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**Bosnia and Herzegovina: Poverty Reduction Strategy Paper—  
Mid-Term Development Strategy**

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BOSNIA AND HERZEGOVINA  
COUNCIL OF MINISTERS OF BIH  
GOVERNMENT OF FEDERATION OF BOSNIA AND HERZEGOVINA  
GOVERNMENT OF REPUBLIKA SRPSKA  
OFFICE OF THE BIH COORDINATOR FOR PRSP

**MID-TERM DEVELOPMENT STRATEGY OF BOSNIA AND  
HERZEGOVINA (PRSP)  
2004-2007**

*"Let's support reforms, reforms are worthwhile. Reforms are our path to Europe!"*

MARCH, 2004

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## I.1. Abbreviations

ABD / HBS	Anketa o budžetu domaćinstava / Household Budget Survey
ASYCUDA	Automated SYstem for CUstoms Data / sistem za obradu podataka u carinskim upravama
BAC	Bussiness Environment Adjustment Credit / Kredit za prilagođavanje poslovnog okruženja
BEEPS	Business Environment and Enterprise Performance Survey / Anketa ocjene poslovnog okruženja i konkurentnosti kompanija (u zemljama u tranziciji)
BH ŽŽK	Bosanskohercegovačka javna željeznička korporacija / BiH public railroad corporation
CAFAO	Customs and Fiscal Assistance Office / Ured za pomoć pri carinskim i poreskim
CEE	Central and East Europe / Zemlje Centralne i Istočne Evrope
CERD	Committee on the Elimination of Racial Discrimination / Konvencija o eliminaciji svih oblika rasne diskriminacije
CIPS	Citizens Identity Protection System / Projekat izdavanja osobnih dokumenata
CORINE	Program EU
CRC	Children's Rights Convention / Konvencija o pravima djeteta
CRA	Communications Regulatory Agency / Agencija za regulative komunikacija
CRPC	Commission for Real Property Claims of Displaced Persons and Refugees / Komisija za imovinske zahtjeve raseljenih lica i izbjeglica
CSR	Centar za socijalni rad / Centar for Social Work
CTF	Consultative Task Force / Konsultativno radno tijelo
DERK	Državna regulatorna komisija za električnu energiju / State Regulatory Agency for Electricity
DEI	Direkcija za evropske integracije / Directorate for European Integration
DFID	Department for International Development / Odjel za međunarodni razvoj Vlade Velike Britanije
DOT	Digital Opportunity Task Force / Radne grupe za digitalne mogućnosti
EBRD	European Bank for Reconstruction and Development / Evropska banka za obnovu i razvoj
EC	European Commission / Evropska komisija
EEA	European Economic Area / Evropski ekonomski prostor
EIB	European Investment Bank / Evropska investicijska banka
ESI	European Stability Initiative / Evropska inicijativa o stabilnosti
EUPM	European Union Police Mission / Policijska misija Evropske unije
FAO	Food and Agriculture Organization / Organizacija za hranu i poljoprivredu
FDI	Foreign Direct Investments / Direktne strane investicije
FIAS	Foreign Investment Agency Services / Savjetodavna grupa za strane investicije
FIPA	Foreign Investment Promotion Agency / Agencija za promociju stranih investicija
FTA	Free Trade Agreement / Sporazum o slobodnoj trgovini
GDP	Gross Domestic Product / Bruto domaći proizvod
GDLC	Global Distance Learning Center / Globalni centar za učenje na daljinu
GIS	Geography Information System / Geografski informacioni sistem
GTZ	Deusche Gesellschaft fur Technische Zusammenarbeit
HDI	Human Development Index / Indeks ljudskog razvoja
IBHI	International Bureau for Humanitarian Issues / Međunarodni biro za humanitarna pitanja
ICAO	International Civil Aviation Organization
IC/MZ	International Community / Međunarodna zajednica
I(C)T	Information-(communication) technologies / Informaciono-(komunikacijske) tehnologije
ICVA	International Council of Voluntary Agencies / Međunarodno vijeće volonterskih organizacija
IDA	International Development Agency / Međunarodna razvojna agencija
IGA	Investment Guarantee Agency / Agencija za garanciju investicija
IGTF PAR	Inter – governmental Task Force for Public Administration Reform / Vladina radna grupa za reformu javne uprave
ILO	International Labour Organization / Međunarodna organizacija rada

IMAS	International Mine Actions Standards / Međunarodni standardi za uklanjanje mina
IS	Informational Society / Informatičko društvo
ISP	Internet servis provajder / Internet service provider
LSMS	Living Standard Measurement Study / Anketa o ispitivanju životnog standarda
MBA	Master in Business Administration
MDG	Millenium Development Goals / Milenijski ciljevi razvoja
MG	Monitoring groups / Monitoring grupe
MIGA	Multilateral Investment Guarantee Agency / Multilateralna agencija za garanciju investicija
MOU	Memorandum of Understanding / Memorandum o razumijevanju
MTEF	Middle-Term Expenditure Framework / Srednjoročni okvir rashoda
MVTEO/MFTEO	Ministry of Foreign Trade and Economic Relations / Ministarstvo vanjske trgovine i evropskih integracija
NGO/NVO	Non-government Organizations / Nevladine organizacije
NHDR	National Human Development Report / Izvještaj o humanom razvoju
NEAP	National Environment Action Plan / Nacionalni akcioni plan u oblasti zaštite okoliša
NEHAP	National Environment Health Action Plan / Nacionalni akcioni plan u oblasti zdravstva
NISP	National Information Society Policies / Nacionalne politike o informatičkom društvu
NORAD	Norwegian Agency for Development Cooperation
OECD	Organization for Economic Cooperation and Development / Organizacija za ekonomsku saradnju i razvoj
OHR	Office of the High Representative / Ured Visokog predstavnika
OSCE	Office of Security and Cooperation in Europe
PDV	Porez na dodanu vrijednost / Value Added Tax (VAT)
PIC	Peace Implementation Council / Vijeće za implementaciju mira
PIF	Privatization Investment Fund / Privatizacijski investicioni fond
PIU	Project Implementation Unit / Jedinica za implementaciju projekta
PRSP	Poverty Reduction Strategy Paper / Srednjoročna razvojna strategija BiH
REFA	German Association in charged for organization and development of enterprises/ Njemačko Udruženje koje se bavi organizacijom i razvojem preduzeća
SAA	Stabilization and Association Agreement / Sporazum o stabilizaciji i pridruživanju
SAP/SSP	Stability and Association Process / Proces stabilizacije i pridruživanja
SEED	Southeast Europe Enterprise Development
Sida	Swedish International Development Corporation Agency
SMEs/MSP	Small and Medium Enterprises / Mala i srednja preduzeća
SOR	Srednjoročni okvir rashoda / Middle-Term Expenditure Framework
SOTAC	Social Sector Technical Assistant Credit / Projekat tehničke pomoći za socijalni sector
TI BiH	Transparency International BiH
TTI	Transport Training Institute / Institut za transportni trening
UNDP ICT	Forum United Nations Development Project Information communication Technologies / Forum UNDP-a za informaciono-komunikacijske tehnologije
UNMAC	United Nations Mine Action Center / UN-ov centar za uklanjanje mina
UPOV	The International Union for the Protection of New Varieties of Plants / Međunarodna organizacija za zaštitu biljnih vrsta
VAT/PDV	Value Added Tax / Porez na dodanu vrijednost
VE	Vijeće Evrope / Council of Europe
VM	Vijeće ministara BiH / Council of Ministers BiH
WTO	World Trade Organization / Svjetska trgovinska organizacija
WG	Working groups / Radne grupe
WHO/SZO	World Health Organization / Svjetska zdravstvena organizacija
WTO	World Trade Organization / Svjetska trgovinska organizacija

## **I.2. THE GENESIS OF THE BiH MEDIUM-TERM DEVELOPMENT STRATEGY (PRSP)**

The preparation of the BiH Medium-Term Development Strategy (PRSP) started in April 2002 and lasted approximately eighteen months. The preparation of the strategy was initiated by the previous governments, which developed its two earlier versions, while the final text was defined by the present governments. BiH Council of Ministers, Federation Government and RS Government adopted the final version of the Strategy. BiH Presidency also extended its support to the final version of the strategy, while BiH Parliament emphasized its support for implementation phase and requested from BiH Council of Ministers every six months to submit a progress report of the status of implementation of PRSP.

The long duration of the PRSP preparation was the result of the determination of the BiH Council of Ministers and the two entity governments to develop the strategy in consultation with the civil society and other segments of the public. To this end, over 300 round tables were held around the country, with several thousand participants. Three drafts of the PRSP were submitted for public debate, and in keeping with this three cycles of public consultations were organized. All three drafts of the strategy were presented to the competent committees in the BiH Parliamentary Assembly and to the entity parliaments. The media campaign was organized to inform the citizens with the drafts of the strategy and to encourage them to participate in public debates and in this way contribute to the definition of final priorities.

The government structures at all levels led the preparation of the BiH Medium-Term Development Strategy. The Coordination Board for Economic Development and EU Integrations, composed of the Chairman of the BiH Council of Ministers (as the Board's Chair), BiH Minister of Foreign Trade and Economic Integrations, BiH Minister of Finance and Treasury, BiH Minister of Foreign Affairs, prime ministers of both entities, finance ministers of both entities, the Director of the BiH Directorate of European Integrations and the Mayor of the Brčko District. The Coordination Board was in charge of defining the final priorities on the basis of the debates conducted and of the results of the activities of the working groups. During the preparation phase, the Coordination Board met 18 times. The task of technical coordination of the strategy's preparation was entrusted to the Office of the BiH Coordinator for Preparation of PRSP and to entity PRSP preparation offices.

Definition of proposals of priorities and of the strategy itself was the task of 20 working groups, composed of the representatives of the Council of Ministers and of the entity governments, as well as of the lower levels of government (Brčko District, cantons, municipalities). The working groups covered the following sectors: macroeconomic and fiscal framework, business environment, privatization, financial sector, labor market, the combat against corruption, foreign trade regime, public administration reform, statistics, education, social protection, health care, agriculture, forestry, water management, environment, infrastructure, energy, information technologies, mine action and industry.

In keeping with the decision of the BiH Council of Ministers that the PRSP was to be developed through broad public consultations, the working groups included representatives of the non-governmental organizations from both entities, as well as business associations. A particular emphasis was laid on involvement of the youth organizations from around the country. The young people demonstrated a very keen interest and took an active part in the development of the strategy, and the same was the case with the trade unions from both entities. The representatives of foreign investors in our country also contributed to the preparation of the strategy through their association. Involvement of the representatives of civil society into the work of governmental working groups for the preparation of the PRSP provided an opportunity to these organizations to directly influence the definition of priorities.

The preparation of the PRSP required active engagement of the scholars and experts. To this end, the Council of Scholars for the Preparation of PRSP was established, chaired by the chancellors of the Sarajevo and Banjaluka universities. The Council was composed of 22 eminent scholars from universities around the country. The task of the Council of Scholars was to provide expert support to working groups in the development of priorities, through expert reviews, participation in the deliberations of the working groups, participation in public debates and providing advice. In addition to the scholars, a 28-member expert team was formed with the task to perform research for the need of the working groups, collect the statistical data, revise the drafts and, together with the scholars, provide advice concerning definition of priorities.

In view of the necessity to secure additional donor funds for the implementation of the PRSP, representatives of donors and international organizations were consulted during the preparation of the document. It is, however, pertinent to note that the representatives of international organizations took no part in the work of the working groups.

A total of 213 representatives of governments at all levels, civil society representatives, scholars and experts participated in the process of defining the priorities of the BiH Medium-Term Strategy. It is

important to note that only local scholars and experts were involved and that the strategy represents the product of domestic institutions and domestic expertise.

Bearing in mind that the preparation of the strategy was initiated by the previous governments, and that it was completed by the new governments, as well as the fact that local scholars, experts and civil society representatives were involved, that extensive public consultations were held, with the involvement of the parliaments, PRSP should rightly be seen as not only the strategy of the governments in BiH, but of the entire society of Bosnia and Herzegovina, which had been the goal from its very inception.

In this respect **Section I.3.** of the Strategy contains a list of all 216 Members of the Coordination Board, of PRSP Teams, Working Groups, Academic Advisory Board and Team of Experts who directly participated in preparation of the BiH Medium Term Development Strategy – PRSP.



### **I.3. List of Members of the Coordination Board, of PRSP Teams, Working Groups, Academic Advisory Board and Team of Experts Who Participated in Preparation of the BiH Medium Term Development Strategy - PRSP**

#### **Members of the Coordination Board for Economic Development and European Integrations:**

1. Adnan Terzić, Chairman, BiH Council of Ministers
2. Dr. Ahmet Hadžipašić, FBiH Prime Minister
3. Dr. Dragan Mikerević, RS Prime Minister
4. Dr. Mladen Ivanić, BiH Foreign Minister
5. Ljerka Marić, BiH Minister of Finance and Treasury
6. Dragan Doko, BiH Minister of Foreign Trade and Economic Relations
7. Osman Topčagić, Director, BiH Directorate for European Integrations
8. Dragan Vrankić, FBiH Minister of Finance
9. Branko Krsmanović, RS Minister of Finance
10. Branko Damjanac, Mayor, Brčko District

#### **Representatives of the BiH Council of Ministers and of other state-level institutions:**

11. Orhan Pašalić, Office of the Chairman of the BiH Council of Ministers
12. Dragana Tadić, BiH Ministry of Foreign Affairs
13. Dušanka Basta, BiH Ministry of Foreign Trade and Economic Relations
14. Šefik Rizvanović, BiH Ministry of Civil Affairs
15. Mario Nenadić, BiH Ministry of Human Rights and Refugees
16. Medžid Lipjankić, BiH Ministry of Human Rights and Refugees
17. Jusuf Kumalić, BiH Ministry of Finance and Treasury
18. Maja Križanović, Directorate for European Integrations
19. Saša Leskovic, Office of the State Coordinator for Public Administration Reform
20. Jakob Finci, BiH Agency for Civil Service
21. Jozo Bagarić, BiH Veterinary Office
22. Darwin Lisica, MAC BiH
23. Sahrudin Sarajčić, BiH Statistics Agency
24. Dr. Hasan Zolić, BiH Statistics Agency
25. Slava Popović, BiH Statistics Agency

#### **Representative of the BiH Central Bank**

26. Dragan Kovačević, Vice Governor of the BiH Central Bank

#### **PRSP offices**

27. Zlatko Hurtić, BiH Coordinator for PRSP
28. Srećko Bogunović, RS Coordinator for PRSP
29. Marinko Božić, FBiH Coordinator for PRSP

#### **Members of working groups at the level of the entities and Brčko District**

30. Adila Hodžić, FBiH Ministry of Labor and Social Policy
31. Adnan Pašalić, Brčko District
32. Ahmed Duranović, FBiH Ministry of Agriculture, Water Management and Forestry
33. Aida Bogdan, RS Ministry of Economic Relations and Coordination
34. Aleksandar Kosić, MAC RS
35. Aleksandra Simić, RS Ministry of Finance
36. Alija Tihić, FBiH Civil Defense Directorate

37. Anita Čemažar, RS Ministry of Finance
38. Anka Šeranić, RS Ministry of Health and Social Protection
39. Ante Nikolić, RS Ministry of Finance
40. Asim Zečević, FBiH Ministry of Labor and Social Policy
41. Aziz Čomor, FBiH Ministry of Agriculture, Water Management and Forestry
42. Bakir Mujić, FBiH Pension Insurance Fund
43. Borislav Jakšić, RS Ministry of Regional Planning, Construction and Environment
44. Borjana Krišto, FBiH Ministry of Justice
45. Borovčanin Snježana, RS Employment
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50. Branko Grabež, RS Civil Defense
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55. Darija Sejmanović, RS Ministry Finance
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60. Dr. Radoslav Grujić, RS Ministry of Education and Culture
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64. Drago Bijelić, RS Ministry of Economy, Energy, and Development
65. Dunja Pejić-Hadžić, RS Ministry of Trade and Tourism
66. Duško Radošević, RS Ministry of Finance
67. Džemaludin Mutapčić, FBiH Ministry of Justice
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69. Đuro Grbić, RS Ministry of Economy, Energy, and Development
70. Emina Pandžo – Hasanbegović, FBiH Ministry of Education and Science
71. Emir Silajdžić, FBiH Ministry of Finance
72. Ermina Gežo, FBiH Tax Administration
73. Esad Osmanbegović, FBiH Ministry of Transport and Communications
74. Fadil Suljić, FBiH Employment Office
75. Fani Majkić, FBiH Ministry of Health
76. Filip Šarić, FBiH Ministry of Finance
77. Frano Dogan, FBiH Customs Administration
78. Fuad Čerkez FBiH Securities Commission
79. Gojko Mirjanić, RS Agricultural Institute (representing RS Government)
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81. Gordan Jelić, RS Ministry of Health and Social Protection
82. Gordana Đurić, Agricultural Faculty (representing RS Government)
83. Gordana Gardašević, RS Ministry of Governance and Local Governance
84. Gordana Opačić, RS Ministry of Economic Relations and Coordination

85. Izet Žigić, FBiH Ministry of Energy, Mining and Industry
86. Jadranka Stojanović, RS Ministry of Trade and Tourism
87. Jela Radišić, RS Banking Agency
88. Kasema Čatović, FBiH Ministry of Energy, Mining and Industry
89. Kemal Čaušević, FBiH Ministry of Finance
90. Kutlija Dragan, RS Civil Service Agency
91. Ljiljana Sokolić, RS Ministry of Transport and Communications
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93. Ljubo Glamočić, RS Ministry of Economy, Energy, and Development
94. Marinko Biljanović, RS Ministry of Transport and Communications
95. Mehmed Cero, FBiH Ministry of Regional Planning and Environment
96. Mervana Hadžimurterzić, FBiH Ministry of Agriculture, Water Management and Forestry
97. Mevla Softić, FBiH Statistics Institute
98. Milan Srdić, RS Ministry of Economy, Energy, and Development
99. Milan Šicar, RS Ministry of Economy, Energy, and Development
100. Mile Srdanović, FBiH Ministry of Energy, Mining and Industry
101. Milena Mandić, RS Employment Office
102. Miodrag Babić, RS Ministry of Finance
103. Mira Bradara, FBiH Ministry of Finance
104. Mirko Dobrnjac, RS Ministry of Economy, Energy, and Development
105. Miro Maksimović, RS Ministry of Agriculture, Water Management and Forestry
106. Miroslav Rogić, RS Ministry of Governance and Local Governance
107. Mirsad Hromić, FBiH Development Planning Institute
108. Mirsad Nikšić, FBiH Ministry of Energy, Mining and Industry
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111. Mladen Radivojević, RS Ministry of Governance and Local Governance
112. Mladen Vasić, FBiH Ministry of Agriculture, Water Management and Forestry
113. Mustafa Brkić, FBiH Banking Agency
114. Nada Rajković, FBiH Ministry of Agriculture, Water Management and Forestry
115. Namik Bukvić, FBiH Ministry of Labor and Social Policy
116. Nedjeljko Babić, FBiH Ministry of Trade
117. Nedžad Branković, FBiH Ministry of Transport and Communications
118. Nemanja Drašković, RS Ministry of Economic Relations and Coordination
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122. Ostoja Kremenović, RS Pension Insurance Institute
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125. Radmila Kostić, RS Ministry of Regional Planning, Construction and Environment
126. Radomir Graonić, RS Ministry of Health and Social Protection
127. Radovan Vignjević, FBiH Ministry of Labor and Social Policy
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131. Ranko Krsman, RS Ministry of Finance
132. Saša Trifković, RS Ministry of Governance and Local Governance

133. Slaven Pekić, RS Ministry of Justice
134. Slavica Bogdanović, RS Ministry of Economy, Energy, and Development
135. Slavko Šobot, RS Statistics Institute
136. Snježana Marjanac, RS Ministry of Finance
137. Snježana Rudić, RS Ministry of Finance
138. Sreten Blagojević, RS Ministry of Transport and Communications
139. Stanimir Stamenković, RS Health Institute
140. Stevan Jović, RS Ministry of Health and Social Protection
141. Strahinja Ćurković, RS Ministry of Justice
142. Tina Radonjić, RS Ministry of Economic Relations and Coordination
143. Tomo Lučić, FBiH Ministry of Health
144. Trivo Marinković, RS Customs Administration
145. Velinka Topalović, RS Ministry of Agriculture, Water Management and Forestry
146. Zada Gabela, FBiH Ministry of Finance
147. Zaim Hećo, FBiH Ministry of Transport and Communications
148. Zdravko Marjanović, RS Ministry of Education and Culture
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**Representatives of NGOs, trade unions, private sector and the young people:**

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158. Bojana Škrobić, representative of the Youth organization of BiH (KOM)
159. Fikret Zuko, NGO representative
160. Idriz Čilić, NGO representative
161. Igor Stojanović, NGO representative
162. Samir Haljeta, NGO representative
163. Sulejman Hrle, BiH Trade Unions
164. Tomislav Grizelj, private sector representative of FBiH
165. Damir Miljević, private sector representative of RS
166. Duljko Hasić, representative of Chamber of Commerce of BiH

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168. Dr. Anto Domazet
169. Dr. Aziz Šunje
170. Dr. Azra Hadžiahmetović
171. Dr. Boris Tihi, Member of the BiH Academy of Arts and Sciences
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173. Dr. Dragoljub Mirjanić
174. Dr. Dušan Šušević
175. Dr. Ešref Gačanin
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- 180. Dr. Muris Čičić
- 181. Dr. Mustafa Omanović
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- 184. Dr. Salih Fočo
- 185. Dr. Sead Kreso
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- 193. Boris Hrabač, Health Care
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- 197. Duljko Hasić, Industry
- 198. Ervin Zolić, Statistics
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- 200. Ismet Muratagić, Industry
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- 203. Kenan Rašidagić, Social Sector
- 204. Lamija Kozarić, Financial Sector
- 205. Milenko Krajišnik, Fiscal Sector
- 206. Mladen Rudež, Environment
- 207. Muhamed Hodžić, Forestry
- 208. Rasim Kadić, Labor market
- 209. Reuf Hadžibegić, Energy
- 210. Sabrija Šerifović, Regional Integration
- 211. Sead Jeleč, Agriculture
- 212. Seid Jažić, Industry
- 213. Senad Kikić, Agriculture
- 214. Senada Spahić, Business Environment, Anticorruption
- 215. Šefika Hafizović, Fiscal Sector
- 216. Željko Račić, Fiscal Sector

## **I.4. GOALS OF THE BIH MEDIUM-TERM DEVELOPMENT STRATEGY (PRSP)**

### **1. Create conditions for sustainable and balanced economic development**

Through implementation of the macroeconomic reform scenario of the Medium-Term Development Strategy, BiH should, by end-2007, restore a partial creditworthiness on the international capital markets, establish functioning market economy and strengthen the capacity of domestic companies to compete in external markets, particularly in the EU market. In view of existing variations in the level of economic development between different parts of the country, creation of preconditions for balanced development of all parts of BiH is also crucial.

### **2. Reduce poverty**

One in five inhabitants of BiH may be considered poor.<sup>1</sup> The implementation of the BiH Medium-Term Development Strategy (PRSP) requires acceleration of structural reforms, which in the short term may cause job losses, and consequently an increase in poverty. Therefore, over the coming medium-term period, all levels of government will implement such economic policy measures that will prevent the increase in poverty and will lower the poverty rate by 20% from the present level.

### **3. Accelerate EU integrations**

Integration of BiH into the EU is a generally accepted goal of all governments and all segments of BiH society. However, to attain this landmark goal, the BiH society must demonstrate that it shares the EU values.<sup>2</sup> In the course of preparation of the BiH Medium-Term Development Strategy (PRSP), in cooperation with the BiH institutions, and particularly with the BiH Directorate for European Integrations, the issues of relevance for achievement of this goal have been integrated into this document. Therefore, the implementation of the Strategy will contribute to accelerated integration of the country into the EU, and the focus was placed on signing and implementation of the Stabilization and Association Agreement (SAA).

