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Fiscal Accountability in Bosnia and Herzegovina

Is the Fiscal Council the Magic Solution?

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Abstract

Bosnia and Herzegovina does not have coherent countrywide fiscal policy rules nor an institution responsible for setting and monitoring overall fiscal target. Thus, the central issue of this policy paper is past, presence and future of effective intergovernmental fiscal arrangements in Bosnia and Herzegovina among different levels of government. The question arises as to what would be the best, or second best way to institutionalize fiscal policy in order to sustain stability and advance economic growth.

Drawing on large international experience, the study presents a range of fiscal policy objectives, rules and their interactions. It examines rationales for using fiscal rules and reasons for having an institution with the overall fiscal responsibility, all from the fiscal federalism point of view. This essentially entails choosing institution versus rules, or the mixture of the two, exploring where the ultimate fiscal and macroeconomic responsibility should be, and addressing pros and cons of BiH Fiscal Council, all bounded by present Constitutional setting. To answer on these questions, BiH fiscal specificities are evaluated over theoretical and practical experiences of some countries. Four options are explained against this background: status quo, intergovernmental coordinating body (such as the Fiscal Council), State level institution (i.e. Ministry of Finance and Treasury) and a provision embodied in the Constitution.

The study finds that at this stage of BiH development it is crucial to introduce an intergovernmental coordinating body – the Fiscal Council – preferably strengthened by a statutory commitment to at least two numerical rules; balanced budget and limits to debt. Although some simplier solutions might have been more effective, political reality is telling us that entities are not ready to renounce their fiscal sovereignty. Introducing such numerical rules is vital to the existence of the fiscal structure of the country. Over the last year, new debt laws have been prepared, according to which municipalities were provided with an access to borrowing, and in that manner adding to excessive fiscal pressure, that BiH is already facing with and alarming for the urgency in having some central level control over the fiscal stance. Without this institution, BiH fiscal policy would be condemned to limited *ad hoc* maneuvering and increasingly endangered of falling behind other transition economies.

If Bosnia and Herzegovina wants to manage its future, it must manage its fiscal policy!

Table of Contents

Abstract .... **i**

Table of Contents .... **iii**

List of Acronyms .... **iv**

I How the idea came about? **1**

II The Existing Coordination Mechanisms **5**

2.1. The reality of BiH fiscal coordination 5
2.2. Influence of the International Organizations 7
2.3. Transfer to BiH Ownership 7
2.4. First attempt in setting up the Fiscal Council 8
2.5. …and the first failure 9

III International experience and application in Bosnia and Herzegovina **11**

3.1. Fiscal Objectives 12
3.1.1. Long-term fiscal sustainability 12
3.1.2. Short-term economic stability 13
3.1.3. Aggregate efficiency 13
3.1.4. Allocative efficiency 13
3.2. Fiscal Rules 14
3.2.1. Budget balance requirements 14
3.2.2. Borrowing constraints 14
3.2.3. Revenue-Raising Assignments 16
3.2.4. Expenditure Assignments and Management 17
3.2.5. Administrative Aspect and Expenditure Management 17
3.2.6. Process Rules and Enforcement Mechanisms 19
3.3. Rules, Objectives and BiH Reality 20

IV Is there a future for the BiH Fiscal Council? **22**

4.1. Rule embodied in Constitution 23
4.2. State Ministry of Finance and Treasury 24
4.3. Fiscal Council 25
4.4. Status Quo 26

V Conclusions **28**

VI Appendix **32**

VII Bibliography **37**

List of Acronyms

BD	Brcko District of Bosnia and Herzegovina
BiH	Bosnia and Herzegovina
CoM	Council of Ministers of Bosnia and Herzegovina
FBiH	Federation of Bosnia and Herzegovina
FC	Fiscal Council
GDP	Gross Domestic Product
IFI	International Financial Institutions
IMF	International Monetary Fund
MT	Maastricht Treaty
MoF	Ministry of Finance
MoFT	Ministry of Finance and Treasury
OHR	Office of the High Representative
PM	Prime Minister
RS	Republika Srpska
SGP	Stability and Growth Pact
WB	World Bank

How the idea came about?

1

Overall fiscal responsibility by BiH institutions is missing…

Bosnia and Herzegovina (hereafter BiH) does not have a lead institution responsible for the overall fiscal policy nor binding fiscal rules. Considering that the other macroeconomic policy tool, monetary policy, is constrained by the Currency Board arrangement, the problem becomes even more acute.

On the other hand, it has as many Ministries of Finance as different tiers of government. Under its Dayton Constitution, Bosnia and Herzegovina has 14 autonomous and highly interdependent Ministries of Finance (one in each of the State, Federation of BiH, Republika Srpska, Brcko District, and the 10 Cantons) as well as some 140 municipalities, a plethora of independent extrabudgetary funds at most levels of government, and large "off budget" fiscal operations—notably donor funded projects.

…and the coordination has been done under patronage of the international organizations.

Until recently, fiscal coordination between all these actors was in the hands of international community, most notably Office of the High Representative and the International Monetary Fund. This basically meant that policies available to steer the economy of Bosnia and

Herzegovina, were not exploited by local policy makers, and thus the economy was floating without any BiH institution in the driving seat.

However, there is a light at the end of the tunnel

In order to address this lack of fiscal coordination, BiH has pledged to an institutional reform – establishment of a Fiscal Council whose primarily responsibility would be to set overall fiscal target as a way of responding to raising challenges of long-term sustainability and development.

In May 2005, the Chairman of the BiH Council of Ministers and two Entity Prime Ministers officially signed Agreement on Establishment of the FC Council. In line with the Agreement, the main responsibilities included deciding on the overall consolidated budget target of the country, including its distribution between the State and Entities, defining levels of international and domestic borrowing and cooperation with IFIs. Furthermore, it was also agreed to initiate drafting of the Law on Fiscal Council of Bosnia and Herzegovina.

…or it seemed for a second…

However, this form of Fiscal Council failed to meet its purpose. Agreed fiscal target for 2006 was not honored, 2007 target was never even discussed and the agreed draft Law is still missing. These side slips indicated the fragility of the Agreement and necessity to address the Fiscal Council and generally the issue of fiscal coordination with more thoughtfulness.

…and a million dollars question is what to do next…

The question arises as to whether the Council is really what the country needs, and if so, how the current approach that is failing to deliver results could be improved. This ongoing institutional reform towards Fiscal Council introduction will be assessed against underlining principles of fiscal federalism, decentralization and policy coordination developed in theory and practice for a number of countries. The study examines different fiscal policy rules and objectives, as well as the interaction between the two. Furthermore, since institutions play an important role in fiscal federalism in shaping the interactions between governments, special attention will be devoted to the proposed manner of FC functioning.

…and how?

Many countries have adopted institutional mechanisms to facilitate fiscal coordination among different levels of government. This paper is an attempt to identify useful lessons for Bosnia and Herzegovina, in its efforts to establish an efficient institutional setup for fiscal coordination.

