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Bosnia and Herzegovina: Selected Economic Issues

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BOSNIA AND HERZEGOVINA

Selected Economic Issues

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Approved by the European Department

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I. Overview

1. **Bosnia and Herzegovina (BiH) has made significant economic progress since 1995.** Output has trebled and exports have increased more than ten fold. The currency board has become firmly entrenched, inflation has stabilized at industrial country levels, and the banking system has been almost completely privatized.

2. **But major challenges still lie ahead.** GDP growth has slowed markedly even though output is still well below pre-war levels, reconstruction aid inflows will continue to decline and therefore the external current account balance will have to decline sharply, and there is a significant reflux of refugees from abroad—a trend which signals a welcome restoration of stability, but one which, in the short term, compounds unemployment.

3. **This paper focuses on four issues which will inform policymakers' responses to these challenges in coming years:**

- Chapter two assesses the extent to which data unreliability could alter the assessment of the macroeconomic challenges ahead. It concludes that key data—estimates for nominal GDP, the current account balance, unemployment etc—are unreliable. But even on the most "optimistic" of the plausible estimates of these numbers, the central thrust of staff policy recommendations—need for major corporate restructuring supported by a strong fiscal stance—remains firm.

- Chapter three assesses the ways in which the architecture of the fiscal system will need to be strengthened if the fiscal side of this policy recommendation is to be realized. In particular, it highlights the contributions which the Indirect Tax Authority (ITA) will make to remedying some of the flaws, and notes the architectural agenda which still lies ahead.

- Chapter four describes how the large claims of citizens on their governments also needs to be resolved if fixed investment, necessary for economic revitalization, is to be increased. It assesses fiscal sustainability, welcomes the authorities' bold initiatives to secure it by restructuring the domestic claims, and notes key implementation issues in realizing the authorities' plans.

- Chapter five concludes with a survey of selected tax policy issues, from the perspective of need to secure the necessary strong fiscal stance and render tax structures consistent with the corporate restructuring agenda. It notes key next steps towards replacement of the sales tax system with a VAT and suggests a time-line for them and points to key issues in direct taxation. And it surveys issues related to external tariff policies.

II. Data Foundations for Policy Design [1]

1. **This note examines the extent to which the uncertainties about the data affect staff's core medium term policy prescriptions.** Those prescriptions rest on understandings that the external current account deficit is large relative to GDP, that wage arrears and unemployment is high, that corporate fixed investment is low and that corporate loss-making is widespread and heavy. The data on all these matters are highly suspect. But are they so suspect as to render the foundations of staff advice insecure?

A. Nominal GDP and Unrecorded Activity

2. **Official estimates of GDP exclude the grey economy**. Key gaps are listed in Text Table 1. While there is much uncertainty about the value added in these areas, it is likely significant.

Text Table 1. Bosnia and Herzegovina: Non-observed Economy
(percent of official GDP)

	1999	2000	2001	2002
Total	42.4	40.9	40.6	38.8
Unrecorded trade	5.6	5.6	5.6	5.6
Unrecorded activity in Arizona market	1.0	1.0	1.0	1.0
Unrecorded wages of local staff of intl. community	2.0	2.0	2.0	1.0
Rental services for foreign staff of intl. community	1.5	1.2	1.0	0.8
Value added of unregistered businesses	9.0	9.0	9.0	9.0
Understated value added of registered businesses	20.5	19.5	19.5	19.0
Imputed rent for owner occupied housing	0.5	0.5	0.5	0.5
Unrecorded value added for off-budget military and reconstruction expenditure	1.3	1.1	1.0	0.9
Formal activity not recorded	1.0	1.0	1.0	1.0

Source: IMF Statistical Advisor

3. **Preliminary estimates by the IMF Statistical Advisor in Bosnia suggest that the non-observed economy is currently about 40 percent of official GDP.** Much of the unrecorded activities are due to the understated value added of registered businesses. However, the share of the non-observed economy has apparently been declining in recent years with the reduction in the presence of the international community, and better tax administration has increased the coverage of official data—particularly in 2002 where this factor created a significant upward bias in official nominal GDP growth estimates.

4. **Further evidence is provided by velocity of circulation of cash outside banks.** On the official GDP numbers, velocity is unusually low in BiH relative to other currency board

[1] Contributed by Daniel Kanda and Geert Almekinders.

cases—Estonia, Lithuania, and Bulgaria—in the transition area (See Text Table 2). This suggests that GDP could, other things being equal, be significantly underrecorded. This impression is further suggested by low velocity in BiH relative to Croatia and Slovenia. Only Kosovo has a significantly lower velocity than BiH, but multiple special factors likely account for that.

Text Table 2. Velocity of Circulation of Cash Outside Banks for Selected Transition Countries (2002)	
Bosnia and Herzegovina	6.5
Estonia	15.6
Lithuania	15.9
Bulgaria	10.3
Kosovo	2.8
Albania	5.3
Latvia	9.4
Croatia	18.8
Serbia	29.0
Slovenia	38.3

5. **However, the statistical authorities, particularly in the Republika Srpska (RS), doubt these estimates of the non-observed economy.** Their main concern is that coverage of the official data has improved in recent years, particularly in the informal Arizona market in Brcko district, so that the 40 perecnt estimate seems implausibly high in their assessment. What is undisputed is that GDP remains well below pre-war levels.

B. The External Current Account Balance

6. **Assessments of the policy implications of the current account deficit hinge on the estimates of nominal GDP**. On staff estimates of nominal GDP and the current account balance, the current account deficit in 2002 was 18½ percent of GDP. Were nominal GDP 40 percent higher, that deficit would instead be 12 percent of GDP. However, there is additional considerable uncertainty about the nominal value of the current account balance, with staff estimates below others.

7. **The merchandise trade deficit is large, but quite how large is uncertain (Text Table 3).** Staff monitor merchandise trade tracking partner country data as well as customs data. Over the past year, these two sources of data have increasingly converged, mainly as a result of the country-wide introduction of the ASYCUDA customs information system. Unlike staff, the Central Bank of Bosnia and Herzegovina (CBBH) makes adjustments to the customs data for underreporting and undervaluation of both import and exports, making considerably larger adjustments for imports than for exports. This accounts for the higher merchandise trade deficit in its publications, but the assumption that unrecorded trade is as

imbalanced as recorded trade is a strong one—while both would reflect shared macroeconomic influences, the sector level influences could be distinct, and exporters face strong incentives to underreport their activity in Bosnia if they wish to avoid the authorities in the destination (often neighboring) countries. Nevertheless, note that staff estimates take no account of underrecording—implicitly assuming that this trade is in balance, and this largely explains why staff estimates of the trade deficit are smaller than others report. However, all three sources of data suggest that the merchandise trade deficit worsened between 2000 and 2002.

Text Table 3. Merchandise Trade Balance

	1998	1999	2000	2001	2002
Partner country data (used by the staff)					
Trade balance (in millions of US$)	2,468	2,183	2,090	2,235	2,552
Trade balance (in percent of GDP)	-55.1	-44.5	-43.6	-43.8	-45.5
Customs data					
Trade balance (in millions of US$)	2,317	2,548	2,059	2,362	2,929
Trade balance (in percent of GDP)	-51.7	-52.0	-42.9	-46.3	-52.2
Central Bank data					
Trade balance (in millions of US$)	3,116	3,301	2,654	3,010	3,390
Trade balance (in percent of GDP)	-69.5	-67.3	-55.4	-59.0	-60.4

8. **Weaknesses in data on services and private and official transfers compound uncertainties about the size of the current account deficit**. For the time being the staff is using CBBH data on private remittances and our own estimates of official grants.

- **The magnitude and trends in private transfers are a key uncertainty in the current account data and the recent revisions by the CBBH in the relevant estimates are welcome.**[2] The staff still uses the earlier CBBH estimates of the inflow of private transfers. The per capita receipt of remittances in Bosnia in 2002 implied by these estimates is lower than in neighboring countries which are in a comparable state of economic development (Serbia and Montenegro, Macedonia, and Albania) (Text Table 4). However, there is considerable uncertainty about (i) the number of Bosnian emigrants and remaining refugees; (ii) the average level of transfers actually made by emigrants and refugees; and (iii) the level of pensions reveived from abroad. On the first two, the CBBH has recently refined its estimates using banking sector data on private transfers from abroad. On the last, recall that many Bosnian citizens worked, prior to 1992, in parts of Federal Republic of Yugoslavia (FRY) which are

[2] The revised estimates of private transfers, along with other revisions to the balance of payments, were posted on the website of the CBBH in January 2004.

now neighboring countries, contributing to and now being paid by their pension systems. Accordingly, pension receipts from abroad per capita and relative to GDP may be unusually high by international standards. The uncertainty about the size of these remittances is potentially part of the explanation of the size of errors and omissions in the staff and the authorities' estimates of the balance of payments.

Text Table 4. Remittances in 2002

	Croatia	Serbia & Mont.	Macedonia	Albania	Bosnia & Herz.	
					Staff	CBBH rev.
Remittances (in US$m)	1,093	1,719	403	597	554	794
GDP (in US$m)	22,422	15,861	3,694	4,835	5,612	5,612
Remittances (in % of GDP)	4.9	10.8	10.9	12.3	9.9	14.2
Population ('000s)	4,422	10,660	2,044	3,582	3,989	3,989
Remittances per capita ($s)	247	161	197	167	139	199

- **Data on official grants is also of poor quality (Text Table 5).** A UNDP-financed technical assistance project aimed at monitoring and coordinating aid to Bosnia has been running for several years now but credible data have yet to be produced. The staff is currently using "partner country data" on development assistance to Bosnia as reported by donor countries and IFIs to the OECD's Development Assistance Committee to inform estimates of these flows. Note, however, that these data, which are available only through 2001, suggest that aid to Bosnia has not fallen quite as fast as is estimated by the staff. The discrepancy arises because these data do not decompose flows into current and capital grants and it is also not clear to what extent donors are reporting aid to the OECD which in fact has no impact on Bosnia's BOP. For this reason, the staff has so far refrained from using this data, only drawing on it.

Text Table 5. Official Development Assistance

	1998	1999	2000	2001	2002
OECD Development Assistance Committee					
Foreign assistance (in millions of U.S. dollars)	905	850	624	635	…
Foreign assistance (in percent of GDP)	20.0	17.3	13.1	12.7	…
Currently in BOP					
Foreign assistance (in millions of U.S. dollars)	884	839	512	477	388
Foreign assistance (in percent of GDP)	19.6	17.1	10.8	9.5	6.9

9. **While the current account deficit is large and has increased markedly over the past few years, it appears to be mostly financed by non-debt creating flows**. Thus the external debt to GDP ratio is on a strong declining trend (Text Table 6). Moreover, the weaknesses in the external sector data are reflected in large positive errors and omissions in

2001 and 2002. To the extent that this reflects unrecorded inflows in the current account—possibly underestimates of pension receipts from abroad—the actual current account deficit may be smaller than presently estimated by the staff. If, in addition, GDP is underestimated, the current account deficit could in fact be closer to 10 percent of GDP. Note, however, that this is well below the official—including the CBBH—estimates, partly because the staff do not make adjustments for unrecorded trade.

Text Table 6 Current Account Balance

	1999	2000	2001	2002
Current account balance (in millions of U.S. dollars)	-440	-610	-794	-1,036
Current account balance (in percent of GDP)	-9.0	-12.7	-15.6	-18.5
Errors and omission (in millions of U.S. dollars)	-273	54	522	296
Errors and omission (in percent of GDP)	-5.6	1.1	10.2	5.3
External debt (in percent of GDP)	65.3	59.2	46.4	38.9
Merchandise exports (percentage change in the euro-value)	9.8	22.5	7.1	15.9

C. Employment and Wages

10. **Employment and wage data are also fraught with uncertainty reflecting the high incidence of wage arrears and the large number of insolvent companies**. The available data suggest that about 20 percent of people registered as employees in the personnel departments of companies receive no wages. Moreover, about 15–20 percent of the average accrued wage per worker goes unpaid each month. Thus, average accrued and paid wages diverge significantly. The monthly wage data published by both entity statistical agencies are average paid wages. Data on the accrued wage bill are collected annually, in the context of the collection of national accounts data, but are not published and are not regularly decomposed into accrued wage rates and employment.

11. **At staff's request, the authorities attempted estimates of accrued wage rates, derived from the national accounts data on the accrued wage bill.** These can be compared with reported data for paid wages, but comparisons are risky. The published data calculates average monthly paid wages as the ratio of the total monthly paid wage bill to the number of employees paid in that month. Hence those workers who were not paid in that

month are ignored in the calculation. In contrast, estimates of the average accrued wage are calculated as the ratio of the total accrued wage bill to the total number of employees. Thus these two measures are not directly comparable—in fact the published average paid wages are typically higher than the (unpublished) estimates of average accrued wages, which is counterintuitive but correct because the set of workers in each is different and low accrued wage workers tend disproportionately to go unpaid. (Text Table 7). A more informative comparison of paid and accrued wages requires that paid and accrued wages be compared for an identical set of workers. However this detailed assessment has not been carried out.

Text Table 7 Accrued and Paid Net Wages in 2002 (Km)

Federation	
Accrued net wage	458
o/w public admin.	650
Paid net wage	483
o/w public admin.	646
Republika Srpska	
Accrued net wage	269
o/w public admin.	498
Paid net wage	347
o/w public admin.	565

12. **Interpretation of wage data is also complicated by widespread underreporting, particularly in the private sector, as a means to avoid labor taxes**. As a result a sectoral breakdown of wage data suggest that government wages are generally higher than private sector wages. However, a World Bank report, based on data from a Living Standards Measurement Survey (LSMS) of households conducted in 2001, found—upon controlling for other factors such as educational background—that there was a substantial wage premium from working in the private sector. The discrepancy between the wage data reported by households to the LSMS surveyors, and the data reported by enterprises to the statistical agencies is a measure of the degree of underreporting of wages, though it is not completely clear that the household respondents to the LSMS surveyors were reporting accrued wages or paid wages. The authorities have also noted that Pension Fund data provides evidence of underreporting—an implausibly high proportion of employees are reported to be earning only the minimum wage.

13. **Similar problems arise in measuring employment**. Because of pervasive wage arrears and corporate difficulties, four different types of employees may be distinguished:

- those who actually work and get paid;
- those who actually work but do not get paid;
- those who do not work but get paid (though not necessarily the full amount of wages);
- and those who do not work and do not get paid.