In view of the complementarity with SAA, the PRSP strategy will be taken into account on the occasion of the preparation of the National Plan for Adoption of the 'Acquis communautaire' (NPAA), as a fundamental document for the European integration process. The implementation of the PRSP Strategy will contribute to meeting of the second and third Copenhagen Criteria, i. e. existence of a functioning market economy able to endure on the EU market (Criterion 2) and the ability to assume obligations arising from the membership (Criterion 3).

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<sup>1</sup> LSMS findings.

<sup>2</sup> 'The Report of the EC to the Council on Preparations of BiH to Start negotiations on the Stability and Association Agreement with the EU' (EC Feasibility Study), Brussels, 18 November, 2003.

**General priorities for attainment of the goals of the BiH Medium-Term Development Strategy (PRSP):**

- **Achieve a general consensus in the society regarding the reform program to be implemented in the coming period**
- **Maintain macroeconomic stability**
- **Implement fiscal system reform**
- **Secure faster growth of the export-oriented private sector, which will require:**
  - a) enhancement of the business environment for domestic and foreign investment and the support to the development of entrepreneurship,
  - b) acceleration of the privatization process,
  - c) reduction of the corruption in the society and implementation of the judiciary reform,
  - d) maintaining stability of the financial markets and faster development of capital markets,
  - e) implementation of the labor market reform,
  - f) further liberalization of the foreign trade in the region,
  - g) support to exports.
- **Implement the public administration reform**
- **Establish an adequate system of social assistance**
- **Implement sectoral reforms, in particular:**
  - a) education reform
  - b) liberalization of the electric power market,
  - c) liberalization of the postal and telecommunications market
  - d) securing greater support for agricultural production
- **Conclude the Stabilization and Association Agreement with EU, which should result from the implementation of the above reforms**
- **Achieve full membership in the WTO.**

These priorities are developed in more detail in other parts of the BiH Medium-Term Development Strategy (PRSP).

## **I.5. EXECUTIVE SUMMARY OF BiH MEDIUM-TERM DEVELOPMENT STRATEGY (PRSP)**

### **POVERTY PROFILE**

To permit successful planning and conduct of poverty reduction activities, it was indispensable to determine the number of the poor, their territorial distribution and the most vulnerable categories of the population. In measuring poverty, the BiH Medium Term Development Strategy (PRSP) relied on the data collected in the Living Standard Measurement Survey. This survey found that the general poverty line, i. e. the total annual spending below which a person is considered poor is KM 2,198. When this line was applied to the LSMS results, it was determined that some 19.5% of the BiH population is below the poverty line (16% in FBiH and as much as 25% in RS). Moreover around 30% of the population is located very close to poverty line. Although it should be noted that, because it is based on a survey, and not on a list, these figures must be considered as rough, with the confidence interval of  $\pm 3.6\%$  around the base figure.

Another important conclusion in the poverty analysis was that it is widespread among the population and that the poor are a heterogeneous group. Nonetheless, children, people with low level of education, elderly and disabled, classical social cases and rural population are most frequently below the poverty line. Poverty risk is most marked for children, particularly below the age of five, displaced persons and returnees, unemployed and people with low education.

Analysis performed for the needs of the PRSP also pointed to close links between (dis) respect for human rights and poverty, level of education and poverty, gender equality and poverty, as well as to higher vulnerability of rural inhabitants and to differences in poverty levels between members of different ethnic groups in BiH.

### **MEDIUM TERM MACROECONOMIC FRAMEWORK**

Basic goals of the macroeconomic framework of the Mid-term Development Strategy BiH (PRSP) are the achievement 70% of the pre-war GDP and realization of country's limited creditworthiness at the international capital market by the end of 2007. In this context, a Reform scenario is defined and it stipulates that GDP is to grow in the coming four years on the basis of the real growth rate of 5 to 5,5 %. Other significant pre-requisites for the realization of Reform scenario are:

- To maintain inflation at the level from 1 to 2 %. The orientation towards preservation of the Currency Board in the future will present the basic ground for the accomplishment of such pre-requisite;
- To reduce the overall public expenditures from 46% of GDP, to 43% by 2007;
- To lower the public debt to around 49 percent of GDP by 2007;
- To bring the current account deficit to the sustainable level of 11% of GDP, by 2007; The realization of this pre-requisite will largely depend on having the export growth in coming years in compliance with the projected rates from 13 to 15%;
- To ensure larger scale of foreign investments inflow – up to around \$2 billions, by the end of 2007;
- To increase the level of private savings by 2007 for 7 times;
- To ensure new cycles of donor's assistance in the amount of \$1,5 billions.

### **FISCAL REFORM**

A fiscal reform goal within the Mid-term Development Strategy BiH (PRSP) is to reduce the public expenditures and achieve greater sustainability through the fiscal consolidation. Given the ongoing trend of decreasing donor's assistance it will be necessary to ensure bigger participation of the domestic public revenues in the public expenditure financing. Fiscal reform is also related to the Mid-term macroeconomic framework and the following measures will be implemented:

- More efficient mechanism for public revenues collection will be established with the focus at the strengthening of the Indirect Taxation Authority of BiH, bringing in the VAT and establishment of the single Custom Administration at BiH level;
- An adequate allocation of public revenues will be ensured between various levels of authorities in BiH. Strengthening of the state level will initiate the follow-up of the state



budget strengthening. In the context of realizing the poverty reduction activities, it will be necessary to strengthen the fiscal revenues of local communities. Bearing in mind the complexity of the BiH state structure, it is necessary to ensure an adequate VAT allocation between the various levels of governments in the country;

- Sector's expenditure will be brought at the more sustainable level. This primarily refers to the expenditures in the field of education, health, social transfers, defense and police;
- An institutional framework for preparation of consolidated fiscal account at BiH level will also be established;
- The transparency in public revenues collection and spending will be strengthened;
- Treasury operations will be brought in and applied at all levels of authorities as well as in all out-of-budget institutions of governments;
- The public debt will be reduced from 67% of GDP to 50%, by the end of 2007.
- Foreign borrowing strategy will be based on the continuation of concessional borrowing, while the commercial borrowing will be possible only at the end of 2006 or in 2007.

## **PRIVATE SECTOR GROWTH – STRUCTURAL REFORMS**

### ***Business environment for domestic and foreign investors***

Mid-term Development Strategy BiH (PRSP) has paid due attention to the promotion of business environment, local and foreign investments and development of entrepreneurship. In order to complete the process of creating the single economic space in BiH (which is still divided by differences in regulations/provisions between entities) it will be necessary to harmonize *the provisions regulating the freedom of movement of goods, services, capital and persons* with EU laws and regulations. It will also be necessary to establish the legal and institutional framework, which is to guarantee the free competition and protection of consumers and also provide the mutual recognition of technical standards for goods from both entities.

The establishment of a single public procurement system, bringing in the VAT and strengthening the coordination in managing the public infrastructure will additionally promote the business climate. The implementation of already harmonized labor legislation in the entities must ensure the elimination of all forms of discrimination in employment, which is to contribute to larger scale of labor force mobility. The continuation of applying the model of regional development will have a significant role in facilitation of economic development and there must be a defined strategy for this and suitable laws and regulations must be approved for this purpose. In this regard, it is important to strengthen the network of regional development agencies.

The activities of eliminating the administrative obstacles for local and foreign investments will be continued with, especially in the area of business registration. Judicial system reform will provide faster resolution of economic disputes and it will also be necessary to amend the laws on obligations in order to ensure greater protection of creditors. The elimination of unfair competition (smuggling) and more efficient protection of intellectual, industrial and commercial property will be important task for the next mid-term. Inspection services in BiH will be re-organized and rationalized, while the realization of already adopted Action Plan will precede the implementation of reforms for more efficient struggle against corruption.

It is necessary to modernize the system of land, real-estate management and use of it, which will go hand in hand with strengthening of urban planning system.

New structure of economy calls for strengthening of the corporate management system – primarily the strengthening of transparency. Already existing tripartite dialogue with private sector should be further on strengthened too.

Strengthening the competitiveness of BiH enterprises must be the main and long-term goal of reforms and the key fields for urgent operations are: the reduction of taxes, especially pay-roll taxes, reduction in size of informal economy, liberalization of the labor, energy and telecom markets, speeding-up the process of dispute resolution, lowering the cost of entry. Together with aforementioned, further strengthening of the Foreign Investment Promotion Agency's capacities, applying the foreign investment strategy and creation of the State Commission for Concessions (and suitable commissions at lower levels) should ensure the attraction of more foreign investors in our country. In this light, it is very important to continue with and facilitate the process of privatization.

Public opinion is the key point for success of all these reforms. Maintaining the political stability and avoidance of social disorders is certainly the key for successful implementation of the reforms and that is why the public should be regularly informed and included in the open

dialogue on the process of reforms. It is especially important to conduct a campaign, which would promote the understanding of the public about the role and significance of foreign investments. It is also important to work on improving the international image of BiH.

Significance of small and medium enterprises for development of BiH is recognized in the document General Framework of Economic Development Strategy (dated in 1999). It is necessary to adopt the development strategy for easier and faster development of this category of companies, which will be able to utilize the limited investment opportunities in BiH in the best possible way due to their flexibility. It is also necessary to establish legal and institutional framework to support the development of entrepreneurship. Especially is important it initiate the wider affirmation of knowledge on entrepreneurship through inclusion of subjects on entrepreneurship into the curriculums of schools and universities as well as by strengthening the specific education for entrepreneurs and managers. The governments in BiH have recognized the fact that the establishment of Guarantee Fund for Small and Medium enterprises is a significant concrete step that would facilitate access of bank loans to SMEs.

### ***Privatization***

Privatization process, and especially the process of privatizing the "strategic enterprises" that was in tardiness during the past years, will be speeded-up. This will be achieved through the strengthening of an institutional framework. The entity agencies for privatization will take the leading part in preparation of the enterprises for privatization. Other problems related to the country-wide corporate restructuring will be improved by resolving of big and growing corporate debt and by reorganizing the system of protection from unemployment in order to ensure adequate social programs of workers that might lose their jobs due to the process of speeding-up reforms. Special strategies will be prepared for the regulation and privatization in the sectors of energy, telecommunications, railways, and water management, waste-management as well as in the sector of forestry and in media. Strengthening of transparency of the privatization and responsibility of the state-led managing boards and managements in managing the state enterprises will be also important step forward. In parallel with this it is equally important to establish more efficient institutional framework for bankruptcy procedures and prepare list of companies and action plans for initiating bankruptcies.

### ***Financial sector***

It is necessary to strengthen the stability of banking sector by improving the local bank's capacities for risk management. Equally is important to ensure appliance to the rules for capital adequacy. Further strengthening of stability of the banking sector could be improved by having the Central Bank of BiH to play limited role of the bank of last resort in compliance with the currency board rules. The strengthening of the existing framework for supervision of banks will be continued. The State Agency for Supervision of the Banks will be established in 2005 and it will operate within the Central Bank of BiH. The policy of decreasing the number of the banks will be continued: all banks will have to meet the requirements from the State Deposit Insurance Agency, otherwise the working licenses of banks shall be withdrawn.

The measures will be undertaken in order to improve the term structure of deposits. In the sphere of crediting, there will be further work on reduction of risk in the bank operations, which should lead to further decrease of interest rates and greater corporate lending. There is still a need for harmonization of the bank regulations between the two entities as well as with the regulations of EU. Legal and regulatory framework will be established for the operations of leasing, which provides the additional opportunities for induce of economy.

It is also important to harmonize the inter-entity regulations in insurance sector and implement the activities that would equalize the local insurance sector with the foreign insurance companies. It is necessary to improve regulation of the sector, and stimulate companies to develop new instruments and services.

The strengthening of corporate management and transparency is especially important for the faster development of capital market in BiH. This is to increase the attractiveness of these markets as well as their liquidity. Application of the new instruments, such as the short-term certificates of the Central Bank of BiH will also help the further capital market development. The possibility of uniting the regulatory framework at the state level will be reconsidered in order to stimulate merger of the capital markets with positive effects on increasing their liquidity.

Micro-financial sector has turned out to be very successful in providing the financial services to very small enterprises. Its further development will be stimulated through smaller guarantee funds, especially in agriculture. Important step forward in developing this sector will be to improve the regulatory framework by harmonizing it between two entities.

### ***Labor market***

It is necessary to eliminate all forms of discrimination and induce the mobility of labor force in the whole country. System of salaries and collective bargaining agreements should be reformed for the purpose of mitigating of the down wage rigidity of minimal wages, which is to lead to the reduction of gray economy. It is also necessary to strengthen the institutional framework and control over the Employment Offices, especially in the field of financing the employment programs that were quite non-transparent up-to-date. Revision of the use of privileges on the basis of non-employment, such as the right to health insurance, will influence the reduction of gray economy. In order to pave the road for speeding-up reforms it will be necessary to extend the period for utilization of unemployment benefits. It is essential on a long-term basis to reform the education system so that it can meet the needs of the labor market. It is especially important to stimulate the development of vocational education, as one form for re-qualification and additional qualification.

### ***Anti- corruption***

Establishment of the suitable bodies within the state and entity ministries of justice will provide better coordination of anti-corruption activities. Further reform of the judicial system and strengthening of the efficiency of the bodies specialized to uncover and suppress the corruption are the key points for the success in this field. The forthcoming public administration reform will also contribute to more successful anti-corruption activities. Strengthening of the system of management and control over public finances and especially the reform of the indirect taxation system (that leads to the bringing in VAT) will additionally reduce the space for corruption and abuses of power. Especial attention will be given to the management of the public enterprises. It will be necessary to promote greater transparency in privatization process as well as in the financing of education and health system. The establishment of single custom administration at BiH level will also influence the reduction of corruption. Money laundry and human trafficking incidents are the specific problems that BiH is facing lately -- special attention will be given to modification of the legal framework and adoption of suitable action plans to improve the coordination among institutions dealing with these matters.

### ***Foreign trade and export promotion***

The liberalization of foreign trade will be continued within the framework of obtaining the full membership at the WTO and meeting the criteria for integration into the EU. It will be necessary to enhance the coordination in implementing the state laws on foreign trade between respective ministries at the state and entity level. Moreover, it will be important to strengthen the institutional framework for the purpose of utilizing the unilateral trade preferential agreements approved and given to BiH by the EU and other developed countries. Further simplification of the custom procedures, establishment of the institutional framework for protection of local consumers and strengthening the foreign trade statistics are also priority tasks for the next mid-term period. The new Custom Tariff Law will be approved in order to accommodate the needs of the BiH's economy. Introduction of stricter control of the rules of origins and application of the reciprocities in appalling the foreign trade rules will also be one of the main emphasis for the next period. Important step forward will be signing of the Pan-European Charter on Cumulation. In order to reduce the trade deficit, it is necessary to apply more efficient ways to protect and stimulate the development of local agricultural production.

Increasing the rate of export represents the key challenge in the implementation of the PRSP. Aforementioned measures will directly or indirectly stimulate the increase of export. However, an overall strategy for increase of export will be developed, which will define the productions where BiH possess a competitive advantage, the most favorable markets for goods and services from BiH and institutional framework for export. Current low level of production must be increased and the competitiveness of BiH enterprises strengthened. In the context of increasing of export, it is necessary to facilitate privatization and insure bigger inflow of foreign investments. It is especially important to create the system for support to the exporting enterprises, which will be based on transformation of the existing Agency for investment guarantees BiH into Export-Credit Agency BiH. Reviving of railways and inclusion of the road transporters in international associations should create the conditions for reduction of transport costs.

## **Public administration reform**

In order to implement the reform of public administration system, it is primarily needed to conduct functional reviews of administration at all levels of authorities. The strategy of public administration reform and follow-up action plan will be adopted by the end of 2004. It is necessary to strengthen the administrative capacities of BiH for the requirements of the EU integration process. The current activities in implementation of the State Civil Service Law and the reforms in defense and security sector will be continued.

## **Statistics**

It is of great importance for overall reform process to strengthen the statistic system in BiH. It must function as single system to ensure that all institutions will be provided access to data necessary to plan activities. This process will be based on already adopted law at the state level.

## **SECTORAL PRIORITIES**

Strengthening and amending of the legal framework and of institutional structures are indispensable in all sectors covered by the BiH Medium-Term Development Strategy, and specific priorities have been identified for each sector, as follows:

PRSP pays a special attention to the establishment of an adequate **social welfare system**. In order to reduce the exposure of the pensioners to poverty risk, the stability of pension payments will be increased through a more regular collection of contributions and by expanding the coverage of pension payers. It is necessary to regulate relations between the entity pension funds and lay foundations for a comprehensive reform of the pension insurance system. In protection of war and military disabled, veterans and family members of the dead, rationalization of both beneficiaries and benefits will be carried out, mechanisms will be set up to assist these categories in finding employment and administrative capacities of the competent line ministries will be enhanced. The system of social assistance will be adapted to the capacities of the society and it will be ordered along modern principles, with introduction of market elements and alternative models, with the emphasis on equality of all beneficiaries in access to benefits; the legal framework will be established and funds allocated to ensure a common minimum of benefits at entity level, primarily in child protection and protection of civil victims of war. Although available funding for support to sustainable return are being reduced, a greater efficiency in the area will be achieved through linking the work of all administrations in charge of implementation of the Annex 7, from the municipal to the state level. Rebuilding of some 50,000 housing units is planned over the next three years. In all these sectors administrative capacities must be strengthened, particularly for collection, processing and exchange of data.

In the **education sector**, the reform of management and financing methods will permit savings and release funds for sustainable funding of education. The coverage of students at all levels will be expanded and all forms of discrimination will be eliminated. More flexible study programs, with broad application of information technologies, will be introduced, and the standards and methods adapted to the appropriate European ones will be introduced, in conformity with the requirements of the Bologna Declaration and Lisbon Convention. The teacher-training system will be improved and made continuous. A framework state level law will regulate the higher education system, and mechanisms for supporting scientific research will be set up. Alongside the modernization of the vocational education, a system of out-of-school training will be developed.

Achieving universal health insurance coverage of the population, without discrimination, defining the basic package of health-care rights and strengthening of the solidarity system are the priorities in **health care**. Rationalization of the system of health care institutions, to include formalization of the 'network of health care institutions', will reduce expenditures from health insurance funds and will continue in parallel with the continuation of reforms of primary health care, through introduction of the system of family medicine. The contracting mechanisms between health insurance funds and health care institutions will be implemented, as well as new, incentive-based models of compensation to health care employees. The role and capacity of the public health care system will be strengthened, and the system for regulation of medicines will be established at BiH level. Improving the transparency of the systems of procurement and of planning and control of capital investments, as well as adoption of appropriate models for the system of supplementary medical practice, will contribute to combating corruption in the health care sector.

Development of institutional capacities, primarily achieving full operational status of the BiH Veterinary Office and establishment of the BiH Plant Health Protection Administration, and a better coordination between existing cantonal and entity bodies are the main tasks in the **agriculture sector**. The system of subsidies will be established to promote focusing on a limited number of types of production in which BiH has competitive advantages, at the minimum level of 3% of consolidated government budgets. The legal and institutional frameworks for development of organic foods will be set up. The instruments for supporting exports of agricultural products will be developed, and customs protection measures in line with the WTO rules will be applied. The business environment will be enhanced, and development of cooperatives and NGO associations of farmers will be supported.

To improve efficiency in exploitation of forest resources, which are one of the greatest development potentials of BiH, the **forestry** management system needs to be improved. The major tasks are to establish updated databases and conduct the national forest inventory, which will determine the real situation and lay foundations for a new organizational structure for forestry management. Establishing mechanisms for protection of forests from natural and other disasters, as well as for rehabilitation of forests, which had been neglected for long (demining, rehabilitation of degraded forests and barren areas, revitalization and sustainable management of game). Separation of protected forest areas (such as national parks, nature parks and forest preserves) will ensure at least a partial preservation of the most valuable natural heritage. In the exploitation aspect, it is vital to complete privatization and reorganization in forestry (particularly in FBiH), and to enforce the laws regulating sustainability of wood production, as well as other applicable international standards. Exploitation of other forest products (mushrooms, medicinal and aromatic herbs) and productions (bee-keeping) will be supported and promoted.

**Water management** will be organized on the level of river basins. A regulatory mechanism will be established for monitoring the work of municipal councils on setting tariffs and for ensuring the preservation of the quality of water and protection of the environment. The autonomy and management capacity of water utilities will be reinforced, and the degree of cost-recovery of utility services will increase to reflect real costs, with the tendency to prepare these segments for privatization. Investment in expansion of water supply and sewage systems will increase, as well as in regulation of watercourses and protection from harmful effects of waters. More efficient utilization of water for irrigation and power generation, exploitation of mineral and thermal waters, as well as restarting of navigation on the Sava River will respectively receive increased attention.

In the area of **environment**, the BiH Medium Term Development Strategy (PRSP) relies on the priorities of the BiH National Environmental Action Plan (NEAP), which stress the importance of strengthening of the legal and institutional environment and of the intersectoral approach to environmental protection issues. Steps to reduce pollution of air and water are envisaged, as well as enhancement of the systems of land management and soil protection, building of regional solid waste depository sites and rehabilitation of sites of existing illegal garbage dumps. It will be necessary to establish a system of integral land management, particularly for rural areas, in line with the EU standards and accepted international obligations. Over the coming medium term, the systems for preservation of the biological and geological diversity, natural and cultural heritage will be improved.

Along with the adoption of the BiH Energy Strategy, transformation of the legal system and establishment of modern institution, the basic task (in the **electric power sector**). It will be necessary to separate the existing three vertically integrated power enterprises in BiH to transmission, generation and distribution, with the transmission system remaining under the competence of BiH, while generation and distribution will be privatized. The process will go in three stages: reallocation of assets, corporatization and commercialization. Completion of the Power III Project is also envisaged.

In view of the role of the coal-mining sector in the BiH energy production, the restructuring and capital increases for coalmines are indispensable, which should lead to their ultimate privatization. Priorities in the gas sector are to diversify the gas supply sources, expand the distribution network, construct underground storage facilities and establish the internal gas market. Adoption of the oil sector development policy and of appropriate laws and regulations, as well as establishment of the oil and gas regulatory body, are the key prerequisites for revitalization and privatization in this sector. The coverage of urban areas with central heating will be expanded, and the technical efficiency of the systems will be enhanced. The system of setting energy tariffs will be based on economic prices and will include also the costs of the

environmental protection. Energy savings and utilization of renewable and alternate energy sources will be encouraged.

In the course of the implementation period of the BiH Medium Term Development Strategy (PRSP), vital segments of **road and railway networks and infrastructure** will be revitalized and restored, with the accelerated construction of the Corridor Vc highway as the crucial choice. The management, monitoring and planning systems for construction and restoration of the road infrastructure will be strengthened, and appropriate financing mechanisms will be developed, including foreign investments and concessions. In the railways, particularly, economic sustainability needs to be supported with subsidies, but also through reform of tariff policy and through improvement of the marketing. In air and water traffic, the most important task is to restore the existing airports and river ports to the level compatible with international standards.

For a successful development of the **telecom sector**, an IT bus needs to be built in BiH, and linked with the neighboring countries, penetration in the fixed and mobile telephony needs to be increased, as well as of the Internet; the third generation (3G/UMTS) systems should be introduced in the mobile telephony. The activities of liberalizing the market of telecom will be continued with in this sector.

For the postal system, it is crucial to develop new areas of activity, such as hybrid post, sorting centers, Internet kiosks, catalogue sales etc. The sector of electronic media also needs improvements in infrastructure, primarily modernization of the radio and TV signal transmission network and digitalization of the RTV system.