The study begins in Chapter 1 with an overview of the existing rudiments of fiscal policy coordination in Bosnia and Herzegovina; both from the BiH perspective and briefly from the role of international community. This is followed by a review in Chapter 2 of how the Fiscal Council was tried to be set up and concluded that in reality it is not functioning. This paves a way for the section 3 which articulates a set of characteristics that should underpin the design of fiscal policies. It further examines to which extent choice of rules is conditioned by objectives and institutional arrangements. The fourth section looks at different trade-offs and side effects, depending on the policy option used to address lack of fiscal coordination. Finally in section 5 main arguments are wrapped up and some concluding remarks follow.

At the end, it should also be noted that due to October 2006 elections, it still remains to be seen whether the incoming governments would strive to achieve greater fiscal coordination. If so, it is believed that some of the previously unaddressed issues related to creation of a fiscal coordinating body or a mechanism, are presented in the study, and could serve to policymakers. If not, it is hoped that this study would contribute to actualizing the importance of coordinated fiscal policy once more.

The Existing Coordination Mechanisms

2

2.1. The reality of BiH fiscal coordination

Bosnia and Herzegovina (hereafter BiH) does not have an institution responsible for the overall fiscal policy nor binding fiscal rules. This is crucial issue since BiH policy makers are mostly dependent on using fiscal policy instruments when steering the BiH economy. Normally, the policymakers would have a choice between using the monetary or fiscal policy instruments, or some policy mix between the two. However, the existing monetary policy operates under the Currency Board arrangement[1] and use of fiscal policy is all BiH is left with in attaining the desired results.

Maximization of social welfare function is assumed to be the traditional objective function (Blanchard and Fischer, 1998). However, political and institutional realities play an important role in designing the actual policy and attention is shifted to macro welfare function. This function is defined over certain macroeconomic variables; such as output, unemployment, inflation, current account. Hence, reaching the objective function assigned to policymakers relies mostly on expansionary or contractionary fiscal policy[2] specifically because, under the current

[1] According to Dayton Peace Accords, the Central Bank of Bosnia and Herzegovina maintains monetary stability by issuing domestic currency according to the Currency Board arrangement with full coverage in freely convertible foreign exchange funds under fixed exchange rate 1 KM: 0,51129 EURO. In reality this means that when the currency is pegged, fiscal policy becomes more important. For more information about this issue see International Monetary Fund Country Report No. 06/368, October 2006.

[2] Policies enacted by the government to increase (expansionary) or reduce (contractionary) output. Examples of contractionary policy include raising taxes and decreasing government spending,

legal setting, the government cannot significantly influence the exchange and interest rate by directly altering the money supply. More to the point, fiscal coordination is connected with a set of formal or informal procedures, practices and/or rules steering fiscal policy decisions of various levels of government aimed at securing overall fiscal sustainability and macroeconomic stability, while intergovernmental fiscal relations are more concerned with efficiency[3].

However, a success in reaching macroeconomic objectives is subject to the coverage of government's decisions. In this case, it means that if the overall macroeconomic policy action is not translated into national and sub-national governments' fiscal behavior, the desired outcome will not come to reality. Or more specifically, there has to be a mechanism or institution(s) carrying out and monitoring that the targeted overall, consolidated fiscal budget balance is actually implemented, similar to the role of the Central Bank on the monetary side.

Nevertheless, such institution was not created nor automatic mechanisms were embedded in the Dayton Constitution. Bosnia and Herzegovina was organized as a multilayer country with 14 autonomous and highly interdependent Ministries of Finance belonging to the State, Federation of BiH, Republika Srpska, Brcko District and 10 Cantons, as well as some 140 municipalities, a number of independent extrabudgetary funds at most levels of government, and large "off budget" fiscal operations. In practice, this meant a number of budgets were passed without direct control over the general fiscal performance.

To sum, there must be someone or something thinking more strategically how the country can sustain its economic stability, achieve growth and shift this *ad hoc* floating to more progressive action.

[3] International Monetary Fund Country Report No. 06/368, October 2006.

2.2. Influence of the International Organizations

Some degree of fiscal coordination among these different layers of government was, until recently, achieved through the direct involvement of the Office of the High Representative (OHR) and the International Monetary Fund. The OHR's so-called 'Bonn powers' were used to influence the fiscal policy, and it was virtually the case that the governments were simply adhering to imposed fiscal targets. The IMF also provided significant guidance, both in its advisory role and through two Fund supported programs between 1998 and 2004.

However, it was obvious that such situation could not be a long-term strategy BiH should rely on. The international community has been playing an increasingly less interventionist role and transfer to local ownership has been strongly advocated[4]. Hence, more permanent solution was actively sought.

2.3. Transfer to BiH Ownership

So, in order to address the lack of fiscal coordination, BiH has pledged to an institutional reform – establishment of a Fiscal Council (hereafter: FC, also referred to as the National Fiscal Council). This reform speaks of a need for institutionalizing the fiscal problem and addressing this *circulus viciosus* of a choice between rules and discretion (Eichengreen, Hausmann, Von Hagen, 1999).

The establishment of the Fiscal Council has been recommended by the International Monetary Fund[5], OHR, the World Bank, European Commission and other international organizations represented in the country. This recommendation has also embodied different

[4] Ibid.
[5] See: http://www.imf.org/external/np/sec/pn/2005/pn0576.htm, June 2005

strategic documents negotiated and/or signed with BiH[6]. In addition, one of the economic requirements in the Council Decision on the Principles, Priorities and Conditions Contained in the European Partnership with BiH[7], is to adopt the Law on the National Fiscal Council and establish procedures for its efficient functioning.

The proposal to set up a Fiscal Council is not unique for Bosnia and Herzegovina. There is a significant literature addressing this fiscal phenomenon, that BiH can draw experience from. Even the Stability and Growth Pact and the Maastricht Treaty could be seen as the institutional arrangements for the monitoring of fiscal policy among the member states of the European Union. However, this idea was pushed by the international community; real local ownership has been questionable, and the actions of the new government have to be closely observed.

2.4. First attempt in setting up the Fiscal Council

As a reaction to the initiatives advocated by the international community, BiH Council of Ministers Chairman (hereafter CoM Chairman) and two Entity Prime Ministers officially signed Agreement on Establishment of the Fiscal Council in May 2005. In line with the Agreement, the FC was composed of members and observers with and without voting powers. The FC was composed of the following Members:

1. Chairman of the Council of Ministers,
2. Prime Minister of the Federation of BiH,
3. Prime Minister of the Republika Srpska,
4. Minister of Finance and Treasury of BiH,

[6] For more see Action Plan of BiH Medium Term Development Strategy; http://www.eppu.ba/pdf/TABLE_REPORT_ON_IMPLEMENTATION_OF_ACTION_PLAN_OF_BiH_MTDS_FOR_PERIOD_AUGUST_2003_-_MARCH_2005.pdf

[7] For details see Council's Decision from November 2005: http://europa.eu.int/comm/enlargement/report_2005/pdf/com_555_final_ba_partnership/com_555_final_en_ba_partnership.pdf .

5. Minister of Finance of FBiH,
6. Minister of Finance of RS.

Brcko District Mayor and Central Bank Governor were invited as observers with the right to participate in discussions and proposals, but without any voting powers.