Many workers are known to report to work every day at defunct companies, but do no actual work—although they may increase the wage arrears liabilities of such firms. Also, many actually work but do not get paid because of financial problems at their companies. The published employment data do not distinguish between these four types of employees.

However, staff are provided with unpublished data on paid employees from a sample survey covering most large and medium size reporting units. But with data on employment in small enterprises being particularly poor, these estimates of paid employment are subject to wide margins of error. If total employment is defined as only those who worked and were paid, estimates of employment are overstated, while unemployment estimates are understated.

D. Unemployment

14. **Unemployment is measured with significant uncertainty (Text Tables 8 and 9)**. There are two sources of data—official data on registered unemployed from the entity employment agencies, and data from the LSMS carried out in 2001. While they differ in terms of the reported unemployment rate, they both clearly indicate that there is a serious unemployment problem. This coincides with the anecdotal evidence provided by the authorities, trade unions, and business representatives.

Text Table 8. Official Unemployment Rate

	1999	2000	2001	2002
Federation	39.1	38.8	39.8	41.7
RS	36.0	39.2	41.0	39.6

Text Table 9. BiH: LSMS Unemployment and Participation Rates in 2001, ILO Definition

	BiH	Federation	RS
		(In Percent)	
Unemployment rates	16.0	16.8	15.1
Male	15.1	15.9	14.0
Female	17.7	18.2	17.1
Participation rates	49.8	44.9	57.7
Male	64.7	59.4	72.8
Female	35.2	31.3	41.9

15. **The official data on registered unemployment are particularly poor**. A substantial number of workers in the grey economy are known to have registered as unemployed in order to enjoy health benefits. A World Bank labor market report calculates that "only slightly less than a quarter of registered unemployed qualified as unemployed under the standard ILO-OECD definition." With these caveats in mind, the registered unemployment rate in both entities has hovered around 40 percent in the recent past. In the Federation there has been a slight upward trend since 2000. On the other hand, in the RS the unemployment rate rose strongly up to 2001, and has since improved somewhat.

16. **The LSMS data are obtained from a survey of households, and may therefore better capture grey economy activities**. However, the sample was assembled under difficult

circumstances, and may be unreliable. The LSMS unemployment rate, calculated using standard ILO-OECD concepts, was reported to be 16 percent in 2001.

17. **Concern with sample quality in the LSMS data centers on the observation that the participation rates reported are implausibly low, particularly for women—views shared by business representatives and entity statistics agencies**. In addition to sampling problems, the low participation rates could reflect two other factors:

- Refugees and displaced persons may have been wrongly classified as not seeking employment.
- Responses from rural women may have been distorted—many would not have considered their small scale trading and farming activities as jobs, and would likely have reported themselves as not working, and (likely) not seeking work either.

18. **Thus, a better measure of the unemployment situation may be obtained by including at least some discouraged workers as in the labor market, even though they are reportedly not actively seeking work**. Reclassifying all discouraged persons as unemployed would cause the unemployment rate to increase to 31 percent, while the participation rate increases to a more plausible 61 percent, but with female participation rates still implausibly low (Text Table 10). On account of a judgement that including all of these workers as in the labor market may be excessive, notwithstanding the still low implied participation rates, the staff suggest that unemployment may be in the low-to mid-20s.

Text Table 10. BiH: LSMS Unemployment and Participation Rates Incl. Discouraged Persons, 2001

	BiH	Federation	RS
		(In Percent)	
Unemployment rates	31.1	32.8	29.0
Male	24.2	25.4	22.6
Female	41.1	43.1	38.6
Participation rates	60.7	55.6	69.0
Male	72.5	67.0	80.9
Female	49.2	44.9	56.6

19. **The unemployment problem is made more acute by the fact that over two-thirds of the unemployed—defined using standard ILO definitions—are long-term unemployed (Text Table 11)**. The LSMS data indicate that for BiH as a whole almost three-quarters of unemployed persons have been unemployed for more than one year. It is unclear what this pattern

Text Table 11. BiH: Unemployment Duration in 2001, from LSMS data

	BiH	Federation	RS
		(Percent of unemployed)	
1-6 months	21.8	20.2	24.2
7-12 months	6.5	5.8	7.4
1-2 years	29.1	30.0	27.9
3-4 years	15.1	15.6	14.4
5-7 years	15.1	13.4	17.3
More than 7 years	12.4	15.0	8.8

would look like were the unemployed defined to include at least some of the discouraged workers.

20. **Overall, it seems clear that there is a serious and persistent unemployment problem in Bosnia, regardless of which measure is used**.

E. Fixed Investment

21. **There are no official estimates of fixed investment at the BiH level**. The estimates in staff documents are based on gross capital formation estimates for the Federation. These, however, suffer from poor coverage. To illustrate, we prepared alternative estimates of BiH investment using data on foreign direct investment, external loans and capital transfers for reconstruction, total construction output, and consolidated general government investment, as well as conservative assumptions on corporate investment (Text Table 12).

Text Table 12. BiH: Gross Fixed Investment (percent of GDP)

	1999	2000	2001	2002
Alternative estimate of total investment	24	25	21	21
Estimated total public investment	12	9	7	5
Foreign financed	11	7	6	4
Domestically financed	1	1	1	1
Estimated total private investment	12	17	14	16
From FDI and construction	10	15	12	14
Other corporate investment	2	2	2	2
Memo item				
Estimate of total investment in Staff documents	20	21	19	20

22. These indicate an investment-GDP ratio typically somewhat above the estimates currently used by staff, though the difference has been declining—in 2002 the alternative estimate of investment was only slightly higher than the estimates in staff documents. And if GDP is significantly undermeasured, the ratios may be lower than shown unless the share of underrecorded investment in underrecorded GDP is higher than the share of recorded investment in recorded GDP.

F. Corporate Profitability

23. **While data on this is poor quality, it all suggests widespread loss-making in the corporate sectors in both entities**. Moreover, in numerous discussions with the authorities, trade unions, and business representatives they have concurred that the data are broadly representative of the actual situation in the corporate sector. Anecdotal evidence suggests that losses are particularly large amongst State-Owned Enterprises (SOEs).

- World Bank survey data of 105 state owned and private companies indicate that over the period 1999–2001 the percentage of firms in the entire country reporting profits fell from 55 percent to 40 percent (Text Table 13). In the Federation, the percentage fell from 54 percent to 41 percent, while in the RS it fell from 57 percent to 39 percent.

Text Table 13. Percentage of Firms Reporting Profits

	1999	2000	2001
BiH	55	49	40
Federation	54	51	41
RS	57	47	39

- These data also indicate that aggregate profit rates (percent of sales) have been significantly negative in both entities (Text Table 14). For BiH as a whole, the weighted aggregate profit rate has varied from a low of -15 percent to a high of -10 percent over the period 1999–2001.

Text Table 14. Aggregate Profit Rate
(In percent of sales)

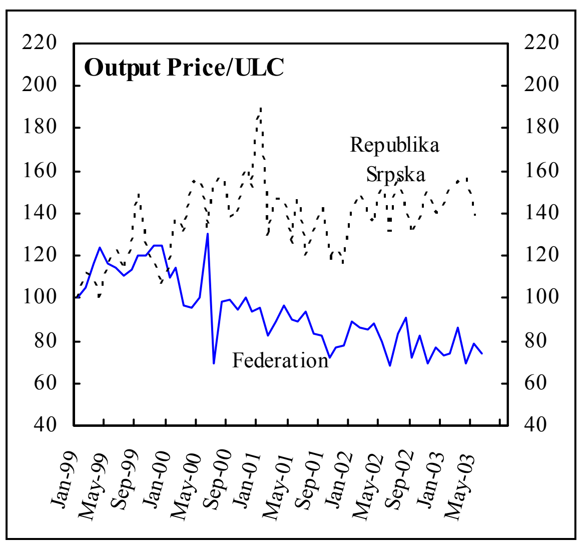
	1999	2000	2001
BiH	-15	-10	-12
Federation	-12	-9	-10
RS	-29	-17	-18

- Data from the accounting reports of over 7000 state owned and private companies in the RS (about 70 percent of all companies in that entity) indicate that aggregate operating profit rates have been negative from 2000 through the first half of 2003, albeit with an improvement in 2002, possibly reflecting the appreciation of the Serbian dinar vis-a vis the KM and other currencies (Text Table 15).

Text Table 15. Republika Srpska: Operating Profits
(In percent of sales)

2000	2001	2002	H1 2003
-7.2	-6.2	-2.1	-1.3

- Recent monthly data on paid unit labor costs and manufacturing prices suggests a continued decline in profit rates in the Federation but an improvement in the RS since end-2001, the latter consistent with that reported by the 7,000 companies.



- A joint DFID/World Bank assessment of financial statements of 40 and 50 strategic SOEs in the Federation and RS respectively, representing some 7 percent of the output in each entity, indicates that most made losses in 2002—aggregate profit rate was -7 percent for the Federation companies and -16 percent for the RS companies.

- As noted above, wage and employment data indicate a significant buildup of wage arrears, suggesting profitability problems at current accrued wage rates. Data on paid and total employment indicate that every month about 20 percent of workers are not paid.

- Notwithstanding problems with tax administration and possible underreporting of profits, revenue from profit taxes are very low in both entities, considering that profit tax rates are 30 percent and 10 percent in the Federation and RS, respectively (Text Table 16). This lends further support to the conclusion of low profitability.

Text Table 16. Revenue from Profit Tax
(percent of GDP)

	2000	2001	2002
Federation	0.3	0.6	0.1
RS	...	0.5	0.6

24. **Overall, therefore, there appears to be widespread persistent corporate loss making in both entities**. This appears to be the key domestic counterpart to the large current account deficit, as lossmaking lowers domestic savings and constrains exports. The situation appears to be getting better in the RS, where wage growth has been more restrained in recent years, but there is so far no evidence of an improvement in the Federation.

G. Conclusion

25. **While key policy recommendations appear to be robust to the data problems, the risk of surprises—pleasant or unpleasant—is high**. Even on the most optimstic estimates of nominal GDP and the nominal current account balance, the external deficit is high, as are wage arrears and unemployment. Statistical and anecodotal evidence also both suggest that corporate investment and profitability are weak. Hence, the statistical basis for the staff's core policy recommendations, while far from secure, suggests that the main assumptions underlying that advice hold.

26. **This discussion nevertheless makes clear the urgent need to improve data quality**. This will require political commitment, increased budgetary resources for statistics, and support for the Office of the High Representative (OHR) mandated integration of all the statistical services under a competent Director.

III. Fiscal Architecture[1]

A. Introduction

1. **General government has an unusually large number of highly autonomous parts.** It includes the main layers of government in both Entities (in the RS, Central Government and Municipalities; and in the Federation, Central Government, Cantons, and Municipalities), the State government, and extrabudgetary funds (including the Health Insurance Funds, and Pension Funds) in both Entities. In addition, there are a variety of off-budget foreign donor funded fiscal activities—aid programs (Table 1 and Figure 1). In different ways, each of these units and activities enjoys a high degree of autonomy. This reflects the compromises made at Dayton to secure peace, and the legacy of the fiscal system of Former Yugoslavia.

2. **This architecture greatly complicates fiscal management—so much so that the fiscal system is more often a source of problems than an effective tool to solve them.** This note outlines key macroeconomic difficulties—notably conecerning delivery of an appropriate consolidated fiscal balance—that current arrangements give rise to, it notes initiatives under way to correct some of these difficulties, and the issues which remain to be resolved.

B. Four Architectural Failings

3. **Current arrangements give rise to macroeconomic concerns in four areas**: coordination of policy towards the consolidated fiscal balance; design of indirect tax policy; separation of responsibility for taxes and expenditures; and funding arrangements for the State.

4. **First, no institution or body in BiH is responsible for targeting and monitoring the consolidated fiscal balance.** In most fiscal systems, this task falls to the central Ministry of Finance. But in BiH, the State Ministry of Finance and Treasury plays a minor role in the overall fiscal system, accounting for less than 4 percent of consolidated government spending. The lack of an institution or arrangement to secure an appropriate consolidated fiscal stance in the otherwise extensive fiscal architecture established by Dayton is particularly remarkable given that a sound consolidated fiscal stance is an essential support for the currency board, and that given the currency board, fiscal policy is the sole remaining discretionary macroeconomic policy instrument.

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[1] Contributed by Peter Doyle and Gunther Taube.

Table 1. Bosnia and Herzegovina: General Government, 1999–2004

(In percent of GDP, unless stated otherwise)

	1999	2000	2001	2002 Prel. Act	2003 Proj.	2004 Proj.
Federation budget						
Revenue (including grants)	8.2	8.8	9.9	9.0	8.3	7.9
Expenditures on a commitment basis 1/	9.4	10.0	10.3	10.1	7.4	6.9
Of which: change in stock of domestic arrears	0.9	0.8	-0.1	0.1	-0.4	-0.7
Of which: transfers to the State	1.2	1.5	1.3	1.7	1.8	1.8
Balance on a commitment basis	-1.1	-1.2	-0.4	-1.1	0.9	1.0
Cantonal budget						
Revenue	14.3	12.5	9.5	8.9	9.0	9.1
Of which: transfers from the Federation budget	0.2	0.2	0.2	0.1	0.1	0.0
Expenditure on a commitment basis	15.3	13.9	11.1	9.3	9.0	9.1
Of which: change in stock of domestic arrears	0.3	0.2	0.9	0.1	0.0	0.0
Balance on a commitment basis	-1.0	-1.5	-1.6	-0.4	0.0	0.0
Federation extra-budgetary Funds 2/						
Revenue	10.9	11.1	11.0	11.1	10.8	10.5
Of which: transfers from the Federation budget	0.1	0.1	0.8	0.2	0.1	0.1
Expenditure on a commitment basis	11.9	11.7	10.2	11.0	10.8	10.5
Of which: change in stock of domestic arrears	0.9	0.6	-0.8	-0.1	0.0	0.0
Balance on a commitment basis	-0.9	-0.6	0.8	0.1	0.0	0.0
RS budget and municipalities						
Revenue (including grants)	9.1	9.2	8.2	10.4	10.4	10.1
Expenditure on a commitment basis 3/	10.7	10.3	8.7	10.4	9.8	9.8
Of which: change in stock of domestic arrears	0.9	1.1	0.2	-0.2	-0.2	-0.1
Of which: transfers to the State	0.8	0.9	0.8	1.0	0.8	0.8
Balance on a commitment basis	-1.6	-1.1	-0.5	0.0	0.6	0.3
RS extra-budgetary funds 2/						
Revenue	4.0	3.9	3.9	3.3	3.4	3.6
Of which: transfers from the RS budget	0.3	0.4	0.1	0.9	0.8	1.0
Expenditure on a commitment basis	4.2	5.0	4.5	3.3	3.4	3.6
Of which: change in stock of domestic arrears	0.2	1.1	0.6	0.0	0.0	0.0
Balance on a commitment basis	-0.2	-1.1	-0.6	0.0	0.0	0.0
State budget						
Revenue (including grants)	2.5	2.8	2.7	3.7	3.5	3.7
Of which: transfers from the Federation and RS budgets	2.1	2.4	2.1	2.7	2.6	2.5
Expenditure on a commitment basis	2.5	2.9	2.7	3.7	3.6	3.7
Of which: change in stock of domestic arrears	0.0	0.1	0.0	0.0	0.0	0.0
Balance on a commitment basis	0.0	-0.1	0.0	0.0	0.0	0.0
Brcko District budget 4/						
Revenue	0.0	0.2	0.9	1.2	1.7	1.7
Expenditure on a commitment basis	0.0	0.2	0.9	1.2	1.7	1.7
Balance on a commitment basis	0.0	0.0	0.0	0.0	0.0	0.0
Foreign investment projects						
Grants	11.2	8.3	6.9	4.5	3.1	2.8
Expenditure on a commitment basis	14.0	9.7	7.9	5.5	4.2	4.3
Balance on a commitment basis	-2.9	-1.4	-1.0	-1.0	-1.1	-1.5
Memorandum item:						
Nominal BiH GDP (in millions of KM)	8,989	10,054	10,959	11,627	12,173	12,911

Sources: Ministries of Finance; and IMF staff estimates.

