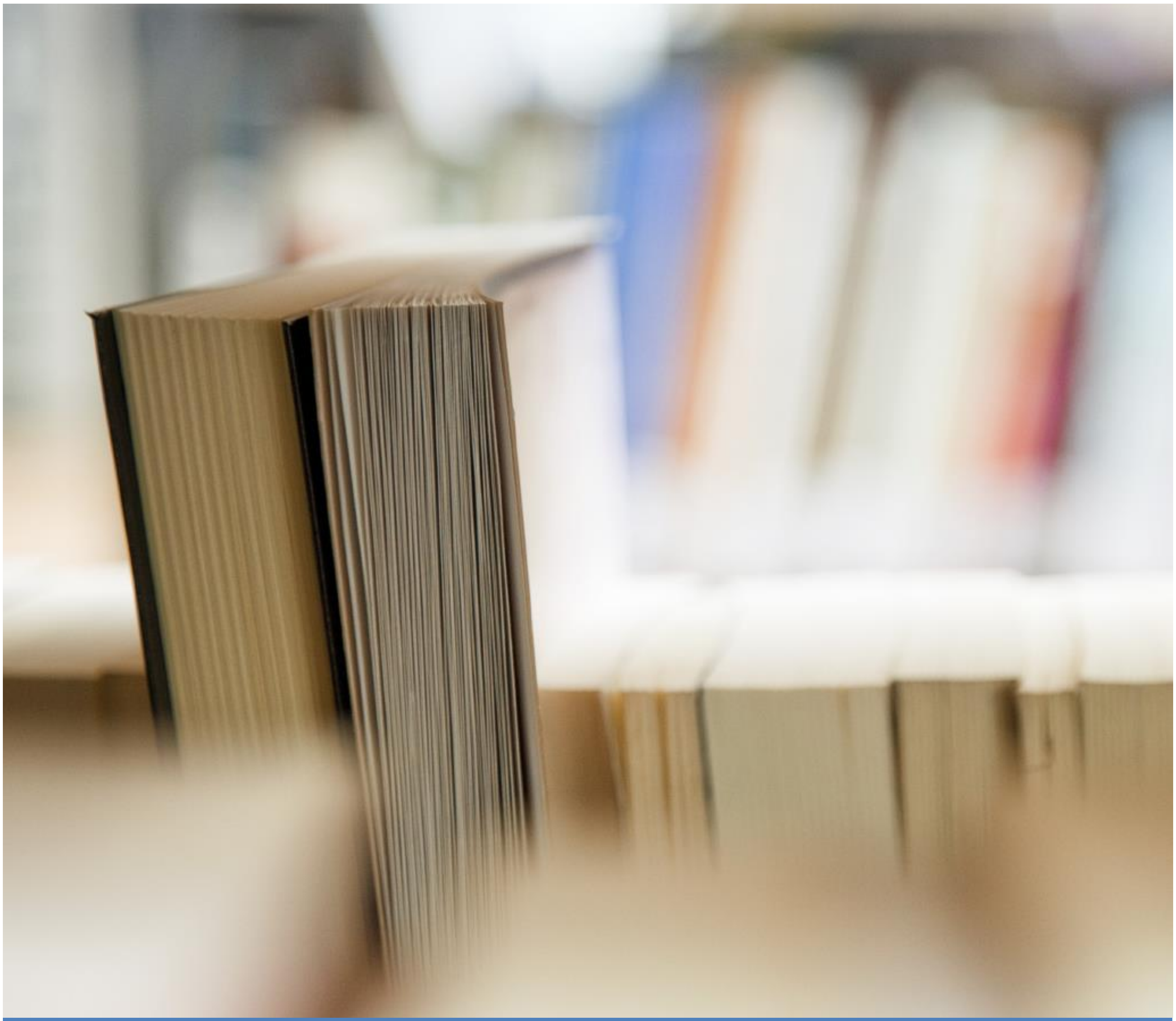

Country briefing

Bosnia and Herzegovina

CSOs as equal partners in monitoring public finances

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BALKAN MONITORING PUBLIC FINANCES

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CREDITS

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This document has been produced as a part of the project "CSOs as equal partners in the monitoring of public finance", which started beginning of 2016 and is implemented by a consortium of 10 organizations from 7 countries and will last for four years.

The aim of the project is to improve the transparency and accountability of policy and decision making in the area of public finances through strengthening the role and voice of NGOs in monitoring the institutions that operate in the area of public finances. In this way, the project will strengthen CSO knowledge of public finance and IFIs and improve CSO capacities for monitoring. Additionally, it will help advocate for transparency, accountability and effectiveness from public institutions in public finance. Moreover, this project will build know-how in advocating for sustainability, transparency and accountability of public finance and IFIs. This project will also increase networking and cooperation of CSOs on monitoring of public finance at regional and EU level. Lastly, it will increase the understanding of the media and wider public of the challenges in public finance and the impacts of IFIs.

Key project activities are research and monitoring, advocacy, capacity building and transfer of knowledge/practices and networking in the field of the 4 specific topics: public debt, public-private partnerships, tax justice and public infrastructure.