The BiH Medium Term Development Strategy in **sector of industry** identified wood, textile, leather, metal and food industries, as well as energy, tourism and information technologies, as priority sectors, and selected a series of measures for restructuring and modernization of industries, strengthening of competition and export capacities, improvement of the entrepreneurial environment and market transparency. Measures of support to these sectors will include: adoption, or harmonization, of domestic regulations with EU regulations, abolishing of the customs duties on raw materials and equipment, simplification of the customs procedures and systems, provision of cheaper power, improved access to credits and establishment of guarantee funds, as well as creation of entity funds for support to scientific research, and support to companies in adopting international standards.

In wood industry, the goal is to discourage export of timber and develop internationally recognizable strategic products. In food processing, the HAACP should be introduced, and the agency for certification of animal-origin products should be established. For leather and footwear and textile sectors, introduction of modern management and technologies is priority, as well as development of capacity of quality control institutions. Improving management and marketing systems is of importance for metal industry as well, together with the adoption of the international standards and regulations and with introduction of the quality management techniques. To stimulate development of tourism, the strategy of tourism development in BiH needs to be adopted and appropriate laws passed at the BiH level, including the Law on National Parks.

**Demining activities** in BiH must have the highest priority to accelerate normalization of life on the largest possible part of the territory. The effort on removal of unexploded ordnance (UXO) will continue over the next four years, as well as the Mine Reduction Education activities (MRE), with the concurrent strengthening of required capacities.

In the **information and communication technology sector (ICT)**, the process of adoption of relevant international technical standards will continue, as well as the process of liberalization, with the establishment of the CRA Council and transformation and modernization of telecom operators. The legal changes required to permit modern electronic commerce (e-commerce) will be made. All levels of government in BiH will introduce the system of electronic services to citizens (e-government). The system of ICT agencies will be established, and the Academic and Research Network of BiH (Arnet) and the Education Network of Elementary and Secondary Schools (EduNet) will be reactivated.

#### **IMPLEMENTATION AND MONITORING MECHANISM OF THE BiH MEDIUM-TERM DEVELOPMENT STRATEGY - PRSP**

On the basis of the work invested in the preparation of the EC Feasibility Study and the BiH Medium-Term Development Strategy (PRSP), the BiH Council of Ministers of BiH, together with the entity governments adopted the Action Plan for Implementation of Priority Reforms. By

adoption of this AP, whose implementation rate is at 81%, governments introduced an initial monitoring mechanism for implementation of strategic documents. In this context, the Council of Ministers of BiH, together with the entity governments, decided to establish the Office for Coordination of Economic Research and Monitoring of the Implementation of the BiH Medium-Term Development Strategy (EPPU). This office will play an important role in developing future macroeconomic projections and drafting analytical materials required for integration of BiH into EU.

The implementation of the PRSP will retain the same elements utilized in its preparation. The strategic decisions will be made within the framework of the Coordination Board of Economic Development and EU integrations. On the technical level the work will be carried out by the working groups that were established during the preparation of the PRSP, and which consist of representatives of the state and entity governments. As in the preparation stage of the PRSP, NGOs will continue to participate in the work of the PRSP implementation working groups. The EPPU will inform the governments, parliament and the public about the course and results of the implementation of the PRSP, through regular reporting on the status of implementation of its action plans and the success rate in meeting the PRSP targets.

### ***Indicators***

To verify whether the set targets are being achieved, an established set of indicators should be followed over the next medium term. With the assistance of UNDP, PRSP was able to incorporate the millennium development goals and indicators, adapted to BiH, into the PRSP monitoring mechanism. To ensure systematic monitoring of the PRSP indicators, additional strengthening of the capacity of statistics bureaus is planned, as well as partnering with NGOs and international institutions. It is important to stress that an undeveloped system of statistics of BiH, and in this context the lack of the data reliability, will represent a particular problem for monitoring and evaluation of the PRSP, and accordingly for the Millennium Development Goals. Some of the indicators with special importance for monitoring of PRSP are: percentage of population below poverty line<sup>2</sup>, unemployment rate, net rate of enrollment in primary school, primary and secondary school enrollment rate, higher education enrollment rate and ect.

### ***The Major Risks and Preconditions for Successful Implementation of the Medium-Term Development Strategy of BiH (PRSP)***

The implementation of the BiH Medium-Term Development Strategy (PRSP) will require a greater determination of the governments in preservation of the achieved political consensus on implementation of reforms. The BiH Medium-Term Development Strategy (PRSP) envisages adoption and/or amending of a large number of laws and sub-laws. To complete these tasks within the given timeframe will require increased efficiency in the work of the parliaments at all levels. The process of acceleration of reforms will cause a short-term increase in unemployment, which might threaten social peace. In the near term, preservation of the social peace will depend on the governments' ability to implement a social program to mitigate negative consequences of increasing unemployment in first year of the implementation of the Strategy.

In view of declining international aid, in the coming period BiH will have to rely on foreign investment as the most important source of financing future development. In this context, in addition to the acceleration of reforms and strengthening of the political stability of the country, the rate of recovery of the world economy and the increase of investment globally will influence successfulness in implementation of the PRSP.

Finally, a major precondition for a successful realization of the BiH Medium-Term Development Strategy (PRSP) is securing of additional assistance in the form of concessional credits and grants. The focus of the international community on other regions, or a failure of the government to convince the international community to continue extending aid to BiH may pose a serious difficulty to the implementation of PRSP goals.

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<sup>2</sup> Using General Poverty Line for BiH.

## I.6. POVERTY PROFILE OF BOSNIA AND HERZEGOVINA

### Poverty Definition

Until recently the term «poverty» was applied in the meaning of insufficiency of revenues for procurement of the minimum basket of goods and services. Nowadays, it is considered that poverty is the state when basic preconditions for a dignified life are lacking. It is recognizable that poverty is manifested in different ways, among which are: lack of income and resources sufficient to ensure viable existence; hunger and malnutrition, poor health, limited or no access to education and other fundamental services; increased mortality, including mortality from disease; homelessness and inadequate housing conditions; unsafe environment, social discrimination and isolation. Exclusion from decision-making and from civic, social and cultural life of the community are other basic features of the negation of human rights. Multidimensionality of poverty as a phenomenon permit us to view it as a condition characterized by lasting or chronic shortage of resources, abilities, choices, security and powers required for an adequate standard of living and attainment of other civic, economic, political, cultural and social rights.

### 1. Poverty in BiH

The Living Standards Measurement Survey -LSMS that was conducted in BiH between September and November 2001, as the first representative welfare survey at the household level, has served as the most important source of information for the preparation of this overview of the poverty profile in BiH. The survey was conducted on a sample of 5.400 households in 25 municipalities of both BiH Entities, with special attention paid to obtaining representative results both at the Entity and at the BiH level.<sup>1</sup> Using the modular survey approach (in areas of: demography, housing, education, employment, migrations, health care, privatization, loans, social welfare, expenditure, non-agricultural business activities and individual agricultural activities) data were collected on households and individuals, as well as on access to and utilization of services and government programs. The data collected made it possible to assess the poverty level in BiH, the composition of the poor, the relative extent of the poverty threat for individual categories of the population and the causes of poverty.<sup>2</sup> It should be made clear that the Survey, although it currently constitutes the most reliable source of statistical data in this field, is nevertheless only a provisional research instrument and cannot provide answers to all important questions posed in the development policy formulation process.

The data from the Living Standards Measurement Survey (LSMS) made possible the poverty demarcation in BiH needed to establish the number/percentage of the population falling into the category of the poor. The poverty line facilitates the identification of the population that sunk into poverty, as well as monitoring changes in their situation over time<sup>3</sup>, making it easier to assess the effectiveness of the measures taken.<sup>4</sup> The analysis of the Living Standards Measurement Survey (LSMS) has made it possible to draw conclusions necessary for determination of the poverty line.

There are two basic poverty lines: the relative and the absolute one. In determining the relative poverty line, the basic approach is to establish how the standard of living of one population category can be compared with that of other population categories within the same society, and it is usually based on a certain percentage of average income or expenditure in the country concerned. This method has some advantages, above all that it is easily determinable and that it automatically tracks increases in the standard of living. However, this kind of demarcation is not adequate for monitoring changes over time, since a rise in the standard of living in a given country may result in a rise in the

<sup>1</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 2.

<sup>2</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, pp 3-4.

<sup>3</sup>The changes may be followed over time only if an LSMS or similar survey is taken every year, which is not the case at this time. LSMS is not yet a panel survey, i. e. a survey conducted periodically. Although the Living in BiH Survey has been developed from LSMS, it does not contain the consumption module which may serve to calculate the poverty line. A Household Budget Survey (HBS) is planned, but the problem with the HBS is that most variables from LSMS have not been included into HBS questionnaire, so the analytical possibilities are significantly constrained, though the poverty line, which is the basis for all poverty-related analysis, can be determined from the HBS findings.

<sup>4</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 5.



standard of all population categories, without the relative situation of the poor altering, or even with a deterioration in their situation.<sup>5</sup>

Bearing in mind the limited availability of data in BiH, the researchers chose the absolute poverty line as the most appropriate instrument for defining and monitoring poverty in our country. The absolute poverty line is determined according to the value of expenditure needed by each individual regardless of the place and time he/she lives in. The absolute poverty line itself may take two forms: the extreme poverty line or the general poverty line. The extreme poverty line - or nutritional poverty line - is determined on the basis of the value of the food package that contains the minimum of necessary calories and nutritive substances. In the analysis of the Living Standards Measurement Survey (LSMS), annual consumption per person was selected as the indicator. It was calculated that the average minimum nutritional needs, taking into account the differences between demographic groups, are around 2.240 calories a day.<sup>6</sup>

The determination of the general poverty line takes into account that an individual also has survival needs other than nutrition, such as housing, clothes, etc. Since it is almost impossible to objectively determine a uniform consumer "basket" of non-nutritional goods and services that would be representative for the majority of the population, the general poverty line for BiH is the total consumption of households whose consumption of food enables them to meet the minimum nutrition and caloric needs. In other words, the general poverty line is established by adding the monetary value of non-food goods and services consumed by the households whose consumption of food equals an absolute minimum of nutritional needs (which represents the extreme poverty line), to the value of that minimum, i.e. to the monetary value of extreme poverty line.

The Living Standards Measurement Survey (LSMS) has estimated the level of the total expenditure (including non-food goods) of the households that spend the absolute minimum on food, measured by its caloric and nutritive values (about 2. 100 calories per person daily). The total expenditure arrived at in this way amounts to 2,198 KM per person per annum, and this is the general poverty line for BiH (while expenditure on minimum nutritional needs, i. e. the extreme poverty line, amounts to 760 KM per person per annum). The fact that food expenses constitute only about 34.5% of the sum representing the poverty line of BiH indicates that non-food costs are of very considerable importance in ensuring survival.<sup>7</sup>

The analysis of available statistical data on annual expenditure per person in BiH has not shown that there are groups in our country whose standard of living is close to or below the extreme poverty line, but **it has been determined that the living standard of around 19,5% of the population of BiH is below the general poverty line (25% in RS and 16% in FBiH).**<sup>8</sup> The limited format and coverage of the survey inevitably result in a wide margin of tolerance of +3,6%. The percentage of citizens who are below the general poverty line differs for different community types, being lowest in urban communities (14%), higher in rural communities (around 20%), and highest in mixed local communities (near 24%).<sup>9</sup>

Supplementary indicators permit a more in-depth analysis of available data. **The poverty gap** is a total amount needed for all poor in a country to rise above the poverty line, divided by the total number of inhabitants of the country. In BiH, poverty gap is 101 KM, or in other words, for all poor to rise from poverty, all BiH citizens (including poor) would need to give all poor 101 KM per person per annum. The money would need to be distributed in order to allow all poor to cross the poverty line (those in deeper poverty would receive more than others).

The Survey results have also shown that a further 30% approximately of the BiH population are just above the general poverty line determined in this manner (with annual expenditure below 3,297 KM, i.e. in a range only 50% higher than the amount constituting the general poverty line). The vulnerability of this group to potential economic shocks that might push them below the general poverty line is very high.<sup>10</sup> The research by UNDP and the BiH authorities for the needs of the Early Warning System, although conducted in accordance with a different methodology, confirms that poverty is widespread and serious, and indicates a rising trend in the numbers of the poor.<sup>11</sup>

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<sup>5</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 6.

<sup>6</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 5.

<sup>7</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 5.

<sup>8</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 6.

<sup>9</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 9.

<sup>10</sup> Bosnia and Herzegovina: Poverty Assessment, Volume II, World Bank, Report No. 25343-BIH, p. 46.

<sup>11</sup> Early Warning System, Quarterly Report April – June 2002, UNDP and BiH authorities, pp. 15-16.

In many surveys, a distinct majority of those polled assess themselves as poor. Although the reasons for subjective poverty as a phenomenon are numerous, among the most important are comparisons with the pre-war era and reliance on the standards of that time, as well as higher expectations and the inability of many households to afford the variety of goods available on the market.

Insecurity is an additional burden for the poor, but also for many others who do not officially fall into that category. Personal insecurity resulting from the declining influence of society and the authorities leads to rising crime and is an impediment to the integration into society and the equal economic opportunities of minorities and women in particular. Economic insecurity is reflected in exposure to various economic shocks, insecurity in terms of property or housing rights (especially displaced persons), and exposure to corruption.<sup>12</sup>

The poor are also seriously affected by the feeling of powerlessness and inability to make their voices heard in communication either with other members of the community or with the authorities. Even given the extensive decentralization of the resources distribution system, the poor frequently have difficulty gaining access to the institutions responsible for the decisions and rulings that have a significant impact on their lives. This is another problem that affects women with particular severity.<sup>13</sup>

Poverty in BiH is deeper and more widespread than in any other country of former Yugoslavia (it is more widespread only in Kosovo),<sup>14</sup> and some 20% of the poor suffer serious shortages in all or almost all key aspects of welfare, ranging from acceptable housing and sanitary conditions and access to health care services, to literacy and integration into society. In addition, the current relatively low poverty rate of the population is the result of expenditures far exceeding current production capacities. So far, extensive international aid allowed this level of consumption, but it will soon cease to be possible. Thus it is extremely important to increase the rate of economic growth, because the danger of a dramatic increase in the poverty rate is very real.

### **1.1. UNDP Report on Human Development in BiH**

In view of the lack of reliable and accurate information and statistical data in BiH already referred to, the activities of UNDP, in collaboration with the BiH authorities and with the assistance of the domestic statistical and research institutions, make a major contribution to filling the information gaps and providing a fuller picture of the situation in our country. UNDP's activities in this field are formulated as quarterly reports within the Early Warning System, where a number of essential trends from the economic and social sphere are monitored continuously. The second major contribution is the publication of the Human Development Reports that constitute comprehensive research into key areas of society and phenomena that have an impact on the quality and standard of living of the members of society.

The Human Development Report, published in September 2002, introduced the Index of human development for BiH for the first time. This index is a scale that enables ranking of individual countries by their level of development compared with other countries of the world. It includes the economic dimension, but it is specifically adapted to encompass human dimensions of development that could not be adequately represented by other statistical and research methods and procedures. The human development index takes into account the issues of accessibility of education, health care, social services and information, as crucial for the successful and viable development of any society. Although issues such as human rights, oppression and discrimination of all kinds cannot be easily included in the index itself, they are also subject of analyses. In that regard, the possibility of comparison with other countries of the world (166 countries are included) facilitates the identification of specific weaknesses and provides an incentive and guidelines for improvements.

The Human Development Index (HDI) for BiH is 0.718. The significance and meaning of the HDI becomes clearer when its components are considered: HDI is composed of three sub-indices: GDP per capita, access to education and average lifetime of inhabitants. At the same time, bearing in mind the often incomplete and imprecise statistical data available for our country, we are not in a position to rank ourselves precisely on the HDI scale, and this number should be regarded as preliminary only.

The Human Development Report/Millennium Development Goals from June 2003 shed additional light on the poverty issue. This report estimated that 27% of adults in BiH are poor from the standpoint of education, and that 16% suffer from poverty in the health-care sense. From the employment aspect,

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<sup>12</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 13.

<sup>13</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 22.

<sup>14</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 7.

22% of work-capable population is poor. Housing conditions are below the poverty threshold for 11% of inhabitants, and 29% live in conditions of «legal poverty» because they live in apartments for which they lack adequate ownership or tenancy rights. In total, this analysis showed that some 72% of adults in BiH are poor from at least one of these aspects.<sup>15</sup>

## **2. Most Vulnerable Categories of the Poor**

Although the identified poverty rate in BiH is lower than had been presumed, the essential conclusion is that the threat of poverty in BiH is widespread among the population and that the poor are a heterogeneous group, so that even a typical household bears a considerable risk of sliding into poverty.<sup>16</sup>

Below the poverty line are most frequently children, persons with low education levels, the elderly and the disabled as well as the rural population. An analysis of data for the population as a whole indicates that children, especially those under 5 years of age, displaced persons and returnees, the unemployed, and persons with low education levels, are particularly exposed to the risk of poverty. Contrary to received wisdom, the elderly are less threatened by the risk of poverty than the average person, and the same can be said for the disabled and war veterans. Those least at risk are the employed, both those in the non-economic sector and those in the "grey economy".<sup>17</sup> Another surprising conclusion is that poverty is not primarily a problem of the unemployed, displaced persons, the disabled, or the families of soldiers killed during the war. All these groups combined constitute less than half the poor. The majority of the poor in BiH are employed persons living in families with children, the result of low wages and the fact that one wage is inadequate to keep a household above the poverty level.<sup>18</sup>

### **2.1. The Young Generation and Poverty**

Children are one of the categories that are most at risk of having a standard of living below the poverty line. Some 56% of the poor live in families with children. The children in RS are particularly vulnerable, since around half of this age group lives in poor families, while in the FBiH this holds for around one-third of all children.<sup>19</sup> Around 13% of children live in families that fall into the category of the poorest, and 29% in households that are on the poverty line. Poverty of families with children is at its most pronounced where none of the family members are employed, and the situation is particularly difficult for displaced households, where the head of household is unemployed.<sup>20</sup>

Children under 5 years of age are particularly at risk. This threat takes many forms, such as: very low access to preschool education (less than 9% of children attend a preschool education institution), lower access of poor children to secondary education, very low health insurance coverage, especially in rural areas. Surveys conducted among the population also confirm that the absence of health care affects young children of both sexes most seriously, since children are seen as more susceptible to accidents and illness, and as less resistant than adults.<sup>21</sup> Children without parental care and other children in care (in the care of social welfare institutions) are at even greater risk than children living in poor families, since the social welfare systems are financially too weak to provide appropriate care.

Unemployment is probably the major problem affecting the young generation, equally in urban and rural areas of BiH. When this is combined with housing problems, the lasting economic crisis and political manipulation, young people become depressed and desperate and turn to drugs and alcohol, or make plans to emigrate as the only way to secure a better future.<sup>22</sup> According to the available data, 92,000 young people left BiH between January 1996 and March 2001, and surveys show that 62% of the young would emigrate if they had the opportunity.<sup>23</sup> This is probably the most detrimental trend for the long-term revival and viability of economic development of BiH. The fact that there are fewer women among newcomers to the labour market (19 to 29 years of age) is interesting, since this means that a larger number of women than men are leaving the country.<sup>24</sup>

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<sup>15</sup> Human Development Report/Millennium Development Goals, June 2003, p. 17.

<sup>16</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 11.

<sup>17</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 12.

<sup>18</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 36-37.

<sup>19</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 35.

<sup>20</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 36.

<sup>21</sup> Gender and Poverty: A Qualitative Survey, IBHI, June 2002, p. 6.

<sup>22</sup> Gender and Poverty: A Qualitative Survey, IBHI, June 2002, p. 6.

<sup>23</sup> Human Development Report, UNDP, September 2002, page 42.

<sup>24</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 111.

## **2.2. Refugees and displaced persons**

The data of the Ministry for Human Rights and Refugees of BiH indicate that 283,900 displaced persons reside in BiH (35% from the territory of FBiH and 65% from RS). It is estimated that more than 500,000 BiH refugees live abroad, and some 100,000 have no permanent status, so the possibility of their return should be anticipated. Some 248,300 displaced persons live in the RS and around 23,500 in Brčko District.<sup>25</sup> According to the data of the Ministry of Refugees and Displaced Persons of BiH and UNHCR, by September 30, 2003, 713,261 refugees and displaced persons returned to the FBiH, while 242,598 went back to their homes in the RS, and 20,951 refugees and displaced persons to Brčko District.<sup>26</sup>

In all parts of the country, these categories, who are frequently without any stable source of income and not being covered by the existing social welfare systems, are considerably more vulnerable to poverty than the population that was not forced to move. In the case of returnees, the picture varies: in the RS returnees are extremely exposed to the risk of poverty, while in the FBiH that risk is lower.<sup>27</sup>

Although LSMS failed to provide sufficient data for an in-depth analysis, the severity of the plight of this category is confirmed by the earlier research. Displaced persons constitute around 45% of the extremely poor in the FBiH, while in the RS, the displaced population accounts for only 21% of all those falling into this category. Eight percent of the poorest and 37% of persons on the poverty line live in a joint household with at least one displaced person. By far the most difficult is the situation of displaced persons still living in collective centers.

In the circumstances of radical cut-backs and the imminent cessation of these types of assistance, the displaced are in an especially difficult position, as there is no organized system at the entity and cantonal level that could take over the role of financing the needs of the displaced. The displaced therefore left in a charge on the municipalities which, in most cases, are unable to provide them with even the minimal conditions for survival. Displacement had an impact on the stratification of the labour market: the displaced are in a much more difficult situation, facing greater difficulties in finding a job and often forced to accept jobs that other groups were not interested in. In view of the difficult economic situation as well as continued ethnic tensions, returnees almost never manage to return to their previous jobs. Single mothers in displaced persons or returnee households face particularly serious problems since, in addition to all the other aspects of discrimination, they do not have access to even the basic forms of social welfare provided to other population groups.<sup>28</sup>

## **2.3. Classic social welfare cases**

There are around 260,000 beneficiaries of social welfare in BiH, i. e. around 7% of the population from each Entity. Additional 125,000 beneficiaries were registered for child care programs (2% of the population in FBiH and 6% in RS)<sup>29</sup>. The categories of social welfare beneficiaries (in both Entities)<sup>30</sup> are children without parental care, educationally neglected children, children whose development is disrupted by their family situation, the disabled and persons with mental and physical developmental problems, persons incapable of working and without any material insurance, elderly persons without any family care, persons with anti-social behaviour as well as persons and families in social need due to special circumstances.<sup>31</sup>

Although 2% of the BiH population is registered as receiving financial benefits as a social welfare right, the reality is that funds are not available for everyone to exercise that right. For instance, only 13% of those registered in the RS are actually receiving welfare payments, and in some municipalities the percentage of those registered that are actually receiving welfare payments is as low as 2-3% while in others it may be over 20%.<sup>32</sup> The situation is similar in FBiH, where some cantons offer no form of social assistance.

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<sup>25</sup> Reform of social security development in FBiH, Inter-ministerial Working Group for Social Policy, February 2002, p. 28 –29.

<sup>26</sup> UNHCR Mission in BiH, [www.unhcr.ba](http://www.unhcr.ba)

<sup>27</sup> Bosnia and Herzegovina: Poverty Assessment, Volume II, World Bank, Report No. 25343-BIH, p. 38.

<sup>28</sup> Gender and Poverty: A Qualitative Survey, IBHI, June 2002, p. 2.

<sup>29</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 127.

<sup>30</sup> Reform of social security development in FBiH, Inter-ministerial Working Group for Social Policy, February 2002, p. 9, and Analysis of the situation in the social sector in RS with proposed measures, Social Sector Working Group, June 2002.

<sup>31</sup> Reform of the development of social security in FBiH, Inter-ministerial Working Group for Social Policy, February 2002, pp. 7-8 and 11, and Analysis of the situation in the social sector in RS with policy proposals, Working Group for Social Sector, June 2002.

