

# POLICY NOTE 1: MACROECONOMIC POLICIES

## A. INTRODUCTION

**1.1** Bosnia and Herzegovina (BH) has made substantial progress in economic reconstruction since the end of the war, but much more remains to be done to establish conditions for sustainable private sector-led growth, curtail risks to hard-won fiscal stability and create an efficient government. Real GDP growth averaged 5 percent over the last five years, helping bring real GDP close to pre-war levels. Job creation has been slow, however, keeping unemployment high. Inflation has remained modest anchored in the currency board arrangement and supported by impressive fiscal consolidation through 2004. But spending subsequently rose relative to GDP from already very high levels, leaving the government outsized, irrationally decentralized and expensive.

**1.2** The banking system has been largely privatized, but progress on other structural reforms has been weak, leaving BH behind all countries in eastern and central Europe in terms of reform implementation. The private sector generates only about one-half of GDP, the lowest level in the region, amid delays in advancing privatization, modest improvements in the business environment and small inflows of foreign direct investment. Efforts to revamp labor markets have stalled, with negative effects on labor mobility and job creation. The authorities are to be congratulated for signing the revised and modernized Central European Free Trade Agreement (CEFTA). Negotiations to join the World Trade Organization (WTO) are ongoing and need to be brought to a successful conclusion.

**1.3** This note examines BH's macroeconomic policies and makes recommendations as to the appropriate policy directions going forward. Other policy notes discuss options and recommendations for tackling structural reforms. The rest of the note is organized as follows. Section B presents the key macroeconomic challenges BH faces. Section C discusses policy recommendations and strategies.

## B. KEY VULNERABILITIES AND CHALLENGES

**1.4** BH faces substantial macroeconomic challenges, which need to be addressed to help improve living standards, complete the transition to a market economy and advance EU integration. Four of these key challenges are discussed below.

### High External Imbalances

**1.5** Low savings, together with small and undiversified exports that are overly dominated by commodity shipments abroad, are keeping the current account deficit large. The current account deficit is likely to have amounted to about 14 percent of GDP in 2006 (11.5 percent of GDP adjusted for the nonobserved economy). The deficit narrowed from about 22 percent in 2005, thanks to robust export growth reflecting in part improved statistical coverage. (The latter was due to improved incentives to declare more realistic values of exports following VAT introduction from the start of 2006.) Even at the much-narrower outcome likely for 2006, the current account deficit is large and a cause of concern that needs to be addressed. It is noteworthy that one-half of exports reflect shipments

abroad of metals and wood, and a large share of the rest are accounted for by food and semi-processed materials.

**1.6 Gross external debt (55 percent of GDP at the end of 2005) is higher than in most other countries in the region, but debt service is moderate given the substantial share of BH's concessional obligations.** Inflows of concessional financing and remittances have been large thus far, but are likely to decline going forward, increasing reliance on costlier financing. At current levels, inflows of foreign direct investment finance just one-fifth of the current account deficit, the lowest share in the region, limiting scope for robust export growth to be sustained.

### **Government Spending is Large and Often Poorly Targeted and Inefficient**

**1.7 Government spending amounted to 50 percent of GDP in 2005 (42 percent of adjusted GDP), a full 4 percent of GDP higher than in countries with similar levels of income per capita.<sup>1</sup>** Government spending is also significantly higher than in faster growing and wealthier economies including Ireland, South Korea and the Baltic states, and is higher than the average for the countries in southeastern Europe. Outlays on public wages and capital spending are substantially larger than among comparator countries, as are health spending and untargeted transfers to war veterans, their families and survivors. The relatively large public wage bill reflects large employment levels in defense, public order and education, and relatively high wage rates at the state level and to a lesser extent in the FBH. Fueled by stronger than planned collection of VAT, spending rose relative to GDP in 2006, further increasing the government burden on the economy.

**1.8 The outcomes of government spending tend to be poorer than in other countries in the region.** Education enrollment and infant mortality, to take just two indicators, are worse than in most countries in central and eastern Europe, as are indicators of the quality of governance and perceptions of corruption. Indeed, the observed quality of outcomes in BH would be consistent with government spending of 30 percent of adjusted GDP, or 10 percentage points lower than observed.