More information about the project can be found on http://wings-of-hope.ba/balkan-monitoring-public-finance/ and on the Facebook Page Balkan Monitoring Public Finances

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CONTENT

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EXECUTIVE SUMMARY

The purpose of this report is to present a preliminary analysis with respect to the monitoring of public finance in Bosnia and Herzegovina, focusing on the areas of public debt, tax justice, public infrastructure and public private partnerships (PPP). The report begins with the overall macroeconomic and governance context, and then continues with a more detailed examination of the key characteristics of the situation in the fields of public debt, tax justice, PPPs and public infrastructure. It concludes with policy recommendations to support public finance monitoring and sustainability. The methodology employed to collect and evaluate relevant information includes: desktop research (secondary research of existing literature), interviews with experts, and the analysis of legislation, institutions and power relations.

Macroeconomic policy, based on the currency board system of fixed exchange rates, has encouraged a model of unsustainable growth based on foreign currency denominated lending by foreign banks to households and the private sector. As such, the expansion of foreign bank credit from 2005-08 and the ensuing financial crisis caused Bosnia's economy to collapse in 2009. Bosnia and Herzegovina entered a double-dip recession (2009 and 2012) interspersed by years of stagnant growth. In response, the government has been obliged to sign three standby agreements with the International Monetary Fund (IMF) in order to obtain loans to finance budget deficits. One of the key aspects of these agreements is the privatization of loss-making public-sector firms.

Public sector expenditure ranks second in the region due to a complex and highly decentralized government structure. The report examines and rejects the argument of the International Financial Institutions (IFIs) that the public finance crisis is due to a lack of fiscal discipline and excessive government spending. In the period before 2008, the government ran a budget surplus. The report concludes that the problem is not excessive public spending as such. Hence it questions whether the IMF structural adjustment programmes can do anything more than consolidate the current spending of the government sector. Instead, the need for an alternative model of economic growth to promote sustainable public finance is presented as a key policy conclusion.

The structure of public debt is examined in relation to its constituent elements, in relation to the share between the different entities, and in relation to the overall trend of the trajectory of its parts. External debt obligations have grown rapidly in recent years and are projected to continue to increase. Internal debt has also been growing, much of it borrowed to cover budget deficits in the wake of the financial crisis. Although the level of public debt is not excessive, the economy remains dependent on foreign

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borrowing to finance current consumption and expenditure as well as existing debt. It is thus extremely vulnerable to external downside risks. IFI conditionality may actually increase risk by consolidating government spending without addressing structural and governance limits to economic growth. In the report these structural and governance limits are highlighted and policy alternatives are presented, focusing on improving government finances in order to increase public investment.

The report links analytically the problem of public finance sustainability and public debt to the problem of tax justice. Indirect taxation, responsible for the largest share of government revenue, is considered to be too narrow a base for viable public finance. From the perspective of tax justice, this system is highly regressive, with the weight of the tax burden falling on employees rather than employers, and on the least well off rather than the better off. The tax system is highly fragmented, leading to duplications and inefficiencies, increasing costs. The report welcomes some aspects of proposed legislation in these areas, but concludes that a progressive system of taxation is desperately needed.

The political-administrative environment in Bosnia and Herzegovina has been inhospitable to PPPs. The report draws on international experiences to raise questions about the cost to the public sector of PPPs, the regulatory capacity of the public sector over provision, and the benefits to the consumer. The limited experiences of PPPs have already raised alarm bells in relation to openness, transparency and accountability to stakeholders. Similar questions are asked of the privatization of public services. The report concludes that the governance of the public sector, which is associated with excessive administrative costs, limited regulatory competency, and clientelism, presents a specific challenge both for the monitoring of public finance and for long-term sustainability.

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INTRODUCTION

The declared aim of macroeconomic policy is to promote monetary and thus financial stability. According to the Dayton agreement of 1995, the Central Bank of Bosnia and Herzegovina is not permitted to function as a Central Bank: "...it may not extend credit by creating money, operating in this respect as a currency board."[1] This means that it may only issue domestic currency when there are sufficient foreign exchanges reserves to back it. Its sole function is to maintain the peg to the Euro through the required foreign exchange reserves ratio. It is prohibited from acting as the lender of last resort, and from conducting open market operations. It cannot influence interest rates and thus the money supply, and hence also the supply of credit. The only active segment of macroeconomic policy is fiscal policy, but given the limitations of monetary policy government spending is financed solely from taxation or public borrowing.

While the monetary anchor is hailed by the IFIs as the foundation for financial stability, it role has in fact been the opposite.[2] As the expansion of the money supply is dependent on foreign currency earnings and monetary policy is barred from supporting exports through exchange rate adjustments, there was only one path to growth, the expansion of foreign bank lending in foreign currency, taking advantage of fixed exchange rates and interest rate spreads with the Eurozone. As in the rest of the post-Yugoslav region, in the period 2005-2008, the expansion of foreign bank credit led to a private debt bubble that drove an import boom and a wave of speculative investment. In that period, the average (annual) rate of growth of bank credit to enterprises was 23.6%, while credit to households and total bank assets (loans) grew by 26.4% and 22.7% respectively. But with the financial crisis and credit crunch in Europe, the tap of bank credit ran dry and the economy collapsed. The inevitable result was a sharp decrease in household consumption and business investment. The mechanism of debt-led growth was broken.