<sup>32</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 127.

## **2.4. The unemployed**

According to official statistical data, in December 2002 the official number and rate of unemployment (unemployed registered with employment bureaus) were 435,505, or 41.1% (42.7% in the FBiH and 38.2% in the RS) of active population.<sup>33</sup> Women represented 44,6% of the overall number of unemployed. Approximately one third of the unemployed were demobilized soldiers, while 4% were family members of killed soldiers and military war disabled.<sup>34</sup> About 34% of the population (38,6% of the FBiH population and 26,7% of RS population) regard unemployment as the single most serious problem faced by the country. As a result of cuts in military personnel, as already announced, as well as the impact of privatization, jobless numbers are expected to continue to rise.

Subject to certain conditions, the unemployed who previously had jobs have the right participate in the safety net which provides benefits of between 117 and 240 KM, payable for a period of between 6 and 12 months. Insufficiency of funds for this purpose led to only 3,320 people receiving these benefits in 2002,<sup>35</sup> and in the first six months of 2003 some 4,700 persons, or 1.6% of the total of those registered with employment bureaus in this entity. Unemployed persons in the FBiH are entitled to health care on condition that they are registered with one of the cantonal employment bureaus. In the RS, during 2002, an average of 1,290 persons per month received unemployment benefits, averaging some 70 KM, and there were some 1,530 on average in the first six months of 2003. Eligibility for unemployment benefits, which are payable over a period of between 3 and 12 months, depending on years of service, is based on a specified number of years of employment during the period preceding the claim.<sup>36</sup>

The Poverty Assessment Study, drafted by a team of World Bank experts using data collected under the auspices of the Living Standards Measurement Survey (LSMS) and in collaboration with domestic experts, has reached a surprising conclusion in the preliminary phase that poverty is not primarily a consequence of unemployment. This conclusion is based on findings that less than 20% of the poor live in households in which the head of the family is not working, while more than double that number live in families in which the head of the family has a job. About 63% of the poor live in households in which at least somebody is employed. On the other hand, 28% of the unemployed are poor<sup>37</sup>, while the unemployed represent only about a third of the overall number of the poor.<sup>38</sup> An explanation for such a wide incidence of poverty among the employed and among members of their households should be sought in the difficult conditions in which the BH economy functions. Average wage in the FBiH in December 2002 amounted to 513 KM, and in the RS to 356 KM<sup>39</sup> (in comparison with the estimated monthly price of the consumer basket, which is 459 KM in the FBiH and 458 KM in the RS).<sup>40</sup> At the same time, a significant number of businesses are showing very poor trading results and pay low wages, often in arrears by several months.

Bearing in mind that women account for only a third of the employed in BiH, and 44,6% of the officially unemployed are women - one of the solutions to the difficult position of families with working members is to promote a more active role for women on the labour market. However, the current state of the economy means that increasing the number of employed women will be a difficult and long-term process.<sup>41</sup>

The Poverty Assessment Study also showed that, although all unemployed persons do not fall into the category of the poor, they are at significantly higher risk of seeing their standard of living falling to below the poverty line than any other category of the population.

## **2.5. Low Income Pensioners**

The LSMS data point out that the elderly, as a group, do not belong to the most vulnerable category, mostly because the level of pensions, especially in the FBiH, is above the poverty line. Only 17% of the

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<sup>33</sup> Bulletin 4, January – December 2002, Central Bank of BiH, pp. 148-149.

<sup>34</sup> Education in Poverty Reduction, Federal Ministry of Education, Science, Culture and Sports, May 2002.

<sup>35</sup> Reform of the development of social security in FBiH, Inter-ministerial Working Group for Social Policy, February 2002, pp. 19,

<sup>36</sup> Analysis of the situation in the social sector in RS with policy proposals, Working Group for Social Sector, June 2002.

<sup>37</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 33.

<sup>38</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 38.

<sup>39</sup> Bulletin 4, January – December 2002, Central Bank of BiH, pp. 153.

<sup>40</sup> Monthly Bulletin of the Federal Statistical Bureau, June 2002, page 55, and Early Warning System, Quarterly Report April – June 2002, UNDP and BiH authorities, p. 36.

<sup>41</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 120-121.

poor are of retirement age.<sup>42</sup> However, the members of that group are mostly concentrated just above that line. Belonging to a higher age group is, however, a common enough characteristic of the poor, and their specific needs and dependence on assistance from other people mean that this group is in exceptionally difficult circumstances. According to the findings of the team in charge of the Poverty Assessment Study, as many as 20% of the poor are either retired or incapable of working. In addition, at least 25% of the poor over the age of 60 are from the category of those who have not acquired the right to a pension.

In comparison with the year 1991, when the ratio of pensioners and employees was 1:3, by the end of the year 1995 the ratio had decreased to 1:1.3, after which it stabilized at about 1:1.4 in the FBiH. The level of pensions in the FBiH (an average pension of 186 KM was disbursed in December 2002) reflects the strength of the post-war recovery. Owing to the tripling of wages, and the 25% increase in the number of people paying insurance, the average pension has tripled by comparison with 1996 levels. By 2001, the average pension in the FBiH had reached 2/3 of average income per capita, which is above the ratio in most countries in transition. However, average pensions are still only around 36% of an average wage in FBiH (513 KM)<sup>43</sup> this solid average conceals significant differences in pension levels, so that older women, widows of pensioners, are to a significant extent exposed to the risk of poverty, while a household receiving two pensions can enjoy an income significantly above the FBiH average. In addition, women pensioners are, in general, in a more difficult position than men, given that women's pensions are lower because, in general, they had lower-paid jobs.<sup>44</sup>

The situation in the RS is significantly more difficult, with each person paying insurance contributions supporting more than one pensioner: a ratio of 1.08:1. As a result, even the very high contributions and transfers from the budget do not make it possible to pay average pensions of more than 30% of average income per capita. The level of pensions in the RS is half of what it is in the FBiH (an average pension in December 2002 as 120.18 KM), i. e. 34% of the average wage of 356 KM).<sup>45</sup> Despite this,+, the RS pension system can function only with significant transfers from the entity budget.

### 3. Specific Issues Related to Poverty in BiH

#### 3.1. Human Rights and Poverty

It must always be stressed that effects and consequences of poverty are multidimensional. This means that negative influence on one dimension of human rights (e. g. the economic aspect) inevitably affects all other rights. It is difficult to claim with certainty that economic growth might by itself lead to poverty reduction and that is why it is of utmost importance to consider poverty from an inter-sectoral perspective.

Existing legal framework in BiH (BiH Constitution, constitutions of entities and cantons, ratified international conventions) provide a high degree of protection of human rights and freedoms. Equal treatment of men and women is guaranteed by law. In addition, BiH ratified a series of international human rights conventions (although it irregularly reported to international monitoring bodies)<sup>46</sup>.

In the summer of 2000, a crucial decision of the Constitutional Court determined that changes must be introduced into entity constitutions to protect the rights of **constitutional peoples** in BiH. Subsequently, constitutional mechanisms were introduced in the entities to balance and safeguard the rights of every constitutional people. This decision ensured equality and proportional representation in political, administrative and judicial institutions.<sup>47</sup>

All areas of social and economic development contain a dimension of human rights and require monitoring and analysis of effects of measures implemented with regard of the individual rights of citizens, as well as rights of different citizen groups, which require a higher degree of protection, such as: children, elderly, women, people in social need, persons with invalidity, families of killed and missing, war victims, displaced persons, and in particular returnees, minorities, refugees, asylum

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<sup>42</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 35.

<sup>43</sup> FBiH Retirement Fund, April 2003.

<sup>44</sup> Human Development Report, UNDP, September 2002, p. 86.

<sup>45</sup> Payment of retirement benefits, RS Retirement Fund, December 2002.

<sup>46</sup> Report of the European Commission to the Council on preparedness of BiH to initiate negotiations with the European Union on the Stability and Association Agreement, Brussels, 18 November 2003, p. 10.

<sup>47</sup> Report of the European Commission to the Council on preparedness of BiH to initiate negotiations with the European Union on the Stability and Association Agreement, Brussels, 18 November 2003, p. 11.

seekers, Roma etc. Social and economic rights of BiH citizens remain constrained because of underdeveloped economy.<sup>48</sup>

According to the reports of the Ombudsmen, the most frequent human rights violation relate to equality before the law, property rights and right to work. The BiH Poverty Assessment demonstrated the strong link between violations of human rights, that are guaranteed by law, and poverty. This link is particularly strong in the case of returnees, as well as of minority populations (Roma).

### **3.2. Education and Poverty**

About 60% of the poor live in households in which the head of the family has primary education only, or not even that. The probability of a household falling into the category of poor households is almost tripled if the head of the family has completed primary school level education only.<sup>49</sup> High-school level education is already a major guarantee of the family's avoiding falling into poverty. This indicates the importance of the improvement of the educational system for young people, as the basic tool for the long-term eradication of poverty. In the medium term, creating new options for adults with lower educational levels would yield positive results for a large proportion of the poor.

One of the basic findings of the majority of studies relates to the negative correlation between the level of education and poverty. In general, the higher the level of education, of either an individual or a household, the lower the probability that they will become unemployed, and therefore that they will fall into the category of the poor. Even in the 25-35 age group, half of all the poor are persons who have primary education only.<sup>50</sup> Lower education levels are linked to working in the "gray economy" - more than a half of the employees with primary school level of education work in the informal economy, while for categories with higher levels of education that indicator is under one fourth.<sup>51</sup> Education level is single most significant of all factors affecting the poverty risk.<sup>52</sup>

### **3.3. Gender Equality<sup>53</sup> and Poverty**

Although there is not enough data to enable an analysis of poverty from the aspect of gender, existing studies point out that poverty takes the same toll amongst women and amongst men. Both men and women believe that the causes of poverty are the war, poorly conducted privatization, lack of the skills in demand on the labour market, corruption and the absence of the rule of law. Both groups seek their way out of poverty through improvements of their employment options, resolving their housing problems, adequate access to health and educational services, as well as through mobilization and activation of the society itself. It is interesting to note that all the groups consider that the alienation and poor cultural life are some of the important consequences of poverty.<sup>54</sup> In the BiH context, the male and female roles were disrupted with the outbreak of the war. Men assumed the role of defenders, protectors with the absolute power and control in public and political life. Women thus lost a role in public life and reverted back to the limits of the home, household and family.<sup>55</sup>

According to the findings of IBHI<sup>56</sup> researchers, the impact of poverty is different on men and on women: men often fall into a depression over unemployment or inability to support their families, while women are more inventive and ready to accept all kinds of jobs, but are prone to stress and tend to sacrifice their own health. In our new social circumstances, women often take on additional responsibilities for supporting their families, together with their traditional roles of mother and housewife.<sup>57</sup>

Women comprise 44.65% of the overall number of unemployed, which is more evident than their share of overall employment (35%)<sup>58</sup> or active population (37.4%).<sup>59</sup> This is the lowest proportion of women in the total active labour force of any country in Southeastern Europe. Low employment rates among

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<sup>48</sup> Report of the European Commission to the Council on preparedness of BiH to initiate negotiations with the European Union on the Stability and Association Agreement, Brussels, 18 November 2003, p. 11.

<sup>49</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 32.

<sup>50</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 44.

<sup>51</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 60.

<sup>52</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 46.

<sup>53</sup> Global Advocacy for Gender: Vienna Declaration, Convention on Elimination of Discrimination Against Women (CEDAW), and Beijing Action Platform

<sup>54</sup> Gender and Poverty: A Qualitative Survey, IBHI, June 2002, p. 25.

<sup>55</sup> Human Development Report/Millennium Development Goals – BiH 2003, UNDP BiH, June 2003, p. 41.

<sup>56</sup> Independent Bureau for Humanitarian Issues.

<sup>57</sup> Gender and Poverty: A Qualitative Survey, IBHI, June 2002, p. 1.

<sup>58</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 38.

<sup>59</sup> Human Development Report, UNDP, Sarajevo, June 2003, p. 18.

women are a problem for two reasons: first, the decline of real wages in comparison with the pre war period indicates that one wage can hardly meet all the demands of a family now; second, the ravages of war and the post war cuts in social benefits for family support have forced families to take on additional domestic responsibilities, without any additional resources.<sup>60</sup>

Women suffer discrimination in employment, in both the private and the public sector, they receive lower wages than men for the same work and they have fewer opportunities for promotion, which has a direct impact on their financial position and makes it harder for them to maintain a satisfactory standard of living. Women are first to be fired during times of restructuring and reform and it is harder for them to find new employment. The available data lead to the conclusion that female-headed households are exposed to significantly higher risks of falling into the category of the poor than male-headed households. A further problem that is a particular barrier to employment for women is the almost virtual non-existence of childcare institutions.<sup>61</sup> For all these reasons, it is not surprising that the data indicate that women in the 19 to 29 age group are less represented in the category of new entrants to the labour market, although it may also indicate that some of the best educated are leaving the country in search of better living conditions.

Even the fact that women have a longer life expectancy contributes to significantly higher exposure of older women to the risk of falling below the poverty line. Women account for 58% of the population over 65. It is very common to find women living alone, without a pension or any other regular income, especially in rural areas.<sup>62</sup> Even when they have acquired the right to a pension, women pensioners receive lower pensions, having as a rule had lower-paid jobs. Bearing in mind that low education levels and illiteracy are the most frequent among the members of this group, it becomes clear how hard it is for such women to make use even of the options that exist for them to receive assistance.

Poor women are especially stricken by the sense of disempowerment and inability to express their opinions, either in their own surroundings or in relation to the authorities. Single mothers (particularly of children with special needs), elderly women, women refugees, Roma women, victims of violence, uneducated and unemployed women, and women in rural areas have special difficulties. Women in returnee households are in by far the worst position of all, due to their minority status and, often, their total isolation from the community to which they have returned. In view of the fact that there are different categories of vulnerable women in BiH, various problems must be addressed when designing assistance programs. Additional research in the area of gender equality is vital to obtain a clearer picture of the situation on the ground.

At the level of BiH, the issue of gender equality is completely regulated by the Law on Gender Equality in BiH<sup>63</sup> This Law regulates, promotes and protects gender equality and guarantees equal possibilities to all citizens, both in the public and private sphere of the society, and prohibits gender-based direct or indirect discrimination. Full gender equality is guaranteed in all segments of society, and particularly in education, economy, labor and employment, social and health care, sports, culture, public life and the media, without regard to marital and family status. However, the focus in the next period must be on the implementation of the Law on Gender Equality in BiH and on integration of gender equality issues into all future strategic documents.

### **3.4. Elderly People and Poverty**

The BiH population is rapidly aging, due to the declining rate in the natural increase of population, increasing life expectancy and emigration of the young. It is estimated that more than 12% of the BiH population is over 65, and for the RS this estimate is 15%. Over 80% of elderly persons are pensioners, about 10% of them receive benefits as war disabled, and about 5% are receiving social assistance.

Bearing in mind that pensions are low and social welfare, which is low and is often in delay, elderly people are one of the potentially most vulnerable groups. Although precise data are not available, some groups, such as elderly women living alone in villages, find it very hard to cope, due to the lack of access to social services, while the isolation of their homes and their own illiteracy often means they have no way of seeking assistance.<sup>64</sup>

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<sup>60</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 38-39.

<sup>61</sup> Gender and Poverty: A Qualitative Survey, IBHI, June 2002, p. 2.

<sup>62</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 102-103.

<sup>63</sup> This Law has been harmonized with EU standards, adopted by the BiH Parliament and gazetted on 16 June, 2003, "Official Gazette" No. 16/03.

<sup>64</sup> Human Development Report, UNDP, September 2002, pp. 53-54.



### **3.5. Poverty in Rural and Urban Areas**

The consequences of the war have extremely complicated the situation in BiH and the position of its rural population, where the level of poverty is significantly higher. Although BiH has no pronounced potential for the development of agriculture, about half the rural population relies to a large extent on agriculture to survive. Many rural communities have been destroyed and their population displaced, either to third countries or within the country, where they are now largely living in cities. The slow pace of demining means that normal life is still impossible in many parts of the country, and a proportion of arable land cannot be cultivated.

Only about 20% of the poor live in urban communities, and poverty is most present in smaller communities, which frequently suffered the worst damage during the war. The risk of falling into poverty in the RS is significantly higher in non-urban, than in urban areas: 27% to 12%., while in the FBiH this risk is balanced: 16% of the poor live in non-urban, and 15% in urban areas.<sup>65</sup>

Practically all the aspects which influence household living standards are more unfavourable in rural areas. In many parts of the country the basic infrastructure is still lacking. Access to educational and health facilities is more difficult and more expensive, and the quality of those which are accessible is lower. The virtual absence of pre-school institutions is increasingly significant, as they could help children from rural areas to compensate for the limitations which are often the result of growing up in a village. Only 6% of children from rural areas attend such institutions, in comparison with 15% of city-dwelling children.<sup>66</sup>

The lack of a comprehensive agriculture development policy deters people from investing in that activity, while options for other types of employment in rural areas are minimal. All this prevents many displaced persons from leaving their temporary residences in the cities, which creates an additional pressure on the very small number of jobs, increases the cost of housing and gives rise to difficulties in the provision of educational, health care and social services.

### **3.6. Ethnic and Religious Dimensions of Poverty**

UNDP findings<sup>67</sup> prepared in collaboration with the BH authorities, indicate that there is a correlation between the ethnic structure of certain parts of the country and levels of household income. In Croat-majority areas, 6.9% of households fall into the category of the poor based on income levels, in Bosniak-majority areas the percentage is between 22% and 25%, and in Serb-majority areas it is between 40% and 43%. Expressed differently, there is a growing gap in the economic development and standard of living between the different regions of BiH: Croat-majority areas enjoy the highest living standards, Bosniak-majority areas are in the middle, and RS has the lowest standard of living. Bosniak-majority Sarajevo Canton is the exception to the rule, thanks to its specific position as the capital and the presence of so many government authorities and international organizations

Almost everywhere in BiH minorities are much more vulnerable in regard to their financial status. In comparison with the above figures on the majority populations of the various areas, more than half of ethnic minority households in RS are poor, and in the Croat-majority areas of FBiH, 15.6% of ethnic minority households are poor. In Bosniak-majority areas, about 25% of ethnic minority households fall into the category of the poor, but the data from 2002 do not indicate any great differences between majority and minority ethnic groups.<sup>68</sup>

A minority group that is almost entirely marginalized in BiH is the Roma population. Although it is impossible to ascertain the number of Roma living in BiH today with any degree of certainty (the estimates of Roma organizations range between 17, 000 to close to 80,000<sup>69</sup>) it is almost certain that they represent the largest ethnic minority.<sup>70</sup> The number of Roma is difficult to ascertain because many of them still live nomadically. Although no in-depth surveys of poverty among Roma have been conducted, all available information indicates that they are one of the most vulnerable groups, living in conditions below even the most minimal for survival and often without the resources to support their families and ensure that their children can receive an education. As a group, Roma have by far the

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<sup>65</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 42.

<sup>66</sup> Household Survey of Women and Children in BiH, 2000, UNICEF and Statistics Agency of BiH, December 2000, pages 47 and 111.

<sup>67</sup> Early Warning System, Quarterly Report April – June 2002, UNDP and BiH Authorities, pp. 16-17.

<sup>68</sup> Early Warning System, Quarterly Report April – June 2002, UNDP and BiH Authorities, p. 34.

<sup>69</sup> Status of Roma in BiH (Poll Findings), Center for Protection of Minority Rights, Sarajevo, 1999, p. 14.

<sup>70</sup> Denied a Future? The Right to Education of Roma Childer in BiH, Save the Children, March 2001, p. 34.

lowest levels of education in the country, their unemployment rate is almost 100%, and more than 90% have no health insurance. Due to their minority status they are marginalized, and their lack of knowledge of the system means that they are effectively deprived of many legal rights, including the right to social assistance.

Of the Roma families polled, 80% have no family members in permanent employment, and the majority mostly survive by doing temporary work or seasonal jobs, as small-scale traders in outdoor markets, or as scrap merchants.<sup>71</sup> Roma encounter discrimination when job-hunting. A further problem is that very few have any formal education and even fewer have professional qualifications of any kind. The results of polls conducted among the Roma show them to be poorly integrated into the education system, with 23% illiteracy and low attendance rates at pre-school institutions and primary schools, resulting in their almost total exclusion from high school, vocational and university education.<sup>72</sup> By way of illustration, a poll by the Roma association "Our Future", covering 582 Roma children aged 7 to 18 in Sarajevo Canton during the school year 1995/1996 found that only 189, or 33%, attended school regularly.<sup>73</sup> As Sarajevo is an urban area in which the majority of children have the opportunity to attend educational institutions, one can assume that the situation in other parts of BiH is even worse. Confirmation for this can be found in a survey on the status of Roma in Tuzla Canton, which covered 189 families and established that only 10 families enrolled their children in schools.<sup>74</sup>

Roma give as reasons for their children's failure to attend school: poverty, the necessity for children to start working and providing for the family at an early age, lack of confidence in the authorities (including schools), ill-treatment by their peers at school, and their inability to provide an environment conducive to study at home. Another reason often cited is the language issue: 86% of Roma polled give their mother tongue as Roma, which adds to their problems at school, where in the overwhelming majority of cases no special provision is made for pre-school assistance to Roma children. Roma have long faced difficulties and exclusion from community, but the BiH Law on the Rights of National Minorities from 2002, and establishment of consultative fora, created a mechanism for protection of their rights.<sup>75</sup>

#### **4. Causes of Poverty**

##### **4.1. War destruction**

About 250,000 people lost their lives during the war in Bosnia between 1992 and 1995, and more than half the pre-war population of 4.4 million people became internally displaced or refugees abroad. The war caused immense devastation to manufacturing capacity and infrastructure, severed trade connections and put an end to the economic reforms that had just been launched in former Yugoslavia. Direct material war damage is estimated at between 50 and 60 bn. US\$, of which about 20 bn. US\$ on industrial capacities<sup>76</sup>. Adding to this the loss of GDP from 1992 to date, overall damage amounts to more than 100 bn. US\$. Because of the war, from a development country (within the former SFRY) BiH had, in European terms, become a poor country.

##### **4.2. Slow Implementation of Reforms**

In the post-war period, issues related to the implementation of the Dayton Accords were the focus of attention of all governments. Implementation of necessary reforms, that would lead to an economic revival, and consequent increase in employment, were delayed. Lack of political consensus on the reform program represented an additional obstacle.<sup>77</sup>

##### **4.3. Unemployment**

Unemployment, especially widespread among the younger population, one of the most significant causes of poverty in BiH. The unemployed are not in fact a majority of the poor, because many live in

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<sup>71</sup> Denied a Future? The Right to Education of Roma Childer in BiH, Save the Children, March 2001, p. 19.

<sup>72</sup> Denied a Future? The Right to Education of Roma Childer in BiH, Save the Children, March 2001, p. 9.

<sup>73</sup> Denied a Future? The Right to Education of Roma Childer in BiH, Save the Children, March 2001, p. 32.

<sup>74</sup> Analysis on the Current Status of the Roma Returnees to Tuzla Canton, Helsinški parlament građana i romska udruženja iz Tuzlanskog kantona, 1999.

<sup>75</sup> Report of the European Commission to the Council on preparedness of BiH to initiate negotiations with the European Union on the Stability and Association Agreement, Brussels, 18 November 2003, p. 13.

<sup>76</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 49.

<sup>77</sup> Human Development Report, UNDP, September 2002, Pages 47-48.

households where one or more persons are employed. Another significant reason is the very strong informal sector (36,2%)<sup>78</sup>. The size of the "grey economy" led the World Bank to conclude that real unemployment rate (based on the very broad ILO definition) could be as low as 16.7%.<sup>79</sup>

#### **4.4. Human Rights Violations**

Human rights violations in BiH, particularly in cases of returnee and Roma populations, influence the poverty rate. Ethnic discrimination is expressed in difficulties in achieving return of private property, threats to personal security or obstruction of returns to pre-war places of residence and pre-war jobs, as well as the general impossibility of finding work, particularly in the public sector. Access to education, health- and social services or participation in the labor market are all hampered.