**1.9 The high level of government spending remains supported by a larger than optimal tax burden, primarily reflecting onerous social security contributions.** At about 36 percent of gross wages on average, the cumulative social security contribution rate exceeds the average for the relatively highly taxed OECD countries (30 percent). Moreover, levied on a relatively narrow base due to pervasive legal exemptions and rampant evasion, high social security contribution rates are a key cause of the high informalization of economic activity.

### **Large Fiscal Pressures Have Emerged and Would Multiply over the Coming Years**

**1.10 Fiscal pressures are substantial and rising.** Fiscal pressures include the need to formalize and settle the large stock of domestic claims, strengthen the state government and handle property restitution. Assuming a modest increase in capital spending of 1 percent of GDP to help rehabilitate roads and other infrastructure, these spending pressures would add 2-3 percent of GDP to government spending by 2010 compared with 2005. Moreover, the governments are moving ahead with plans to engage in large energy and other infrastructure projects, often without prioritized plans, with projected total costs of one-half of annual

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<sup>1</sup> For detailed analysis of government spending, see: *Bosnia and Herzegovina: Addressing Fiscal Challenges and Enhancing Growth Prospects, A Public Expenditure and Institutional Review*, The World Bank, 2006.

GDP or more. These pressures are compounded by the recent adoption of legislation that promises substantially more generous social benefits than fiscally possible, including those under the amended law on rights of veterans in the FBH and the proposed amendments to the law on frozen foreign currency deposits. Raising tax rates to cope with these challenges will be counterproductive, given the already large government burden on the economy, and most probably will be politically infeasible. Adopting laws that cannot be implemented is not sound fiscal policy. Doing so will ultimately build up new domestic claims and continue to muddle the fiscal outlook, as governments pay benefits that are only a fraction of those mandated by law.

## **The Basis for Economic Growth is Narrow and Unemployment is High**

**1.11 The basis for economic growth remains narrow, limiting scope for job creation and sustaining the vulnerability to an ultimate downward adjustment in international commodity prices.** Further, with small inflows of foreign direct investment, opportunities for diversifying the economy and moving up the value-added chain will remain limited. Unemployment is high and little changed over the last several years, amounting to about 23 percent of the labor force, despite ongoing modest job creation.

### **C. POLICY RECOMMENDATIONS**

**1.12 Improving living standards and addressing the macroeconomic challenges would require that the authorities sustain the currency board arrangement while embarking on an ambitious program of macroeconomic and structural reforms.** This note focuses on the macroeconomic policy agenda. The other policy notes address the structural agenda, with Policy Note 2 focusing on the need to advance privatization, streamline the business environment and revamp labor markets.

**1.13 Addressing the macroeconomic challenges requires reforms in a number of areas, as described in more detail in the remainder of the note.** The following three-point agenda highlights the key priorities:

- **Sustain the currency board arrangement (CBA).** Prudent fiscal policy and structural reforms are needed to help sustain the CBA, especially given the authorities' intentions to adhere to the board until if not after ultimate EU accession. Given that reforms to sustain competitiveness take hold with some delay, the authorities are well advised to lose no time in embarking on vigorous macroeconomic and structural reforms.

- **Adopt prudent budgets for 2007 that reduce spending relative to GDP and incorporate reductions in payroll contribution rates.** Efforts to reduce the government burden on the economy should help boost growth in output and exports, with social entitlements and the public wage bill offering ample opportunities for reduction, as detailed in the Public Expenditure and Institutional Review (PEIR). On payroll taxes, reducing the contribution rate for unemployment insurance in the FBH and eliminating cross-flows between the extrabudgetary funds for pensions, health and unemployment could be seen as first steps. Scope for rate cuts would increase should the new income tax laws prove to be revenue positive, or VAT revenues continue to be robust.

- **Settle frozen currency deposits and war claims in line with the current laws.** These laws offer the best compromise between the public and private interest and enable a fiscally sustainable settlement. Amendments to the law on frozen currency deposits that

aim to shorten the maturity of the bonds to be issued for settlement, while boosting the interest rate, will put public debt on an upward path.

**1.14 The broader agenda going forward should help ensure that fiscal and expenditure policies support the currency board arrangement and help enhance growth, while minimizing both the government burden on the economy and disincentives to work and invest.** Achieving these objectives would require measures to improve the structure of revenues and expenditures and rationalize public financial management.