What followed was a period of "de-leveraging", as banks, enterprises and households were obliged to repay their debts. In the 2008-2011 period foreign liabilities of commercial banks in BiH decreased by 33.8% (EUR1.09 billion) as a result of the impact of financial crisis on parent banks in the Eurozone. The fall in foreign liabilities was offset by growth in domestic deposits by 18.9% (EUR993 million). In other words the cost of foreign loans was covered by a rise in savings as the spending of enterprises and households went on repaying debt. The result was a contraction of the credit supply and a contraction

[1] See ANNEX 4, Constitution of Bosnia and Herzegovina, Article VII: Central Bank.
[2] For a consideration of regional monetary policy and its role in financialisation, see: Andreja Živković, 'From the market…to the market: The debt economy after Yugoslavia', in Srecko Horvat and Igor Stiks (eds.), *Welcome to the Desert of Post-Socialism: Radical Politics after Yugoslavia*, London Verso, 2015.

of spending on goods and services. Bosnia entered a double-dip recession (2009, 2012) interspersed by years of stagnant growth. When foreign credit collapsed government revenues also nose-dived and public debt increased by over 50%; as of end of 2015 it had risen to 42.5% of GDP. Since then Bosnia has signed three standby agreements with the IMF (2009, 2012, 2016) in order to borrow the money to cover the growing budget deficit (6% of GDP in 2009) and trade deficits (still an astonishing estimated 25% of GDP in 2015).

The IFIs blame the public finance crisis on a lack of fiscal discipline and excessive government spending. The model of sustainable public finance they promote within the framework of the standby agreements is based on downsizing the public sector and public spending, combined with business-friendly labor market, taxation and administrative reform. In considering alternatives it is important to note that the problem is not excessive public spending. In fact, BiH had an average budget surplus of 2.2% of GDP in the 2003-2005 period, and ran a budget surplus based on rising tax receipts right up to the crisis. The key fact is that the increase in tax base was caused by the credit bubble which in the period from 2004 to 2008 added an additional aggregate increase in purchasing power of EUR 4.5 billion, the equivalent of 40% of GDP in 2008. In other words, foreign debt stimulated the consumption bubble that fed economic growth, which in turn provided tax receipts enabling the government to run a budget surplus.

General government current expenditures also dramatically improved following the introduction of a VAT (Value Added Tax) with a flat tax rate of 17% in 2006 that provided a significant and permanent increase in government revenues. Overall government current expenditures increased from an average of around 38.5% of GDP over 2000–05 to around 41.5% thereafter. The flat rate VAT is a regressive form of taxation that hits the poorest sections of society the hardest, causing an increase in the fiscal burden of consumers by ¼ - we return to this in the section on tax justice. Most of the increase in spending took the form of higher public-sector wages and increased, and poorly targeted, social benefits, as well as higher spending on goods and services. Improved government revenues were thus conditioned by and fed into the credit bubble.

Nevertheless, public sector expenditure ranks second in the region owing to a complex and highly decentralized governance structure, comprising a central level of government, the BiH Institutions, Brčko District (DB), and two Entities—the Federation of Bosnia and Herzegovina (FBiH) and the Serbian Republic (RS) – each of which has its own government, extra-budgetary funds (EBFs), and local self-governance units. FBiH has 10 cantons representing a level of government between the government of FBiH and local self-governance units, and each canton has its own government and some

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EBFs. A Fiscal Council was set up in 2008 to coordinate fiscal policies by setting medium-term fiscal targets each year with the aim of reducing the primary deficit and total public consumption and setting the annual ceilings for indebtedness of the budgets of BiH, FBiH, RS, and DB. While there has been some success in consolidating primary balances, the problem of coordinating debt ceilings remains. Indeed, the share of lower levels of government (cantons, municipalities, cities and public enterprises) in the total external debt of FBiH is constantly rising (from 1,046.76 million KM in 2010 to 2,447.62 million KM in 2015).

The privatization of loss-making public-sector firms forms a key plank of the standby agreements and is seen as significantly reducing public sector debt. In 2015 public enterprises accounted for 1,769.22 million KM of the debt of the Federation of Bosnia and Herzegovina (FBiH), doubling from 825 million KM in 2010. But is privatization necessarily a panacea? The privatization process in Republika Sprska (RS) in 2006–07 led to significant windfall receipts, which in the form of higher public-sector wages and higher spending on goods and services were merely recycled in the credit bubble. Thus, while efforts are needed to check the increase in uncovered liabilities by lower levels of government and loss-making state-owned enterprises, the danger is that public budgets continued to be geared to milking one-off income from privatization and reducing welfare spending in order to borrow and repay debt. The problem is rather one of creating an alternative model of economic growth which recognizes the economic significance and potential of the public sector – in terms of the economic multiplier – and thus promotes sustainable public finance.

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PUBLIC DEBT[3]

Public debt amounted in 2015 to 11,936.93 million KM or 42.3% of GDP. FBiH was responsible for 55.06% of this debt, RS for 44.22%. In 2015 total public debt increased by 420.61 million KM or 3.65%. Public debt is divided into internal and external debt. The share of external debt in the structure of total public debt in 2015 was 70.38%, while that of internal debt was 29.62%

External Debt

As of end of 2015, the external debt of BiH totaled 8,401.49 million KM. 63.19% of this debt belonged to FBiH, while RS was responsible for 35.9%. The external debt of Bosnia and Herzegovina in 2015 increased by 2.23% in relation to 2014, following a 10.93% increase in relation to 2013. In 2015 external sovereign obligations totaled 581.33 million KM, of which the repayment of the principal concerned 477.99 million KM or 82.22% and interest payments, service and other costs 103.34 million or 17.78%. Of the total amount of serviced liabilities, the Federation of Bosnia and Herzegovina accounted for 64.55% and the Serbian Republic 34.25%.