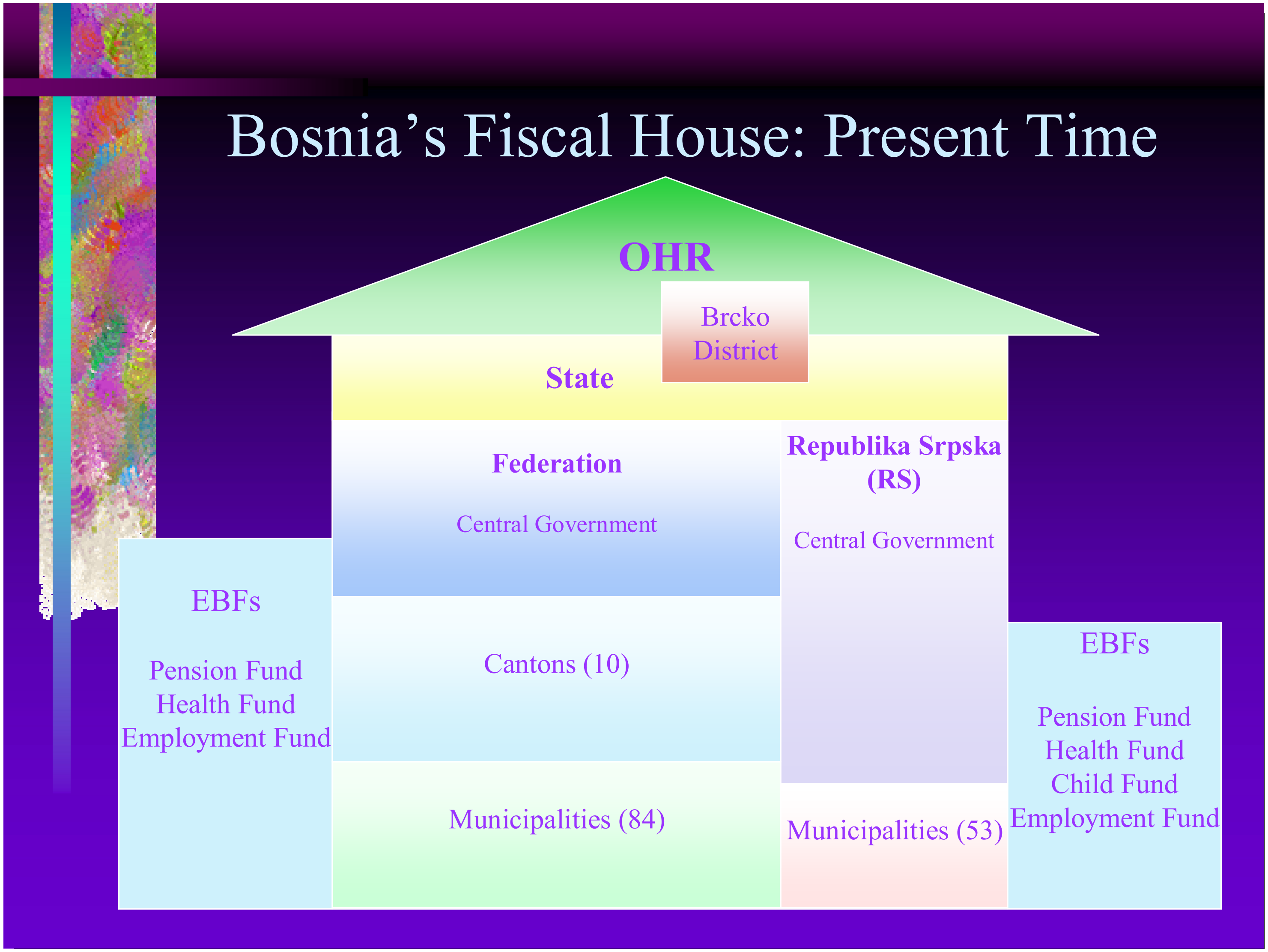
1/ Includes transfers to Cantons and extrabudgetary funds.

2/ Pension Fund, Health Fund, and Employment Fund. Also includes the Children's Fund in the RS.

3/ Includes transfers to extrabudgetary funds.

4/ Data for 1999 and 2000 are incomplete.

Figure 1. Bosnia's Fiscal House: Present Time



5. **In the absence of such an institution, each independent component of fiscal system has incentives to free-ride on the others, undermining incentives to secure an appropriate fiscal balance.** The individual component fiscal institutions—in the Entities and so on—have no incentive to take account of the appropriate aggregate fiscal stance when determining their own balances. In addition to this incentive problem, few of the component parts of government publish data on their activities, which inhibits the ability of "outsiders" to monitor and discipline those developments. The consequent "free-riding" problem undermines essential fiscal support for the currency board.

6. **Controls on borrowing are also weak.** These are set in the budget laws, with sub central government units and extra budgetary funds often allowed to borrow for investment and short-term purposes, subject to ceilings relative to revenue. But ex ante and ex post central monitoring of these activities is inadequate, it is ambiguous if the ceilings refer to stocks or flows, arrears accumulation is not addressed, and extra budgetary funds are often not covered by the rules. Regulations on the provision of government guarantees are also loose. The weaknesses of these rules compounds the free rider problem by allowing scope for the various component parts of government to act relatively freely.

7. **Market discipline—in the form of risk priced into the cost of credit—has proven to be a weak force to address these problems.** Certainly, access to official external credit is tightly disciplined by the creditors and is increasingly differentiated between the two Entities. Alongside, access to external and domestic commercial bank credit has, so far, been relatively modest. But access to credit in the form of spending arrears has been large and—by definition—undisciplined. This partly arises from the lack of a system of commercial courts through which payment can be enforced, and it gives rise to part of the challenge of domestic claims on government (See Chapter 4). But even if all creditors were to price country and exchange rate risk into yields for the individual fiscal units, those units would still obtain credit at yields which predominantly reflect the policies of other units. So the component parts of the fiscal system would still lack price incentives to align their individual activities with the necessary aggregate stance. Market discipline on the free rider problem is thus weak, and would still be weak even if tolerance for spending arrears was reduced.

8. **So weak is the authorities' focus on the aggregate fiscal stance that data on consolidated revenue, spending, and the balance are not even collected.** The Central Bank has recently initiated work to collect consolidated fiscal data some two years in arrears on a GFS basis. But no institution collects up to date consolidated fiscal data, even though this merely requires adding up the data which the component fiscal institutions produce. This is a particularly acute case of data weaknesses which are discussed in Chapter 2.

9. **Second, indirect tax policy has been set and administered at Entity level.** Given free flow of goods across the inter-entity borders, this has led to considerable tax arbitrage when policies—and their administration—have not been harmonized. This has greatly complicated preparation of Entity revenue projections and determination of the related spending commitments, and has on occasion caused heavy losses in revenue. Accordingly, this has weakened the necessary overall fiscal support for the currency board. A concerted

effort over several years has helped to move indirect tax systems towards harmonization, but until recently, harmonization was maintained solely at the discretion of each of the various component parts of the fiscal system. The Entities also operate different corporate income and personal income taxes, but given the slower pace of arbitrage in activity covered by these taxes, the associated risks to the budgets have been more muted than has been the case for indirect taxes, accordingly giving rise to less macroeconomic risk.

10. **Third, tax and expenditure powers are often separated.** For example, policy on external tariffs is set by the State, but the revenue accrues to the Entity central governments to fund their spending. In addition, in the RS, sales tax revenue partly accrues to municipalities, and in the Federation, it accrues entirely to the Cantons and municipalities, but sales tax policy in both cases is under the purview of the central Entity governments. The key risk arising from such divorces of decision-making over revenue from that over spending is that policy on revenue takes insufficient account of spending ambitions, putting those spending ambitions and delivery of the appropriate fiscal stance at risk. And this separation does not only refer to tax and spending; external finance raised by the Entities requires authorization by the State.

11. **These "separation" risks could theoretically be resolved with effective intergovernmental coordination, but this has proved elusive.** Coordination even within coalitions which straddle the different tiers of government has been lacking, perhaps partly reflecting the conflicts which gave rise to these institutional separations in the first place at Dayton. And, in the case of policy on customs tariffs, such coordination between the different tiers of government is further complicated because customs revenue is a much higher share of Federation central government revenue than it is for the RS central government, so that the fiscal implications of any given tariff policy for the two affected Entity governments are very different in each case.

12. **Fourth, as a special case of this separation of revenue and spending authority, arrangements to fund the State are ad hoc.** Funding for State activities is almost entirely provided directly by the Entities. The related transfers are determined in annual ad hoc negotiations between the Entities and the State, and the monthly transfers are made at the (monthly) discretion of the Entities. This renders the State hostage to the Entities and compromises delivery of an appropriate consolidated fiscal balance for BiH even though the State is small.

13. **In addition to these four macroeconomic architectural concerns, a number of further issues arise, straddling macro and micro concerns.** There are no transfer arrangements to equalize spending between or within Entities. Partly as a result, pension and budget remuneration rates vary significantly for similar persons between the Entities, between them and the State, and between all these and Brcko District. These inequities aggravate pressures for upward equalization, a force for increased total spending. Lack of coordination of initiatives in defense, judiciary, intelligence services, police, and war veterans have caused a variety of frictions and inefficiencies, and even on public investment

projects which affect both Entities—such as road building—coordination is poor. And the proliferation of extra budgetary funds diminishes control and transparency.

14. **These characteristics of the fiscal architecture have required an unusually deep engagement by the IMF to address.** Understandings in Fund programs on fiscal balances of the component parts of government alongside general embargoes on accrual of new spending arrears have addressed the free rider problem directly, and therefore have established appropriate aggregate target fiscal stances. Understandings on harmonization of indirect tax policy have helped to eliminate destabilizing tax arbitrage. And the Fund has often played a key intermediating role in resolving issues raised by the separations of revenue, spending external borrowing powers and the annual and monthly administrative transfers to the State. The Fund staff have also consolidated fiscal data, ensuring that the evolution of aggregate fiscal developments has been monitored.

15. **But the unusually prominent role of the Fund in making the architecture work is symptomatic of the need for profound reform, which is now underway.** In addition to standard challenges of operating a fiscal system which arise in any country—unanticipated shocks to the economy or policy and capacity constraints etc—one of the insufficiently noted costs of the multiple failings in the Bosnian fiscal architecture is that the energy required of the authorities simply to operate their system has detracted from the resources they have available to reform it. But reform is nevertheless underway, spearheaded by initiatives in the framework for indirect taxation.

C. Reconstructing the Fiscal Architecture

16. **Reforms of the framework for setting indirect tax policy underway make major headway to resolve many of these architectural weaknesses.** Most obviously, they resolve finally the problem of harmful tax competition in indirect tax policy and administration. But they also could fill the gap in the Dayton fiscal architecture by establishing an institution with an interest—and possibly eventually a mandate—to set and monitor delivery of appropriate consolidated fiscal stance, though key details on this still need to be determined. And even though, as noted below, these reforms are unlikely to completely resolve the free rider problem, the proposals tackle many of the architectural failings.

17. **During 2003, a commission on Indirect Taxation mapped out a new framework closely following earlier IMF recommendations (Box 1)**.[1] Accordingly, the Entity and Brcko customs administrations will be merged into the ITA, all indirect tax legislation will henceforth be State level rather than Entity level legislation, with their parameters determined by the Board of the ITA. This arrangement secures

[1] IMF Country Report No 03/204, July 2003, page 15, paragraph 25.

Box 1: The Framework Law on Indirect Taxation

The law was approved by all Entity and State legislatures in late 2003. Indirect taxes, as defined in this law, include import duties, excises, the sales tax, the VAT, road fees, and other taxes levied on goods and services. These yield revenue of 17 percent of GDP or close to 40 percent of total government revenue in 2003. It establishes the ITA, an independent State-level organization with its headquarters in Banja Luka (capital of the RS) and four regional offices. The latter will be set-up based on functional organization (e.g., audit, enforcement). The ITA Director was appointed in December 2003 by the State Council of Ministers for a period of five years. All indirect taxes will eventually be collected by the ITA, although there are some exceptions for the transition period until the VAT is introduced (see Chapter 5).

The ITA's **Governing Board (GB)** consists of six members (the Entity and State Ministers of Finance, and three experts on indirect taxation, one each to be nominated by the respective governments. The ITA Director and a representative from the CBBH are observers on the Board. The Board meets at least monthly. The Chairman of the GB is to be elected by majority vote from among the Board members for two years. An "Initial Chairman"—who is not a BiH citizen—shall be an additional member of the GB for the first five years and this post has been filled.