The scope of work was set up to include responsibility over the BiH fiscal policy, primarily deciding on the targeted level of the overall consolidated budget of the country, including its distribution between State and Entities, defining levels of international and domestic borrowing and cooperation with IFIs. Furthermore, it was also agreed to initiate drafting of the Law on Fiscal Council of Bosnia and Herzegovina.

2.5. …and the first failure

However, this form of Fiscal Council failed to meet its purpose. The Agreement was questioned as soon as the Council failed the main test put in front of it: the primary surplus[8] of 1.5 percent of GDP for 2006 negotiated between BiH authorities and the IMF as a part of the Stand-by negotiations was not implemented accordingly. Between the time of setting these primary fiscal targets and adoption of the budgets, the RS Government was changed and the new one did not recognize the primary balance agreement reached at the FC.

Considering that the May 2005 Agreement on setting up the FC was not ratified by the respective Governments and Parliaments, the new RS Government was not obliged to implement the negotiated fiscal target positions. It adopted a significantly higher budget for the current year that would, if increased by the same proportion for the FBIH, reduce the primary balance by 1 percent of GDP. Hence, the fiscal target for 2006 agreed by the FC was not honored, and it was

[8] IMF definition of primary balance: Revenues minus Expenditures (excluding interest payments).

argued that the failure was due to lack of enforcement mechanisms in place to implement the Council's decisions.

It was obvious that the Council did not have any legislative or executive power, and decisions made by the Council were not binding on any level of the government. Hence, the issue of Fiscal Council Law was raised again. It was reminded that, by signing the Agreement on FC, the Chairman and Prime Ministers took over the responsibility to enact the appropriate legislation. At this stage, it also seemed that the new RS government was on board for passing the appropriate legislation. However, drafting of the FC Law has not yielded desired results.

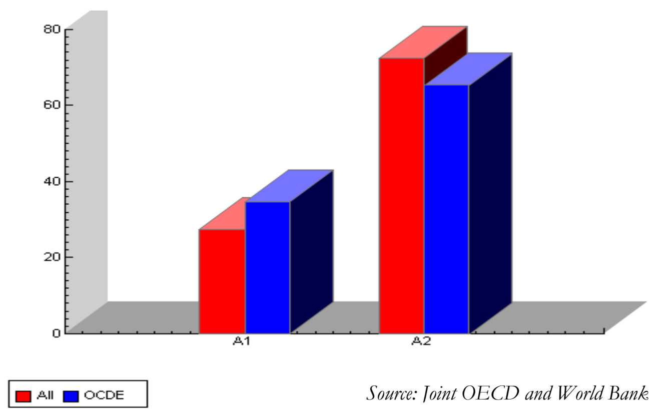
Furthermore, meetings of the Council were almost exclusively taking place at the request or during the IMF missions. This signaled that the real desire of the BiH politicians for creating fully functioning Fiscal Council was still questionable. More importantly, it was a signal that the real understanding of the issue and ownership of the problem was still questionable.

These side slips indicated the fragility of the Agreement and necessity to address the FC and generally the issue of fiscal coordination with more thoughtfulness. It became obvious that the work on FC setting up was not completed simply by signing the Agreement. The Agreement at the moment only exists on paper and the Council now looks more like an informal gathering of highly ranking politicians that have not met for several months rather than a powerful body tasked with major macroeconomic responsibilities. The question arises as to whether this is really what the country needs, and are there some international experiences BiH should exploit.

International experience and application in Bosnia and Herzegovina

The worldwide trend in decentralization has put different objectives and fiscal rules at the center of attention. Many countries have adopted institutional mechanisms to facilitate fiscal coordination among different levels of government. The evidence shows that almost two thirds of total of 60 countries included in joint OECD and World Bank questionnaire on budgeting practices[9] have some fiscal rules limiting the executive fiscal policy discretion (Figure 1 where A1 means "fiscal rules do not exist", and A2 "fiscal rules exist").

Figure 1 - Existence of fiscal rules



Source: Joint OECD and World Bank

Interview results conducted for this study also support this statement. All the main stakeholders in BiH agreed over two things: (1) BiH lacks rules that would enhance fiscal coordination and, (2) if BiH wants to run prudent fiscal policy it should create a coordinating institution tasked to set, implement and monitor the guiding rules. However, answers related to types of rules and its institutionalization varied.

One of the main driving factors of this whole exercise is the constitutional setting of a country. Constrained by this internal environment, and also external position, a country opts between achieving various fiscal objectives and applying different fiscal rules.

[9] For more information see http://ocde.dyndns.org/

3.1. Fiscal Objectives

Although maximization of the welfare function constitutes the essence of existence of fiscal rules, four interrelated objectives are extracted (Sutherland, Price, and Joumard, 2005):

3.1.1. Long-term fiscal sustainability

A large part of literature supports the view that decentralization and sharing of fiscal responsibilities makes macroeconomic management more difficult and costly (Tanzi, 1996), but it does not make it impossible. This is further complicated by the view that decentralization is actually reassignment of spending responsibilities without substantial increases in tax autonomy. Hence, local governments are more likely to increase borrowing, where borrowing is perceived as guaranteed by the central government. The result of this profligate fiscal behavior is demonstrated through moral hazard of central government bail-outs that was further reflected in rising borrowing, expenditures and tax rates.

Countries that have experienced fiscal crisis where more eager to introduce fiscal rules to control local governments, in cases where borrowing autonomy was present. The second major reason for insisting on fiscal rules was a need for fiscal consolidation, especially in cases of European countries and their supra-national commitments to the Stability and Growth Pact[10] and Maastricht Treaty[11]. It must also be recognized that more decentralized a country is, it becomes

[10] Three main elements of SGP are political commitment to fully and timely implement budgetary surveillance process, preventive elements of monitoring the budget deficits and keeping it within the reference value of 3% of GDP, and dissuasive elements undertaken in cases of breach of the reference value entailing immediate corrective action and allowing imposition of sanctions. For more see: http://ec.europa.eu/economy_finance/about/activities/sgp/sgp_en.htm

[11] With the Treaty of Maastricht, the Community clearly went beyond its original economic objective, i.e. creation of a common market, and its political ambitions came to the fore. In this context, the Treaty of Maastricht responds to five key goals: strengthen the democratic legitimacy of the institutions, improve the effectiveness of the institutions, establish economic and monetary union, develop the Community social dimension and establish a common foreign and security policy. For more see: http://europa.eu/scadplus/treaties/maastricht_en.htm

more difficult for the central government to maintain macroeconomic stability through fiscal policy. Hence in these cases hard budget constrain is advocated as well as *ex ante* fiscal balance.

3.1.2. Short-term economic stability

The policy actions used to achieve and maintain long-term sustainability can also go hand in hand with the economic stability. However, there are also exceptions that can even trigger destabilization such as pro-cyclical fiscal policy12 at the local level.

3.1.3. Aggregate efficiency

This is specifically related with the size of the public sector. If the sub-central government has jurisdiction over tax policy, it could simply increase the tax burden as a way to finance inefficiently large local government, rather than to make an attempt to increase efficiency.

3.1.4. Allocative efficiency

Use of well defined fiscal rules related to borrowing constraints, or even performance targets, can help local governments to respond to demands in more appropriate way. This is especially interesting in absence of market mechanisms, where fiscal rules could be less bureaucratic than getting a prior approval of the central government. However, this allocative efficiency may not always be achieved.