While a large part of the debt stock has been contracted on concessional terms over with a favorable maturity structure, the burden of public debt servicing, which doubled in recent years and reached over 3% of GDP in 2012, is estimated to have doubled again in 2013-2014. According to the IMF, external debt servicing obligations are projected to increase again in the coming years and BiH has little or no access to international capital markets. The majority share in the total amount serviced in 2015 was made up of payments to the following three IFI creditors: the European Bank for Reconstruction and Development was paid 121.04 million, the World Bank 119.20 million KM, and the International Monetary Fund 106.68 million KM.

The external debt can be divided into “old“ and “new“ debt. The share of the “old“ Yugoslav debt in external indebtedness was 17.91% in 2015 and showed a constant tendency to decrease, its share falling from 21.75% in 2013 and 19.65% in 2014. The “old“ debt is inherited from commercial debts to the Paris Club and London Club creditors, and IBRD loans.

[h]The statistical information in this section is drawn from: Bosna i Hercegovina Ministarstvo Financija, *Informacija o stanju javne zaduženosti Bosne i Hercegovine na dan 31.12.2015. godine*, Sarajevo, May 2016; Federacija Bosne i Hercegovine Ministarstvo Financija, *Informacija o vanjskom i unutarnjem dugu u Federaciji Bosne i Hercegovine 31.12.2015. godine*, Sarajevo, May 2016.

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The lion's share of the “new debt“ is represented by debts to international financial institutions (World Bank, IDA and IBRD, EIB, IMF, EBRD, European Commission). The new debt in the period 2006-2015 increased three-fold as a result of the payment of funds to multilateral financial institutions to finance infrastructure projects and to support budgets in the Federation. Of “new“ external debt 52.59% relates to infrastructure projects, 34.23% to the public sector, and 13.18% to business activities. We will consider the implication for public finance of the shift to foreign borrowing to meet revenue shortfalls when we come to examine internal debt. As far as infrastructure is concerned, BiH has significant infrastructure needs, mainly road construction and energy generation, which are vital to its economic growth potential. However, the share of public capital spending has been decreasing over time, from around 8% of average in the pre-crisis period to less than 7% thereafter, and its financing has gradually shifted from revenues to debt generating foreign financing.

Internal Debt

The internal debt of Bosnia and Herzegovina amounted to 3,535.44 million KM in 2015. In an exact inversion of the proportions of shares in external debt, here FBiH was responsible for 35.74% of internal debt, while RS claimed 63.99%. The internal debt in 2015 was 7.20% higher than in 2014, while in 2014 it was higher by 9.26% compared to 2013. BiH has limited formal public debt as it did not issue bonds and treasury bills until 2007. They were issued to address the substantial domestic liabilities from the pre-war period and fiscal claims resulting from the 1992-95 war. In 2004 both FBiH and RS enacted laws dividing the claims into three groups: general liabilities, liabilities on the basis of savings in foreign currency inherited after the breakup of former Yugoslavia and liabilities on the basis of war damages. The internal debt stock of the Federation of Bosnia and Herzegovina in these three groups amounts to 994.89 million KM as of end of 2015.

An increasing segment of the internal debt represents borrowing to cover budget deficits in the wake of the financial crisis. To finance its budget deficit the Federation of Bosnia and Herzegovina issued bonds in 2015 to the nominal amount of 310.00 million KM with a maturity of 3-7 years at interest rates from 2.21% to 3.9%. The stock of debt on this basis is 520.00 million KM. In 2015 RS issued long-term bonds to finance budget expenditures to the nominal amount of 241.26 million KM, with a maturity of 4-5 years at interest rates from 3.50% to 4.75%. This debt stock of amounts to 534.51 million KM. To cover budget shortfalls and develop the financial market, RS issued six-month treasury bills to the total amount of 166.75 million KM at interest rates from 0.81 to 3.20%. Debt outstanding on this basis amounted to 86.75 million KM. At the end of 2015, outstanding liabilities of the general government sector on the issue of securities amounted to 2.1 billion KM, 13.7% higher compared to the previous

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year. Funds raised by issuing securities are mainly used to settle the current liabilities of the entity governments.

Public budgets are being financialized not only in order to borrow and repay debt, but also to finance current expenditure. Public institutions are also turning to the foreign commercial banks to finance capital investment, public sector debt and infrastructure projects. Thus, the indebtedness of RS to private banks in BiH as of end of 2015 amounts to 56.20 million KM and relates to capital investment, public sector debt and infrastructure projects. Public sector debt with commercial banks was 1,028 billion KM in 2015. The internal debt of municipalities, cities and cantons relating to the debt arising from borrowing at commercial banks and from bonds amounted to 539.22 million KM, of which the debt based on bonds amounts to 44.69 million KM and debt based on credit borrowing 494.53 million KM. From the point of view of public finance sustainability, the increasing dependence on more expensive commercial credit represents a new stage of dependency on the failed credit-based model of growth.