The **GB is in charge of indirect tax policy**. If the GB is unable to reach decisions by consensus, various tie-breaking rules apply.

a. Decisions on changing import duties can be taken by simple majority, but this has to include the vote of the State Minister of Finance reflecting the role assigned to the State in Dayton in regard to external tariff policy.
b. For other decisions (e.g., on rates or exemptions of the sales tax or VAT), a simple majority of votes is required, including the votes of both Entity Ministers of Finance. This reflects the practice that Entities have designed indirect tax policy and received the associated revenue. It also maintains the link between authority over revenue policy and the spending funded by it at Entity level.
c. Decisions on revenue distribution can only be taken by a majority including the votes of all three Ministers of Finance.

The GB will advise all the fiscal authorities on the implications of indirect tax policy for public finances with the objective to prepare fiscally responsible budgets. It can initiate the preparation of new laws, the amendment of existing laws, and the issuance of regulations on indirect tax policy. The GB presents its proposals to the State Council of Ministers, and subsequently to the State legislature, for approval. Prior to this, the GB can give the parliamentary budget committees in the RS, Federation, and Brcko District the opportunity to comment on draft laws or law amendments, if deemed necessary.

All revenue collected by the ITA will accrue to a single account. The funds will be allocated first for external debt service (through the State), then to fund the administrative transfers due from the Entities to the State, then for operating costs of the ITA, and the remainder will be allocated to the Entities and Brcko District according to a formula based on their shares in final consumption. The details of this revenue allocation formula will need to be determined.

harmonization of administration of all indirect taxes and customs, harmonization of indirect tax policy across the whole country, and, through the voting rules of the Board, a close link is maintained between decisions on indirect tax policy and spending to be funded from the associated revenue.

18. **In addition, the authorities envisage developing the ITA Governing Board into a body to coordinate broader fiscal policies.** As the only institution where the three key Ministers of Finance will be formally required to coordinate, it provides a natural venue to develop coordination more generally. The Board could thus double as a National Fiscal Council (NFC). At the outset, such broader coordination will be entirely voluntary to reflect the sensitivities which gave rise to the devolved constitutional arrangements in Dayton. Any development of its role will require consensus.

19. **The NFC could address several more of the architectural difficulties noted above.** It could provide a venue where the authorities could propose targets for and monitor delivery of the consolidated fiscal balance. Within its current powers, it could also make proposals on the apportionment of the targeted consolidated balance between the various component fiscal units—including the Entities and the State. And it could advise on expenditure reform policies that affect both Entities and the State and guide formation of direct tax and public sector borrowing rules.

20. **The NFC's voluntary status means it can only ameliorate the free rider problem, rather than end it.** As indirect tax policy is rendered subject to mutual vetoes, negotiations between the various partners over the exercise of these vetoes could take into account such broader issues, such as the free rider problem—"I will agree to your indirect tax proposal if you agree to a deficit target acceptable to me." Thereby, the free rider problem could be addressed, even if not completely resolved. Complete resolution of this problem may require formal development of some form of "internal stability pact," aiming to achieve for Bosnia what the Stability and Growth Pact (SGP) was aimed to achieve for the Euro area. But even leaving aside the tricky issues of enforcement and penalties, the formulation of such a pact will be technically and politically demanding. Given the existence of the State, which covers the whole country, ceilings on borrowing or deficits cannot be defined on a uniform basis relative to GDP for each component of the aggregate fiscal system—the approach implicit in the SGP which defined limits for each member country. So an even more complex system may be required, given the current constitutional arrangements and the reluctance to transform them.

21. **In any event, an institutional setup will be required for the NFC.** Given the role for it outlined above, its natural membership would be the three Ministers of Finance with the Central Bank as observer. But it could also be the same membership as for the GB of the ITA—the three ministers, plus one expert nominated by each government. It could be supported by a small secretariat, perhaps lodged within the ITA but separated from the ITA's tax administration functions. And if its role is to deepen, it may need a legal mandate at some point (i.e., delegated decision making power from Entity and State parliaments) as well as well-specified decision-making rules, which may differ by type of issue. All this lies ahead.

Note, however, that unlike NFCs elsewhere, which are often aimed to depoliticize fiscal policy by handing it over to experts, the proposal here is motivated by need for more effective fiscal policy coordination, not depoliticization.

22. **The ITA and NFC proposals require support from reform in three other areas—within-Entity tax assignments and fiscal practices, the rules on borrowing, and determination of annual funding for the State.**

- In the Federation, the assignment of sales tax revenue to the Cantons and the consequent heavy reliance of its central government on customs revenue concentrates the exposure of both to revenue shocks. A new intra-Federation revenue allocation formula could give each a share of all taxes, though any reforms should anticipate VAT (Chapter 5). Also in the Federation, internal intergovernmental liaison needs strengthening, notably through regular monthly meetings between the Canton and central government Ministers of Finance, and the practice should be formalized.

- Rules on borrowing by each part of the fiscal system need to be strengthened, notably to ensure that the NFC members have the authority to ensure that their Entities' consolidated fiscal balance outturns will be consistent with agreements they commit to at the NFC. The practice of accrual of spending arrears has much diminished over the past two years. But the discipline to stop it will require completion of reforms underway to establish commercial courts and the associated enforcement of payment.

- With the monthly transfers to the State secured by the ITA, a formal system to determine annual administrative transfers to the State is required to replace the ad hoc arrangements now in place. A rule could be based on a percentage share of some revenue streams—perhaps all indirect tax revenue—or on a simple fixed nominal annual increment each year. The former approach would have the drawback that the impact on the State budget of any change in indirect tax policy would be greater than its impact on Entity budgets because all its revenue would come from that source while only part of Entity's revenue would come from that source. This inequality would cloud decisions on adjustments to indirect tax policy. The latter would avoid these problems, but the number chosen for the automatic annual increase would have an arbitrary element. Either approach would have to allow for adjustments which may be made to the expenditure functions of the state, and for need to encourage the State to secure economies in spending on its activities. A formal rule, on either basis, would allow better medium-term planning by both the Entities and the State and therefore help to secure an appropriate consolidated fiscal stance.

D. Conclusion

23. **The fiscal system established at Dayton is undergoing fundamental reform.** But key elements of the indirect tax reforms which are spearheading those efforts have yet to be worked out, notably in relation to the tasks and functioning of the proposed NFC. And even if those matters are satisfactorily resolved, key revenue assignments, borrowing rules, and

arrangements for the administrative transfers to the State still need to be determined. Critically, the reforms underway retain the spirit of Dayton—pooling sovereignty rather than transferring it, and they therefore work within the compromises which were necessary to secure peace. But they seek to address the worst effects of the Dayton compromises on aggregate fiscal policy. Thus, within those constraints, the fiscal system is becoming a more effective tool with which to solve problems, but there is still some way to go.

IV. Domestic Claims on the Governments[1]

A. Introduction

1. **The citizens of BiH have accumulated large claims on their governments.** These claims accrued before, during, and after the 1992–95 war. They mostly relate to frozen foreign currency deposits, war damage claims, and government spending arrears. The claims could exceed 200 percent of GDP.

2. **Though countries faced with such burdens have generally resolved them through hyperinflation, the authorities have committed to a uniquely ambitious solution which guards macroeconomic stability.** They propose to do this by converting the claims into very long bonds and cash payments, both at large discounts in net present value (NPV) terms. This note describes the claims, outlines the problems they posed, assesses the authorities' proposals, and notes the implementation challenges ahead.

B. Extent and Nature of the Claims

3. **Current estimates of the domestic claims exceed 200 percent of GDP (Text Table 1)**. However, the exact magnitude of the claims depends on various legal and procedural issues. Also, other claims may yet emerge.

Text Table 1. Potential Domestic Claims
(In percent of entity GDP or total GDP)

	RS	Federation	Total
Frozen deposits	28	14	18
War claims	126	139	131
Vouchers	0	71	48
Spending arrears	9	6	7
Liabilities to banks	0	0	0
Others	1	1	1
Total	164	230	204

Frozen foreign currency deposits

4. **Residents of the former Socialist Federal Republic of Yugoslavia (SFRY) were allowed to hold their savings with domestic banks in foreign currency-denominated deposits**. The counterpart assets to these deposits were held in the central bank in Belgrade and the deposits carried an explicit guarantee from the SFRY government.

5. **The foreign currency deposits were frozen when, following the secession from the SFRY, BiH banks no longer had access to the counterpart foreign exchange reserves in Belgrade.** Without such a freeze, commercial banks in BiH would have collapsed. A similar freeze was effected in Croatia and Serbia and Montenegro. The latter two countries have since put in place repayment schedules according to which depositors will receive their money back over an extended period of time (see Annex I). Until December 2003, this had not been done in BiH.

[1] Prepared by Geert Almekinders.

6. **The BiH governments took over the guarantee on the frozen deposits.** More than KM 2.2 billion (18 percent of GDP) in deposits are still outstanding, affecting more than a quarter of the population. The possibility to use frozen deposits as a means of payment in the divestiture of government-owned apartments and companies only led to a KM 0.3 billion reduction in the face value of the stock of frozen deposits during 1998–2003. Of the 1.3 million deposit accounts, some 800,000 do not exceed KM 100 (US$65).

War damage claims

7. **A 2001 ruling by the RS Supreme Court allowed citizens to file claims for war damages against their own government.** The court ruled that the Law on Obligatory Relations—inherited from the SFRY and designed to address claims of individuals against each other for damages—was applicable to war damage claims.[2] Therefore, the use of the RS army in combat operations was considered an activity within the scope of the RS government's obligations. This gave rise to lump sum benefits for damages caused by death of relatives and other non-material damages suffered by veterans and victims of war.

8. **Thousands of claims have been filed in the RS courts.** The total value of the claims on the RS government resulting from this are estimated at KM 4.5 billion (126 percent of RS GDP). This includes some KM 3 billion in accrued penalty interest.

9. **So far, in the Federation, the procedures for filing non-material damage claims appear less well-established**. However, claims for non-material damages have also been filed in the Federation courts. Given that combat operations during the 1992–95 war took place mostly on what is now the territory of the Federation, it could be expected that the damage claims arising would, if allowed to proceed, more than proportionally exceed those in the RS.

Domestic spending arrears

10. **Weaknesses in public expenditure management caused the accumulation of substantial government spending arrears in the post-war years through 2001.** Concerted efforts were made in the first half of 2003 to establish the total stock of domestic spending arrears. With assistance from an expert from the IMF's Fiscal Affairs Department, and after scrutiny by the Entities' audit institutions, the arrears were estimated at 9 percent of entity GDP in the RS and 6 percent of

Text Table 2. Spending Arrears
(In percent of entity GDP)

	RS	Fed.
Wages	1.1	0.3
Pensions	2.9	2.3
Veterans benefits	1.7	1.6
Suppliers	2.4	0.6
Others	1.1	1.4
Total	9.2	6.3

[2] Appellate case No. 28/01 dated June 22, 2001.

entity GDP in the Federation (Text Table 2). Some legal issues are yet to be resolved in defining these arrears.[3] Moreover, a systematic assessment of spending arrears of the Federation cantons is still to be completed.

Claims on government resulting from the privatization of state-owned enterprises

11. **In the process of privatization of banks and companies, the entity governments took over responsibility for their debts**. The latest estimate of these claims on the RS government amount to KM 40 million. However, more work is needed regarding the verification of these claims, including in the Federation.

Claims on government resulting from the issuance of privatization vouchers

12. **Privatization vouchers still represent potentially very large claims on the Federation government**. Immediately after the 1992–95 war, the governments of both entities issued vouchers to their citizens. The amount of vouchers allocated depended on various parameters such as age, length of government service, length of military and government service during the war, unpaid pensions, unpaid wages, etc. These vouchers could be used, at face value, to purchase government-owned assets such as apartments and companies at inflated book values. In the RS these vouchers recently expired. However, in the Federation the use of the remaining outstanding stock of vouchers, some KM 5.8 billion (71 percent of Federation GDP), was extended in 2003.

Debts to domestic banks

13. **The governments' debts to domestic banks unrelated to the takeover of privatization-related claims are small**. In November 2003, they amounted to KM 23 million (0.2 percent of GDP).

Other claims

14. **Other claims may yet emerge**. A key remaining source of possible additional claims is the restitution process—with citizens still pressing for compensation (and for property to be returned) following seizures after 1945. In addition, a recent judgment by the Human Rights Chamber of Bosnia and Herzegovina ordered the payment of KM 3.5 million to relatives of the Srebrenica massacre victims. The judgment reportedly related to the cases of

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[3] For instance, successive budget laws in the RS appear to have virtually ruled out government arrears. These laws stated that, to the extent that budgetary assets were not available, sublegal regulations (such as the labor law or the pension law) could not create obligations of the government. Similarly, the pension laws in both entities indicate that average monthly pensions are to be adjusted to the financial means available to the pension fund in a given month.

49 missing persons and the court has another 1,700 cases on its books relating to Srebrenica alone. The exact implications of this recent judgment by the Human Rights chamber have still to be determined. And the estimates for the identified claims may also be significantly amended.

C. Three Problems Raised by the Domestic Claims

15. **Firstly, public indebtedness including the claims is, by standard measures, unsustainable—and hence an impediment to investment, employment, and growth.** Pending a resolution of the claims, potential investors are deterred by the possibility that:

- A costly settlement could require higher taxes or a cut in government services.
- A default on the claims could undermine payment discipline throughout the economy.
- And a fiscal crisis could develop if all creditors would stop lending to the government because it can not pay its obligations.

16. **Secondly, policy towards restructuring public indebtedness including the claims has to take the external debts as given because they have already been written down substantially by external official and commercial creditors in the late 1990s.** At the end of the war, external debt was unsustainable and was not being serviced. By end-1997, total external public debt, including outstanding external payment arrears and late interest exceeded US$4 billion (100 percent of GDP). As a result of a debt relief by the London Club group of commercial creditors, the Paris Club group of bilateral official creditors, as well as multilateral creditors, Bosnia's external debt has been reduced to a sustainable level and further concessions from external creditors are unlikely (see Annex II for an external debt sustainability analysis). At end-2003 total external debt is estimated at US$2.6 billion (34 percent of GDP). Given that much of it is on concessional terms, the net present value of the debt, at 26 percent of GDP, is substantially lower than its face value. And the annual debt service burden, at 2.1 percent of GDP or less than 8 percent of the estimated value of exports of goods and nonfactor services in 2003, is manageable.