#### **4.5. Inadequate Social Assistance System**

In the conditions of insufficient fiscal revenues, the existing social assistance system is incapable of providing for the large numbers of the poor. Discrimination is present in realization of benefits, in that the transfers to military disabled are higher and more regular than to other categories of persons with disabilities. At the same time, discrimination is also regionally-based. Unlike other parts of the country, poor cantons in FBiH and poor RS municipalities are not allocating funds for social assistance, due to the shortage of funds in their budgets. The inadequate organization of social assistance in post-war conditions, together with the decentralized formulation and implementation of social policy, with policy determined on one level (entity) and implemented on another (canton or municipality), makes the adequate provision of assistance much harder. The peripheral municipalities, especially in the RS and Goražde Canton, pose a particular problem, as many were created through a division of pre-war municipalities and most lack even the most basic physical infrastructure, let alone the capacity to organize social assistance and care for the poor within their jurisdiction. Finally, the oversight of the benefits' approval process is inadequate, which leads to the conclusion that social assistance benefits granted to date need to be reviewed.

Social assistance is an important factor in reducing poverty: the current assistance is equal to some 17% of GDP in BiH. Transfers to households comprise the largest share – around 15% of GDP. One in five inhabitants is a recipient of social assistance in some form. This assistance comprises around 11% of total household spending. For some 13% of the polled, the assistance is the shield from sliding into poverty, because for that group it increases spending by 50% on average. Many households in BiH receive some form of assistance, but less than half of the poor households are covered by these programs. Compared with other countries in the region, social assistance in BiH was unequally distributed between vulnerable groups and has limited effect to reduction of general poverty level in the country.<sup>80</sup> As previously mentioned, the existing social assistance system favors one group in relation to others, thus the total social transfers are not equally shared between all those in need of such assistance. The issue of financial assistance of both entity governments to war veterans is a particularly complex. Contrary to the public opinion, the analysis of the data collected during the Living Standard Measurement Survey (LSMS) demonstrated that the war disabled and war veterans face considerably lower risk of sliding into poverty in relation to average inhabitant of BiH. This may be explained by higher sensitivity of governments to this category, owing to their ability to exercise far more effective influence on the public opinion in comparison with other categories of the poor. Thus, for instance, transfers to the veteran populations are 13 times higher in FBiH, and 2 times in RS, than allocations for child protection.

Amounting to nearly 4% of GDP, veteran transfers represent a major burden for entity budgets and restrict the capacity for assistance to other vulnerable categories of the population. In addition, in both entities, significant additional financing is channelled to these categories from lower levels of government. It has been recognized that the most severely disabled (over 50% of disability) are not adequately protected, while the assistance is provided for a great number of work-capable disabled.

That the situation of social assistance beneficiaries is not even worse may be explained by other forms of assistance they receive. During the war and post-war period, humanitarian aid was particularly significant, as it often included, in addition to food, clothes and medicines. Humanitarian assistance was shared and through government bodies and through NGOs, and was available to nearly everyone in need. However, this form of assistance has been considerably reduced in recent years and one must expect that in the near future it will no longer have a significant role in meeting the basic needs of the

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<sup>78</sup> According to LSMS findings.

<sup>79</sup> Human Development Report, UNDP and Economic Institute Sarajevo, September 2002, Page 35.

<sup>80</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BiH, p. 99.

vulnerable categories of the population. On the other hand, other survival strategies are in evidence: many poor rely on assistance of the family and relatives, and many others have access to arable land. Assistance from abroad is also a significant means of substituting or complementing social protection. Most of this assistance flows outside official financial channels, making it impossible to determine their levels with certainty. The BiH Central Bank estimates that private transfers from abroad in 2001 reached KM 2.1 billion, i. e. equal to 22% of GDP, which is far above the other countries in the region. It is, however, impossible to determine what share of these funds goes to the poor or to those who would be poor without such assistance.<sup>81</sup>

#### **4.6. Quality of Education**

The quality of education has a direct influence on employment options, and thus on the possibilities for poverty reduction.

#### **4.7. Corruption**

Corruption, which is widespread in BiH, affects the poor especially hard, whether it is the matter of visit to a doctor, realization of the right to some form of social assistance, obtaining documents, education, return of property or employment.. Displaced persons, the elderly, the rural population and unemployed are often forced to pay for such services because they lack the channels of communication that would allow them to access these services in any other way.

#### **4.8. Inability to Influence the Institutions of the System**

Inability to influence the institutions of the system are both a cause and a consequence of poverty. In most cases the poor lack or are unaware of the channels of communication with the authorities that make the decisions and control the resources affecting their lives, which reduces their chances of breaking out of the "vicious circle" of impoverishment and participating in the formulation of policies and measures adjusted to their needs.

### **5. Priority Activities for Poverty Reduction**

A major goal in implementation of the Medium-Term Development Strategy of BiH (PRSP) is reduction of the poverty level by 20% by 2007. To achieve this goal, it will be necessary to implement the following reforms and measures, which are described in detail in the text of the Strategy:

- implement the fiscal reform to ensure a more effective collection of public revenues and higher assistance to the poor;
- accelerate the growth of the private sector to increase employment as one of the most effective ways of reducing poverty;
- establish a more adequate system of social protection to ensure a minimum of social rights and a more balanced distribution of social assistance for all categories of the poor in the entire country;
- reduce the corruption, which mostly affects the poor;
- reduce the level of "informal economy", which will lead to increases in pensions and reduction of poverty among the elderly;
- ensure safeguarding of human rights guaranteed by the existing legal framework and signed international treaties, which will lead to a better integration of returnee and Roma population into the community and reduce the poverty levels among these categories;
- fully implement the BiH Law on Gender Equality, which will reduce the gender effect on the poverty level;
- implement the reform of the education system, provide out-of-school forms of education and make them accessible to persons with low levels of education, which is most frequently the cause of their poverty.

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<sup>81</sup> Bosnia and Herzegovina: Poverty Assessment, World Bank, Report No. 25343-BIH, p. 27.

## **II. MEDIUM-TERM MACROECONOMIC FRAMEWORK AND FRAMEWORK FOR FISCAL REFORM**

### **II.1. MEDIUM-TERM MACROECONOMIC FRAMEWORK**

#### **1. Objectives**

**1.1. By 2007, reach 70% of 1991 GDP;**

**1.2. By 2007, achieve partial credit worthiness on international capital market.**

#### **2. Situation: Recent Trends**

After the war, GDP in Bosnia and Herzegovina fell to about 20% of its pre-war level. Since 1995, BiH recorded high levels of growth averaging over 25% per year. As a result per capita GDP more than doubled from around KM 900 in late 1995 to an estimated KM 2,900 in 2003, although one needs to emphasize that the aforementioned level of GDP remains around half of the level executed in 1990. There are significant differences between the two Entities, with per capita GDP in the RS being only around 75 percent of that in the FBiH. Substantial regional differences in the level of economic development exist in both Entities.

From very high levels (over 75% in 1996 and 35% in 1997) real economic growth fell to around 10% in 1999 and an estimated 3.5% in 2003. This reflected a number of factors, including the end of the immediate post-war economic rebound, which was a result of a significant inflow of donor funds, falling levels of international assistance, slower than anticipated progress with economic reforms, political instability in the region, economic crisis in the world and the adverse climatic conditions in 2000 and 2003 which affected agricultural output.

In the course of the previous period, certain progress has been achieved in a number of areas<sup>1</sup>. The Central bank of BiH was strengthened: in 2003, the coverage of imports with reserves amounted to around 5 months. Due to the growth of public revenues, consolidated fiscal deficits were decreased, from 9 percent of GDP in 1999 to a modest surplus in 2003. Tax administration was strengthened, which yielded positive results, as constant growth of revenues was being recorded. Trade deficit, which amounted to 50 percent, in relation to GDP, between 1996 and 1999, is now constantly declining. In 2003 trade deficit declined on around 40% of the GDP. In period after the war exports were increased nine times over. Better control of expenditure was established, through the treasury system, which is functioning on the state and entity level, and which is now being introduced on cantonal and municipal levels, too. Fiscal consolidation was undertaken, through the implementation of additional activities aimed at demobilization of soldiers, and the reform of public administration is in preparation, too. Industrial production still shows positive growth rates. After the decline in 2001 and 2002, the scope of industrial production in RS in 2003 grew by 5 percent. In FBiH it grew by about 4,5 percent, which is still less than in 2002. The general assessment is that BiH is developing solid macroeconomic policies and achieving results in structural reforms<sup>2</sup>.

Economic development is multidimensional, and, to a large extent, it depends on maintaining macroeconomic stability and openness of economy in BiH. Economic growth and stabile economic developments creates the preconditions for increasing the employment rate and the rate of efficiency of the social protection system, which, at the end, leads to the reduction of poverty.

#### **2.1. Problems**

Recent economic development has been associated with substantial external and internal imbalances generated by the post-war adjustment and reconstruction of the economy. The massive reconstruction programme required a very high level of imports that has been reflected in the still present extremely large current account deficit, which amounted to around 17% of GDP in 2003. Slow renewal of domestic production affected the exports, which were weak, and which, in 2003, amounted to about 31 percent of total imports. Unemployment rate was also at a very high level.

The reconstruction of the country required a significant public investment program, which, for example, in 2001, represented about 10% of GDP, having fallen from around 15% of GDP in the late 1990s. Levels of public consumption have remained high, at around 23% of GDP in 2003, which

<sup>1</sup> Final Mission Report on Consultations on Article IV, IMF, December 2003.

<sup>2</sup> "Commission Report to Council on BiH Readiness for Initiation of Negotiations on Stabilization and Accession Agreement with the EU" (Feasibility Study), Brussels, November 18th 2003

affected the growth of tax burdens and fiscal revenues that have grown in line with the Gross Domestic Product (GDP). The continued high level of public consumption to a significant extent reflects the limited progress with economic transformation. In parallel with that, throughout the period, there is a constant trend of extremely high levels of public expenditure. In 2003 they amounted to about 46% of GDP and they by far outreach the average for transition countries.

High levels of imports, public consumption, public investments and public expenditure were, in the most part, possible due to substantial inflows of foreign aid, the spending of a significant number of foreigner residents in BiH and high levels of remittances from BiH citizens living abroad (refugees).

The data on the overall budgetary deficit are still unknown, and it could turn out to be higher than the data shown in this document indicate, due to strong indications that the cantonal and municipal budgets got indebted in the domestic banking sector. According to the IMF<sup>3</sup> data cantonal budgetary deficits financed in this manner reached the amount of about 42 mill KM in the year 2002, which is far above planned level.

A particular difficulty is present in the level of the so-called corporate debt, which is, in the most part, the debt of companies in state ownership or companies privatized through certificates (vouchers). In fact, of special concern is the appearance of the so-called "non-payer culture" in relation to wages, contributions, taxes and liabilities to suppliers, creditors etc. Debts of those enterprises grew to such an extent that they pose one of the most severe obstacles for privatization and continuing development of the country.

Activities in the recent period failed to result in achieving total integration of the single economic space in BiH, and the size of the gray economy (36 percent of GDP) creates a magnitude of problems. The transition is posing a set of questions bearing social and cultural consequences, that are already present in BiH, such as, for example, «to pay or not to pay the taxes», «to register or not to register the workers».

### **3. Medium-Term Macroeconomic Framework: we have lost 18 years, must we lose another 18?!**

Table 1 shows the projected midterm macroeconomic framework for the PRSP. This framework is called "Reform Scenario" and it implies aggressive implementation of reforms envisaged in the proposal of the Mid-term Development Strategy for BiH (PRSP).

#### **3.1. Reform Scenario**

The scenario envisages that, in mid term, the real GDP growth rate will increase from 3.5 percent in 2003 to 5 percent in 2004, reaching about 5.5% by 2007. Such growth rates envisaged by the Reform Scenario would enable BiH to regain the pre war levels of GDP by the end of the decade, and accelerate the integration of BiH into EU.

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<sup>3</sup> Bosnia and Herzegovina – Second and Third Review Under the Stand-By Arrangement, May 2003

**Table 1. Reform scenario**  
**Bosnia and Herzegovina: Mid-term Macroeconomic Framework, 2003-2007**

	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.
<b>Real sector</b>					
Nominal GDP (In millions of KM)	12.173	12.911	13.854	14.893	16.040
(Percentage change)	4,7	6,1	7,3	7,5	7,7
Real GDP (In millions of 1999 KM)	10.806	11.357	11.981	12.640	13.335
(Percentage change)	3,5	5,1	5,5	5,5	5,5
CPI, period average percentage change	0,1	0,9	1,8	2,0	2,2
<b>Savings and investment (In percent of GDP)</b>					
Consumption	111,1	108,4	106,1	103,4	100,5
Public consumption	22,5	22,3	21,2	20,1	19,1
Private consumption	88,7	86,1	84,9	83,3	81,4
Investment	19,9	20,3	21,2	21,8	22,2
Public investment	4,5	4,9	4,9	4,9	5,0
Private investment	15,5	15,5	16,3	16,9	17,2
National savings	2,3	4,5	6,0	8,3	10,4
Public savings	1,8	1,5	2,5	3,2	3,4
Private savings	0,5	3,0	3,5	5,0	7,0
Foreign savings	17,7	15,8	15,2	13,6	11,8
<b>General government (In percent of GDP)</b>					
Total revenue and grants	46,7	45,8	44,7	43,5	42,5
Grants	3,4	3,3	2,3	1,5	1,1
Total expenditure	46,3	46,0	45,4	44,3	43,1
Current expenditure	41,9	41,1	40,5	39,4	38,1
Capital expenditure	4,5	4,9	4,9	4,9	5,0
Own-financed capital expenditure	0,2	0,6	0,8	1,1	1,7
Foreign financed capital expenditure	4,2	4,3	4,1	3,8	3,3
Overall balance	0,4	-0,2	-0,7	-0,8	-0,6
Overall balance excl. grants	-3,0	-3,5	-3,0	-2,4	-1,7
Accumulation of arrears	0,5	0,7	0,5	0,5	0,5
Financing	0,2	0,8	1,2	1,3	1,1
Domestic financing	0,0	-0,2	0,6	0,7	0,3
Foreign financing	0,1	1,1	0,6	0,6	0,8
<b>Total foreign assistance 1/</b> (In millions of US dollars)	5 350	6 486	4,5 372	3,7 322	2,6 283
<b>Balance of payments (In millions of US\$)</b>					
Current account balance (including official transfers)	-1.237	-1.302	-1.368	-1.324	-1.187
(Percent of GDP)	-17,7	-15,6	-15,2	-13,6	-11,3
Export growth rate (In percent)	34	22	13	14	15
Import growth rate (In percent)	22	12	5,4	6,5	6,4
Gross reserves	1.725	1.714	1.764	1.814	1.864
(Months of imports of goods and n.f. services)	4,5	4,5	4,4	4,3	4,1
Total public debt 2/ (In millions of US\$)	2.572	4.930	4.997	5.038	5.041
(In percent of GDP)	34,0	39,7	36,2	32,5	28,5
Total external debt service in percent of exports of goods and non-factor services	8,6	7,2	7,0	6,1	4,4
<b>Memorandum item:</b>					
Percentage change in real current public expenditure	1,3	4,9	-1,3	2,5	2,8

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

1/ Includes disbursements of foreign loans, and grants.

2/ Includes external public debt, stock of expenditure arrears, debt to domestic banks, and frozen foreign currency deposits.  
 Excludes any liabilities arising out of war damage claims.

The key risk to realization of the Reform Scenario is the possibility that the necessary pace of reforms proposed by the Mid-term Development Strategy for BiH (PRSP) will not be achieved, which would result in lower rates of economic growth. The impact would be further exacerbated by a sharper than expected fall in external resource inflows, which can be expected to be increasingly linked to the timely implementation of reform measures.

### 3.2. Scenario in the Case of a Slower Implementation of Reforms (status quo)

Due to the risk that the governments might fail to achieve the necessary pace of implementation of reforms, the PRSP team prepared an alternative mid-term macroeconomic projection which is titled "Scenario in the Case of a Slower Implementation of Reforms". That scenario is based on the trends in growth and implementation of reforms, which existed between 1996 and 2002 (status quo scenario).

Table 2: Scenario in the Case of a Slower Implementation of Reforms				
	2004	2005	2006	2007
	Proj.	Proj.	Proj.	Proj.
<b>Real Sector</b>				
GDP in nominal terms (KM million)	11,593	11,924	12,298	12,717
(percentage change)	3.5%	2.9%	3.1%	3.4%
GDP in real terms (KM million)	11,185	11,398	11,614	11,835
(percentage change)	1.8%	1.9%	1.9%	1.9%
CPI: period average percentage change	1.7%	1.9%	2.0%	2.1%
<b>General Government (% of GDP)</b>				
Total balance (KM million)	-321	-341	-353	-347
Total Revenues and Grants	53.3%	53.0%	52.8%	52.6%
Total Expenditure	56.0%	55.9%	55.6%	55.3%
Overall Balance	-2.8%	-2.9%	-2.9%	-2.7%
Total Foreign Assistance (grants and loans in m.US\$)	371	381	356	341

According to this scenario, GDP growth rate in real terms would, in 2004, will fall down to 1.8 percent, after which it would stabilize at the level of 1.9 percent annually (Table 2). In 2006, GDP growth in real terms would be around 10% lower than the one projected within the Reform Scenario. In real terms, public consumption would fall by 8 percent, which would require significant reductions of allocations for social benefits, public service and public investment financing. In case of this scenario, there is a risk that, due to internal and external imbalances, enforced adjustments would take place, which would additionally undermine economic growth and stability. Prospects for building a sustainable economy and reaching the pre war GDP level would be utterly uncertain, international aid would decline drastically, the country would not have credit worthiness to get indebted on the international capital market, and the prospects for entering EU by 2009 would be significantly undermined.

Taking into account the adverse effects of maintaining the status quo and a slower implementation of reforms, BiH does not have any alternative other than to accept the Reform Scenario and accelerate the reforms. Even in the case of the implementation of the Reform Scenario, which requires the implementation of an ambitious reform plan envisaged by the Mid-term Development Strategy of BiH (PRSP), BiH will lose 18 years of development, as the reinstatement of the pre war GDP levels is envisaged in 2009, and not prior to that. **The question to ask the governments and the public in BiH is: must we lose even more?**

### 3.3. Important Prerequisites for the Realization of the Reform Scenario

In order for the objectives envisaged by the Reform Scenario (Table 1) to be achieved, it will be necessary to undertake the following priority activities and measures:

#### 3.3.1. Maintain GDP growth rate of 5 to 5.5 per cent per annum

Growth rate in real terms in 2003 amounted to 3.5 percent of GDP. The drought that affected the region this year was also one of the significant causes of the reduction of the growth rate in real terms. In the following four year, the growth rate should reach the level of between 5 and 5.5 percent of GDP. Besides the implementation of the set of priority reform activities and measures, the final results of the Reform Scenario realization shall still be affected by external factors. **The decline of oil prices and rebound of the world economy, and, especially, of European economy,** shall continue to be important factors determining the rate of economic growth.



### **3.3.2. Maintain Low Inflation, Decrease Overall Public Expenditure, Consolidate Public Debt**

With the arrangement of the "currency board" it is to be expected that the inflation will remain low throughout the period, at between 1 and 2 percent. On the fiscal account, the overall deficit before grants is expected to fall from around 3 percent of GDP in 2003 to around 1,7 percent of GDP in 2007. Overall public expenditure, which amounted to about 46 percent of GDP in 2003, shall have to fall to about 43 percent of GDP by 2007. High level of public expenditure in recent years was facilitated by a significant scope of international financial aid, significant expenditure of foreign residents, and significant monetary transfers. In the course of the aforementioned period, it is expected that the level of public expenditure shall fall from around 22% of GDP in 2003 to 19% of GDP in 2007. Fiscal discipline will be further reinforced by continuation of the policy of avoiding commercial external borrowing and restrictive borrowing of governments on the domestic capital market. The realization of entity level plans for the reduction of public debt shall result in the decline of the overall level of public debt from around 60 percent of GDP in 2004 to around 49% in 2007. The highly concessional nature of external debt means that external debt servicing payments will remain modest, falling from 8,6% of export receipts in 2003 to 4,4 percent in 2007.

### **3.3.3. Decrease the Current Accounts Deficit and Trade Deficit and Increase Exports**

In 2002 the foreign trade deficit deteriorated due to a sudden increase of imports caused by a sudden expansion of consumers' credits, the scope of which increased by 102% in comparison with 2001. That caused the deterioration of current account deficit for even 4,5 percent. The adverse set of circumstances is further exacerbated by the fact that in last year the level of remittances from abroad was decreased<sup>4</sup> due to the fact that the refugees are still returning to BiH in significant numbers.

The Reform Scenario envisages that in the course of the 2004-2007 period, exports should grow at a rate of between 13 and 15 percent, and that the growth rate of imports should be retained at between 4 and 6.5 percent. It is envisaged that the realization of those rates of imports and exports should lead to a decrease of the trade deficit and the current accounts deficit from about 17 percent of GDP in 2003 to about 11 percent in 2007.

### **3.3.4. Increase the Scope of Investments; Ensure an Increased Inflow of Foreign Investments**

The scope of investments should grow from about 20 percent of GDP in 2003 to about 22 percent of GDP by 2007. In parallel with the decrease of the scope of public investment as percentage of GDP, primarily due to the decrease of grants and the implementation of rationalization measures in public consumption, growth of private investments is envisaged, from about 15 percent of GDP in 2003 to about 17 percent of GDP in 2007.

Achieving higher rates of private investments shall require a higher scope of foreign investments. The scope of foreign investments have to be increased gradually, from the level of about 2,5 percent of GDP in 2002, in order for it to reach the level of about 9 percent by 2007. In absolute terms, that means that around US\$ 2 billion shall have to be mobilized on that basis by 2007.<sup>5</sup> That is an important prerequisite for the success of the Reform Scenario, as a higher level of foreign investments shall have to compensate for the declining levels of international aid. At the same time, a higher level of foreign investments shall contribute to the growth of exports, as there are other advantages that foreign investments bring, such as new technologies, new management and new markets.

### **3.3.5. Increase the Level of Private Savings**

Regardless of the continuing growth of private savings in the previous years (due to the exchange of old currencies to EURO and the increase of confidence in the domestic banking sector), the level of private savings<sup>6</sup> in 2003 remained at the level of just 0,5 percent of GDP. Reasons should be found in the fact that, in last year, there was a delay in privatization, which slowed down the development of the private sector. Profitability and productivity of enterprises in BiH is at a low level, which has a direct effect on the low level of private savings. An important precondition for the success of the Reform Scenario is for private savings to grow continuously in order to reach the level of about 7 percent of GDP in 2007, which will require implementation of a set of measures that should lead to a more accelerated growth of the private sector and the growth of citizens' savings.

### **3.3.6. Ensure the Continuation of Favorable International Financial Aid**

BiH is not a credit worthy country, which means that it cannot acquire credit indebtedness on the international capital market. Due to that, in order to maintain the growth rates envisaged by the

<sup>4</sup> Central bank of BiH

<sup>5</sup> Between 1996 and 2002 BiH attracted about 1,1 billion EURO.

<sup>6</sup> Defined in accordance with the National Accounts Methodology which implies differentiating total deposits of private entities and companies from total credit indebtedness of the same entities and companies.