Debt structure and risk

External debt is subject to currency, interest rate and refinancing risk. The average interest rate on external debt is relatively low, reflecting concessional borrowing and low benchmark interest rates. The average interest rate on external debt in 2015 was 1.49%, a decrease of 12.08% compared to 2014. Approximately half of the BiH external debt is exposed to interest rate risk as the share of loans with variable interest rates in the structure of external debt is 49.8%. On average it takes 4.2 years to re-fix interest rates on foreign debt, and 52.4% of total external debt has been subject to changes in interest rates. Compared to the previous year, interest rate risk has decreased slightly, but in order to further reduce exposure borrowing at fixed interest rates is desirable while taking into account that the current cost of variable interest rates is lower than that of fixed interest rates.

The average external debt maturity of 7.2 years was slightly lower in 2015 compared to 2014, when it was 7.6 years. The average "grace" period in 2015 amounted to 6.6 years, reflecting a larger share of external loans with a longer "grace" period. Indicators of risk of refinancing slightly deteriorated in 2015, suggesting that maturities should be extended to mitigate risk. 92.8% of the external debt is denominated in 3 foreign currencies, the Euro, IMF special drawing rights (SDR) and US dollars. However, IFI risk assessments emphasize that only 48.8% of foreign debt is subject to changes in exchange rates, or exposed to currency risk due to the existing monetary policy based on fixed exchange rates. However, it is a fact that the increase in the value of the external debt in 2015 was wholly due to

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currency appreciation (primarily the US Dollar). It is argued that a reduction in currency risk is possible through an increase in external borrowing in euros in relation to other foreign currencies.

So how should we assess risk, that is public finance sustainability? IFI assessments tend to agree that the level of public debt is not excessive – for example it is well below the Maastricht limit of 60% of GDP – and is sustainable in relation to foreign currency reserves and share of exports. Similarly, at first glance it seems that the level of the consolidated deficit is low (2% of GDP). However, given the structural trade deficit, and the consequently high current account deficit (7.9% in 2015), the economy remains extremely dependent on borrowing to finance current consumption and expenditure as well as existing debt. It is thus extremely vulnerable to external risks (Eurozone rates of economic activity, foreign bank lending). Furthermore, as BiH is unable to borrow on the international capital markets by issuing government bonds the only possible sources of funding remain the IFIs and the domestic capital market. IFI conditionality may represent the biggest threat to public finance sustainability: the downsizing of the public sector reduces government revenues, without necessarily replacing them with public or private investment, and thus short-term debt is repaid without checking longer-term rising public debt.

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TAX JUSTICE[4]

At over 41% of GDP, public sector expenditure is the second largest in the region due to the complex and highly decentralized governance structure. Public spending on wages and consumption of goods and services accounts for over 55% of current expenditures in BiH, significantly more than the 38% regional average by BiH's peers. The overall level of tax and social security contributions is one of the highest in the region, with indirect taxes and social security contributions together providing more than 90% of revenues. The IFIs argue that this tax burden undermines cost competitiveness and contributes to the high share of informal employment in BiH. The standby arrangement with the IMF calls for tax cuts to stimulate employment in the formal sector and attract foreign investment.

Let us first note that standard rates of all taxes in BiH are low and competitive in regional comparison. Both FBiH and RS have a personal income tax flat rate of 10%, one of the lowest in the region. Similarly, the corporate income tax flat rate of 10% in both entities is substantially below the regional average. Revenues from corporate and personal income taxation are very low, and not only because of low rates. Narrow tax bases, generous corporate income tax exemptions and incentives, and low compliance rates cut into revenues. The VAT system has a single standard rate of 17%, with no reduced rates, which enhances its efficiency. While many countries have a higher standard VAT rate than BiH, they usually have a multiple rate structure. The VAT threshold is one of the lowest in the region, pulling in many small and medium-sized taxpayers. Progress has been made in improving revenue administration, especially in the collection of indirect tax revenues like VAT.

It is hardly surprising then that direct taxes – personal and corporate income – provide only 8% of revenues, of which personal income tax brings in about two-thirds. This is less than half the regional average of 17.5% of revenues deriving from direct taxes. Indirect taxes – VAT, customs duties, excise taxes, and road fees - furnish about half of government revenues both in BiH and in the region, which is substantially higher than the EU average of 38%. Revenues from property taxes are generally low in the region, but BiH collects even below regional average, only 1% of total tax revenues. In FBiH property tax is paid only on weekend homes and the sale of property, while RS in 2012 introduced a single property tax of 0.05%–0.5% of market value.

[4] The statistical information in this section is drawn from the following: World Bank, *Bosnia and Herzegovina Public Expenditure and Financial Accountability Assessment (PEFA)*, Report No. 82646-BA, May, 2014; Bosnia and Herzegovina, IMF Country Report No. 15/298, October 28, 2015.