17. **Third, the majority of the domestic claims are still unregulated in the sense that no formally agreed terms and conditions for interest and repayment exist—so citizens have no idea of when or how satisfaction will be provided.** One of the few guidelines is that the governments of both entities have adopted moratorium laws which stipulate that the frozen foreign currency deposits and war damage claims will not be paid out until budgetary resources have been identified. However, holders of other claims have initiated court cases to obtain payments and attempted to seize government deposits to pay the court-ordered awards. Such court awards could therefore disrupt basic government operations.

18. **Accordingly, the authorities took the view that efforts to secure public debt sustainability had to focus on restructuring the domestic claims and that their resolution was urgent.**

D. Sustainability

19. **The first challenge was to determine how much of the domestic claims to settle and how much to write off.** A study published in the recent World Economic Outlook[4] indicates that emerging market economies whose public debts exceed 50 percent of GDP face a high risk of economic crisis and that the sustainable public debt level for a typical emerging market economy may only be about 25 percent of GDP.

20. **Two frameworks were used to assess sustainability of the domestic claims in the Bosnian context.**

21. **First, the status quo was assessed using a framework endorsed by the IMF's Executive Board[5] (Table 3 and 5).** This indicates that Bosnia's current public indebtedness—excluding these domestic claims—is comfortable, even in the face of the shocks examined in that framework, fundamentally because economic growth is projected well above real interest rates and because the primary fiscal balance is projected to remain firm over this short- to medium-term horizon. However, the public debt ratios are on an increasing trend in an alternative scenario in which it is assumed that the structural reforms necessary to sustain the growth rates of the past 5 years are not implemented. This suggests, with a qualification that the reform effort needs to be strong, that there is capacity to settle at least some of the domestic claims without compromising sustainability in the short-to medium term.

22. **Second, a longer term framework was developed.** This abstracts from "particular" features of the Bosnian economy currently—such as its current access to some concessional external credit and so on. This framework operates in NPV terms. In this context, if real interest rates are assumed at 2 percentage points higher than trend real growth,[6] the debt ratio is on a declining path if a fiscal primary surplus of 1 percent of GDP is maintained, the 2003 outturn (base case scenario in the Text Table 3). This exercise therefore confirms the finding of the standardized debt sustainability analysis, that there is scope for a debt settlement.

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[4] See "Public Debt in Emerging Markets: Is it Too High?", Chapter III in the IMF's *World Economic Outlook* of September 2003

[5] See *Assessing Sustainability* (www.imf.org) and *Sustainability Assessments—Review of Application and Methodological Refinements* (www.imf.org).

[6] In the very long run, BiH's external debt will be rolled over into debt instruments with a market-based interest rate and real growth will have converged to industrial country levels.

Text Table 3. Scenarios for Settlement of Domestic Claims (in percent of GDP)

	2003	Base Case 2010	(a) 2010	(b) 2010
NPV of Public debt	26	23	49	33
New debt in 2004	…	0	25	10
Primary balance	1	1	1	1
Overall balance	-1	-1	-3	-1
Real growth (%)	3.5	3	3	3

23. **Two alternative scenarios were prepared for sensitivity purposes.** In scenario (a) with long-run growth of 3 percent and real interest rates of 5 percent, 25 percent of 2003 GDP of new claims are recognized in NPV terms, along with the primary surplus of 1 percent of GDP. Debt ratios do not fall in this scenario and reach 49 percent of GDP by 2010. The authorities viewed this strategy as too risky. Scenario (b) takes the same growth, interest rate and primary balance assumptions and considers recognition of 10 percent of GDP in new debt. Here debt ratios are on a declining trend, falling to 33 percent of GDP in 2010.[7]

24. **Thus, with a long run growth-interest differential in the region of 2 percentage points, recognition of a NPV of 10 percent of claims could be sustainable with a primary balance of 1 percent of GDP.** In NPV terms this would mean that public debt was some 36 percent of GDP and on a declining path. Recognition of claims in excess of that would require a strengthening of the path for the primary balance to retain sustainability. However, the authorities regarded this as undesirable.

[7] The assumption of a 2-percentage point differential between real growth and real interest rates is important. If that differential was 4 percentage points, either because growth was weak or risk premia were high or both, BiH sustainability considerations would plead for settling even less of the domestic claims. However, the case for basing an assessment on a 4-percentage point differential between interest and growth rates is not strong. If long run growth was 3 percent, this differential would imply nominal KM rates of 9 percent, compared with euro rates currently around 4.2 percent. This spread of 450–500 bps compares with spreads for Bulgaria and Romania, countries with risk profiles similar to Bosnia, of around 250 bps.

E. Proposals to Restructure Domestic Claims

24. **The authorities decided to limit the total cost of the plan to settle the vast amount of domestic claims on government to 10 percent of 2003 GDP in NPV terms**. This requires large write-downs on the bulk of the claims as well as immediate action to place an embargo on the completion of court rulings on war damage claims to prevent new claims emerging and to remove the legal basis for the accrual of penalty interest on the war claims. Table 1 summarizes the plans to settle claims on the government of the Federation (top panel) and the RS (bottom panel). The authorities have made concrete proposals on the form of these write downs, but these proposals may be adjusted before implementation to the extent that new data become available on the stock of the claims. The authorities are committed to make any adjustments while retaining the cap of 10 percent of GDP in NPV terms for the settlement.

25. **A key element of the strategy to effect the required write-downs in a manner that is legally sound is to issue to the holders of the claims very long-term bonds which pay a very low or no interest.** For instance, to settle the war damage claims for which finalized court decisions exist, the authorities in both entities plan to issue 50-year amortizing bonds with a 40-year grace period and which pay no interest. This would achieve a 94 percent reduction in the net present value of the claim (Text Table 4).

Text Table 4: Summary of Bond Issues in the Context of the Domestic Debt Settlement Plan

	Face value (in KM m)	Maturity (years)	Grace period (years)	Interest rate	NPV reduction (percent)
Bonds for holders of frozen deposits					
Federation	1005	20	10	0.5%	55
RS	715	30	20	0%	78
Brcko District	85	20	10	0%	60
Bonds for war-related claims					
Federation	900	50	40	0%	94
RS	600	50	40	0%	94
Bonds for budgetary arrears					
RS	168	40	30	0%	88
Total	3472				
(in percent of BIH GDP)	28.5				

Table 1. Bosnia and Herzegovina: Plans to Settle Domestic Claims on the Governments (in millions of KM)

Federation of Bosnia and Herzegovina (in millions of KM)

Title	Amount	Cash payment	Bonds	Write off	Bonds			Interest		NPV
					20 y.- 10y grace	40 y. 30y grace	50y. 40y grace	0%	0.5%	
I General Liabilities										
Disability Pensions	127	28		99						28
Pensions	191	129		62						129
Suppliers	51	20	0	31						20
Net salaries & compensations	26	26		0						26
Other Liabilities	548	0	0	548						0
TOTAL:	942	203	0	740						203
II Frozen foreign currency deposits	1,110	105	1,005		X				X	556
III War damage claims	900		900				X	X		57
IV Commercial bank loans	11	11								11
TOTAL (I+II+III+IV)	2,963	319	1,905	740						826
(in percent of Federation GDP)		3.9	23.4							10.1

Republika Srpska

Title	Amount	Cash payment	Bonds	Write off	Bonds			Interest		NPV
					30 y.- 20y grace	40 y.- 30y grace	50y.- 40y grace	0%	0.5%	
I General Liabilities										
Disability Pensions	60	10		50						10
Pensions	104	60		44						60
Suppliers	88		88			X		X		10
Court Verdicts	25		25			X		X		3
Other Liabilities	30	15	15							17
Privatization	40		40			X		X		5
Net salaries & compensations	41	15		26						15
TOTAL:	387	100	168	119						119
II Frozen foreign currency deposits	775	60	715		X			X		214
III War damage claims	600		600				X	X		38
TOTAL (I+II+III)	1,762	160	1,482	119						372
(in percent of RS GDP)		4.4	41.0							10.3

26. **Legal advice, including from the OHR considers that these proposals are necessary to meet the requirements of the European Court of Human Rights in Strasburg**. The advisors believe that this settlement which pays the face value of the claim over an extended period of time would be viewed as striking an appropriate balance between the rights of individual claimants and the public interest (e.g. preserving a sustainable fiscal position and maintaining macroeconomic stability).

27. **The plans approved by the Federation government allow for the continued use of privatization certificates, but on a limited basis.** The outstanding stock of these vouchers remains large and their continued unlimited use in the privatization process, at face value, could significantly erode the net worth of the government. Accordingly, the authorities propose to allow continued use of these certificates through June 2007 only. However, in any bid by an individual for the privatization of a garage, a business premises, or shares in a company, the share of certificates shall not exceed 10 percent of that individual's bid.[12]

28. **The settlement plan also envisages cash payments of some 4 percent of BiH GDP** (Text Table 5). In addition to the issuance of long-term bonds with a face value of 28.5 percent of GDP and a NPV of 6 percent of GDP, the plans of the Federation and the RS call for the settlement of some claims in cash to be paid out over a number of years:

Text Table 5. Cash Payments Under the Plan

	In KM m	In % of GDP
Federation	319	3.9
RS	160	4.4
State	1	…
Brcko District	9	…
Total	489	4.0

- Some government arrears to suppliers, pensioners, and civil servants will be paid in cash

- Cash payments will also be made to individuals holding small frozen foreign currency deposits.

F. Implementation Challenges

29. **The implementation of the plans is likely to prove even more challenging than their preparation**.

30. **Several tasks in the legal area are crucial**:

- There is need for immediate embargos on the completion of court rulings on war damage claims.

[12] In the privatization of housing, individuals may make up to 100 percent of their payment in certificates.

- Determination of how the writing off of interest on finalized court decisions regarding war claims can be effected and secured in a legally sound way.

- The preparation, for each entity, of one comprehensive law governing the settlement of all claims for each entity government (not separate laws for each class of claims on government). This should make clear to any court to which appeal is subsequently made that the settlement of individual claims is part of a large overall settlement and that the (partial) write-off is necessitated by the large total amount of the claims.

- A possibly protracted verification process. If the verification of the claims is not completed by mid-2004 as envisaged in the governments' decisions, the exact terms of the settlements may have to be adjusted at a later date to ensure that the final settlement is still consistent with sustainability.

- Before the verification process begins, the standards of proof required for each of the categories of claims on government have to be determined.

Procedural and logistical challenges are substantial. They are posed by the following:

- In view of the number of claimants involved, the verification of claims will be logistically demanding. Outside technical assistance may be necessary.

- Databases need to be established in both entities to track the valid claims that have been identified for each class of claims and to improve monitoring mechanisms to track the current use of privatization vouchers and frozen foreign currency deposits.

- More work is needed to verify the claims on government resulting from the privatization of state-owned enterprises. This will require a cooperative effort, in both entities, of the ministry of finance, the privatization agency, the banking agency, and the CBBH.

- Procedures need to be established to track the arrears of the federation cantons. These arrears remained largely a blind spot in the plan to settle claims on government and this needs to be corrected.

- Technical work needs to be initiated in both entities to prepare for the issuance of government bonds. The staff sees merit in the issuance of registered bonds—which would require the drawing up of modalities and requirements for a registry—and believes that the bonds should probably include collective action clauses to facilitate their future reorganization. The authorities should make good use of technical assistance that is being offered to facilitate this work, including from the U.S. Treasury.

- The biggest challenges are political—gathering support for these plans among the public and in the respective National Assemblies. Many citizens' aspirations will be disappointed in this initiative to secure fiscal sustainability.

G. Conclusion

31. **The authorities have taken a bold step, without international precedent in terms of its scale and ambition.** In large part, the claims on government are the result of earlier policy errors and attempts to pay them in full would simply compound those mistakes—putting macro stability and prosperity at further risk. The authorities will need to be equally bold in implementing their plans.

FROZEN FOREIGN CURRENCY DEPOSITS IN CROATIA AND SERBIA AND MONTENEGRO

1. In **Croatia**, the government assumed responsibility for the foreign currency denominated-deposits in 1992. At the time, they amounted to about US$3 billion. The government issued to the banks "counterpart bonds" which were denominated in domestic currency and indexed to the German mark. In order to prevent the withdrawal of these deposits from the banking system—which would have precipitated the failure of the banks—these deposits were blocked for a period of three years (until July 1995), and thereafter unfrozen at the minimum rate of 20 semi-annual installments.[1] The government also issued bonds (called JDA and JDB bonds) to finance the first two installments of principal of the counterpart bonds. The stock of frozen deposits was reduced considerably early on, partly due to the fact that banks were permitted to reduce the deposits more rapidly at their own discretion, but mainly due to budgetary repayments, which have amounted to about ½ percent of GDP per annum. Interest payments on these deposits have been made twice annually, and in a timely fashion

2. In **Serbia and Montenegro**, the government suspended withdrawals from households' foreign exchange balances with domestic banks in 1991. The deposits were redeposited with the central bank of Serbia and Montenegro, whose foreign reserves were run down. A 1998 law converted the deposits into public debt, capitalized the interest (based on a government-set interest rate of 2 percent per annum) and established an ambitious repayment schedule for these deposits. The total public debt assumed by this law amounted to DM 7.4 billion, equivalent to 35 percent of GDP in 2001. Based on this law, the repayment started in 2000 and the federal government issued a decree in January 2001 on two special state bonds to be issued to the holders of such deposits. The servicing of these bonds would have placed a heavy burden on the budget starting in 2005. With a view to alleviating these pressures, the federal and Serbian governments decided to modify the original repayment schedule to ensure that annual payments would be limited to no more than 0.9 percent of projected GDP in 2005 and subsequent years, compared to over 2 percent of projected GDP in 2005–11 on average under the original repayment schedule. Uncertainty arose over the overall size of the obligation as withdrawals were more limited than expected.

[1] In addition, during the three-year period the deposits were blocked, individuals were permitted to buy back their blocked deposits at a 30 percent discount or to exchange them for government bonds which could be used to purchase socially-owned apartments or enterprises. These proved to be attractive alternatives and, as a result, frozen foreign currency deposits fell from HRK 13.9 billion at end-1993 to HRK 10.8 billion in June 1995.

