 September.

By 1 October the government should have adopted the final budget memorandum, which is also harmonised with the macroeconomic framework. The budget must be agreed by the government by 1 December and by parliament by 15 December; despite the very short time frame, parliamentary approval is normally reached on time over two one-day sessions. The budget is classified according to the economic classification as well as the organisational and functional classifications of the budget expenditures. The entity has also benefited from foreign assistance on programme budgeting as well as on medium-term budgeting issues, as have the state and the federation.

Similarly to the Federation of Bosnia and Herzegovina, in Republika Srpska the Law on the Budget System requires that budget resources and budget expenditures 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 the budget rebalance, applying the procedure of budget adoption.

There also exist, similarly to the BiH Federation, extra-budgetary funds. These funds are legal entities financed from the special purpose (earmarked) contributions, and they include:

- Pension and Invalid Insurance Fund of the Republika,
- Health Insurance Fund of the Republika,
- Public Child Care Fund of the Republika,
- Employment Bureau of the Republika

Over the past few years the RS MoF has been trying to encourage line agencies to take a more active role in estimating requirements, on the assumption that it is better for spending ministries to come up with such an estimate than to have a figure imposed on them by the Ministry of Finance. Formal budget hearings between the Ministry of Finance and budget-users took place in RS for the first time in 2005, and this practice has continued.

The Budget Planning Sector provides the government with regular reports on budget execution so as to enable the monitoring and analysis of the expenditures of line agencies.

## ***Budget execution and accounting***

No accounting regulations are fixed by the Law on the Budget System – the law delegates responsibility for setting the rules to the Ministry of Finance, stating that the Minister of Finance is to pass the following secondary legislation:

- Rulebook on Accounting Policies;
- Order on payment of specific budget revenues belonging to the Republika, municipalities, towns and Funds;
- Rulebook on contents of individual accounts in the framework of accounts for the Republika, municipality, town or Fund budget beneficiaries;
- Rulebook on financial reporting for the Republika, municipality, town or Fund budget beneficiaries;
- Instruction on making the annual account statement for the Republika, municipality, town or Fund budget beneficiaries.

The overall BiH Treasury System is used, but the chart of accounts is slightly different from that of the BiH Federation, although in essence it is the same. Cash management and forecasting are the responsibility of the Treasury and are carried out through monthly projections that incorporate obligations for expenditures on large items, such as salaries and pensions – different expenditure categories are set as priorities in covering monthly expenditures incurred. Expenditures incurred early in the fiscal year are paid either at the end of the previous year or from a reserve fund designated for such a purpose, which is carried over from the previous year.

## 2. Assessment

In overall terms, the complex administrative system in the country makes it obvious that there is a considerable lack of co-ordination in the area of public expenditure management. More formal and informal co-ordination is therefore needed in all aspects of public finance. In addition, very different rules and regulations are currently in place regarding public finance. This is the main risk factor as it has an impact on all future reforms in the area of public finance, and many of the current weaknesses in the system are common to the state and the entities.

**A number of important improvements in public finance have been implemented in recent years, and some steps have also been taken to improve co-ordination, the most recent – and probably at this stage the development with the most impact – being the adoption of the Law on the Fiscal Council. However, further challenges remain in terms of implementing the law. Some other results achieved relate to the steps taken to harmonise budget calendars and the common Treasury Single Account (TSA).**

**Especially during the past year, efforts have been made to increase administrative capacity. The state and the entities have all reassessed their current number of posts and prepared amendment proposals to the systematisations, which are important steps forward in view of the continuing problem of understaffing. However, any increase in the number of posts should be made with care, ensuring the relation between the creation of new posts and the activities being carried out as well as the planned results; in overall terms it should be kept in mind that increasing the number of staff in the administration is not a goal in itself. In any case, ministries will have to be alert to the quality of potential candidates; in general the public service in Bosnia and Herzegovina has encountered difficulties in recruiting qualified staff. A proper human resources management policy, with decent career paths, will need to be offered in order to attract and above all to retain qualified staff.**

These administrative constraints currently influence mainly the capacity of the administration to evaluate the impacts of new pieces of legislation and amendments and its capacity to carry out the budget analysis function, thereby contributing to the establishment of fiscal discipline and to the achievement of a rational allocation of resources. At the same time, more sophisticated and complex tasks have started, such as the development of the Medium-Term Expenditure Framework (MTEF) and programme budgeting, the value of which is rather questionable in a situation where the basis for development of the budget (e.g. the capability of performing budget analysis and of assessing the financial impacts of the various planned activities) is close to non-existent.

**It could be said that while public finance is recognised as an issue of importance (the main reform activities foreseen are included in the Public Administration Reform Strategy), the capacity to move forward in this area remains dependent, on the one hand, on a difficult political consensus and, on the other, on the capability to benefit from the limited human resources in the administration and to nevertheless increase these resources.**

## 3. Recommendations

In the planning and implementation of future reforms it would first of all be rational to focus efforts on strengthening the basic stages in budget preparation and execution (including financial impact analysis and overall analysis of budget requests) and then gradually moving further to more sophisticated developments, while taking into account the limited administrative capacity and general lack of staff. The sequencing of various development activities in public finance must be thoroughly assessed and planned.

The Organic Budget Laws should be reviewed for compliance with good European practice and above all for clarity and internal consistency. This review could also aim to further harmonise the laws at state and entity levels.

Most importantly, efforts should be made to improve fiscal co-ordination; it is crucial to improve the harmonisation of budgeting and accounting methodologies so as to be able to provide reliable overall government financial statistics. Among other activities, the development of IT systems to support public finance (including budget preparation) could contribute to ensuring the better performance of public finance functions, relieving the current technical administrative burden, and helping the harmonisation processes between the state and the entities.

Furthermore (and also in connection with the suggestions made in the previous paragraph concerning IT system developments), in the event that the co-ordination issue is not considerably improved, many risks

could also emerge with regard to the implementation of the projects financed by EU funds or through other donor assistance. These risks mainly relate to sustainability problems, as the responsibilities for future activities – after the donors have left and technical assistance projects have been finalised – could remain obscure. Therefore, special attention should be given to ensure that clear responsibilities are assigned for future developments after donor-funded projects have ended.

The possibility of centralising various public finance functions should also be carefully assessed; it would be irrational to expect that the competences for all functions of public finance could be of reasonable quality if created at state level and at entity level.

#### **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 levels of government in BiH, the main assistance in the area of budgeting has been provided by the UK DFID. It started in 2004 with support for the introduction of the Medium-Term Expenditure Framework (MTEF) at state level and for the strengthening of the budget preparation process. This project aimed to unify the budget processes at state and entity levels of government as well as to create a unified calendar. The harmonisation of budget calendars has been done, 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, introducing 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 on tax legislation and on the modernisation of tax administration in the Federation. The PAR Office as well is planning to support public finance reforms; a possible project would also include IT developments.