Reform Scenario for 2003-2007 period, it shall be necessary to ensure additional international financial aid, at least at the level of about US\$ 1,5 billion. That aid has to comprise of favorable credits and grants, with a very limited share of commercial credits in the later part of the mid term period. On the basis of initial consultations which were held with key donors, there is a level of readiness for a so-called consultative meeting with donors and potential investors to be held after the end of the preparation of PRSP and after the PRSP is adopted by the authorized bodies, and on that meeting additional possibilities for a new cycle of international aid to BiH would be considered. It is quite certain that any international aid for the coming period will be conditioned with a significant level of progress in the realization of reforms, which implies the implementation of the Reform Scenario and the reform program contained in the Mid-term Development Strategy of BiH (PRSP).

In the coming period, it shall also be necessary to reach an agreement with the IMF in connection with the reform program. In contrast with the previous period, characterized by the short term Stand-by arrangement, it shall be necessary to reach an agreement on a mid term program (EEF).

#### **4. Monetary Policy: BiH Central Bank**

Managing fiscal policy on the principle of the "currency board" should keep on being a very important prerequisite for maintaining fiscal stability, in the coming mid term period, too. It should ensure a low level of inflation, fiscal policy that should exert pressure on maintaining low deficit, with an increased level of public investments and accelerated implementation of structural reforms. However, the functions of the Central Bank of BiH should be expanded with the objective of strengthening the financial sector and providing incentives for the development of capital markets.

In view of this, it is necessary to amend the Law on Central Bank of BiH, in order to enable the bank to play a limited role of the "**bank of last resort**" in the coming mid term period, within the framework of the currency board rules. This is important because of the fact that there is term inconsistency present between the deposits and credits awarded, which increases the so-called "systematic risk". Due to the domination of short term deposits, banks (in most cases those with the majority of domestic capital) are, because of the need to maintain liquidity, forced to keep more assets than is usual. Taking into account that those resources are not interest bearing, banks have higher operation costs, which affects the price of banking services and the level of interest. An important prerequisite for the Reform Scenario is the growth of private savings (both citizens' and corporative), which depends in the stability of the banking sector. The Central Bank would, through a limited role of the "bank of last resort", have an instrument with which it could forestall crises of liquidity in certain banks, and, with the reduction of the so-called "systematic risk" it would contribute to the stability of the banking sector.

Central Bank of BiH should also be allowed to issue short term bonds within the framework of the currency board. The domestic banking sector feels the need for short term securities in which it could make investments. Emission of short term securities by the Central Bank would result in a reduction of assets held abroad by domestic banks, and it would facilitate the development of capital markets, as an important prerequisite for the realization of the pension system reform.

As a result of the management of monetary policy on the principle of the "currency board" it shall be necessary to ensure a **stable level of national reserves** in the coming medium term, too. The existing level of national reserves of about 5 months of overall exports is satisfactory and it represents a stabilizing factor in the functioning of the Central bank of BiH. In order to ensure the stability of the currency board, it is necessary to reduce the current account deficit in line with the aforementioned parameters, as that deficit, together with the amount of the public debt, represents the most severe threat to macroeconomic stability. In connection with that, besides the reduction of the public debt, it is necessary to reduce the current account deficit, and, as has already been mentioned, through increasing export rates, decreasing import rates and increasing the inflow of foreign investments.

In parallel with that, it shall be necessary for the Central Bank of BiH to continue with the implementation of measures of monetary policy with the objective of limiting the scope of consumers' credits at the extent to which they represent a threat to the increase of the current account deficit.

## **II.2. FRAMEWORK FOR FISCAL REFORM**

### **1. Objectives:**

**1.1. *Decrease the share of public expenditure in the GDP***

**1.2. *Achieve sustainability through fiscal consolidation***

### **2. Situation**

The entity governments have adopted Budget Framework Papers (BFPs) for the preparation of the 2004 budget which include a Medium Term Expenditure Framework (MTEF) for 2004 – 2006. The fiscal reform programme for BiH as a whole, as presented in this chapter, is broadly consistent with the MTEF for each entity.

Levels of domestic revenues that, in 2003, amounted to about 47 percent of GDP, including grants, and public expenditure, at about 50 percent of GDP, are still significantly higher than in other transition economies with similar GDP levels. The high levels of revenue and expenditure are common to both FBiH and RS, although RS revenue and expenditure is higher than FBiH, when expressed as a % of GDP and lower when expressed as values per capita.

Slower economic growth and the decline of foreign aid flows have resulted in a stagnation of the general government spending since 2000, although current expenditure in real terms continued to grow. Reflecting the differences in GDP per capita, public expenditures in RS are currently at the level of only about 75% of public expenditure in FBiH.

Significant, although declining, level of foreign grants and loans, which, in 2002, amounted to 8 percent of GDP, sustains an important program of public investments relating to reconstruction. High levels of expenditure are present in many important sectors, including defense, law and order, education, health and social protection. Overwhelming public services and relatively high level of public sector wages are resulting in high administration related costs.

Fiscal planning and management is hindered by decentralized government structures: 94 percent of overall budgetary expenditure falls to entity and lower levels, while in FBiH, 55 percent of budgetary expenditure falls to cantonal and municipal levels, with 22 percent of RS expenditure at the municipal level.<sup>7</sup> Resource allocation between different levels of government is often unadjusted to responsibilities for service provision in the public sector.

There are significant discrepancies in per capita spending between the entities, but also within the entities themselves. Overlapping responsibilities are evident, as well as overlapping in the allocation of public revenues on different levels of government, especially between cantons and municipalities in FBiH. Institutional frameworks for macroeconomic analysis of fiscal policies remain very limited.

The existing model of fiscal operations produces high tax burdens. That creates significant disincentives for the development of economy in the private sector and contributes to the growth of gray economy and wide expansion of tax evasions

### **3. Fiscal reform in the Conditions of the Reform Scenario and the Scenario in Case of a Slower Implementation of Reforms**

In the context of fiscal reform it is also necessary to analyze the effects in the case of both the realization of the Reform Scenario, which implies an aggressive implementation of reforms envisaged by the Mid-term Development Strategy of BiH (PRSP), and the scenario in case of a slower implementation of reforms. While PRSP does not expect that the slower reform will take place, it is, nevertheless, necessary to make contingency plans for managing public finances in case external factors actually cause a slower rate of economic growth.

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<sup>7</sup> FBiH and RS BFPs, October 2003.

### **3.1. Fiscal Reform: Reform Scenario<sup>8</sup>**

Relatively rapid economic growth will permit progress to be made towards fiscal consolidation with the overall general government deficit for 2004-2007 remaining at a low level of about 0,6 percent of GDP (including grants). That should provide scope for funding regular servicing of foreign and domestic debt in line with plans for the reduction of public debt. Total revenues and grants over the period are projected to fall from about 47% of GDP in 2003 to about 43% of GDP in 2007. This is in line with the entity MTEF projections (BFP)<sup>9</sup>.

On the public expenditure side, total expenditure is projected to fall from about 46% of GDP in 2003 to 43% of GDP in 2007, which is also in line with entity MTEF projections (BFP).

Thanks to the favorable structure of external debt it is expected that the servicing of foreign debt will decline from 8.6 percent of overall exports in 2003, to around 4.4 percent by 2007. In view of the importance of capital investments for the development of the country in the conditions of insufficiently developed private sector, in the coming mid term period it shall be important to maintain their scope at the level of about 5 percent of GDP, regardless of the decline of international aid. However, domestically financed public investment will have to be increased, from 2% in 2002 to 2.6% of GDP in 2007, to compensate for a decline in foreign financed investment.

External concessionary credits will continue to provide the primary source of financing of the budget deficit, although total foreign assistance is expected to fall from 8% of GDP in 2002 to 2% of GDP in 2007. Public sector borrowing from domestic sources will continue to be tightly controlled.

### **3.2. Fiscal Reform: Scenario in Case of a Slower Implementation of Reforms**

This scenario illustrates possible consequences of a slowdown in the pace of economic reform leading to lower rates of investment and growth. It assumes that real economic growth from 2004 onwards will only be one third of that in the Reform Scenario and that external aid flows would only be two-thirds of expected as donors respond to the slow pace of reform by delaying the release of planned financial aid and reducing new funding commitments. As a result, public expenditure would remain static in real terms. That would lead to significant deterioration in the quality of public services and would make it more difficult to meet the demands for social assistance, which would increase the level of poverty in comparison with the current one.

## **4. Fiscal Reform Priorities**

Priority activities in the area of fiscal reform shall be directed towards decreasing the share of public spending in the GDP. In connection with that, allocations for defense and law and order should be reduced, and allocations for wages in public administrations should be constrained. In parallel with that, mechanisms for more efficient collection of public revenues and reduction of the scope of gray economy shall be established, control over the collection and expenditure of public revenues shall be strengthened, budget management and planning shall be improved. Finally, sector spending shall also have to be reduced to sustainable levels.

### **4.1. Establish a More Efficient System of Public Revenue Collection**

Significant progress has already been made in the harmonization of indirect taxes, rationalization of exemption policies and reduction of high rates of labor taxes<sup>10</sup>.

The focus of this reform area is put on establishing the BiH Board for Indirect taxation, within which a unified customs administration is going to function on the state level. Another important step is the introduction of value added tax (VAT) on the BiH level, with the fundamental aim of elimination of the existing obstacles to economic development, more efficient collection of direct revenues, prevention of fraud and corruption, reduction of the level of gray economy, and achieving progress towards EU integration and WTO membership.

In the same period, it is necessary to prepare and realize the reform of direct taxation, also with the aim to modernize the system and harmonize it with European practices. In this context, it is important to eliminate all present forms of double taxation, especially in the case of profit tax and income tax.

<sup>8</sup> Separate projections of fiscal operations for the state level have not been developed yet. However, one can expect that the state level expenditure will grow, from the initial low levels, due to the expected expansion of functions necessary for fulfilling the criteria of EU integrations.

<sup>9</sup> Adopted by both entity governments in October 2003.

<sup>10</sup> Especially in the case of RS

Finally, in parallel with the strengthening of the customs administrations, it shall be necessary to continue with the strengthening of tax administrations.

The establishment of a new system of revenue collection shall contribute to increasing efficiency, as well as to the reduction of the level of gray economy. Introduction of the VAT is an importantly instrument in achieving this goal. However, taking into account that the implementation of the VAT is expected in the final phases of the implementation of the Mid term Development Strategy for BiH (PRSP), positive effects of its introduction could not be taken into account when designing entity Mid Term Expenditure Frameworks (BFPs).

Although the general objective of the BiH Medium Term Development Strategy (PRSP) is to reduce the overall tax burden, especially for the economy, through the reduction of the scope of public spending, it was determined that there is room for increasing certain types of taxes. That primarily refers to the so-called «property taxes» which are under the scope of authority of sub-entity levels of government. However, on those levels, especially municipal ones, there is a practice of enforcing new tax burdens which do not have any foundation in the legislation. This concerns the introduction of various administrative fees. In line with that, it is necessary to ensure the implementation of the legislation and prevent such occurrences.

With the objective of more efficient collection of public revenues based on oil, it is necessary to create preconditions for the transport of oil and oil derivatives by rail and waterways exclusively (Brčko).

#### **4.2. Ensure Adequate Allocation of Public Revenues to Different Levels of Government and Strengthen Coordination Between Them**

A further set of issues relates to the assignment of revenues and expenditure responsibilities. As has already been mentioned, BiH is functioning as a highly decentralized system, in which almost all revenues are collected and spent on sub state levels. According to the Constitution of BiH, institutions on the state levels have limited authorities, only, so, due to that, the level of expenditure on the state level is also low. The largest part of public revenue spending happens on entity and cantonal levels. In both FBiH and RS, municipalities play a limited role, directed primarily to urban planning, public utility services, local facilities, culture and limited functions in health and education. As has already been mentioned, municipal expenditure accounts for just 7-8 percent of overall entity spending, and in RS it amounts to 22 percent.

There are substantial regional variations in per capita revenues, especially in FBiH, which was, in the absence of sufficient equalization mechanism, reflected in the quality of public service delivery. For example, in 2001-2002 cantonal per capita revenues averaged KM 521 across all cantons, ranging from KM 299 in Gorazde to KM 1,172 in Sarajevo.

On the other side, entities have adopted policies which had implications on expenditure programs on cantonal and municipal levels, without a thorough consideration of the availability of resources for covering the resulting costs on the sub entity level. That presents a special problem, especially when it comes to legislation in the sector of social protection. When determining tax-sharing mechanisms, insufficient attention was paid to public expenditure needs of sub entity governments. For example, in FBiH, although canton governments have the major responsibility for the delivery of public services, their share of total FBiH revenues<sup>11</sup> has fallen from 61% in 1999 to and estimated 49% in 2002. The situation improved due to the change of the point of collection of sales tax, which occurred in the course of 2003<sup>12</sup>. However, the cantons are, in general, faced with enormous difficulties in budgetary expenditure planning because of the insufficient level of coordination between the entity and the cantonal level in decision making, which results in the change of revenue and expenditure policies.

The strengthening of state level revenues shall be executed in parallel with the introduction of the VAT, and, until that period, the state budget shall be filled with transfers from entity budgets. A part of the reforms is directed towards the strengthening of public administration (for example. Defense reform, customs reform...) which should not lead to an increase of the overall public spending: the transfer of entity authorities to the state level shall lead to the reduction of their budgets. In 2004 the Brčko District shall initiate regular transfers of a part of its revenues to the state budget.

In the course of the coming period one can expect a further decrease of customs revenues, of up to 20 percent per annum, especially because of the implementation of the free trade agreements with the countries of the region. Taking into account that the customs represent a very important source of revenues for entity budgets (especially in FBiH), and in order for disturbances in entity financing to be avoided, it shall be necessary to compensate for the loss of revenues, primarily through increasing the

<sup>11</sup> Excluding extra-budgetary fund revenues.

<sup>12</sup> Sales tax is now collected on the point of production or import, instead at the retail level.

level of efficiency in the functioning of customs administration, and, in the coming mid term, through the reallocation of revenues on the basis of VAT. An important step in that direction is the reduction of the number of customs offices, customs desks and border crossings for the trade of goods.

The preparation of public administration reform in BiH is ongoing and one of its objectives is to eliminate the overlapping of activities, to increase efficiency and establish coordination between different levels of government. In line with the strengthening of the system of public revenue collection and reforms in the area of public administration, it shall be necessary to ensure **adequate allocation of public revenues to different levels of government**.

In connection with those issues, it is necessary to:

- Ensure the coordination of activities in relation with the decision making with implications on the change of revenue and expenditure policies. This is especially important in the case of FBiH, where the Ministry of Finance of FBiH has established regular coordination with cantonal ministries of finance, which needs to be strengthened constantly,
- Ensure that the allocation of resources between entity and sub entity levels reflects the distribution of responsibilities connected to public service provision,
- Establish a higher level of solidarity, in order to assist poorer cantons and municipalities.

#### **4.3. Constrain Public Sector Wage bill Spending**

At 19.6%<sup>13</sup> of GDP in BiH, wage bill spending in the public sector is almost three times the level of other Central and Eastern European (CEE) transition countries. One consequence is that spending on current operations and material costs are on a low level, which is threatening the quality of public services.

The high level of wage bill spending in BiH is not, to such a degree, a consequence of the size of public service employment<sup>14</sup>, as of the level of public sector wages and salaries, which are significantly higher than in similar transition countries (especially in the case of FBiH and the state level). An equally significant factor is that the levels of public sector wages are different on different levels of government: wages on the state level are up to 40 percent higher than wages in RS public services. Wages in the district of Brcko and City Administration of Mostar are the highest in BiH. In FBiH, wages on public administration are by 35 percent higher than average, and, in RS, by 37 percent, while the difference in the District of Brcko is the most pronounced (67 percent). The disparity in the level of wages in the country additionally affects the differences in the quality of public service provision.

In contrast with the practice present in all developed countries, the level of public sector wages is significantly higher than the level of wages in the real sector of economy, with the exception of the financial sector<sup>15</sup>. Polls among the employers (see section on labor market) have ascertained that they have significant difficulties in finding adequate labor force on the market, which is, inter alia, a result of the high level of interest for working in public administration and public enterprises. Nevertheless, there continue to be substantial pressures for additional salary and wage increases in public administration. In the course of the previous year (2002), the Government of FBiH has increased the budget item for wages by about 30 percent in comparison to the year before, while the RS did the same, at the level of about 10 percentage points. The trend of growth in public sector wages continued in 2003 also.

In view of the aforementioned, in the coming mid term period (2004-2007) it is necessary to constrain the allocations for public sector wages. However, taking into account the different wage levels, this measure should not be implemented equally in both entities and the Brčko District. That means that the average budgetary wage increase in FBiH should not be over 2 percent, while in the RS it should not be over 4-5 percent, and any additional wage increase should be compensated for with an adequate decrease of the number of public servants.

Constraining wage allocations shall enable the decrease of overall allocations on that basis as the share of GDP in the coming mid term – in RS, from about 10 percent in 2003 to 7.8 percent in 2006, and in FBiH from about 16 percent in 2003 to 12.3 percent in 2006.

<sup>13</sup> From Aid Dependence to Fiscal Sustainability, PEIR, World Bank, September 18th 2002

<sup>14</sup> Studies by ESI (Bosnia and Herzegovina Public expenditure and explosive debt, 2003) show that the number of officials in BiH is not overwhelming (except in the case of the Brčko District). About 4.5 percent of BiH population (about 3.8 million) are public sector employees, which is lower than in Croatia, and two times lower than in Czech Republic.

<sup>15</sup> World Bank estimates show average sector wages and salaries in the public sector as 67% higher than industrial sector earnings in the FBiH. The corresponding ratio for the RS was even higher at 86%. (PEIR, WB, 2002).

#### **4.4. Reduce Allocations for Defense and Law and Order (including Judiciary)**

Budgetary spending on defense at 4.5% of GDP<sup>16</sup> (2.7 percent in RS, 5.1 percent in FBiH<sup>17</sup>) is over twice the average (1.9% of GDP) for other CEE countries. Substantial off-budgetary expenditure and arrears means that in recent years, the true level of defense expenditure has been significantly higher<sup>18</sup>. Spending on defense is also excessively concentrated on personnel (around 80% of budget).

Spending on public order and safety at 4.4% of GDP<sup>19</sup> is over twice the average for other CEE countries and four times the average for EC countries. Expenditure in the sector is driven by high levels employment which are substantially above pre-war levels.

In the defense sector, reforms and demobilization should be continued, in order for the allocations for defense in FBiH to be reduced from 5.1 percent of GDP in 2002 to 2.3 percent in 2006, and, in RS, from 3.8 percent in 2002 to 1.9 percent in 2006. In the course of 2004, alone, both entities are planning to demobilize about 8,000 soldiers, which will lead to additional savings at the level of about 1 percent of GDP.

In the area of law and order, rationalization plan needs to be prepared, in order for the allocations for that purpose in FBiH to be reduced from 4.5 percent of GDP in 2002 to 3.5 percent in 2006, and in RS, from the same level in 2002 to 3.9 percent in 2006.

#### **4.5. Adopt Legal Framework for Public Procurement**

The adoption of a legal framework for public procurement shall lead to further strengthening of the single economic space and transparency in public revenue spending. The adoption of this legal framework is a conditions for a faster integration of BiH in the EU and for the membership in the WTO. However, it is important to mention that the new legal framework in this area shall lead to more significant savings in public expenditure.<sup>20</sup> Besides the adoption of the legal framework, it shall be necessary to establish adequate public procurement agencies, as well as bodies for auditing public procurement.

BiH needs to gradually harmonize its laws on public procurement with those of the EU. It is also necessary to strengthen the corresponding institutions and judiciary, in order for the public procurement procedure to be implemented according to the regulations.<sup>21</sup>

#### **4.6. Increase the Share of Domestic Public Revenues in the Financing of Current (Operating) Costs**

The major part of public revenues is being spent on public administration wage bill. In recent years, allocations for material (operating) costs were below the necessary level, and the majority of those costs were covered from donors' resources. However, the overall allocations, from both domestic and donor revenues, were not sufficient, which lead to weaknesses in the level of equipment in public administration and the deterioration of government infrastructure. In order for public services to be improved, in the coming mid term (2003-2007) it is necessary to ensure a higher share of public revenues in the financing of current (operating) costs of public administration. Constraining the nominal level of allocations for public administration wage bill shall enable an increase of allocations for that purpose, which should, in 2006 amount to 4 percent in FBiH and to 4.5 percent in RS (of GDP).<sup>22</sup>

#### **4.7. Increase the Share of Domestic Public Revenues in the Financing of Public Investments**

Since 1996 the international donor community has, mostly through donations, largely financed the public investment program in BiH. For example, in the previous years, domestically financed capital spending has accounted for around 10% of all public investment. The need to move ahead quickly with reconstruction projects has meant that the major share of internationally financed projects have been managed through independently established project implementation units (PIUs) operating

<sup>16</sup> PEIR, WB, 2002.

<sup>17</sup> FBiH and RS Government BFPs, October 2003.

<sup>18</sup> World Bank estimates put total defence spending at around 9% of GDP (PEIR, WB, 2002).

<sup>19</sup> PEIR, WB, 2002

<sup>20</sup> World Bank Study on the BiH Public procurement System, 2002.

<sup>21</sup> "Commission Report to Council on BiH Readiness for Initiation of Negotiations on Stabilization and Accession Agreement with the EU" (Feasibility Study), Brussels, November 18th 2003

<sup>22</sup> FBiH and RS Government BFPs, October 2003.

outside of the framework of the government budget. This has resulted in a number of problems. It has been difficult for Entity and sub-Entity governments to track credit investments into public investment, which has seriously undermined accountability related to the servicing of those credits. On the other side, decisions on public investment projects have often been taken without adequate harmonization with financial capacities.

Due to the expected decrease of international aid flows, the share of domestically financed public investment will have to increase substantially. By 2006 it is estimated that domestically financed projects will account for two-fifths of all public investment, with externally financed projects largely being financed from concessional credits.

Therefore, in the coming mid term period (2004-2007) it shall be necessary to increase the share of domestic resources in the financing of public investment programs, by 15% per year in comparison with the 2003 allocations.

There is an urgent need to strengthen the planning and management of the public investment program in both entities, and recent establishment of Aid Coordination Units on the state and entity level is a step in that direction. The RS Government has already adopted a Public Investment Program for the coming mid-term, and it is expected that the FBiH Government shall do the same by the end of February of this year.

#### **4.8. Reduce Sectoral Spending to Sustainable Levels**

An analysis of expenditure by function suggests that spending levels in Bosnia across a number of major sectors are substantially higher than those in other CEE countries.<sup>23</sup> Consequently, there is considerable scope for the reform of spending programme linked to the overall reduction of public expenditure as a share of GDP.

Spending on **education**, at 6.4% of GDP, is also higher than average for other transition economies (3.3% of GDP), with spending considerably higher in the FBiH (6.8% of GDP) than in the RS (4.7% of GDP).<sup>24</sup> The highly fragmented education system, particularly in the FBiH, results in high unit costs, inequitable provision, and poor outcomes. High levels of spending and inefficiencies show that an increase of spending on education in nominal terms should not be permitted, but, instead, it should be reduced, especially in FBiH. Education sector reform, which is ongoing, shall reduce the spending for this purpose to 5.6 percent of GDP in FBiH and to 4.5 percent of GDP in RS, by 2006.<sup>25</sup>

Public spending on **health** is financed primarily from Health Insurance Fund contributions, and, to a lesser extent, by budget interventions. At 6.9% of GDP in FBiH and 6.4% of GDP in RS<sup>26</sup>, spending levels in the health sector are significantly higher than average allocations for that area in other transition countries (4.4%). It is estimated that the level of allocations on the basis of payments for health services in the private sector accounts for an additional 5% of GDP in both entities. However, health revenues fall significantly short of the financial requirements of the legally stipulated level of health services.