BOSNIA AND HERZEGOVINA—EXTERNAL DEBT SUSTAINABILITY ANALYSIS

A. Summary

1. **The debt sustainability analysis (DSA) presented in this annex includes three components:**

- a **medium-term baseline scenario** which sets out assumptions on economic policies and key parameters;
- a set of **stress tests** around the baseline, which are intended to explore the robustness of baseline projections to alternative assumptions on key parameters and macroeconomic performance. The stress tests are based on BiH's performance during 1999–2003; and
- an **alternative scenario** which illustrates debt dynamics in the absence of policy reforms aimed at restructuring the corporate sector and the labor market.

2. Partly reflecting data availability, **the analysis focuses on the sustainability of public and publicly-guaranteed external debt.** As a result of creditworthiness problems, private sector external debt is small.[1] And so far, domestic debt of the general government is negligible.[2] The prospective issuance of bonds under the governments' plan to settle domestic claims will obviously increase the face value of the outstanding stock of public debt. However, the NPV of these bonds is about 6 percent of GDP and because the bonds are envisaged to have very long maturity and grace periods and pay no or very little interest, the implementation of the domestic debt plan will only affect BiH's sustainability and vulnerability to shocks over the very long term.[3]

3. **The baseline scenario shows a continuing steady improvement in debt indicators.** This fundamentally reflects that economic growth is projected well above real interest rates

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[1]At end-2003, the EBRD's and the EIB's lending portfolio to the private sector amounted to €38.7 million and €12.5 million, respectively. BIS data suggests that private sector credit from foreign commercial banks has been available mostly only to BIH's commercial banks.

[2] The governments of BiH have not yet issued any domestic debt instruments. General government debt to the banking system, which is denominated in domestic currency, amounted to less than ¼ percent of GDP at end-2003

[3] The stress tests consider the impact on medium-term debt sustainability of a hypothetical government takeover of sizable contingent liabilities; the experiment is a standardized one and not tailored to the estimated size of domestic claims on the governments or other contingent liabilities.

and because the primary fiscal balance is projected to remain firm through 2009. Under those circumstances, Bosnia's current and projected indebtedness is comfortable, even in the face of the common array of shocks.

4. **However, the alternative scenario indicates that substantial risks remain if structural reforms are not implemented as envisaged in the baseline scenario**. In the "no policy change" scenario growth slows, essentially because the "peace dividend" has been exhausted and the structural reforms necessary to underpin medium-term economic development are not implemented. In this scenario it is also assumed that the governments are unable to contain pressures to increase spending. In conjunction with the modest growth of the tax base, this would cause a reversal of the recent gains in fiscal consolidation. Under those circumstances, and since the governments do not have access to central bank credit, public debt ratios would increase to unsustainable levels and the country would become very vulnerable to shocks.

B. Background on BiH's External Public Debt

5. **The substantial improvement in Bosnia's debt indicators over the past six years is the result of a concerted effort.** Following the breakup of the former SFRY and during the war, BiH accumulated substantial arrears towards all of its external creditors. At end-1997, total external public debt, including outstanding external payment arrears and late interest exceeded €3.6 billion (100 percent of GDP). As a result of a concerted effort by the authorities of BiH, the London Club group of commercial creditors, the Paris Club group of bilateral creditors, and multilateral creditors, the external debt at end-2003 is estimated at €2 billion (34 percent of GDP) (Text Table 6).

Text Table 6. External Public Debt by Creditor at end-2003

	(in € m)	(in % of total)
World Bank	1,075	53
IBRD	474	23
IDA	602	30
IMF	106	5
EBRD	44	2
EIB	47	2
Paris Club	502	25
London Club	134	7
Others	114	6
Total	2,023	100

Memo item: Potential addition to London Club debt: € 223 million

6. **Policy measures implemented by the governments of BiH contributed to the improvements in the debt and debt-servicing ratios** in four ways:

- Despite sometimes difficult conditions, the authorities made efforts, beginning in 1996 and 1997 to normalize the country's relations with all creditors (see below).

- Fiscal consolidation led to an improvement in the primary balance by almost 9 percentage points of GDP between 1999 and 2003.
- Sound macroeconomic policies contributed to real GDP growth rates averaging 5½ percent over the same period.

- Almost all of Bosnia's new borrowing has been on concessional terms.

7. **Commercial and official bilateral and multilateral creditors also helped BiH to make a fresh start by spreading out debt service payments over time:**

- Following clearance of arrears to the Fund, membership in the IMF was achieved in December 1995 and Bosnia immediately became the first member to make use of Fund resources under the institution's policy on emergency assistance for post-conflict countries.

- Clearance of arrears to, and membership in the World Bank was accomplished in 1996 through the consolidation of IBRD obligations into three loans.

- In December 1997, a rescheduling agreement with the London Group of commercial bank creditors was signed, reducing eligible debt by 73 percent in NPV terms.[4]

- In October 1998, a rescheduling and debt-reduction agreement was signed with the Paris Club group of sovereign creditors. Under the agreement, Bosnia's eligible debt was reduced by 67 percent in NPV terms.

8. **With high concessionality and a relatively long maturity structure, and against the backdrop of continued high government revenues, the debt-servicing burden of BiH's external debt is manageable**. The rescheduling agreements with the Paris Club and London Club groups of creditors in 1998–1999 substantially reduced the burden of the relevant debts. Also, Bosnia continues to receive concessional loans from the World Bank and more than half of total debt is now owed to the World Bank (Text Table 6). Reflecting the concessionality of much of the external debt, the NPV of the total debt amounts to about 26 percent of GDP and the annual debt service burden, at 2.1 percent of GDP or less than 8 percent of the estimated value of exports of goods and nonfactor services in 2003, is manageable.

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[4] The agreement with the London Club group of creditors stipulates that of the total amount of restructured obligations (€357 million) a "basic amount" equivalent to 37.5 percent of the total will be subject to servicing over 20 years with 7 years grace and graduated amortization payments, with interest rates starting at 2 percent per year during the first four years, 3½ percent per year during the next three years, and LIBOR plus 13/16 thereafter. For the "performance amount", equivalent to the remaining 62.5 percent of the restructured obligations to the London Club group of creditors, bonds will be issued to the creditors if GDP per capita exceeds US$2,800 (measured at 1997 prices) in two consecutive years by 2017. This would therefore add €223 million to BiH's external debt (Text Table 6). The staff presently estimates per capita GDP at US$1,822. Adjusted for inflation, the threshold now amounts to about US$3,000.

C. Baseline Medium-Term Scenario

9. **The baseline scenario is predicated on maintenance of a stable macroeconomic environment and accelerated implementation of structural reform**. It assumes an annual average real GDP growth rate of 6 percent of GDP during 2004–2009, about equal to growth during 1999–2003 (Table 2). The current account deficit would decline progressively, with export and imports assumed to grow at an average annual rate of 13 percent and 5 percent, respectively, in euro terms, about equal to the growth rates estimated for 2002–03.

10. **On the financing side, aid, including new concessional borrowing, is assumed to decline further.** This is in line with recent trends and indications from key donors who plan to scale down assistance to Bosnia and/or provided more in the form of technical assistance rather than direct general financial assistance. Given that Bosnia's creditworthiness assessment is expected to improve only slowly, commercial borrowing is not expected to fill the void soon. Instead, foreign direct investment in Bosnia is projected to increase somewhat, to an average of 5¾ percent of GDP over the medium term.

11. **The baseline scenario shows a steady further improvement in external debt indicators** (Table 3). The debt to GDP ratio is projected to fall to 22 percent by 2009. Reflecting the assumed strong growth of exports, the external debt to exports ratio is projected to be cut in half, from 136 percent in 2003 to 67 percent in 2009.

D. Stress Tests

12. **Standard sensitivity tests were applied to gauge the robustness and ambitiousness of the baseline projections.** The tests assume that key macroeconomic variables (e.g. growth, interest rates, and the current account balance) are above or below their recent historical averages by a factor reflecting their historical volatility. Historical averages are computed for the last five years (1999–2003) and volatility is measured through standard deviations.

13. **The stress tests show that the medium-term debt dynamics can be quite sensitive to common shocks to key macroeconomic variables**. As expected, lower growth causes the debt to GDP ratio to worsen compared to the baseline (stress test B2). The largest adverse effect on the debt ratio is from a worsening in the current account balance (stress test B4) and a 30 percent nominal depreciation of the KM (stress test B6). However, given that the shocks are assumed to be only temporary, the debt ratio starts to improve again beyond 2006 because of the projected strong growth and continued concessional interest rates on the external debt.

Table 2. Bosnia and Herzegovina: Macroeconomic Framework, 2000–09

	2000 Est.	2001 Est.	2002 Est.	2003 Est.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.
Real sector										
Nominal GDP (In millions of KM)	10,054	10,959	11,627	12,173	12,911	13,861	14,951	16,200	17,607	19,169
(Percentage change)	11.8	9.0	6.1	4.7	6.1	7.4	7.9	8.4	8.7	8.9
Real GDP (In millions of 1999 KM)	9,479	9,895	10,441	10,806	11,352	12,001	12,704	13,490	14,355	15,298
(Percentage change)	5.5	4.4	5.5	3.5	5.1	5.7	5.9	6.2	6.4	6.6
CPI, period average percentage change	5.0	3.2	0.3	0.1	0.9	1.7	2.0	2.1	2.2	2.2
Savings and investment (In percent of GDP, national accounts basis)										
Consumption	110.0	113.1	112.5	111.1	108.2	105.9	103.2	100.3	97.5	95.3
Public consumption	25.5	23.5	23.4	22.5	22.1	21.0	19.9	18.9	18.0	17.1
Private consumption	84.4	89.6	89.1	88.7	86.1	84.9	83.3	81.4	79.5	78.2
Investment	20.6	18.9	20.4	19.9	20.3	20.9	21.4	21.9	22.1	22.3
Public investment	10.9	9.2	6.3	4.5	4.8	4.5	4.2	4.1	4.0	4.0
Private investment	9.7	9.6	14.1	15.5	15.5	16.3	17.1	17.8	18.1	18.3
National savings	7.6	2.7	1.9	2.5	4.6	6.0	8.2	10.9	13.2	15.0
Public savings	0.4	1.2	0.3	2.0	1.5	2.6	3.1	3.4	3.5	3.5
Private savings	7.2	1.5	1.7	0.6	3.0	3.4	5.1	7.5	9.7	11.5
Foreign savings	13.1	16.2	18.5	17.4	15.8	14.8	13.1	11.0	8.9	7.3
General government (In percent of GDP)										
Total revenue and grants	53.7	49.7	48.1	46.7	45.8	44.4	43.0	41.7	40.5	39.3
Grants	9.5	7.2	5.1	3.4	3.3	2.1	1.4	1.0	0.8	0.6
Total expenditure	60.7	53.1	50.4	46.3	45.9	44.4	42.9	41.6	40.4	39.2
Current expenditure	49.8	43.8	44.1	41.9	41.1	39.9	38.7	37.5	36.3	35.2
Capital expenditure	10.9	9.2	6.3	4.5	4.8	4.5	4.2	4.1	4.0	4.0
Own-financed capital expenditure	1.2	1.3	0.8	0.2	0.5	1.1	1.7	2.2	2.6	2.5
Foreign financed capital expenditure	9.7	7.9	5.5	4.2	4.3	3.4	2.5	1.9	1.4	1.4
Overall balance	-7.0	-3.3	-2.2	0.4	-0.1	0.0	0.1	0.1	0.1	0.1
Overall balance excl. grants	-16.4	-10.6	-7.3	-3.0	-3.4	-2.1	-1.3	-0.9	-0.7	-0.5
Accumulation of arrears (- = increase)	-3.9	-0.8	0.2	0.5	0.7	0.6	0.5	0.5	0.5	0.4
Overall balance on a cash basis	-3.1	-2.5	-2.4	-0.2	-0.9	-0.6	-0.4	-0.4	-0.4	-0.3
Financing	3.1	2.5	2.4	0.2	0.9	0.6	0.4	0.4	0.4	0.3
Domestic financing	1.1	0.7	0.5	0.0	-0.2	-0.1	0.0	-0.2	0.1	0.4
Foreign financing	2.0	1.8	1.9	0.1	1.1	0.7	0.4	0.6	0.3	-0.1
Total foreign assistance 1/	12	9	8	5	6	4	3	2	2	1
(In millions of US dollars)	576	477	447	352	486	334	260	221	193	152
Balance of payments (In millions of US$)										
Current account balance (including official transfers)	-621	-811	-1,036	-1,224	-1,319	-1,333	-1,276	-1,156	-1,021	-907
(Percent of GDP)	-13.1	-16.2	-18.5	-17.4	-15.8	-14.8	-13.1	-11.0	-8.9	-7.3
Export growth rate (In percent)	7	5	20	35	22	13	14	15	15	14
Import growth rate (In percent)	-1	6	16	23	12	5	6	6	6	7
Gross reserves	497	1,221	1,279	1,725	1,714	1,764	1,814	1,864	1,914	1,964
(Months of imports of goods and n.f. services)	2.2	5.1	4.6	5.1	4.4	4.4	4.2	4.1	4.0	3.8
Total public debt										
(In millions of US$)	2,814	2,382	2,523	2,572	4,930	4,997	5,038	5,041	4,966	4,880
(In percent of GDP)	58.8	48.2	42.2	34.0	59.7	56.2	52.5	48.5	44.0	39.7
Total external debt service in percent of exports of goods and non-factor services	7.3	6.3	8.5	7.8	6.6	6.6	5.7	4.0	4.7	4.4
Memorandum item:										
Percentage change in real current public expenditure	1.3	5.9	11.3	1.3	4.0	1.9	2.3	2.7	3.0	3.2

Sources: Data provided by the Bosnia and Herzegovina authorities; and IMF staff estimates and projections.

1/ Includes disbursements of foreign loans, and grants.