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What emerges from this is a highly regressive tax structure, resembling the period before the rise of modern welfare states with strong elements of fiscal redistribution to the poorest sections of society to correct market outcomes. In Bosnia, the richest members of society pay the same income tax as the poorest. Profits and property receive only token levies, which means that indirect taxation, which ultimately pays for the infrastructure and services on which business depends, is in effect a subsidy to business levied on the poorest members of society, who carry virtually the entire tax burden on their narrow shoulders. And when tax breaks and incentives are factored in it becomes rather difficult to explain – from the IFI point of view – why corporate income tax compliance is so low or why investment remains sluggish. From the point of view of public finance sustainability, the system of indirect taxation is too limited a base to maintain current expenditure, let alone to finance capital investments which, via the economic multiplier, can create jobs and increase revenues. A viable alternative needs to be based on a system of progressive taxation with upper levels of income tax at the upper end of West European averages.

The share of social security contributions in government revenues is over 40%, compared with a regional average of 31% and an EU average of 30.5%. The structure of contributions is different in the two entities: in the FBiH employers also contribute to employee social security. In FBiH employees pay 31% on gross wages: 17% for pension insurance, 12.5% for health insurance, 1.5% for unemployment insurance. In RS they contribute 33% on gross wages: 18,5% for pension insurance, 12% for health insurance, 1% for unemployment insurance, 1.5% for child protection, plus a special solidarity levy of 0.4% of net income on salary over 500 KM. In FBIH, the employer contributes 10.50% on the gross wage: 6% for pension insurance, 4% for health insurance, 0.50% for unemployment insurance. In RS no such contributions are paid.

The IFIs argue that the tax wedge – in particular the burden of social security contributions – is relatively high in both entities compared to elsewhere in the region and a strong disincentive for people to move from informal to formal employment. But this is no more than special pleading. What is being implied is that the tax burden on the salary of the employee is in fact a cost to the employer, that is taxes push up the wage costs. However, where social security contributions represent a deduction from gross salary they are paid by the employee and not the employer. It is the case that labor costs in the private sector are determined by market forces and, as everyone otherwise admits, are low and regionally competitive. With regard to employer contributions the corresponding figures are more than 20% in 10 European countries at different levels of development – Austria, Belgium, the Czech Republic, Estonia, Hungary, Italy, the Slovak Republic, Spain and Sweden. These countries are not associated with corporate non-compliance and with a flourishing grey economy.

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In fact, the weight of the tax burden falls on employees and not employers. Corporate income tax should be raised to at least the Eurozone average of 24% and employer social security contributions should similarly follow suit. This would be a step towards tax justice, that is shifting the burden of paying for social services from the low wage earners to those who can afford to pay. In the meantime, corporate income tax efficiency could be certainly be improved through the elimination of tax incentives and exemptions and the reform of tax administration to improve compliance. The FBiH government is preparing a new corporate income tax law, in co-operation with the IMF, which will reduce deductions and tax expenditures. While welcome this will not significantly broaden the tax base for reasons noted above.

The RS plans to review its corporate income tax law to foster consistency between the two entities. Because of the decentralized fiscal structure, the taxation of allowances is not harmonized across the two entities, and this is a barrier to the creation of a single market. Employees in BiH often receive tax-free meals, holiday, and transportation allowances as part of their remuneration. In the RS, these allowances are taxed as part of overall compensation. However, it does not follow, as the IMF claims, that untaxed benefits represent a substantial share of employee compensation and that this narrows the tax base. The narrowness of the tax base is due to the failure to implement a progressive taxation system and the over-taxation of employees.

Finally, the actual burden of social security spending needs to be examined because of its impact on both tax justice and public finance sustainability. The problem is not one of excessive social benefits, which are considerably lower in BiH than elsewhere in the region. The highly fragmented nature of the administration of welfare provision leads to substantial duplication and inefficiencies, increasing costs. For example, the numbers of medical staff and hospital beds in BiH remain low in regional comparison, while the number of non-medical staff working in health care is at the high end. Furthermore, spending on war veterans' swallows up non-contributory social assistance, representing in effect a guaranteed income denied to the unemployed or other social categories at risk. As a result, the poorest 20% of the population receive only 36.8% of the total social assistance budget, while the richest quintile receives a disproportionately high share of social assistance benefits (17%). Hence the problem is not social spending as such but maladministration, corruption and once again a distribution of resources skewed towards the wealthy.

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PUBLIC-PRIVATE PARTNERSHIP

There are different names for Public-Private Partnerships (PPP) in use resulting from different legal frameworks of public – private projects and from the fact that this term is not uniquely treated in different legal sources of the EU.

Public-Private Partnership is a model of long-term contractual relations between the public and the private sector; it can relate to the provision of financing, project design, construction, management and/or maintenance of infrastructure and/or service provision on behalf of the private sector, traditionally purchased and provided by the public sector.[5]

The basic idea of Public-Private Partnership is to link, whenever possible, the risk sharing between the public and the private sector on the one hand with a higher efficiency in project implementation, to be provided by the private sector, on the other hand.

According to Draft Law on Public Private Partnership, PPP is partnership between public and private sector set by the agreement for realization of the PPP projects.[6]

The political administrative environment in Bosnia and Herzegovina is such that in B&H there is no unified Law on Public Private Partnership. While one entity, Republic of Srpska, has adopted Law on PPP, the other entity, Federation of B&H, has been in adoption process for several years and there is only Draft Law on Public Private Partnership.