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12 Pro-cyclical fiscal policies are policies that are expansionary in booms and contractionary in recessions. Pro-cyclical fiscal policy involves higher (lower) government spending and lower (higher) tax rates in good (bad) times, and a countercyclical fiscal policy involves lower (higher) government spending and higher (lower) tax rates in good (bad) times (Kaminsky, Reinhart, and Végh, 2004).They are generally regarded as potentially damaging for welfare: they raise macroeconomic volatility, depress investment in real and human capital, hamper growth, and harm the poor. More generally fiscal policy is procyclical if the primary balance-to-GDP ratio with respect to the output gap is strictly negative, so that the primary balance falls more than output in booms, and rises more than output in recessions. For more see Manasse, P., Procyclical Fiscal Policy, IMF Working Paper, January 2006.

3.2. Fiscal Rules

The underlining pattern observed in various country specific studies is that the choice of fiscal rules is conditioned by the type of institutional arrangements between different tiers of government. Furthermore, distinction between objective setting rules and implementation rules is quite important. Hence, different types of fiscal rules were devised in order to meet country specific settings and broad objectives indicated above:

3.2.1. Budget balance requirements

This fiscal rule is often set once a year, usually imposed by higher levels of government, and has limited coverage if only the current budget is targeted. A variety of country specific experiences is included in Table 1.

Table 1 - Budget Balance Requirement

A. Coverage and duration

	Current budget balance	Current budget balance and capital account	Current budget balance, capital account and off-budget items
Annual	Germany local	Canada state	Canada state
	Japan local	Czech Republic local	Poland local
	Netherlands local	Denmark local	
	Italy state	France local	
	France local	Germany state	
	New Zealand local	Korea local	
	Sweden local	Portugal local	
	Switzerland local	Turkey local	
Multi-annual	Canada local	Canada local	Austria state
	Finland local	Spain local	Spain state
	Norway local		

Source: Joint OECD and World Bank Questionnaire

3.2.2. Borrowing constraints

The control of sub-national borrowing shows a considerable diversity in approaches. It depends, among other issues, on constitutional status of sub-national government, degree of political and administrative controls and tradition of fiscal discipline. Constrains are usually imposed by the higher levels of government and vary from full prohibition of any types of borrowing to no constrains, the latter fully relying on market discipline (Table2).

Table 2 - Borrowing constraints / Access conditions

	Prohibited	Prior approval is required	Restricted to certain purposes	No restriction on access to borrowing
Imposed	Denmark local Korea local (current)	Canada local Japan (capital) Korea (capital) Spain local (capital) Turkey local *Greece local* *Ireland local* *Luxembourg local* *Mexico local* *United Kingdom local*	Germany local Norway local Spain local (capital) Portugal local *Canada local* *France local* *Hungary local* *Italy state and local* *Slovak Republic*	Canada state Czech Republic local France local Netherlands local* Japan local (current) Poland local
Negotiated binding	Spain region (current)	Spain region (capital)		
Self imposed			*Switzerland state*	Canada state

Source: Joint OECD and World Bank Questionnaire

The grey area in between of these extreme cases varies from:

- rules based constrains – meaning numerical constrains (i.e. no borrowing allowed if debt to GDP ratio exceeds 60% or limits on the rate of new debt creation) and currency constrains (for example, in the Netherlands, local governments can only borrow in euros),
- administrative controls - prior approval on project-by-project basis and written permission by a higher level of government, and
- cooperation by different levels of government in designing and implementing debt controls - where the “golden rule” of public finance is strongly advocated, meaning that the restriction on borrowing is limited to financing investment programmes[13].

Furthermore, sub-national governments could use local enterprises and banks as additional channels for borrowing. Hence, in reality, each of the models has pros and cons and more importantly it should be tailored to meet the country specific needs.

[13] Rule states that over the economic cycle, the Government will borrow only to invest and not to fund current spending. The justification for the Rule derives from macroeconomic theory. Other things being equal, an increase in government borrowing raises the real interest rate consequently crowding out (reducing) investment because a higher rate of return is required for investment to be profitable. Unless the government uses the borrowed funds to invest in projects with a similar rate of return to private investment, capital accumulation falls, with negative consequences upon economic growth. The Government's other fiscal rule is the Sustainable Investment Rule, which requires it to keep debt at a "prudent level". See Fitoussi and Creel, 2002; Blanchard and Giavazzi, 2003.

Both, budget balance requirement and borrowing constraints essentially try to control stock and flow of debt. It is suggested in the literature that the more difficult the budget balance requirement is to override, it is less likely for the country to run higher deficits. Similarly, tighter borrowing conditions are associated with lower levels of debt (i.e. embodied in the Constitution). These two policies are usually used to ensure the long-term sustainability of fiscal policy.

3.2.3. Revenue-Raising Assignments

There is significant literature covering this issue, but presenting fairly different options. From the macroeconomic point of view, there are strong arguments that most of the taxing powers should not be at local levels with bottom to top approach in revenue sharing, especially in cases where sharing arrangements should be frequently negotiated. It is argued that the upward sharing arrangement is viable only in countries with long tradition of close policy coordination (Ter-Minassian, 1997).

It is also indicated that the other extreme case in which the central government has all the taxing powers is as undesirable as the previous one. Sub-central governments with more tax autonomy tend to run smaller deficits if there is a degree of tax competition keeping taxes low. Preferred and quite commonly used worldwide alternative is to have own source of revenues assigned to each level of government combined with various intergovernmental transfers to bridge the gap between revenue and expenditure assignments[14].

[14] Usually central government takes responsibility over more mobile taxes such as taxes on foreign trade, less mobile taxes like personal income tax is at the lower level, while multistage taxes, i.e. VAT usually accompany difficulties if levied at the sub-national level. However, central government may also choose to apply a minimum tax rate in order to prevent tax-base erosion.

3.2.4. Expenditure Assignments and Management

Narrowing a gap between final beneficiaries and expenditure assignments is seen as the best way to achieve the efficiency in allocation of resources. This argument is widely used in the literature to advocate decentralization of public expenditures to lower levels of government. However, this might have significant effects on the overall macroeconomic performance and the central government should retain the responsibility over the expenditures that could largely influence demand side. Furthermore, efficiency gains may be lost due to inadequate institutional setting, lack of transparency and accountability at the lower levels of government. In addition, it might be difficult for the central government to resist bailing out of local governments which calls for adoption of a fiscal rule.

3.2.5. Administrative Aspect and Expenditure Management

Administrative aspects are increasingly getting more attention and pose new challenges especially in addressing the efficiency of the whole system. Generally, centralized administration would increase consistency and would permit economies of scale. Decentralized administration would entail greater responsibility and flexibility. However, this also depends on the type of tax that is collected.

Expenditure management is the crucial element in achieving desired macroeconomic objectives. Especially in federal states, one of the ways how this could be implemented and monitored is by creating an institution, such as Financial Planning Council in Germany, or similar institutions in other countries.