Table 3. Bosnia and Herzegovina: External Debt Sustainability Framework, 2000–09
(In percent of GDP, unless otherwise indicated)

	Actual/Estimates				Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
					I. Baseline Projections					
External debt 6/	58.8	48.2	42.2	34.0	**32.8**	**31.2**	**29.3**	**27.1**	**24.2**	**21.6**
Change in external debt	-6.9	-10.6	-6.0	-8.2	-1.2	-1.6	-1.9	-2.3	-2.8	-2.7
Identified external debt-creating flows (4+8+9)	12.1	10.6	8.5	3.4	5.5	6.6	5.0	3.1	1.1	0.5
Current account deficit, excluding interest payments	11.7	15.2	16.2	15.5	15.3	14.1	12.5	10.5	8.2	6.7
Deficit in balance of goods and services	30.4	32.5	30.9	29.0	28.9	27.1	24.9	22.5	19.9	17.8
Exports	26.9	26.3	24.6	25.1	27.2	27.7	28.8	30.0	31.3	32.4
Imports	57.3	58.7	55.5	54.0	56.1	54.7	53.7	52.5	51.2	50.3
Net non-debt creating capital inflows (negative)	-3.1	-2.6	-3.8	-4.2	-5.1	-6.1	-5.9	-5.8	-5.8	-4.9
Automatic debt dynamics 1/	3.5	-2.0	-3.8	-7.9	-4.8	-1.5	-1.6	-1.6	-1.4	-1.3
Contribution from nominal interest rate	1.4	1.2	1.3	0.7	0.6	0.9	0.8	0.6	0.8	0.7
Contribution from real GDP growth	-3.7	-2.4	-2.4	-1.2	-1.4	-1.7	-1.7	-1.7	-1.6	-1.5
Contribution from price and exchange rate changes 2/	5.8	-0.7	-2.7	-7.4	-3.9	-0.6	-0.6	-0.6	-0.6	-0.5
Residual, incl. change in gross foreign assets (2-3)	-18.9	-21.2	-14.5	-11.6	-6.7	-8.2	-6.9	-5.3	-3.9	-3.2
External debt-to-exports ratio (in percent)	218.5	183.7	171.9	135.8	120.6	112.7	101.8	90.1	77.3	66.5
Gross external financing need (in billions of US dollars) 3/	0.7	0.8	1.1	1.3	1.4	1.4	1.4	1.2	1.1	1.0
In percent of GDP	13.6	16.9	18.3	17.5	17.1	16.0	14.2	11.7	9.7	8.1
Key Macroeconomic Assumptions										
Nominal GDP (US dollars)	4.8	4.9	6.0	7.6	8.3	8.9	9.6	10.4	11.3	12.3
Real GDP growth (in percent)	5.5	4.4	5.5	3.5	5.1	5.7	5.9	6.2	6.4	6.6
GDP deflator in US dollars (change in percent)	-8.2	1.3	6.0	21.2	13.0	1.9	2.1	2.2	2.2	2.2
Nominal external interest rate (in percent)	2.1	2.1	2.9	2.0	2.1	2.9	2.7	2.4	3.2	3.2
Growth of exports of gods and services (US dollar terms, in percent)	-3.1	0.7	13.2	29.0	18.7	9.4	12.3	13.1	13.4	12.7
Growth of imports of goods and services (US dollar terms, in percent)	-2.5	5.8	14.4	23.0	13.5	5.0	5.9	6.0	5.9	6.9
Current account balance, excluding interest payments	-11.7	-15.2	-16.2	-15.5	-15.3	-14.1	-12.5	-10.5	-8.2	-6.7
Net non-debt creating capital inflows	3.1	2.6	3.8	4.2	5.1	6.1	5.9	5.8	5.8	4.9
					II. Stress Tests for External Debt Ratio					
A. Alternative Scenarios										
A1. Key variables are at their historical averages in 2005-09 4/					**32.8**	**33.4**	**35.2**	**38.4**	**42.5**	**47.1**
A2. "No policy change" scenario (see Table 6c)					**32.9**	**32.5**	**32.0**	**31.4**	**30.1**	**28.7**
B. Bound Tests										
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006					**32.8**	**31.2**	**29.5**	**27.2**	**24.4**	**21.7**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006					**32.8**	**33.2**	**32.6**	**30.1**	**27.1**	**24.2**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006					**32.8**	**36.8**	**37.8**	**30.4**	**23.3**	**17.3**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006					**32.8**	**37.1**	**42.4**	**39.4**	**35.9**	**32.6**
B5. Combination of 2-5 using one standard deviation shocks					**32.8**	**37.1**	**41.4**	**38.4**	**34.8**	**31.3**
B6. One time 30 percent nominal depreciation in 2005					**32.8**	**40.2**	**33.8**	**27.9**	**22.0**	**16.9**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

E. “No Policy Change” Scenario

14. The steady worsening of the public debt ratio under a “no policy change” scenario highlights the risks associated with possible delays in implementing reforms of the corporate sector and the labor market. The expansion of exports and total output since 1997 is in large part related to the “peace dividend”. However, the corporate sector may soon find itself unable to extend the rebound it has enjoyed since the war. Corporate lossmaking, high unemployment, and limited progress in privatization suggest that comprehensive structural reforms are necessary to sustain the recovery of exports and total output. The projected course of key macroeconomic variables in the absence of necessary reforms is summarized in Table 4. The expansion of export, required to sustain overall growth in the economy, would come to a halt. Compared to the baseline scenario, this would give rise to permanent output losses and a commensurately smaller tax base. As a result, government revenues would be insufficient to satisfy the demands for additional public spending. Given that the government has no recourse to borrowing from the central bank, new domestic spending arrears would be accumulated, adding to the outstanding stock of domestic debt and exacerbating vulnerabilities to external and domestic shocks.

Table 4. Bosnia and Herzegovina: "No Policy Change" Scenario, 2003–09

	2003 Est..	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.
Real sector							
Nominal GDP (millions of KM)	12,173	12,709	13,142	13,525	13,797	14,012	14,230
Real GDP (percentage change)	3.5	3.4	1.7	0.9	-0.1	-0.6	-0.6
CPI, period average percentage change	0.1	0.9	1.7	2.0	2.1	2.2	2.2
Investment	19.9	19.3	18.7	17.8	16.9	16.3	15.8
National savings	2.5	3.3	3.1	3.3	4.0	5.1	6.0
Domestic savings	-11.1	-9.6	-9.5	-9.4	-9.1	-8.3	-8.0
Public	1.6	0.6	0.1	-1.4	-3.7	-6.4	-9.4
Private	-12.7	-10.2	-9.6	-8.0	-5.5	-1.9	1.4
General government (percent of GDP)							
Overall balance	0.4	-0.9	-2.5	-4.6	-7.4	-10.5	-13.9
Accumulation of new arrears (gross)	0.0	0.7	2.5	4.7	7.5	10.7	14.0
Repayment of old arrears (gross)	0.5	0.7	0.6	0.6	0.6	0.6	0.6
Overall balance on a cash basis	-0.2	-0.9	-0.6	-0.5	-0.5	-0.4	-0.4
Public debt	34.0	61.4	62.5	65.9	72.1	80.8	92.6
Balance of payments (US$ millions.)							
Current account balance (including official transfers)	-1,224	-1,319	-1,333	-1,276	-1,156	-1,021	-907
(Percent of GDP)	-17.4	-16.0	-15.6	-14.5	-12.9	-11.2	-9.8
Export growth rate (in %)	35	10	7	5	3	3	1
Import growth rate (in %)	23	8	2	2	0	-1	0

Sources: Data provided by the Bosnia and Herzegovina authorities; and IMF staff estimates and projections.

Table 5. Bosnia and Herzegovina: Public Sector Debt Sustainability Framework, 2000–09
(In percent of GDP, unless otherwise indicated)

	Actual				Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
					I. Baseline Projections					
Public sector debt 1/	58.8	48.2	42.2	34.0	**59.7**	**56.2**	**52.5**	**48.5**	**44.0**	**39.7**
Of which: foreign-currency denominated	58.8	48.2	42.2	34.0	32.8	31.2	29.3	27.1	24.2	21.6
Change in public sector debt	-6.9	-10.6	-6.0	-8.2	25.6	-3.5	-3.7	-4.0	-4.5	-4.3
Identified debt-creating flows (4+7+12)	3.5	0.8	-6.4	-9.3	5.1	-4.4	-4.4	-4.4	-4.1	-3.8
Primary deficit	5.6	2.2	1.0	-1.1	-0.7	-0.9	-0.9	-0.8	-0.9	-0.8
Revenue and grants	53.7	49.7	48.1	46.7	46.1	44.7	43.3	42.0	40.7	39.6
Primary (noninterest) expenditure	59.4	51.9	49.1	45.6	45.4	43.8	42.4	41.2	39.8	38.7
Automatic debt dynamics 2/	-0.9	-0.6	-7.3	-8.2	-1.8	-3.4	-3.4	-3.5	-3.1	-2.9
Contribution from interest rate/growth differential 3/	-5.6	-3.7	-1.5	-1.2	-1.3	-3.3	-3.4	-3.4	-3.1	-2.9
Of which contribution from real interest rate	-2.4	-1.3	1.0	0.2	0.3	-0.1	-0.4	-0.5	-0.2	-0.2
Of which contribution from real GDP growth	-3.2	-2.4	-2.5	-1.4	-1.6	-3.2	-3.1	-3.0	-2.9	-2.7
Contribution from exchange rate depreciation 4/	4.8	3.1	-5.8	-7.0	-0.5	-0.1	0.0	0.0	0.0	0.0
Other identified debt-creating flows	-1.3	-0.7	-0.1	0.0	7.6	-0.1	-0.1	-0.1	-0.1	-0.1
Privatization receipts (negative)	-1.3	-0.7	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	7.7	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	-10.4	-11.4	0.4	1.2	20.5	0.9	0.7	0.3	-0.4	-0.5
Public sector debt-to-revenue ratio 1/	109.5	97.0	87.7	72.9	129.6	125.8	121.4	115.6	107.9	100.3
Gross financing need 5/	7.6	3.8	3.2	1.0	1.1	0.9	0.7	0.4	0.5	0.6
in billions of U.S. dollars	0.4	0.2	0.2	0.1	0.1	0.1	0.1	0.0	0.1	0.1
Key Macroeconomic and Fiscal Assumptions										
Real GDP growth (in percent)	5.5	4.4	5.5	3.5	5.1	5.7	5.9	6.2	6.4	6.6
Average nominal interest rate on public debt (in percent) 6/	2.2	2.2	2.7	1.8	2.0	1.6	1.5	1.3	1.8	1.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-3.8	-2.3	2.2	0.6	1.1	-0.2	-0.6	-0.8	-0.4	-0.4
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.4	-5.3	14.1	20.7	3.1	0.2	0.1	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	6.1	4.4	0.5	1.2	1.0	1.7	2.0	2.1	2.2	2.2
Growth of real primary spending (deflated by GDP deflator, in percent)	-2.8	-8.8	-0.1	-3.9	4.5	1.9	2.3	3.0	2.8	3.7
Primary deficit	5.6	2.2	1.0	-1.1	-0.7	-0.9	-0.9	-0.8	-0.9	-0.8
					II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios										
A1. Key variables are at their historical averages in 2005-09 7/					**59.7**	**59.5**	**59.2**	**58.5**	**57.1**	**55.8**
A2. "No policy change" scenario (see Table 6c)					**61.4**	**62.5**	**65.9**	**72.1**	**80.9**	**92.8**
B. Bound Tests										
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006					**59.7**	**58.3**	**56.7**	**52.3**	**47.3**	**42.7**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006					**59.7**	**60.9**	**63.6**	**62.7**	**60.9**	**59.0**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006					**59.7**	**66.5**	**72.4**	**66.9**	**61.1**	**55.5**
B4. Combination of 2-4 using one standard deviation shocks					**59.7**	**65.4**	**70.9**	**65.6**	**60.0**	**54.6**
B5. One time 30 percent real depreciation in 2005 8/					**59.7**	**70.9**	**66.2**	**61.1**	**55.6**	**50.4**
B6. 10 percent of GDP increase in other debt-creating flows in 2005					**59.7**	**66.2**	**61.9**	**57.3**	**52.2**	**47.3**

1/ General government gross debt. The steep increase in 2004 reflects the issuance of long-term bonds as part of the settlement of domestic claims on government.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

V. Selected Challenges in Tax Policy[1]

A. Introduction

1. **Tax policy will be critical in supporting medium-term policy objectives.** With a premium on maintenance on a strong fiscal stance, continued strong collections—alongside a determined effort to curb expenditure—will be key. In addition, the tax burden is high relative to the capacity of the tax administrations to collect payments, and 40 percent of GDP excluding grants, high relative to GDP. Thus, initiatives to lower the tax burden, consistent with a strong fiscal stance, will support broader reform initiatives.

2. **Reforms to indirect and direct taxes, and to customs tariffs are underway which, if successful, will help secure both these goals.** But success will require that implementation risks which arise in each case are addressed. This note outlines the objectives for reform in these three sets of taxes and draws attention to implementation risks in each case. In most cases, determination of the appropriate means to address the risks will require technical assistance.

B. Indirect Taxes and the Road to the VAT

3. **The authorities have committed to shift from sales tax to the VAT.** This reflects their assessment of the administrative and efficiency advantages of the VAT relative to the sales tax. Their decision thus reflects the need to ensure a strong revenue stream. The foundation arrangements for the VAT have been laid with the establishment of the ITA, which unifies the formerly disparate customs administrations and provides for a decision-making framework for policy on indirect taxes, including eventually, VAT (Chapter 3).

4. **Key challenges lie immediately ahead for the VAT.** As for all VATs, the law will need to be well designed, the reform will need to be well explained to citizens and taxpayers, and administrative arrangements within the tax administration will need to be strong. But in addition, further risks arise in the transition from sales tax raises which are unique in this context—notably concerning revenue allocation and sales tax administrations.

5. **In particular, technical issues in implementing the principle of revenue allocation according to final consumption must be resolved.** The transfer of revenue collection functions from the Entity tax administrations to the ITA will not occur overnight, but in a sequence. As a first step, all revenue collected by the merged customs administration will accrue to the ITA's single revenue account once it is established.[2] From this account

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[1] Contributed by Gunther Taube and Geert Almekinders.

[2] The indirect tax framework law requires the adoption of regulations on the allocation of indirect tax revenue, methods of payment into the single account, and customs policy, within six months from entry into force of the framework law (i.e., by end-June 2004). The ITA Director has to submit to the Governing Board a customs reorganization plan within 90 days
(continued)

revenue will need to be distributed, and the authorities are currently preparing technical proposals on what type of allocation formula to use for this purpose. One option that is under consideration would use past sales tax revenue collection as a proxy for final consumption as a basis for this formula. However, important details for this formula (e.g., baseline period) and on the allocation mechanism (e.g., frequency of revenue transfers to Entities) need to be determined. The law allows the Governing Board to review the revenue allocation formula every six months until the VAT is introduced. In addition to dealing with this kind of transitional issue, there may be need to establish different formulae for the different taxes.