Legal regulations related to PPP in B&H include:

- Entity and cantonal laws which regulate the work of local government, utility, management of construction and agricultural land and other legal regulations and bylaws;
- Laws on Concessions (B&H, entity and cantonal);
- Law on Obligations (entity laws);
- Law on Public Private Partnership;[7]

[5] Public Private Partnership as an instrument for improvement of public services at local level, SNV Netherlands Development Organization, Center for Management, Development and Planning, November 2009.
[6] Draft Law on Public Private Partnership of FB&H
[7] Law on Public Private Partnership of RS: published in „Official Gazette RS“, number 59/09., Law on Public Private Partnership of FB&His in adoption procedure

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- Law on Public Procurement4.[8]

According to the legal framework which applies to PPP in B&H, subject of PPP can be the construction, use, maintenance and management or reconstruction of property in order to satisfy public needs in the following areas: municipal infrastructure; health infrastructure; educational, cultural and sports infrastructure; transportation (highways, main roads, railways, waterways, ports, airports ....); use of water and other water bodies; energy (hydro-reservoirs, use of energy and mineral resources, oil and natural gas); use of medicinal thermal and mineral water; communication in other areas where the public interest can be recognized.

In B&H, the award procedure is regulated by: the Law on Concessions, Law on Public Procurement, the Law on Public Private Partnership of RS, and the proposed Law on Public Private Partnerships of FB&H.

The process of approving proposals of PPP projects is carried out by public authorities. Keeping a register of PPP contracts and supervision of the implementation of the PPP contract is carried out by the Commission for Concessions of the Federation of Bosnia and Herzegovina for projects within the competence of the Federation of Bosnia and Herzegovina and Commission for Concession of cantons for projects within the competence of the Canton, city or municipality.[9]

The legal framework sets the basic principles in the realization of this economic legal model.

The concession model is a frequently applied contractual form of PPP which is in B&H regulated by appropriate legal framework. It is characterized by direct link between the private partner and the beneficiary. The private partner provides a service to the user instead of the public partner but under its supervision. The main characteristic of the system of concessions is that a very large number of concession contracts and public-private partnership is assigned via unsolicited offer, with no sufficiently open, transparent and competitive procedures.[10]

An example of institutional PPPs in B&H is Gasification and Distance Heating System in Bijeljina Municipality.

[8]"Official Gazette B&H'', number 49/04
[9]Draft Law on Public Private Partnership of FB&H
[10]Concessions and public private partnerships in B&H

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The experience in PPP in B&H as well as in neighboring countries is not much, but modest experiences show that this model in some cases was approached without detailed analysis of effects of entering into this arrangement, of course at the expense of the public sector. E.g., by the PPP model, sports halls were built in B&H whose annual rental which is paid by local community exceeds the revenues generated by the provision of services.[11] Until now, whenever was discussed about the PPP on local level (whether on thematically organized seminars, conferences, workshops or interviewing mayors and experts), for the lack of practical experiences in the use of PPP in realization of projects of local development, the problem of legal framework was emphasized.

[11]Public Private Partnership as an instrument for improvement of public services at local level, SNV Netherlands Development Organization, Center for Management, Development and Planning, November 2009.

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PUBLIC INFRASTRUCTURE

The managing of public infrastructure is a burning issue of all local communities in Bosnia and Herzegovina. The Law on public utilities regulates the work of public utilities in satisfactory manner in the terms of interest of local governments. The problem is, however, that other laws do not comply with provisions of this law which in practice often cause overlaps of jurisdictions or lack of understanding by relevant local and higher authorities. With privatization of public utilities, local communities have lost their influence on the quality of provision of these types of services to the citizens.

Besides, many communal infrastructure objects are built from the self-contribution of local citizens, but they are not owned by local governments. A common view of all local communities is that objects which are built from the self-contribution, as well as communal infrastructure, whose founders are local communities or they are specific to local communities, should be returned to local communities because only they have interest and obligation to ensure their well-functioning.[12]

When local community is faced with the lack of available budget funds, the partnership between public and private sector and involvement of private investors could contribute to realization of infrastructure projects and building objects of public interest. Construction of roads, hydro power plants, hospitals, schools, landfills, police and fire stations, important projects in the system of country defense are just some of the areas in which this concept could be applied. Investments in renewable energy sources, such as mini hydro power plants, infrastructure communal projects and waste water treatment plants are just some of the models in which partnership between public and private sector could come alive.

The project financing as a form of financing public needs by merging public and private sector seems as attractive form of funding because it compensates the lack of public (budget) funds needed to cover costs of financing infrastructure projects. However, preparation and realization of projects which use the PPP models is very complex, long and expensive. Moreover, the increased cost of provision can actually lead to a transfer of resources from the public to the private sector. Also, PPP is not a suitable solution for projects in which there are rapid technological and other changes, because of which is very difficult with sufficient certainty to determine standards of service delivery and also to provide sufficient contractual flexibility needed for adaptation to such rapid changes, and at the same time to predict and pre-arrange the possible costs of such adjustments.

[12]Creation and introduction of the model of disposition and ownership of local resources, The Institute of Economics Banja Luka, November, 2007.

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An additional problem and the risk of PPP projects is the pursuit of higher profits which may lead to increasing prices and reducing the quality of public services.