BOX 1 - Fiscal rules in Switzerland

Switzerland is a highly decentralized federal country, where the cantons are autonomous in all the spheres of competences where the confederation is not authorized by the constitution. This constrains the ability of central government to impose fiscal rules on sub-central governments (and as a result the confederation can face difficulties in conducting counter-cyclical fiscal policy). The confederation changed the constitution in 2001 to the effect that the budget is balanced over the cycle, but this “debt brake” does not apply to the cantons.

There is considerable variety in the cantons’ own fiscal rules and the rules they impose on their communes. For example, 13 cantons have their own “debt brakes” of various degrees of restrictiveness and requirements to hold referenda on expenditure vary across the cantons. The cantons determine budget balance objectives and debt service limits for the communes. In some cases, the cantons are responsible for deficits experienced at the communal level.

A number of studies have identified features that have helped restrain the growth in the size of government. These include most notably the institution of direct democracy (the requirement to hold referenda on expenditures that exceed certain thresholds). Tax competition between the cantons has helped maintain pressure on policymakers to keep rates low, particularly on the more mobile tax bases. As a result, the argument that sub-central government has a tendency, from political myopia, to tax inefficiently or excessively has not been an important motivation for fiscal rules in Switzerland. Other factors that lead to smaller government include the small size of the cabinet, bodies that oversee the finance commissions and, in some cantons, rules that debar bailouts of communes (Schaltegger and Feld, 2004; Schelker and Eichenberger, 2005; and Blankart and Klaiber, 2005). And a recent federal court ruling that a canton (Valais) did not have the obligation to bail out a delinquent commune (Leukerbad) has further strengthened the position of the cantons *vis-à-vis* the communes and enhanced the potential monitoring and sanctioning role financial markets can play.

Notwithstanding these aspects of the fiscal policymaking landscape, during the 1990s, the growth of sub-central government as a share of GDP increased and liabilities almost doubled in real terms. This occurred despite most cantons having adopted recommendations contained in the Conference of Cantonal Ministers of Finance’s *Handbook of Public Budgeting* to balance their budgets over the business cycle and to reduce debt over a 10-year period. The growing debt levels provoked over a third of cantons to introduce new limitations on the accumulation of debt. These “debt brakes” have proven to be successful at preventing deficits (Feld and Kirchgässner, 2004, 2005). Another source of pressure has been exposure to guarantees given to canton owned banks. The recent experience of a few cantons having to bail out publicly owned banks has led to a reassessment of these types of guarantees.

The problems of the 1990s emerged because the existing fiscal rules were ill adapted to cope either with cyclical variations in revenue or the secular upward pressures on spending (Bodmer, 2004). Direct democracy -- by voting on *new* spending -- is weak in addressing growing programme spending. Thus, as programme spending rose during the 1990s, both as a result of the economic downturn leading to larger social security spending and the consequences of population ageing, this has led to a severe squeeze on spending, which may be leading to allocative inefficiencies. Furthermore, the constraints of the rules have led some canton to shift expenditure off-budget and increasingly resort to non-tax revenue. This serves to reduce the transparency of budgetary reporting, which is already murky with respect to social security and health spending and only weakly constrained by a recommendation to use a common reporting standard. On the other hand, no investment insufficiency has arisen because debt brakes have usually differentiated between current expenses and investment.

The experience of Switzerland highlights the fact that certain institutional features, such as direct democracy and tax competition can help constrain the size of the public sector and obviate the need for tax rules. It also shows that appropriate borrowing and debt rules can enhance fiscal policy even where there is financial market oversight: cantons with stronger debt brakes have experienced a slower growth of expenditure than those with weaker brakes. Nevertheless, such rules need to be flexible with respect to cyclical shocks -- significant minorities of cantons now allow a correction with respect to the business cycle -- and forward looking if they are to deal effectively with spending pressures stemming from ageing and demand driven growth of entitlement spending.

From OECD Study on Sub-Central Government Fiscal Rules

3.2.6. Process Rules and Enforcement Mechanisms

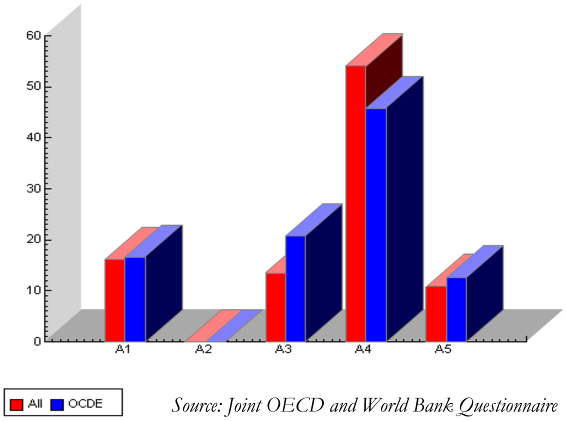
Process rules can help implementation of budgetary objectives and usually include transparency in production of financial account, especially at the sub-central levels of government. Furthermore, *ex ante* and *ex post* monitoring and control play an important role in observing adherence to the rules. *Ex ante* monitors that the underlining forecasting assumptions are aligned across the country, while *ex post* controls if the rules were observed. In most cases, monitoring involves reporting to higher levels of government. In some cases, controls are even associated with maintaining the credit rating or distributed publicly and subject to public opinion.

It must also be mentioned that fiscal rules are less needed if financial markets are effective in controlling fiscal imprudence. However, this is subject to no bail out approach by central government, development of financial markets (in the sense that they could survive governments' default) and timely and accurate information on the budgets outturn (without accounting gimmickry).

Sanctions are also used to complement the process of ensuring compliance to the rules and in absence of effective sanctions, breach in targets will simply result in target's revision. Although the literature argues that the severity of sanctions is important in establishing the credibility of the rule, there are mixed international experiences. Results obtained from the OECD/World Bank questionnaire show that close to 50% of the countries does not have some sort of sanctions in place[15].

[15], OECD Economic Studies No.41, 2005.

Figure 2 - Sanctions applied



Source: Joint OECD and World Bank Questionnaire

A1 : It is reflected in the pay of the heads of ministries/entities with responsibility for delivering the target.
A2 : It is reflected in the future career opportunities of the heads of ministries/entities with responsibility for delivering the target.
A3 : It is reflected in the size of the budget for the department or government organization/agency

A4 : There are no rewards or sanctions

A5 : Other, please specify

However, some sort of flexibility should also be embodied in the system so that a country can cope with unexpected economic shocks and deal with cyclical pressures. In most cases these escape clauses are activated during local economic shocks associated with natural or other disasters. During these times, "rainy day" and extrabudgetary funds are used.

3.3. Rules, Objectives and BiH Reality

During the window of opportunity for setting up the Fiscal Council, when most of the things were rushed trough, just to satisfy requirements for the new Stand-by Arrangement with the IMF and gain access to the World Bank funds, BiH politicians signed an Agreement on setting up the Council and initiated work on drafting the appropriate legislation. It was considered that the scope of work and fiscal objectives were agreed. The Agreement envisaged that the consolidated fiscal position of BiH would be negotiated at the FC level and than adopted through the normal parliamentary procedure. It was proposed that the Council would acknowledge the macroeconomic forecast done for the country, and approve medium term fiscal plan for a period of three years. The Council was also seen as an arena where the consolidated annual fiscal target, surplus or deficit, would be divided between the State and the Entities.