In view of that, the efficiency of health spending needs to be improved, through the rationalization within the sector itself, which implies the improvement of management in public health funds, direction of resources to priority programs of prevention and treatment, and improvement of public procurement procedures. Future spending on health shall depend on the level of inflow of resources into health funds. It is expected that by 2006 spending in this sector shall fall to 6.9 percent of GDP in FBiH and, in RS, from 6.4% in 2002 to 5.9 percent.<sup>27</sup>

Public spending on **social transfers** (including allocations on the basis of veterans' rights, unemployment, pensions and classical forms of social protection) at 18.9% of GDP in FBiH and 14.7% in RS<sup>28</sup> is only slightly higher than the average for CEE countries (14.2% of GDP). However, the high percentages of allocation do not show the real picture of the situation, taking into account the relatively generous and extensive veterans' entitlements. Allocations on that basis account for around one third of total social transfers. On the other side, social welfare services continue to face acute funding problems and an unclear and overlapping division of responsibility between different levels of Government. In the FBiH, the recent Law on Social Services placed considerable additional spending

<sup>23</sup> Comparisons of functional allocations with the level of GDP should be taken with a certain level of caution, due to the still significant presence of gray economy.

<sup>24</sup> FBiH and RS Government BFPs, October 2003.

<sup>25</sup> FBiH and RS Government BFPs, October 2003.

<sup>26</sup> FBiH and RS Government BFPs, October 2003.

<sup>27</sup> FBiH and RS Government BFPs, October 2003.

<sup>28</sup> FBiH and RS Government BFPs, October 2003.



responsibilities on the Cantons without any corresponding adjustment in revenue assignment. There is still a lack of clarity in the assignment of responsibilities and resources with respect to refugees, displaced persons and returnees, especially in FBiH.

Spending on social transfers need to remain in the existing levels. It is expected that spending on this purpose in 2006 shall amount to 17.8 percent of GDP in FBiH and 13.5 in RS.<sup>29</sup> Social transfers towards the veterans' population shall remain at the same level, while other social transfers shall be increased by 4% per annum<sup>30</sup>, in order to finance poverty reduction oriented programs.

Spending on utilities shall increase at 5% per year, to allow for improved services, especially amongst the poorest areas. Finally, spending on development programs shall be increased by 2.5 % per annum, to allow for a higher level of agricultural support.<sup>31</sup>

The necessary reform measures in each of those sector are identified in the following text of the PRSP.

#### **4.9. Reorienting Public Expenditure in Compliance with the Priorities of the Mid Term Development Strategy for BiH (PRSP)**

The priorities identified in the Mid Term Development Strategy for BiH (PRSP) will have an impact on the nature of future public expenditure, both for investment and for recurrent activities. The instruments for the realization of those priorities will include the entity Mid Term Expenditure Frameworks (BFPs) entity Public Investment Programmes (PIP) and discussions with donors.

The Reform Scenario of the Macroeconomic Framework of the PRSP expects rapid implementation of reforms to generate growth of about 5,5% per year. Under this reform scenario, it is expected that the public revenues in both entities shall grow at the rate of 4.5 percent per year.<sup>32</sup> The total level of public investment during the four year period 2004 – 2007 will be about KM 2.3 billion, of which about KM 500m is already programmed for completion of ongoing projects. The allocation of the remaining KM 1.8 billion is ascertained by entity Public Investment Programmes which are an integral part of the PRSP.

The PRSP working groups have done some initial work on estimating the financial implications of the reforms. This work has included consideration of financial implications of the implementation of reforms within conventional investment projects, as well as other 'one-off' and recurrent costs. The recommendations of the PRSP are presented in figures 1 and 2 below.

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<sup>29</sup> FBiH and RS Government BFPs, October 2003.

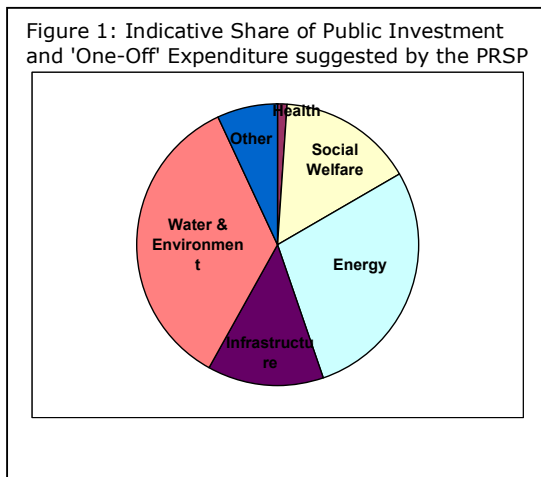
<sup>30</sup> FBiH and RS Government BFPs, October 2003.

<sup>31</sup> FBiH and RS Government BFPs, October 2003.

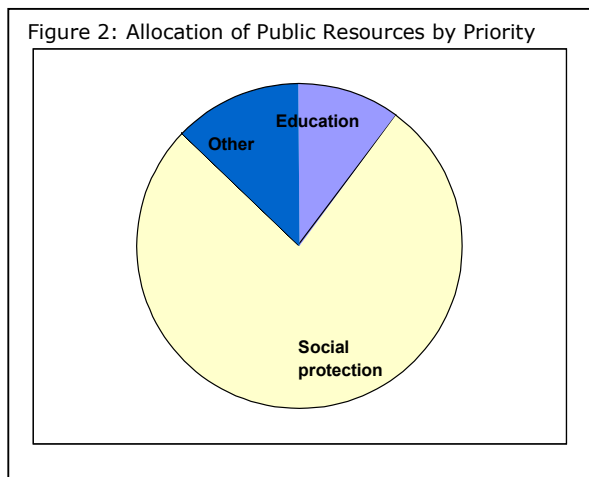
<sup>32</sup> FBiH and RS Government BFPs, October 2003.

Allocations for the program of public investments and other one-off interventions are presented in Figure 1.

Investment requirements for the financing of the public investment program are substantially higher than the projected growth rate of public revenues, so that it shall be necessary for a part of the public investment program to continue to be financed by donors, but in amounts significantly lower than before.<sup>33</sup> Most reforms will have to be funded from savings in recurrent spending arising from increased efficiency. However, in case the expected growth rate of 5 % per annum in real terms is ensured, some incremental resources will be available in the coming four years, which will in most part be a result of the decrease of the defense spending, spending on law and order, public administration wages (as a share of GDP), internal savings, including the implementation of new legal regulations in the area of public procurement, and more efficient collection of public revenues. According to the Reform Scenario, it is expected to be KM 87 million higher in 2007 than in 2003, in real terms.



It is also expected that defense savings shall provide an further KM 88 million per year by 2007, thus allowing for non-defense spending to be KM 175 million higher in 2007 than in 2003, in real terms.



Work on reorienting recurrent expenditure in line with the PRSP is ongoing, and is linked to the MTEF and budget process. Figure 2 presents an early indicative sectoral allocation of incremental recurrent costs. Most education reforms will be funded from savings and all health improvements will be self-funding within the Health Insurance Fund. As a result, it is the reforms in social welfare which dominate incremental recurrent spending. Some increase in agricultural subsidies is also foreseen, in line with recent parliamentary decisions.

Figure 2 represents sectoral recommendations of the PRSP for the allocation of those additional public revenues. The major part of reform in education sector shall be financed from savings, and in the health sector through the increase of efficiency and self-financing of health insurance funds. As a result, the major part of additional public revenues should be used for the financing of reforms in the social protection sector, inter alia for the financing of social implications of accelerated implementation of structural reforms (acceleration of privatization, reform of public administration, restructuring of mines etc.). A certain increase of subsidies in agriculture is also envisaged, in line with the recent decisions of entity parliaments, and it shall also be necessary to ensure a higher share of domestic public revenues in the financing of works in the sectors of transport and water management, which will be most affected by the reduction of donor aid.

Savings executed through the realization of the Reform Scenario in the coming mid term should also be used for the reduction of taxes. In that, priority should be given to the reduction of tax burdens and contributions levied on wages, which would yield multiple results: it would have a stimulating effect on the growth of the private sector, attraction of foreign investments and reduction of the gray economy.

The level of additional public resources available is strongly related to the rate of economic growth envisaged by the Reform Scenario. On the other side, in the Scenario of Slower Implementation of reforms (ie with only 1.9% growth), total revenue envisaged for 2007 are by KM 113 million lower than according to the Reform Scenario. If growth is only 1.9% and defense savings are not realized, then recurrent spending would have to decline by KM 26 million in real terms, to protect the

<sup>33</sup> In the first part of 2004. a consultative donors' meeting shall be held, and the aid programme to BiH at the level of \$ 1.5 billion should be considered. That is the amount identified in the PRSP as necessary for assistance to the payment balance and financing of the public investment program.

KM 2.3 billion investment levels, the servicing of external debt and the reduction of the level of domestic public debt.

#### **4.10. Improve the System of Public Spending Planning and Management**

In 1999 both entities undertook steps directed to the development of the Mid-term Expenditure Framework (MTEF), with the objective of strengthening macro-fiscal planning and improving connections between government policies and resource allocations. In the course of that year, entity governments adopted mid term expenditure frameworks for 2004-2006, which were used as an important document in the preparation of the Mid Term Development Strategy for BiH (PRSP).

It shall be necessary for the entity governments to revise the BFP regularly, in line with the priorities of the PRSP. The MTEF shall present an important element for strengthening the annual budget preparation cycle, through the provision of more reliable and detailed projections of revenues. This issue is extremely important in the case of FBiH, where the cantons are faced with serious difficulties in connection to revenue projections. The FBiH Government, and, especially, the Federation Ministry of Finance should establish a regular practice of holding monthly meetings with cantonal governments and ministries. In that context, activities in connection with the planning and realization of public investment programmes need to be adjusted with the priorities of the PRSP and entity mid term expenditure frameworks.

In line with the recommendation of the EU Feasibility Study, it shall be necessary to adopt budget laws on all levels, in line with the Mid Term Expenditure Frameworks (MTEF), and introduce unified government accounts. It shall also be necessary to undertake steps on recording all payments to public bodies on all levels of government, including payments of grant funds and other modes of international assistance.<sup>34</sup>

Entity ministries of finance need to strengthen their departments for: macroeconomic analysis and projections, fiscal analysis and analysis of budgetary policies, consolidation and analysis of fiscal data and reporting. On the other side, line ministries will need to strengthen their departments for sector policy analysis and public investment program planning. It can be expected that it will include the establishment of sectoral units for creating strategies, programs and budgets in the most significant line ministries.

#### **4.11. Establish Institutional Framework for Preparing Consolidated Balances on BiH Level**

On the state level there is no mechanism for the preparation of consolidated fiscal balances. So far, that was done by the IMF and that is a practice that needs to be terminated. Besides the BiH Ministry of Finance and Treasury, the BiH Indirect tax Administration should be engaged in the preparation of consolidated fiscal balances, and a body (a council) could be formed within that institution, with the task of coordinating fiscal issues on BiH level.

#### **4.12. Introduce Treasury Operations in All Public Institutions**

The establishment of treasury functions in 2001 has significantly strengthened budget execution, as it enabled a more efficient control of spending and a better management of cash assets. It will be necessary to establish treasury operations on the sub entity level, which includes both cantons and municipalities<sup>35</sup>. Additional steps which need to be taken include: the implementation of treasury procedures on the functioning of extra budgetary funds, the improvement of the classification of public expenditure in order for a higher level of consistency and correctness in recording to be ensured.

#### **4.13. Strengthen Transparency and Accountability in Collection and Spending of Public Revenues**

In the area of public finance, a significant step ahead has already been achieved through the establishment of external audit offices and through the establishment of treasury procedures. Additional steps which need to be taken include the following: presentation of mid-term expenditure frameworks to entity parliaments, preparation and publishing of reports aimed to the general public, on public revenue spending, further strengthening of audits, involving parliamentary commissions into the control of budgetary execution.

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<sup>34</sup> "Commission Report to Council on BiH Readiness for Initiation of Negotiations on Stabilization and Accession Agreement with the EU" (Feasibility Study), Brussels, November 18th 2003

<sup>35</sup> In the FBiH, the Sarajevo Canton has introduced the treasury system of operations, while in the RS the introduction of that system is prepared in five pilot municipalities.

There is a practice of managing significant public revenues and other resources outside of the budget. In both entities, almost 50 percent of public spending happens outside of the budget, mostly through health and social insurance funds. Necessary mechanisms of coordination between different levels of government do not exist, which has led to overlapping of functions, inconsistencies between the allocation of revenues and expenditure responsibilities, especially on the cantonal and municipal level. Entity ministries of finance must get enabled for the monitoring of extra budgetary funds, which represent a significant element of Government fiscal operations. In FBiH, insufficient analysis of spending on sub-entity levels has contributed to significant imbalances that appeared in the allocation of public sector resources, both between different levels of government, and on individual levels. The elimination of those weaknesses shall require that the entity ministries undertake activities on including the remaining extra budgetary sources of financing into the budget and improving the comprehensiveness and quality of budgetary analysis and monitoring. It shall also require that the ministers of finance make the presentation of budgets of extra budgetary funds to the parliaments, together with annual budgets, as is stipulated by the relevant laws on budgets in each of the entities. It shall be necessary to establish an adequate mechanism for coordination of budget planning issues with the District of Brčko.

In line with that, the Roads Directorate in RS shall be totally included in the Budget in 2004, and, in FBiH, full transparency in view of the usage of resources of the federal Roads Directorate, including the cantonal directorates, shall be ensured.

It shall be of key importance to increase the level of transparency and financial management in the operations of public enterprises.

#### **4.14. Public Debt**

Internal public debt in BiH in 2003 amounted to about 67 percent of GDP. In 2002, the total external debt amounted to Km 4,045,862,013<sup>36</sup>, which is about 40 percent of GDP. In view of external indebtedness, BiH can be considered a moderately indebted country. However, what makes BiH an over-indebted country is the size of internal debt, which represents one of the most severe threats to macroeconomic stability of the country. According to the Reform Scenario, the total public debt should, by 2007, be reduced to about 49 percent of GDP. In connection with that, entity governments opened an *escrow* account,<sup>37</sup> on which a part of privatization proceeds are deposited, together with the resources from succession, in order to ensure a starting basis for the reduction of the public debt.

The reduction of public debt to the level of 49 percent of GDP is important element for achieving credit worthiness of BiH on the international capital market. That would have a positive effect on the macroeconomic stability, prospects for a faster integration of BiH in the EU, increasing the level of interest of foreign investors and enable a larger scope of credit funds for the development of BiH.

Both entity governments have adopted plans for the reduction of the public debt, in which the following claims were identified as parts of the internal public debt:

- general claims (arrears of budgetary and extra budgetary beneficiaries),
- claims on the basis of old foreign currency savings,
- claims on the basis of war damages (mobilized and taken over tangible and technical assets and equipment, delivery of materials, produce, goods and services rendered for the demands of military operations, pecuniary assets taken over).

In compliance with the plans for the reduction of public debt, the amount of resources to be used for the repayment of internal debt is limited to the level of 10 percent of GDP. A part of the claims shall be settled in cash, with resources from the *escrow* account, but the majority shall be settled through the emission of long-term bonds. A significant amount of internal debt needs to be written off.

In order to realize the plans for the reduction of public debt, it is necessary to adopt a legal framework in the first part of 2004.

#### **4.15. External Borrowing Strategy**

The macroeconomic framework envisages that BiH may attain external and fiscal sustainability, as well as limited external creditworthiness, by 2007, but this will require a considerably greater effort on structural reforms, along with the continuation of donor support. This requires adoption of a strategy of foreign borrowing.

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<sup>36</sup> BiH Ministry of Finance and Treasury

<sup>37</sup> An account on which resources are kept until the signing of a contract or fulfillment of other conditions

#### 4.15.1. Analysis of the External Debt of BiH

After the dissolution of former Yugoslavia, and during the wartime period, BiH had considerable arrears to all its creditors<sup>38</sup>. Recognition of all obligations accruing to the end of the war was a precondition for the normalization of the membership and continued extension of credits by the International Monetary Fund (IMF) and the World Bank. In the course of the debt-rescheduling process in 1996 – 1997, BiH managed to normalize relations with the majority of creditors and renew its membership in the IMF and the World Bank<sup>39</sup>. An agreement was reached with the Paris Club, which led to the reduction of BiH debt by 67%. In December 1998, an agreement was concluded with the London Club to write off 73% of this debt<sup>40</sup>.

At end-2001, the overall indebtedness of BiH, was Km 4,045,862,013 (about 40 percent of GDP), of which KM million 2,613 (64.4%) concerns F BiH, and KM million 1,432 concerns RS (35.4%). The indebtedness of BiH on the basis of old (pre-war) debt, with December 31<sup>st</sup> 2002, amounts to KM 2,310,334,262 (57% of overall debt), and the new (post-war) indebtedness amounts to KM 1,732,528,751 (43% of overall debt).<sup>41</sup>

The major share of the external debt was incurred with the World Bank (KM 2,173 million): on the basis of pre-war indebtedness, this debt amounts to KM 967 million, and on the basis of post-war indebtedness, KM 1,206 million (see Table in the text below). The write-off and the rescheduling of a significant part of commercial credits on the basis of IDA conditions<sup>42</sup> have contributed to the favorable situation in connection with the servicing of the external debt. The private sector had limited access to foreign credits, mostly because of the lack of credit worthiness of the country. Excluding the amount for which the repayment is outstanding, the debt of the private sector represents only 0.6% of overall remaining external debt. The currency structure of the external debt is mostly in US\$ and EUR.

Through analyzing the structure of post-war indebtedness, one can notice that the majority of credits were spent on budgetary support and financing in the sectors of education, health and social protection (KM 938 million). That is followed by credits for infrastructure investments (KM 493 million), and the credits spent on investments in economic activities, mostly in the private sector, are at the bottom (KM 303 million).<sup>43</sup>

TABLE 1: SUMMARY REVIEW OF THE STRUCTURE OF BIH BORROWING BY CREDITOR AND SHARE OF "OLD" AND "NEW" DEBT IN 1998-2002 PERIOD

	BALANCE OF DEBT				
	1998	1999	2000	2001	2002
	<b>Amounts in KM</b>				
<b>Old debt – total</b>	<b>1.375.827.701</b>	<b>2.464.536.214</b>	<b>2.496.374.897</b>	<b>2.599.815.973</b>	<b>2.310.334.262</b>
Paris Club	80.342.730	1.071.465.724	1.093.562.388	1.093.669.493	1.038.252.520
London Club	261.919.000	261.919.000	261.919.000	261.919.000	261.919.000
World Bank IBRD	956.811.503	1.035.250.094	1.089.745.567	1.197.609.567	967.255.022
Other	76.754.485	95.901.396	51.147.942	46.617.913	42.907.720
<b>New debt – total</b>	<b>863.835.536</b>	<b>1.271.475.797</b>	<b>1.531.960.515</b>	<b>1.766.064.588</b>	<b>1.735.528.751</b>
European Invest, Bank	0	0	0	7.370.670	20.210.420
World Bank IDA	729.637.014	962.675.512	1.093.900.935	1.252.873.845	1.206.232.151
Saudi Fund For reconstruction and development	29.764.717	34.893.329	42.703.705	47.637.535	47.200.235
IFAD	16.569.656	33.178.008	39.245.806	40.064.806	38.651.223
IMF	56.965.675	141.215.973	220.643.699	245.714.475	260.849.552
European development Bank Council	3.347.200	9.516.602	10.391.991	10.936.149	9.258.267
EBRD	20.520.717	55.365.170	89.407.091	108.214.122	99.671.845
European Commission / Union	0	19.558.300	19.558.300	39.116.600	29.116.600
Other	6.994.557	15.090.903	16.108.988	14.136.596	14.338.458
<b>Balance of debt – old and new debt - together</b>	<b>2.239.663.237</b>	<b>3.736.012.011</b>	<b>4.028.335.412</b>	<b>4.365.880.561</b>	<b>4.045.863.013</b>

<sup>38</sup> The arrears in end 1995 were estimated at USD 1.9 billion, of which USD 342 million to the World Bank alone.

<sup>39</sup> After the repayment of the arrears, BiH became a member of the IMF in December 1995. By signing the Consolidated Loan, which regulated the arrears, BiH renewed its membership in the World Bank.

<sup>40</sup> It was agreed that, out of the total amount only USD 147.8 million will be serviced over the following 20 years, while the rest of the debt will come due only after BiH GDP per capita reaches USD 2,800.

<sup>41</sup> BiH Ministry of Finance and Treasury

<sup>42</sup> 20-year WB loans, with over 10-year grace period and interest 1-2%.

<sup>43</sup> BiH Ministry of Finance and Treasury

**STRUCTURE OF NEW DEBT BY SECTOR – PURPOSE**      Amounts in KM

	1998	1999	2000	2001	2002
<b>New debt - total</b>	<b>863.835.536</b>	<b>1.271.475.797</b>	<b>1.531.960.515</b>	<b>1.766.064.588</b>	<b>1.735.528.751</b>
Credits for investments in infrastructure*	270.320.213	384.425.126	475.993.330	530.446.973	493.549.822
Credits for investments in economic activities**	132.983.799	187.244.233	242.600.114	261.097.636	303.121.281
Credits for public – budgetary expenditure***	460.531.524	699.806.384	813.427.071	974.519.979	938.857.648

SOURCE: MINISTRY OF FINANCE AND TREASURY OF BIH

\*Water, roads, electricity, waste management, telecommunications

\*\*Privatization projects, small enterprises, agriculture IGA

\*\*\* Social program, PFSAC, IMF, education, health

**4.15.2. Is the External Debt of BiH a Large One?**

When assessing the external debt burden of a country, the nominal value of the total external debt is not a useful indicator. The important element is the debt structure (share of concessional with respect to commercial credits). In the case of BiH, more than one-third of the total external debt is comprised of concessional credits, and an important share of the commercial debt has been rescheduled under concessional terms (London Club).

In comparison with the countries of Southeastern Europe and with the countries with a similar per-capita income, BiH debt is relatively high (around 67% of GDP). Despite the rescheduling and consolidation, the debt-to-GDP ratio of BiH is second highest in the region of Southeastern Europe, after Bulgaria<sup>44</sup>. However, there is a major difference: the debt structure of BiH is relatively good, which is illustrated by a relatively favorable ratio of debt servicing and the exports of goods and services. As of end-2002, the payments coming due for the total foreign obligations were only around 8.6% of the total exports of goods and services. A high share of concessional credits in the overall structure of external debt of BiH, and favorable arrangement made with the London Club of Creditors put BiH in a privileged position from the aspect of external debt servicing in the coming mid term period (2004-2007). The Reform Scenario envisages that the ration between the annual debt servicing allocation and overall exports will fall in comparison with 2003 (8.6%) and that in 2007 it will amount to about 4.4 percent.

Regardless of the overall relatively favorable foreign debt-servicing situation, its inflexibility is evident, i. e. it would be extremely difficult to get any further debt restructuring, even in the event of sudden economic shocks.

***In view of all this, when it concerns external indebtedness, one can conclude that BiH belongs to the category of moderately indebted countries.***

**4.15.3. Sustainability of the external debt of BiH and external debt strategy in the coming medium-term**

When assessing a country's potential creditworthiness, the analysis of the external debt sustainability is normally based on three key determinants: total existing debt and its repayment terms, fiscal and external repayment capacities, increase, composition and terms of new foreign financing.

The analysis performed in the context of the Reform Scenario shows that the conditions of external borrowing in the course of the implementation of the Medium-term Development Strategy of BiH – PRSP (2003 – 2007) will be crucial for restoration of the creditworthiness of BiH at the international capital markets by 2010. Securing additional US\$ 1.5 billion in new credits and grants (non-returnable aid) is also a vital precondition for this scenario.

Debt sustainability analysis within the Reform Scenario indicate that creditworthiness may be restored by the end of this decade. In that context, the strategy of foreign borrowing in the coming mid term period needs to ensure the following:

- that the majority of external borrowing is exclusively under favorable terms, especially in the first part of the mid term period,
- that a limited level of commercial borrowing is engaged exclusively in those sectors that can repay it by themselves (such as, for example, telecom, energy), and in the second half of the mid term period,

<sup>44</sup> It is important to remember that the high debt-to-GDP rate is partially caused by the steep decline of the production after the war.