### **Tax Policies**

**1.15 The authorities should continue to shift raising funds from direct taxes and distortionary social security contributions to indirect taxes.** As a first step, the authorities should resist the temptation to change the single-rate VAT, as the current structure provides for optimum administrative efficiency and limits opportunities for fraud. In addition, the following steps are suggested:

- **Harmonize the corporate and personal income tax laws in the entities and the District of Brcko.** Consider ways to further eliminate exemptions to create a level playing field for all companies, domestic and foreign.
- **Improve collection of taxes and social security contributions.** Move to unify the base for personal income taxation and social security contributions.

### **Expenditure Policies**

- **Reduce the level of government spending by at least 5 percent of GDP over the medium term, moving outlays closer to the levels among the faster growing economies and countries with broadly similar incomes per capita.** This should help lighten the government's burden on the economy and create room for private sector-led growth.

- **As a general rule, eliminate inefficiencies in sectors or programs before committing new funds to these areas.**

- **Using the analysis in the remaining policy notes and the PEIR quoted above, improve the structure of government spending to reduce the share of expenditures that are often seen as not conducive to boosting economic growth and reducing poverty.** As a first step, move to reduce the share of current spending and increasing the share of expenditures on operations and maintenance. Minimize tax write-offs unrelated to corporate restructuring and cut subsidies to companies.

- **Establish a realistic target for reducing the size of public employment across governments and begin working to meet this target.** Follow this with a strategic review that: (i) reduces areas of likely duplication across levels of government, and (ii) prioritizes remaining functions/activities at the entity and the cantonal level to strengthen those that are understaffed and significantly scale back those that are less critical.

- **In advancing defense and police reform,** set wage rates and employment levels in a fashion that would be fiscally sustainable while providing for incentives to retain and recruit capable personnel in line with the governments' longer-term priorities.

- **Prioritized and carefully planned strengthening of state institutions should help limit costs.** As a principle, shifting institutions from the sub-national to the national level of government without adding functions should be at least cost-neutral. The authorities should work toward offsetting costs related to creating new or strengthening existing state-level institutions and functions through reductions in spending elsewhere.

- **Settle the outstanding domestic claims and handle restitution to balance the public and the private interest.** Whether restitution will be in kind or monetary needs to be determined by efforts to limit fiscal consequences.

- **Introduce means testing for veterans' benefits and prevent double dipping by veterans from other social programs, while conducting a comprehensive review of all sub-entity veterans' programs.** The inability to curb growth in veterans' benefits 11 years after the war is a key challenge for the authorities, keeping outlays on social welfare and child protection one of the lowest in central and eastern Europe.

## **Public Financial and Expenditure Management and Control**

- **Strengthen fiscal coordination, starting with the urgent enactment of the law on the National Fiscal Council (NFC).** Make the Council operational.

- **Strengthen the budget preparation process by cementing the key role of the Medium-Term Expenditure Frameworks as anchors for the annual budgets and by shifting toward program budgeting.** Government priorities need to be fully integrated into the budget process, with a specific emphasis on capital spending. Create an efficient and transparent mechanism for evaluating all capital outlays within the overall fiscal envelope, consistent with the government priorities. Strengthen the capacity for Public Private Partnerships.

- **Align the internal financial control framework with the EU prescribed model of Public Internal Financial Control (PIFC).** Adopt the legislative and organization framework for a sound internal audit system and move swiftly to implement the laws.

- **Make the Public Procurement Body operational and stick to the letter and spirit of the public procurement law.** Criteria for evaluation of tenders for both works and goods should be changed to monetarily quantifiable criteria, as the current point-system is prone to abuse and manipulation.<sup>2</sup>

- **Strengthen the external audit institutions and focus on financial rather than performance audits.** Form a secretariat for the coordination committee for the three external audit institutions to set the agenda and advance common issues, such as preparation of a common audit methodology. Devise a strategy for auditing local governments.

- **Data quality needs to be improved dramatically and capacity for consolidating fiscal data strengthened substantially to enable reliable analysis.** Preparing consolidated fiscal accounts at least at annual frequency should be a priority. Explicitly including foreign-financed investment projects in the entity and state budgets should also be carried out to help improve transparency and the ability to analyze fiscal developments.

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<sup>2</sup> Consult Chapter 7 of the BH Fiduciary Update for further details and recommendations.