Posusje Municipality entrusted their communal activity of collecting and transporting the waste to the private utility company „Ladanusic cistoca“ Ltd Posusje by concession contract. After successful removal of illegal dumps and improvement of communal services in this municipality, the Public-Private Partnership between Municipality and private utility company „Ladanusic cistoca“ was established with aim of establishing and building recycling yard and recycling centre on „Storm“.

Bijeljina Municipality used its geostrategic position in the region that in a qualitative way solved the heating system in this municipality. They now have two projects: Distance heating for Bijeljina City with the use of geothermal energy and Gasification of Bijeljina Municipality for whose realization Municipality conceded utility work to private partner. Private partner is a company founded by Municipality and a company from private sector.

Gracanica Municipality is trying to solve their problem with heating and air pollution through the Public-Private Partnership. The private partner founded a company „Eko-toplane“ Ltd Gracanica which uses renewable energy sources (biomass) as raw mass. The municipality conceded this utility work to private partner.[13]

[13] Public Private Partnership as an instrument for improvement of public services at local level, SNV Netherlands Development Organization, Center for Management, Development and Planning, November 2009.

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CONCLUSIONS AND RECOMMENDATIONS

Macroeconomic policy, based on the currency board system of fixed exchange rates, has not been so much an anchor for monetary stability as for a model of unsustainable growth based on foreign currency denominated lending by foreign banks to households and the private sector. With its collapse in the crisis of 2008, no new engine of growth has emerged. This failure is inseparable from the institutional limitations on monetary policy, which can neither influence the supply of credit (money), nor the competitiveness of exports, nor government borrowing. Any sustainable model of public finances depends in the first instance on retaking monetary sovereignty; that is, a central bank whose central objectives include not only price stability, but as in the US, employment and growth.

There is little evidence to support the argument that the public finance crisis is due to a lack of fiscal discipline and excessive government spending. In the period before 2008, the government ran a budget surplus. With the credit crunch and deleveraging, tax receipts declined and budgets went into permanent deficit. We conclude that the problem is not excessive public spending as such. Hence, we question whether the IMF structural adjustment programmes – privatisation of the public sector, consolidation of public spending, combined with business-friendly labor market, taxation and administrative reform – can do anything more than consolidate the current spending of the government sector.

Therefore, we do not share the risk assessment of the IFIs with regard to external and sovereign debt. Given the structural trade deficit, the economy remains dependent on foreign borrowing to finance current consumption and expenditure as well as existing debt. It is thus extremely vulnerable to external downside risks. IFI conditionality may actually increase risk: the downsizing of the public sector reduces spending and in turn government revenues, without necessarily replacing them with public or private investment, and thus short-term debt is repaid without checking longer-term rising public debt. Long term public finance sustainability depends on the creation of an alternative model of economic growth which recognizes the economic significance and potential of the public sector – in terms of the economic multiplier – and thus promotes sustainable public finance.

With the failure to replace foreign credit with an alternative model of growth, there has been a shift on the part of public institutions to foreign borrowing, whether from the IFIs or commercial banks, to meet revenue shortfalls or finance capital investment, public sector debt and infrastructure projects. From the point of view of public finance sustainability, the increasing dependence on more expensive commercial credit increases sovereign debt risks. We note that there has been the beginning of a trend towards borrowing from domestic capital markets. While it is preferable that governments develop liquid domestic capital markets for sovereign debt, this is not in itself a solution to the problem of structural barriers to public finance sustainability: like the trade deficit, the regressive tax system, lack of independent monetary policy, and lack of public sector investment.

From the point of view of public finance sustainability, the system of indirect taxation is too limited a base to maintain current expenditure, let alone to finance capital investments in order to create jobs and increase revenues. In order to create a viable tax base, we recommend a system of progressive taxation with upper levels of income tax at the upper end of West European averages. Corporate income tax should be raised to at least the Eurozone average of 24% and employer social security contributions on behalf of employees should similarly be raised to at least 20%. A progressive tax system would also promote tax justice, shifting the burden of paying for government expenditures and social services from the low wage earners to those who can afford to pay.

With regard to the regulation of public infrastructure, the decentralized political structure is responsible for overlaps of jurisdictions or lack of understanding by relevant local and higher authorities. This challenging legal environment has so far been inhospitable to PPPs. We raise various concerns derived from the international experience of PPP. The preparation and realization of PPP projects is very complex, long and expensive. PPP is not a suitable solution for projects in areas of rapid technological change, making it difficult to determine standards of service delivery, provide contractual flexibility and predict costs. PPP projects may lead to increasing prices and reduce the quality of public services, at a higher cost to the public sector than the original public provision. The actual experience of PPPs in Bosnia and Herzegovina raises concerns that procedures regulating PPP projects are not sufficiently open, transparent, and accountable to stakeholders. The experience of privatization has not seen any technology transfer or been associated with improved or competitively priced services: notwithstanding privatization, the public continues to look to different levels of government to deliver services.

Finally, we recognize that the governance structure represents a specific problem, in terms of unnecessary administrative costs, spending to achieve political party ends, as well as a complete lack of transparency, accountability and even minimal regulatory competence. We conclude that that public finance sustainability is inconceivable without a wider reform of governance, and in particular with an increased capacity on the part of CSOs to advocate for sustainable public finance.

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