However, various key principles developed throughout this paragraph were not properly addressed.

The most controversial issues were representation, or more specifically, ethic representation in the FC, what the voting requirements would be and how the FC decisions would be presented to respective governments and parliaments, in order to ensure their implementation. Hence, the main discussions were on the membership, deadlock and enforcement mechanisms, rather than objectives and rules. Considering that it would be very difficult to make all decisions by consensus and the question would be if decisions would be made at all, a decision making and deadlock breaking mechanism acceptable to all stakeholders were not agreed upon. As for the enforcement mechanism, its importance should be seen in light of the changes in the government of one of the two BiH entities. As soon as the new government took the chair, the government adopted the budget that went above limits set by the FC. By doing so, the Pandora’s Box of inefficiency and accountability of the whole process was opened.

Reasons for this failure were also addressed during interviews held with major players involved in the process. The common responses were “lack of political will” and “too close to elections to do anything serious”. However, it was also hinted that the whole preparation process was simply rushed through without serious considerations of what it entailed. It was also suggested that as soon as the governments were formed, setting up the FC would be raised again. Now, the next chapter will try to help the system by assessing some major theoretical considerations against BiH specificities.

Is there a future for the BiH Fiscal Council?

4

All stakeholders agree that there is a lack of fiscal coordination and that some stronger fiscal rules could facilitate control over BiH fiscal policy. It is clear that past practice of using "international" pressure to achieve some sort of fiscal target will not be possible in the future. Furthermore, with the introduction of laws that allow local borrowings, consolidated fiscal target position becomes even more vital. If a way to agree, implement and maintain these targets is not found, Bosnia and Herzegovina jeopardizes potential for its future economic prosperity.

However, there is little understanding as to how it could be done, what would the best option be and what are pros and cons for any of the approaches. Hence, special attention is devoted to presenting ideas about policy rules and / or institutions tailored for Bosnia and Herzegovina. Nevertheless, it should be kept in mind that the ideal rule does not exist.

Respecting the concepts developed in the previous chapter, on fiscal policy objectives[16] and fiscal rules[17], four different policy alternatives could be isolated:

1. **Constitutional rule,**
2. **State level institution** (i.e. Ministry of Finance and Treasury),
3. **Intergovernmental coordinating body** (such as the Fiscal Council), and
4. **Status Quo**.

[16] long-term sustainability, short-term stability, aggregate and allocative efficiency;
[17] budget balance requirements, borrowing constraints, revenue-raising assignments, expenditure assignments and management, administrative aspects and expenditure management and process rules and enforcement mechanisms.

Each of these options encompasses pros and cons and yields different outcomes. Nevertheless, the alternatives are bounded by political, economic, legal and cultural factors and are presented depending on implementing difficulties.

4.1. Rule embodied in Constitution

A simple way to promote fiscal rules, thus to achieve some of the fiscal objectives could be achieved if certain provisions were embodied in the Constitution of Bosnia and Herzegovina. This primarily referrers to numerical limits to debt, budget balance requirements, revenue and expenditure, that could be imposed to general government (meaning all government levels), or different levels of government. If these fiscal rules are enshrined by Constitution, they would provide a guiding principles and a benchmark for assessment and would directly contribute to fiscal discipline.

Although this might be the most binding solution for lower tires of government, thus would have potentials to deliver desired results, there are three major drawbacks of this option:

(1) Changing Constitution is virtually mission impossible, and only plausible at this stage if politicians shift the core of their focus from post-war political rhetoric, to future looking economic progress;

(2) The desired effect would fall short, without appropriate enforcement and monitoring, especially avoiding accounting gimmickry[18]. Hence, in any case some institution would have to be tasked to secure implementation and compliance with the Constitutional provisions. This could possibly be done by authorizing the State

[18] Even Europe had experienced this phenomenon of accounting gimmickry when some of its members played with their numbers in order not to breach numerical limits set by Stabilization and Growth Pact and Maastricht Treaty.

Ministry of Finance and Treasury or some other institution. However, this problem could be seen as universal to all options.

(3) BiH is still in the transition phase and too rigid rules might not work for the advantage of the country.

Hence, even if numerical rule embodied in the Constitution would be desirable, the reality speaks that it would be highly difficult to implement it. However, this option could be looked at from a long-term perspective and argue for its introduction within some timeframe. In addition, numerical rules and institutions should not be seen as exclusive, but rather as complementary.

4.2. State Ministry of Finance and Treasury

Securing fiscal sustainability, determining fiscal targets and debt structure, publishing information on fiscal outturn, are some of the functions frequently assigned to the Ministry of Finance.

However, according to Dayton Constitution, the State was not assigned with countrywide responsibility over consolidated budgets and corresponding obligations, and these functions have remained under Entities' jurisdiction. The State Ministry of Finance and Treasury is only responsible for Budget of the State level institutions and the international obligations of Bosnia and Herzegovina.

As it is the case in the previous option, assigning overall fiscal responsibility at the state level might be seen as policy prudent behavior, however, politically quite impossible to accomplish. Even though running fiscal policy and setting up fiscal targets might have been simplier if only one institution is in charge of it, but the reality is that Entities are keen on keeping as much control as possible and would not give up on it without serious rethinking of the institutional arrangements in the Country.

4.3. Fiscal Council

As already indicated, Fiscal Council setting up was initiated, mostly pressured by the IFI's, but the outcomes are not tangible. Hence, this option is worth exploring as another way how fiscal discipline could be enhanced. The major incentive to do so is in the fact that the fiscal policy would be in the hands of an intergovernmental body, thus agreed at a common panel. Considering that the constitutional reality is that the State MoFT cannot simply make an order to entities, this could ensure comprehensibility of the FCs decisions. However, the question is if the pioneering difficulties could be overcome.

One of the important considerations is who would be sitting at the FC, and if it should be those as in the first Agreement. However, again political reality must be acknowledged, as there would be strong pressure to satisfy ethnical composition. It order to overcome this potential obstacle, there could be two options:

(1) To include Chairman of the CoM and entity Prime Ministers in the membership. However, the previous experience with this structure speaks that it would be very difficult to, first of all, have all these six officials present at the same place, let alone to make a decision. Hence, decision making process deserves a special attention. Second, even if this option is applied to the present, newly elected governments, again ethnical balances would not be achieved. In theory, this could mean that whenever government is changed, and if the ethnical proportions are not meet, there could be pressures to include some other positions in the FC as members with voting power.

(2) It might be plausible to combine numerical rules and setting up of the FC where the opportunity of drafting the FC Law could be used to introduce some benchmarks.

However, regardless to the decision making process, there must be a clear guidance how decisions will be implemented. If the imposed numerical rule is breached, sanctions would also be defined in the Law. On the other hand, if a set of numerical commitments is negotiated between different levels of government, the influence is more indirect and depends on strong enforcement mechanisms.

The Council would also be responsible for statistical and accounting standards of the Government Finance, consolidated mid-term and long-term documents of the budget framework and adherence to harmonized budgetary calendar.