6. **The relationship between the sales tax administrations and the ITA also needs to be resolved in the run up to the VAT.** While the framework law on indirect taxation prescribes that revenue from all indirect taxes will eventually (i.e., once the VAT is introduced) be collected by the ITA, the law includes some provisions that leave the administration of certain indirect taxes to the Entities during the transition period. These refer to the sales tax on domestically produced goods and services (including the railroad fee in the RS, and tobacco products on which the sales tax or railroad fee is accounted for during the purchase of tax stamps), excise tax on domestically produced goods (i.e., alcoholic and non-alcoholic beverages, tobacco products, coffee, oil and oil derivatives), and the domestically collected road fees.

7. **This approach poses a number of risks to revenue collections.** For example, well-trained and qualified staff will likely be attracted to work for the ITA, not least because this organization has a future, eroding the capacity of the Entity sales tax administrations in respect of domestic production. Further, if taxpayers know that the sales tax administration is to close, their incentives to comply with it currently may erode.

8. **These risks might be addressed if the sales tax administration for domestically produced goods and services was integrated into the ITA prior to introduction of VAT.** The sales tax administration could be progressively incorporated into the ITA during 2004–05, perhaps first for sales tax on domestically produced excisables and then for the other domestically produced goods and services. This approach would also avoid the simultaneous—and therefore doubly risky—introduction of a new tax administration and a new tax when VAT is introduced.

9. **But incorporating sales tax into the ITA carries risks too.** It would significantly compound the administrative burden on the ITA which already faces multiple institution-building challenges—including merging two customs systems, both with significant operational weaknesses, and with different pay scales and staffing issues.

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after the framework law becomes effective (i.e., by end-March 2004); the plan shall be approved by the GB within 30 days following its submission.

10. **Alternative solutions should also be explored therefore.** One approach could be to provide good sales tax administrators incentives to stay there until the sales tax administration is completely wound down. Such incentives could be in the form of job guarantees in the ITA. And risks of non-compliance by taxpayers ahead of the demise of the sales tax administration could be addressed by publicity indicating that sales tax arrears outstanding after the introduction of the VAT would continue to be enforced by the ITA.

11. **Concerning the structure of the VAT, the ITA is required by end-2004 to prepare a draft State level VAT law consistent with European Union standards, to be introduced no later than early 2006.** Accordingly, the authorities envisage a modern, broad-based VAT structure. In particular, they are considering two positive rates (standard rate, plus one reduced rate for food and selected other products), few exemptions (e.g., postal, health, and education services; financial services), zero-rating for exports, including customs duties and excises in the tax base, and a sufficiently high annual turnover threshold to exclude small traders. With technical assistance from the EU, a VAT implementation plan will be prepared by end-March 2004.

12. **But revenue allocation issues will also need to be carefully weighed in the design of the VAT.** For example, while a two-rate system would follow international norms, the administrative burden of having two rather than one rate is magnified in this case because the geographical origin of collections from goods under each rate may need to be tracked precisely in order to allocate the revenue appropriately between the Entities. This would strengthen the case to implement a single rate. Even leaving this aside, the general agreement that VAT proceeds should be distributed on the destination basis requires expression in a formula. The formula could be based on VAT returns or economic indicators (e.g., consumption as determined in the national accounts). But as the national accounts statistics are weak (see Chapter 2), it would appear advisable to apportion VAT revenue, at least at the outset, on the basis of past sales tax revenue collection and later according to VAT collections.

13. **Given the advanced state of readiness of the VAT law, progress towards unification of the customs administrations, and the key role of VAT in combating tax evasion, there is a strong case to target implementation of the VAT earlier than January 1 2006.** While undue haste carries risks, the attached timeline suggests that, with application, implementation from mid-2005 is feasible (See Table 1).

Table 1. Establishing the ITA and Introducing VAT—Action Plan

Immediate Actions	
Identify and agree on building for ITA headquarters in Banja Luka Agree on ITA budget and funding for 2004 Appoint other members of ITA Board	
Short- and Medium-Term Actions and Milestones	
Prepare VAT implementation plan Appoint VAT development team	January 2004
Prepare transition plan for ensuring the continued effectiveness of sales tax administration during the transition to VAT Recruit senior staff for ITA Send draft VAT law to IMF for comments	February 2004
Merger of customs administration under ITA should be fully operational. Agree on inter-Entity and Brcko customs revenue allocation formula and establish single revenue account Decide on strategy and implementation plan for integrating collection of sales tax on domestically produced excisable goods into ITA	March 2004
Complete ITA IT strategy	April 2004
Decide on VAT minimum threshold	May 2004
Present draft VAT law for discussion by ITA Board and policymakers	June 2004
Open first two regional ITA offices	June 2004
Agree a new indirect tax revenue allocation rule in the Federation Begin public education campaign for VAT implementation	July 2004
Agree on allocation formula for VAT and distribution mechanisms between Entities (IMF Technical Assistance)	September 2004
VAT law passed by legislatures	December 2004
VAT introduction	July 1, 2005

C. Corporate and Labor Tax Issues

14. **Alongside these efforts to strengthen indirect taxation, direct taxes are also under review.** Both Entities are preparing reforms to corporate income taxes which could be

implemented in 2005. Given that currently three corporate tax structures apply—one in each Entity (with rates of 30 and 10 percent) and another in Brcko District—harmonization will be a key issue. Collections from these taxes are, however, minimal (See Chapter 2).

15. **Brcko District has recently implemented a corporate income tax reform.** It introduced a new concept called "Allowance for Corporate Equity" (ACE) and the Entities are considering doing likewise. This entails a deduction for the imputed cost of equity that makes the tax system neutral regarding the choice between debt and equity financing. However, this tax is complex, favors capital-intensive enterprises with overvalued assets—a significant risk given the accounting weaknesses—and it could have excessive revenue costs.[3] These concerns appear to be decisive against and ACE-based profits tax. Nevertheless, there is a case for the Entities to harmonize their corporate tax structures as differentiation may increasingly give rise to arbitrage through corporate registration in one entity or the other. And duplication (triplilcation) is a further barrier to inward investors for whom more than one corporate tax system is unexpected.

16. **In addition, the Federation could usefully rationalize the internal allocation of revenue from its corporate income tax.** Collections from banks and other financial institutions (e.g., insurance and reinsurance companies), electric power generation, post and telecommunications services, and gambling accrue to the central government. But collections from companies in other sectors are allocated to the Cantons. This issue should be addressed as part of the broader review of revenue assignments within the Federation, as part of strengthening overall fiscal architecture (See Chapter 3).

17. **Labor taxes are also high, unharmonized across Entities, and complex.** Total labor taxes are 52 percent in the RS and 69 percent in the Federation (both expressed relative to net wages). This compares with an average tax rate for Central and Eastern European Countries in 1997/98 of 75 percent and 45 percent in OECD countries (both according to OECD data).Though not obviously out of line with the transition area, the apparently high rates of unemployment and tax evasion suggest that these rates may be excessive for the Bosnian context (See Chapter 2). Furthermore, in the RS, allowances are subject to taxation, while in the Federation they are not. Were reductions in labor taxation made, this would alleviate pressure for companies from rising wages, improve incentives for more employment, reduce underground economic activity, and reduce overall tax burdens. However, neither Entity was willing to undertake such reforms in the 2004 budgets. This largely reflected pressures from the spending side and implementation complications. The latter arise from the earmarking of particular labor taxes to particular expenditures—so that reductions in a particular labor tax may require offsetting additional transfers from the central budget to the affected fund(s) to replace revenue lost.

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[3] An ACE-based corporate profit tax was also introduced in Croatia in 1994, but abandoned in 2000 and replaced with a more orthodox corporate profit tax.

D. Taxation of International Trade

18. **Tariffs and the associated collections have been lowered in recent years, putting pressure to strengthen direct and indirect tax receipts.** The nominal effective composite import tariff is some 10 percent (Table 2). The composite consists of *ad valorem* customs duties, an import verification fee and specific surcharges on mostly agricultural goods:

- Customs duties are low with a maximum of 15 percent and an unweighted average of 6.4 percent. This is in line with European countries and below the world average of 13 percent.

- A one percent import verification fee is levied on all imports.

- Surcharges, none of which are *ad valorem*, are levied on about 850 mostly agricultural items. Revenue from the surcharges is equal to about 30 percent of revenue from "normal" customs duties on all 11,000 items in the tariff schedule. This suggests that the effective composite tariff rate on goods for which surcharges are levied is very high.[4]

19. **The effective rate has been lowered to about 8 percent due to the phasing in of free trade agreements (FTAs) with neighboring countries.** Free trade agreements are now effective with all of the former Yugoslav republics as well as with Albania, Bulgaria, Moldova, Romania, and Turkey. All these agreements, except those with Albania and Moldova are asymmetric in the sense that they provide for immediate duty free access of most of BiH's exports to those countries (and a phasing out of duties on a select list of goods over a three-year period) while tariffs on all imports into BiH from these countries are phased out over periods of three to five year.

[4] Effective January 1, 2003, the specific surcharges were formally merged with the *ad valorem* customs duties to create a composite tariff schedule. However, in the data reporting the two components are still reported separately.

Table 2. Bosnia and Herzegovina: Customs Revenues and Implied Import Tariffs by Entity, 2000–03.

	Customs revenue (1) (in KM m)	Evidence tax (2) (in KM m)	Surcharges (3) (in KM m)	Imports (4) (in KM m)	Effective tariff rate (5)=(1)/(4) (in percent)	Effective Evid. Tax (6)=(2)/(4) (in percent)	Composite rate incl surcharges ((1)+(2)+(3))/(4) (in percent)	Effective tariff rate	Effective Evid. Tax	Composite rate incl surcharges
								Corrected for effect of FTAs (in percent)		
Federation of Bosnia and Herzegovina										
2002	349	45	106	5,731	6.1	0.79	8.7			
m1-10 2003	278	35	80	4,780	5.8	0.73	8.2	7.1	0.9	10.1
Republika Srpska										
2000	113	18	49	1,900	5.9	0.97	9.5			
2001	108	16	58	1,697	6.4	0.94	10.7			
2002	125	18	44	2,164	5.8	0.82	8.6	7.8	1.1	11.6
2003	112	16	37	2,151	5.2	0.74	7.6	6.9	1.0	10.1

Sources: Customs administrations of the Federation and the RS.

20. **Under the FTAs, customs duties on goods imported into BiH are to be reduced to the following percentage of the normal tariff schedule**:

Table 3 Percentage of Standard Tariff Rates to be Applied to Imports from FTA Partner Countries

	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	Value of imports in 2002, in US$m
Croatia	70	60	40	0				698
Slovenia		70	50	30	0			435
Serbia and Montenegro		60	40	0				331
Macedonia		60	50	40	0			28
Turkey			65	50	35	15	0	30
Romania (only industrial goods)			50	40	0			13
Bulgaria (only industrial goods)			50	40	0			11
Albania (only industrial goods)				60	40	20	0	0
Moldova				50	40	0		0

21. **Surcharges aside, the tariff regime has broadly desirable characteristics, but the agenda ahead could usefully reflect several concerns.**

- First, further reductions in trade protection will support broader efforts to restructure domestic output. In this context, effective January 1, 2004 imports from Croatia and Serbia and Montenegro were supposed to have obtained duty free access to Bosnia and Herzegovina (see schedule above). However, in response to producers' concerns the authorities unilaterally postponed full implementation of the relevant FTAs for three months. This decision could complicate other trade negotiations and aspirations to secure accession to the WTO in 2004.[5]

- Second, revenue losses from trade liberalization impact most severely on the Federation central government, which relies heavily on those receipts, than on the RS central government which has a broader revenue base (See Chapter 3). Given the broader benefits of further trade liberalization, there may be need to adjust the internal revenue allocation systems within the Federation so as to better accommodate this.

- Third, given the general weakness of corporate governance—which essentially mean that many companies do not seek profits and therefore do not react appropriately to price signals—the gains to further trade reform are being attenuated by corporate weaknesses. This strengthens the case to accelerate the corporate reforms.

[5] BiH applied for WTO accession in May 1999 and a memorandum on the foreign trade regime was reviewed by the working party on BiH accession in November 2003. The next meeting of the working party could take place in the spring of 2004, following submission of BiH's comprehensive legislative action plan.

- A trade agreement with the EU provides some assurance that effective protection will not rise. This arises because BiH has duty free access to the EU on condition that it does not increase trade tariffs on goods imported from the EU. This arrangement is secured at least until 2005 and its scope will widen effective May 1, 2004 with the inclusion of the 10 EU accession countries.[6] It leaves scope, however, for accelerated reductions in tariffs on imported inputs to increase effective protection and for some trade diversion if tariffs are not applied uniformly. The authorities could consider adding commitments that, FTA's aside, the tariff regime would be uniform and that tariffs across the board will be lowered together.[7]

- Last, though EU accession is not yet imminent, duties on imports from the EU will be zero at the point of accession and it would be advisable to anticipate that in advance to allow appropriate adjustment of the economy ahead of full implementation. This could warrant adoption of a multi-year phased reduction in rates, following the example of other EU accessants.

E. Conclusion

22. **Reductions in tariffs have led recent initiatives to lower the overall tax burden, but a more integrated approach seems warranted in future.** In indirect taxes, initiatives are focused on strengthening administration and laying the groundwork for the VAT. These are welcome, but critical implementation risks—notably on revenue allocation and transitional arrangements for sales tax collections which have no direct parallel in other VATs—need to be addressed. And the revenue allocation processes also call for a simple VAT structure, preferably a single rate. A strong VAT, alongside determined expenditure reform will facilitate reductions in the overall tax burden. The latter appears best achieved through further tariff reductions and reductions in the burden of labor taxation. The former requires a reconfiguration of the internal revenue allocation system in the Federation. And both tariff and labor tax cuts will only realize their full potential in the context of profound reform of corporate structures through privatization and so on. In that context, corporate taxes should move towards simplification, harmonization, and a low rate, so as to encourage enterprise reform while also ensuring that as profitability strengthens, collections strengthen alongside.

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[6] Slovenia's entry into the EU causes its exports to Bosnia and Herzegovina to be taxed again at 100 percent of the import tariff schedule effective May 1, 2004.

[7] Regrettably, certification and phyto-sanitary regulations for meat and animal products fall short of EU requirements, impeding full utilization by producers of the beneficial access to EU markets. Approval of national phyto-sanitary legislation, which is part of the conditionality of the EU's macro-financial assistance facility, should help bring the quality of plants and seeds produced in Bosnia and Herzegovina up to international standards.