- that the level of credits taken for budgetary support is reduced, and that the borrowing for the support to accelerated development of private sector is increased,
- that borrowing on the basis of technical assistance provision is reduced and ensured through grant resources.
- to start with realization of so called Swap arrangement<sup>45</sup>

Further development of debt-servicing and monitoring mechanisms between the State and the entities is a crucial prerequisite for strengthening the capacities for foreign debt management and for prevention of further borrowing by local authorities from the domestic banking sector. Its goal is to: create a comprehensive reporting system on indebtedness of all levels of governments and of all public funds, establish clear procedures for budgeting, monitoring of indebtedness and issuance of guarantees and develop procedures for coordination of intra-entity borrowing.

It is important to emphasize that Bosnia and Herzegovina has high claims on the basis of works executed by BiH companies before the war. Negotiations with Russian federation on the pre-war clearing debt are ongoing. Similar negotiations have to be initiated with other countries (Iraq, Libya).

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<sup>45</sup> In the framework of reprogramming of debt towards Paris Club

### **III.1. ENHANCING THE BUSINESS ENVIRONMENT FOR DOMESTIC AND FOREIGN INVESTMENT AND SUPPORTING ENTREPRENEURSHIP**

#### **1. Goals**

##### ***1.1. Promote entrepreneurship and more rapid private sector development***

Remove administrative barriers for the start up of businesses -- reduce the time period required for the registration of business to 15 days.

##### ***1.2. Create conditions for a more efficient privatization process***

A more favorable business climate will significantly improve the privatization process.

##### ***1.3. Attract more foreign investment***

In the time period between 1996 and 2002, BiH attracted about USD 2,1 billion KM (1,1 billion EURO) in foreign investments. It is necessary to attract an additional USD 2 billion in foreign investments during the period from 2003 until the end of 2007 in order to meet the macroeconomic goals outlined in the midterm proposal of the Poverty Reduction Strategy Paper (PRSP).<sup>1</sup>

#### **2. The Current Situation:**

The enhancement of the business environment along with stimulation of entrepreneurship is an important prerequisite for private sector growth. This implies, above all, the establishment of an appropriate legal, business, social, security, and in general, socio-economic climate.

The European Bank for Reconstruction and Development (EBRD) publishes a *Transitional Report* in which it, among other areas, assesses the business environment of countries in transition. In its 2002 Report, BiH was placed among the countries that have improved their business climate compared to previous years, but still must resolve a number of issues before the business environment could be considered attractive for domestic and foreign investment.

The Economic Intelligence Unit of the prominent magazine, *The Economist*, analyzes business environments of countries in transition and on the basis of its findings ranks countries according to the quality of their business environment. In its latest report<sup>2</sup>, which analyzes 27 countries, Bosnia and Herzegovina fell from the 20<sup>th</sup> position to the 22<sup>nd</sup> position, despite the fact that its cumulative score went up from 4.15 to 4.77. The explanation for this fall can be found in the fact that other countries, such as Serbia and Montenegro, which used to be ranked below BiH, improved their business environments with a greater level of success in less time. Out of all the countries in transition, Serbia and Montenegro made the highest jump, managing to get to the 14<sup>th</sup> position from the 25<sup>th</sup> position in just two years.

In 2001, the Ministry of Foreign Trade and Economic Relations of BiH, in cooperation with the World Bank (Foreign Investment Advisory Service – FIAS), conducted two studies in order to find answers to the question of creating a more favorable business environment for domestic and foreign investment. The two studies in question are *An Investigation into Administrative Barriers to Investment in BiH* and *A Diagnostic Examination of Corruption in BiH*. In 2001, the Council of Ministers of BiH, together with the entity governments, adopted a long-term *Action Plan for the Enhancement of the Business Environment to Attract Domestic and Foreign Investment*, which is now in the implementation phase. Additionally, the Council of Ministers of BiH has adopted a *Jobs and Justice* document, with the goal of improving the business environment and initiating reforms in the shortest time span possible.

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<sup>1</sup> Source: Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina, IMF

<sup>2</sup> Economies in Transition: Regional overview, Country Forecast, September 2003



Businessmen from all over the country, together with government representatives and the international community, led by the OHR, have formed a so-called "Bulldozer Committee". The goal of the Committee is to propose concrete measures to improve the business climate in accordance with the already adopted strategic documents. The Bulldozer Committee has already presented the governments on all levels with two sets of reforms geared at improving the business climate.

In April 2003 there was an advisory meeting of the BiH Council of Ministers, entity governments, and representatives of entity and state parliaments at Mt. Bjelašnica in which a *People First* declaration was adopted. The declaration underlines, among other issues, the need to implement the midterm PRSP document, and the comprehensive reforms in order to ensure private sector growth. As a result of this meeting, the Council of Ministers, together with the entity governments, adopted a six-month Action Plan at the end of July 2003 for the Implementation of Urgent Reforms geared towards improving the business climate.

### **3. Noted Problems:**

The absence of a single economic space is a great obstacle to the creation of an attractive business climate for domestic and foreign investors and approximation to the European Union. There are still a number of barriers to inter-entity trade alone.

Administrative barriers to setting up and operating businesses, i.e. drawn out registration, high start up costs, tax rates that are among the highest in Europe<sup>3</sup>, inspections, and corruption are all obstacles to faster private sector development. The legal framework on bankruptcy in the Federation of BiH, which has not been updated, is a part of this problem. The size of the gray economy presents a particular problem. According to European Commission estimates and the World Bank, the gray economy accounts for 36 to 40 percent of the country's overall economy.

Judiciary inefficiency in resolving commercial disputes and a weak legal framework protecting creditors further attribute to the weak business environment.

The above factors, combined with competitiveness and a poor world image, have greatly contributed to the low foreign investment numbers attracted to date. Rather high tax rates, comparatively expensive labor, insufficiently developed technology, an internally divided market, and the high costs of doing business (permits, electricity, postal services, etc.) rate among the highest.

### **4. Priorities**

As compared to previous years, there has been noted improvement in removing administrative barriers for domestic and foreign investment. The pace of implementation of reforms in this area leads one to believe that by the end of 2004 a majority of administrative barriers will have been removed, commercial disputes will be resolved at a higher rate, and appropriate protection of creditors will be ensured. Thus, the focus of improving the business climate will shift from removing administrative barriers to creating conditions for higher competitiveness of the local economy, reducing tax rates, and strengthening corporate management.

#### **4.1. The strengthening of a single economic space in BiH**

The provisions of the BiH Constitution guarantee freedom of movement of persons, goods, services, and capital.<sup>4</sup> However, despite the success of the past few years, there still exist certain obstacles that make it difficult to conduct business countrywide.

The harmonization of the tax system was achieved largely in the area of indirect taxation. However, in the area of direct taxes, e.g. income tax, one still finds double taxation.

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<sup>3</sup> "Commission's report to the Council regarding BiH's readiness to start negotiating with the EU about the Stabilization and Association Agreement"(Feasibility Study), Brussels, 18<sup>th</sup> November 2003.

<sup>4</sup> "There shall be freedom of movement throughout Bosnia and Herzegovina. Bosnia and Herzegovina and the Entities shall not impede full freedom of movement of persons, goods, services, and capital throughout Bosnia and Herzegovina. Neither Entity shall establish controls at the boundary between the Entities." Article I (4) BiH Constitution.

The European Commission project, Single Economic Space<sup>5</sup>, noticed a number of inter-entity problems pertaining to trade, production, carrying out services, and the mobility of the work force. The project focuses on a limited number of activities, including the production and trade of medicines for human consumption, the movement of goods with the CE mark, phyto-sanitary controls in the entities, inspection (Brčko), market barriers in the entity laws, bus transport, free movement of the labor force, and market surveillance. Practices in all of the above areas points to an absence of the constitutionally guaranteed freedom of movement of goods, services, capital, and persons.<sup>6</sup>

The fact that the state level government does not have a larger role in creating and coordinating the economic policy of the country poses a particular problem.

Infrastructure is an area that is quite fragmented, as can be seen in the functioning of the railroads.<sup>7</sup>

The transposition of the EU *Acquis Communautaire* (the complete legal heritage of the EU), as a part of the stabilization and association process, will help resolve the above problems and integrate the BiH economic space. Added institutional building and technical infrastructure modeled after the internal EU market, will aid in creating a single economic space and movement towards integration into the EU market. This, in turn, will accomplish three important goals – an improved business climate and increased efficiency of the BiH market; better consumer protection; the creation of preconditions for more exports to the EU.

**In line with the above, it is necessary to achieve the following priorities:**

**4.1.1. Harmonizing regulations pertaining to the freedom of movement of goods, services, capital, and persons with respective EU regulations**

In drafting the National Plan for the Adoption of the *Acquis Communautaire* (NPAA) particular attention must be given to those regulations which deal with the freedom of movement of goods, services, capital, and persons. The Stabilization and Association Agreement with the EU (SAA) does not regulate the issue of movement of persons in its entirety; rather, its provisions pertain to the movement of the work force from a candidate country to the EU member states and vice versa.

**4.1.2. Establishing a legal and institutional framework for fair competition and consumer protection**

In order to achieve a properly functioning market economy it is necessary to have effective consumer protection. In this respect, BiH must<sup>8</sup>:

- Create and active consumer protection policies in line with EU legislation,
- Harmonize Consumer Protection Laws with those of the EU,
- Establish independent and efficient administrative structures to ensure the fulfillment of basic requirements in terms of health and safety,
- Ensure consumer advocacy, information, and education.

It is necessary to establish a BiH Council of Competition and provide sufficient funding from the budget for its work. Following the establishment of the BiH Council of Competition, Entity Offices for Competition and Consumer Protection should be established as well.

In order to safeguard consumer health and safety, it is necessary to harmonize three important market segments with the EU laws -- product legislation, conformity assessment, and market

<sup>5</sup> "Single Economic Space Strategy in BiH", European Commissions, September 2003.

<sup>6</sup> Bosnalijek from Sarajevo is treated as a foreign enterprise in the RS; Saniteks Company from Velika Kladuša, which has a CE mark which allows it to export to the EU market, must undergo a conformity assessment procedure with FBiH legislation in the Federation of BiH, while the same procedure is not required in the RS; there are different lists of seed sorts in the two entities; inspectors in the Southern part of the Brčko District apply RS laws, while those in the Northern part of the District apply FBiH legislation; bus transport between the RS and Serbia and Montenegro is considered local, while passenger transport between the FBiH and Serbia and Montenegro is considered international travel; nationals of Serbia and Montenegro are not treated as foreign laborers in the RS, while in the FBiH they are.

<sup>7</sup> Locomotives are still changed at the inter-entity boarder.

<sup>8</sup> "Commission's report to the Council regarding BiH's readiness to start negotiating with the EU about the Stabilization and Association Agreement"(Feasibility Study), Brussels, 18<sup>th</sup> November 2003.

surveillance. It is particularly important to adopt by-laws and create an institutional framework for the implementation of the BiH Law on Consumer Protection. The SAA itself also stresses the significance of the issue of consumer protection, as its proper functioning is essential for ensuring an effective market economy.

In the future Stabilization and Association Agreement (SAA) with the EU, BiH will have to refrain from those measures which have a negative impact on fair competition. Therefore, it will be necessary to ensure full transparency in government subsidies, by developing and publishing an annual subsidy inventory.<sup>9</sup>

#### **4.1.3. Introducing mutual recognition provisions for products to the BiH legal system<sup>10</sup>**

In this respect it is necessary for both entity governments to mutually recognize all technical trade standards in order to prevent having to obtain two licenses and two permits. This would allow businesses to operate unobstructed throughout the BiH market.

#### **4.1.4. Establishing a single public procurement system for the entire country**

In public procurement, there still exists discrimination of companies based on the entity they come from, despite the BiH Constitution. Therefore, with the aim of improving the business climate, it is necessary to adopt a new legal framework on public procurement on the state level. The implementation of such laws will contribute to strengthening the single economic space in the country.

#### **4.1.5. Increasing the mobility of the labor force and eliminating discrimination in hiring practices**

Despite contemporary labor laws that are also harmonized between the two entities there is still discrimination in hiring practices, especially when it comes to the returnee population. In addition to political factors, there are also other factors, which affect the low mobility of labor force in the national market (see the Labor Market segment). Therefore, for example, the minimum wage, unemployment benefits, and pensions differ between the entities, while the levels of social welfare, healthcare, and the quality of education differ not only between the entities, but also among the cantons in the Federation of BiH.

#### **4.1.6. Improving public infrastructure management coordination**

It is necessary to intensify the activities of the BiH Public Railroad Corporation (BHJŽK) in order to make a plan for restructuring the railroad and developing regulations for a more efficient flow of railroad traffic. It is further necessary to intensify the work of the Public Road Traffic Corporation, which should coordinate the activities of both entities in the area of the road network. Accelerated activities on the liberalization of the electricity and telecommunication markets will further contribute to greater integration of the BiH market (see Infrastructure, Telecommunications, and Energy segments).

#### **4.1.7. Stimulating regional economic development**

According to the EU regional development model, an economic region is a single economic space comprised of multiple local units bound together by geographic, historic, cultural, and economic ties. With the support of the European Commission, a process to strengthen regional development has started. This process was well received by municipalities. There are five economic regions being developed in BiH at this time. Several regional development agencies have been established.

The experiences of Hungary, Poland, Slovenia, and the Czech Republic show that regional development has a large effect on the overall improvement of a country's economy. In the case of BiH, the establishment of economic regions will lead to a strengthening of the single economic space in the country.

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<sup>9</sup> "Commission's report to the Council regarding BiH's readiness to start negotiating with the EU about the Stabilization and Association Agreement"(Feasibility Study), Brussels, 18<sup>th</sup> November 2003.

<sup>10</sup> "Commission's report to the Council regarding BiH's readiness to start negotiating with the EU about the Stabilization and Association Agreement"(Feasibility Study), Brussels, 18<sup>th</sup> November 2003.

The existing network of regional development agencies in BiH is very weak at the moment. Due to insufficient staff and resources, these agencies have extremely limited capabilities in stimulating regional development. Therefore, they must be strengthened and provided with sufficient funding by interested municipalities. Furthermore, it is necessary to improve coordination between the agencies and with governments on the local level.

The priorities, to further develop economic regions are as follows:

- Adopt a suitable legal framework and establish a proper forum, at the BiH level, which would propose policies and measures for regional economic development;
- Finalize the process of defining economic regions, based on voluntary linking of municipalities;
- Define a strategy for regional development;
- Strengthen the existing and establish new regional development agencies.

#### **4.2. Maintaining macroeconomic stability**

In the years following the end of the war, BiH succeeded in maintaining macroeconomic stability. This is an important presumption for a better business environment in the upcoming period.

#### **4.3. Eliminating all forms of unfair competition**

A significant portion of the BiH economy is still gray (36%). There is smuggling of goods, especially those with higher tariffs. Even though an accurate analysis has never been carried out, the international community, the OHR, and CAFAO in particular, have made public audit information that shows an amount of up to KM 1 billion a year.<sup>11</sup> Unfair competition is also a large obstacle to substantial domestic production, and consequent increased employment.

It is important to strengthen the State Border Services, establish a customs administration on the state level, simplify customs procedures and reduce the number of custom-houses, adopt procedures that will ensure the import of petroleum and petroleum products by rail only, and increase control over the free custom zones. It is especially important to establish a BiH indirect taxation authority and introduce a value added tax (VAT) before the end of 2006.

#### **4.4. Removing all administrative barriers to domestic and foreign investment and reducing the cost of registering businesses**

In 2001, it took an average of 120 day to register a business. According to this year's research conducted by the World Bank, over the last two years the number of days has dropped<sup>12</sup>; it now takes 59 days<sup>13</sup> to register a business. Nonetheless, this change does not constitute a satisfactory improvement. However, the entity governments report that the number has fallen down to around 30 days.<sup>14</sup> Regardless of the various data, it takes too long to register a company in BiH. There are several factors that attribute to this, including strict administrative regulations, inadequate administrative apparatus, and the large number of state level institutions involved with registration (12 to be exact). It is therefore necessary to simplify registration procedures and reduce the number to institutions involved in the process to a bare minimum, as in the case of the registration of foreign enterprises.

When comparing registration costs, it is evident that start up costs for companies registering their business in BiH are extremely high, and much higher than in other countries in transition or the OECD countries<sup>15</sup>. Consequently, measures need to be taken to reduce the costs of registering a company in BiH.

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<sup>11</sup> Statement given by the Ambassador Don Hays, Senior Deputy to the High Representative in BiH, in *Oslobođenje*, the BiH daily newspaper, issue number 20370 of 24 October 2003.

<sup>12</sup> Since the Action Plan for Enhancement of Business Environment for Domestic and Foreign Investment has started to be implemented.

<sup>13</sup> "Doing business in 2004, Country Profile of Bosnia and Herzegovina", WB, June 2003.

<sup>14</sup> "Bosnia and Herzegovina, Report on the Implementation of the European Charter on Small and Medium-Sized Enterprises," Ministry of Foreign Trade and Economic Relation of BiH, September 2003.

<sup>15</sup> "Bosnia and Herzegovina, Report on the Implementation of the European Charter on Small and Medium-Sized Enterprises," Ministry of Foreign Trade and Economic Relation of BiH, September 2003.

In relation to the above, it is paramount to adopt a framework Law on the Registration of Businesses, as well as respective entity laws, and to establish entity business registers and one single date base for BiH.

#### **4.5. Accelerating commercial dispute settlements**

Settling commercial disputes in BiH is a lengthy and costly affair. According to World Bank research,<sup>16</sup> the average time period required to settle a commercial dispute in a judicial proceedings takes around 630 days. With the exception of Slovenia and Poland, in BiH this procedure lasts longer than in any of the other countries in transition and twice as long when compared to the OECD average.

At the moment, judicial reform is underway, a part of which is amended criminal and procedural laws. Several activities have been underway in cooperation with USAID, including the formation of 16 commercial divisions as a part of first instance courts in BiH, the appointment of judges, and judicial training in the area of commercial disputes. In addition to the above, there should also be an alternative, out-of-court system for commercial dispute settlement (arbitration).

#### **4.6. Simplifying the tax system in BiH**

There is double taxation in BiH, especially in the areas of profit and income taxes. The introduction of a VAT will to a large extent simplify the country's tax system.

Reform of tax on profit and income tax would lead to their simplification and the abolishment of double taxation. Additional activities should include continuing with the reduction of tax withholding which would automatically stimulate a reduction of the gray economy; adopting a Code of Conduct for tax officials on all levels; and the establishment of an independent appellate body on all levels to decide on appeals of tax administration decisions.

#### **4.7. Strengthening corporate governance<sup>17</sup>**

Efficient corporative governance is an important prerequisite for the creation of better business environment, which means the proper functioning of the financial market in BiH. Strong corporative governance improves access to capital markets, increases the trust of investors, and strengthens a company's competitiveness. The main problem with corporate governance in BiH lies with the fact that 60 percent of the economy is still state owned. On the other hand, the privatization model used has led to ownership dispersion, the appearance of PIF, as well as a fragmented and insufficiently liquid capital market. The fact that there is no tradition of corporate governance results in a lack of information on the part of owners regarding their rights and responsibilities, and this presents a particular problem.

In addition to focusing on the ongoing reforms in the area of enterprise legislation, other issues, such as a quicker privatization process, continued activities in strengthening the capital market, and especially its regulatory framework must also be dealt with. An important measure in supporting corporate governance would be if stock companies and public companies were required by law to be quoted on the stock market. This would not only contribute to the development of the capital market, but would also increase their transparency.

#### **4.8. Restructuring of inspections**

Due to the multi-layered system of state organization, there is much overlap of authority when it comes to inspections. The system of inspection of private sector activities is massive, the required coordination does not exist, and the inspectors' discretionary power is too great. There are too many inspections, and this work is not transparent. The governments of the Federation of BiH and the RS

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<sup>16</sup> "Bosnia and Herzegovina, Report on the Implementation of the European Charter on Small and Medium-Sized Enterprises," Ministry of Foreign Trade and Economic Relation of BiH, September 2003.

<sup>17</sup> "Commission's report to the Council regarding BiH's readiness to start negotiating with the EU about the Stabilization and Association Agreement"(Feasibility Study), Brussels, 18<sup>th</sup> November 2003.

have adopted action plans for the reorganization of inspections. These action plans address reforms in three major areas – drafting regulations, the internal organization of entity inspections, and the training of inspectors.

In the upcoming period it will be necessary to adopt a BiH framework Law on Inspections, as well as respective entity laws. Furthermore, a Federation inspectorate and the RS inspectorate must be established. In the Federation of BiH, each canton has its own inspectorate. The aim of the restructuring of the inspectorates is to centralize inspections into several inspectorates in order to increase their efficiency, transparency and to reduce costs.

#### **4.9. Ensuring more efficient protection of creditors and creating greater access to bank loans**

As previously stated, there should be a more efficient system for the resolution of commercial disputes. This must be accomplished in the upcoming period. In addition to slow court procedures, another problem is the fact that a proper system for the protection of creditors does not exist. Credit securing is not systemized, nor is there an efficient mechanism for collection, both of which present obstacles to greater availability of loans to the private sector. The collection of collateral in BiH is still quite complicated and must be simplified. It is necessary to adopt a number of new laws and to amend existing ones, so that there is a more efficient mechanism for the protection of creditors in place. In relation to the above, it is necessary to adopt mutually harmonized entity level Law on Obligations and Law of Things in the FBiH and the RS, and the Law on Notaries in the RS. It is particularly important to adopt a state level Law on the Registration of Pledges on Movable Property, as well as entity Laws on the Registration of Pledges on Movables, and to establish a single register of pledges on the BiH level.

The Bankruptcy Law and the Law on Liquidation play a significant role in creating an attractive business environment. Recently, the RS adopted a Bankruptcy Law, which meets the requirements of the contemporary business climate. However, the same cannot be said of the FBiH, which gives an unlimited right to collect back salaries in full. In this way, other creditors are put in an unfavorable position and have no incentive to decide for bankruptcy and restructuring of a company in order to revive it. With such a law, creditors are more likely to liquidate a company. Therefore, the FBiH Bankruptcy Law must be amended.

#### **4.10. Implementing reforms in order to combat corruption more efficiently**

According to research done by the World Bank in cooperation with local experts<sup>18</sup>, the level of corruption in BiH presents a big obstacle to private sector development. According to this research, "18 percent of costs incurred by companies go to pay bribes"; and in the process of doing business, managers spend one tenth of their managing time communicating with government representatives.<sup>19</sup> It is necessary to implement an action plan for combating corruption, which is an integral part of the PRSP.

#### **4.11. Modernizing the system for land and real estate management**

There are no harmonized laws regarding ownership and transfer of ownership of all types of real estate. Obtaining zoning permits and building permits is a slow and costly affair. The unresolved issue of restitution poses an added problem. A number of problems have been discovered during privatization regarding the transfer of ownership of real estate, which additionally complicates privatization, making it less efficient, especially in the case of PIF.

What is needed is to strengthen the urban planning system and coordination at all levels to eliminate the Institute for Urban Planning's monopoly in the process of preparation of infrastructure development of locations, as well as to introduce private sector competition, and to merge the procedures for obtaining zoning permits and building permits. In this context, modern cadastre laws must be adopted in order to integrate land books and the cadastre, a state Law on Restitution must be adopted, and the process of amending existing laws must be accelerated in order to resolve property

<sup>18</sup> A Diagnostic Examination of Corruption in BiH, World Bank, 2001.

<sup>19</sup> A Diagnostic Examination of Corruption in BiH, World Bank, 2001, pg.25-26.





































































































































































































































































































































































































































































































































































































































































