4.4. Status Quo

Potentially, doing nothing is an option. This would be consistent with political economy concepts of short-term horizons of policymakers, and questionable fiscal policies where potential long-term costs are not always considered. Pre and post October 2006 elections behavior in BiH confirms this argument. While the country had enough strength to implement one of the most important reforms – the introduction of a countywide value added tax – it missed an opportunity to use significant increase in collected revenues and consolidate government finances.

However, in this specific case, the decision on introducing an institution or a set of rules is simply a matter of time, and more the time passes, harder it will be felt in the country. If the current macroeconomic indicators of BiH are observed, things do not look that alarming, comparing to some previous years. However, by looking at the trends, this year could be seen as the turning. If the focus is moved a few years ahead, the picture severely deteriorates. Hence, keeping this current status potentially can have severe consequences for the macroeconomic stability and sustainability of growth; two major objectives of fiscal policy.

Conclusions

5

Setting up the Fiscal Council of Bosnia and Herzegovina could help management of BiH fiscal policy in the current constitutional setting and political environment.

Sustainability, macroeconomic stability, aggregate and allocative efficiency are all at stake in Bosnia and Herzegovina since there is neither institution nor binding fiscal rule guiding policy thinking. The responsibility over fiscal policy is fragmented and divided among various levels of government, and in practice there is nothing combining these actions and fitting it into a countrywide policy objective.

In order to manage fiscal policy, the government often adopts fiscal rules as a way to strengthen their policy actions. In case of EU countries, they adhere to supra-national commitments (Stability and Growth Pact and the Maastricht Treaty) of budget balance and debt rules where debt ceiling is related to the repayment capacity.

However, in order to do so, there are institutions responsible of making sure that these objectives and rules materialize. Setting up of these institutions is bounded by Constitutional realities and any alterations are subject to political will. Although traditionally countrywide experience states that the general responsibility over the fiscal policy has been in the hands of the

Ministries of Finance, more and more countries are introducing more direct fiscal rules and / or intergovernmental organizations as a response to legal limitations and political pressures.

Hence, setting up the Fiscal Council, an institution whose main responsibility would be running prudent fiscal policy, would be one giant leap for BiH. The strength of Council would be further enhanced by numerical rules embodied in the Law on Fiscal Council. In this manner, BiH would get an arena where fiscal objectives and appropriate rules would be debated.

However, in order to achieve this, the Law on Fiscal Council should be adopted where special attention would be given to.

(1) *The scope of work* – should be precisely defined and as policy oriented as possible. It would be the place where decisions, such as should country borrow more to finance investments or which region of the country should be given priority, would be agreed. The Council would also be responsible for statistical and accounting standards of the Government Finance, consolidated mid-term and long-term documents of the budget framework and adherence to harmonized budgetary calendar.

(2) *Membership and decision-making process - The most appropriate option would be to have* representation of MoF of the State and the two entities as the FC members, while the governor of the Central Bank, would have the observer status, while the interests of the BD would be represented by the State MoF. Again, considering the political reality, this option would not be accepted since traditionally these three functions have not satisfied the ethnical composition. It order to overcome this potential obstacle, there could be two options:

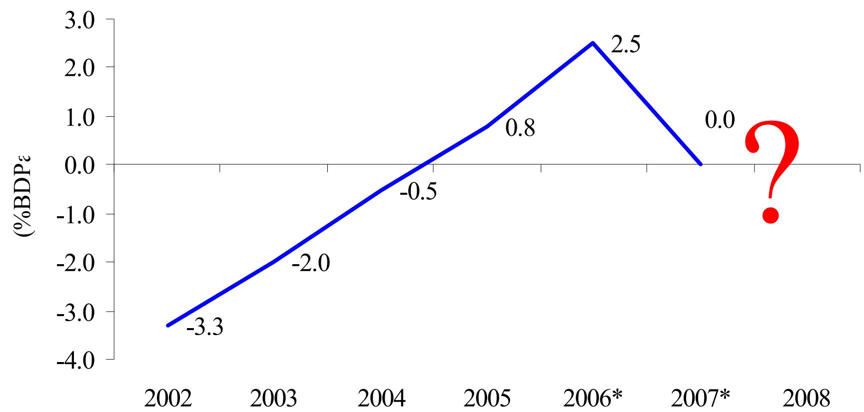
a. To include Chairman of the CoM and entity Prime Ministers in the membership. The previous experience with this structure speaks that it would be difficult to have all six officials attending the FC sessions and respect ethnical balances of constituent peoples.

b. It might be plausible to combine numerical rules and setting up of the FC where the opportunity of drafting the FC Law could be used to introduce some benchmarks. For example, most of the EU 25 countries adhere to supra-national commitments (SGP and MT) of budget balance and debt rule where debt ceiling is related to the repayment capacity. Something similar could be built in the FC Law. This could also ensure automatic decision making mechanism in a case where members of FC have opposite views and agreement is not possible.

(3) *Implementation of decisions* - regardless to the decision making process, there must be a clear guidance how decisions will be implemented. If the imposed numerical rule is *breached*, sanctions would also be defined in the Law, as it is the case with SGP and MT. On the other hand, if a set of numerical commitments is negotiated between different levels of government, the influence is more indirect and depends on strong enforcement mechanisms. Hence, it would be important to introduce strict rules and penalties in order to prevent irresponsible behavior.

Ideal rule or an institution does not exist, and Bosnia and Herzegovina needs to find an appropriate mix that would allow it to take control over its fiscal policy, hence sustainability and growth. Political reality speaks that intergovernmental body is the only implementable option at this moment, although some stronger legal commitments would be as important.

Figure 3 - Fiscal Balance



Source: IMF

In the current system it is difficult to estimate what is the trend of fiscal balance, and almost impossible to manage its movements Hence, if no action is taken soon, major fiscal earthquakes will shake the country and the actions taken now must be seen as preparations to counterbalance its magnitude.

Appendix

6

1. Notes on Schematic Expositions of a Fiscal Architecture for Bosnia and Herzegovina
2. Results of the OECD/World Bank survey on Budget Practices and Procedures

1. Notes on Schematic Expositions of a Fiscal Architecture for Bosnia and Herzegovina[19]

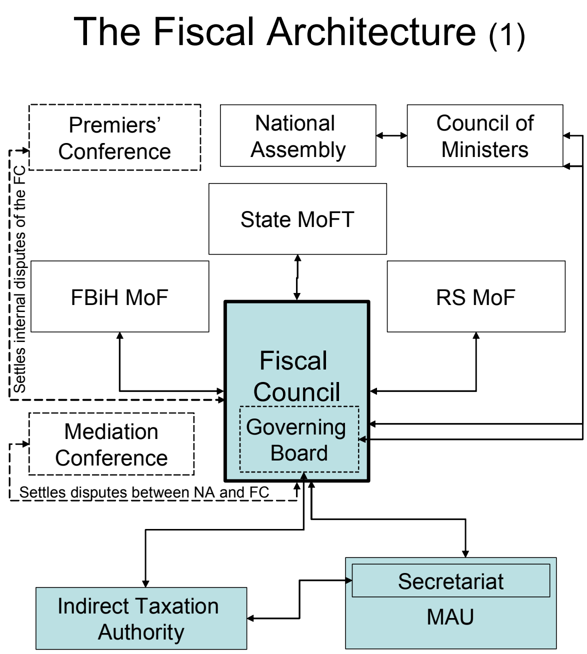
Version 1 - design with a Prime Ministers' Conference, which also acts as a deadlock breaker for non-consensual decisions in the FC.

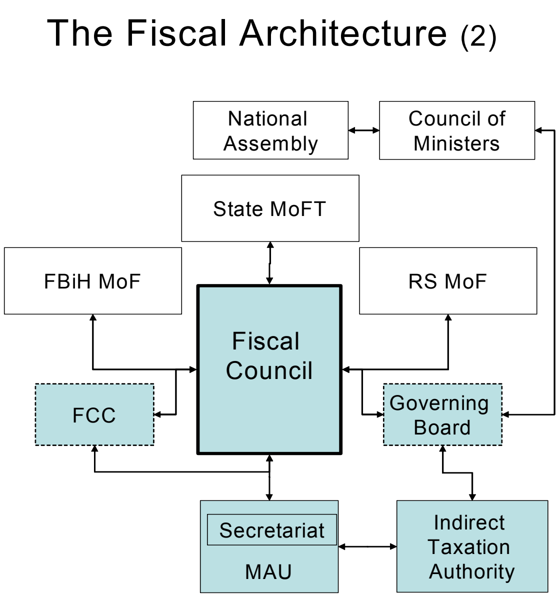
It also contains a Mediation Committee consisting of representatives of the FC and the National Assembly to resolve conflicts arising at the level of State legislation.

The Governing Board of the ITA is merged with the FC.

It was assumed that the coordination competency of the FC does not stretch beyond the Entity level. Therefore the FCC was not included.

It is essential to have a Secretariat, which would also guide the work of MAU. MAU is understood to be a merger of the existing MAU with EPPU, and possibly the Fiscal Sustainability Group.





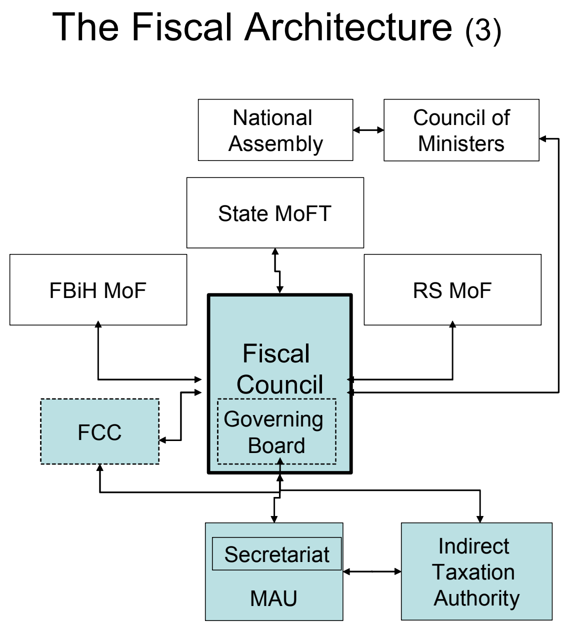
Version 2 reflects an intermediate solution whereby the Governing Board still works in parallel to the FC.

It also comprises a new institution, the FCC, which establishes recommendation for coordinating intergovernmental fiscal relations not only among Entities, but also among cantons and municipalities. It is conceived as a standing committee reporting to the NFC. It includes representatives of the State, the Entities, the cantons, the municipalities, and technical staff from MAU and other experts.

Version 2 does no longer include the Prime Ministers' Conference and the Mediation Committee, but these could be easily incorporated if wanted.

[19] Report produced by Paul Ben Spahn, IMF fiscal policy advisor was used as basis for the notes, August 2005.

Version 3 shows a possible steady-state solution whereby the Governing Board is merged with the NFC.



2. Results of the OECD/World Bank survey on Budget Practices and Procedures

The OECD/World Bank survey of budget practice was launched in February 2003, in more than 60 countries. More than 40 countries have responded to the survey or are in the process to finalize it.

The following table of questions is meant to establish whether aspects of the budget process are defined or found in a formal or legal setting, and where in the countries legal framework those rules appear. For example in the first line, “Public funds can only be spent in programmes authorized by legislation” may be a constitutional provision in one country and an organic law provision in another. Sometimes a country may have rules defining an aspect of budgeting in different places for example in both organic budget law and regulation.

	CONSTITUTION		BUDGET LAW		REGULATION (INTERNAL PUBLIC SECTOR RULES)		NO FORMAL BASIS	
	Total	OECD	Total	OECD	Total	OECD	Total	OECD
Public funds can only be spent in programmes as authorized by legislation	21	14	29	19	6	6	1	1
The budget and financial reporting covers all central government transactions (including extabudgetary transactions)	7	7	27	17	14	11	4	4
All budget transactions to be shown in gross terms	2	2	27	17	9	8	3	2
The minister in charge of government finances has effective power over budget management	5	2	26	17	13	11	3	1
Individual government organizations are held accountable for the funds they collect and/or use	0	0	27	16	15	12	2	1
Individual Ministers are held accountable for the funds they collect and/or use	4	3	26	16	9	7	3	3
Requirements for independently audited financial accounting reports	12	8	22	15	8	5	2	1
Requirements for independently audited non-financial reports	2	1	13	9	9	6	8	6
Conditions for use of contingency or reserve provisions	6	4	23	14	12	9	2	2
Definition of public money	7	3	25	16	6	6	4	4
Rules for the creation of extra-budgetary funds to special cases, authorized by separate statute	4	2	19	14	7	4	5	3

Authorize the government accounts into which all public money must be paid and from which expenditures are made only by appropriation of the parliament	Total 14	OECD 9	Total 29	OECD 19	Total 11	OECD 9	Total 0	OECD 0
Roles for the parliament and the executive in the budget process and the relationship between the two branches with respect to budget responsibilities	Total 28	OECD 19	Total 27	OECD 18	Total 5	OECD 4	Total 2	OECD 2
The form and structure of the annual budget law (or finance bill) to be voted by parliament	Total 9	OECD 8	Total 29	OECD 18	Total 10	OECD 7	Total 1	OECD 1
The definition of main headings and accounts in the annual budget law	Total 0	OECD 0	Total 29	OECD 19	Total 11	OECD 9	Total 2	OECD 2
The definition of the budget deficit and surplus	Total 1	OECD 1	Total 23	OECD 16	Total 10	OECD 8	Total 8	OECD 5
Legal basis for formulation and execution of the budget, including the role and authorities of the Ministry of Finance/Treasury and/or the Central Budget Authority	Total 6	OECD 3	Total 28	OECD 18	Total 14	OECD 12	Total 1	OECD 1
Administrative/judicial sanctions for infractions of budget legislation	Total 1	OECD 1	Total 25	OECD 15	Total 14	OECD 8	Total 5	OECD 4
The basis for management (internal) control and internal audit	Total 3	OECD 1	Total 24	OECD 17	Total 17	OECD 12	Total 3	OECD 2
Authorities and responsibilities for issuing and reporting on government guarantees	Total 5	OECD 3	Total 28	OECD 20	Total 18	OECD 13	Total 1	OECD 1

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