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**Local Government in Bosnia and Herzegovina**  
**Report on Consultations of a**  
**Joint Commission on Local Government**

**June, 2018**

# Local Government in Bosnia and Herzegovina

## Report on Consultations of a Joint Commission on Local Government

A Joint Commission (JC) on Local Government - supported by the European Union Special Representative (EUSR) in BiH, the Swiss Embassy in BiH and USAID - began work at a launch event on October 18, 2017. The JC subsequently held consultations in each of the ten cantons of the Federation of Bosnia and Herzegovina (FBiH) - with cantonal governments and their staffs; local mayors and other municipal officials; business leaders; and civil society representatives - and in the Republika Srpska (RS) - with mayors and other municipal officials; business leaders; and civil society representatives. The JC enjoyed close collaboration with the Associations of Municipalities and Cities in both the FBiH and RS and benefitted from discussions with the Ministry of Local Government in the RS and staff members of the World Bank, IMF, UNDP, OSCE, EBRD and other international organisations. The findings do not necessarily reflect the opinions of any of the sponsor institutions or any other institution. This Report was presented and discussed at a final event on June 6, 2018.

This Report is intended to summarise the main findings of the Joint Commission - including the prevailing opinions of local government representatives - and to make some general recommendations that could improve the workings of the system of local government in BiH. Although the findings refer to a large number of areas and issues, each of them is based on the same general understanding of shortcomings in the present system and intends to convey the same basic message for change:

First, there is room for significant improvement in the systems of local government in both entities. There is significant potential for efficiency gains under the present institutional arrangements and these would largely be achieved through improved vertical coordination between institutions at different levels or through the expansion of cooperation and collaboration between local institutions at the same level (including across entity boundaries). These improvements need to be facilitated and incentivised.

Second, it should be possible to improve the well-being of all citizens at the same time because the reforms outlined in the report do not imply a zero-sum game. There are, at the same time, important equity gains that could be achieved - where the most vulnerable segments of the population would become better off.

Third, the improvements proposed in this Report are achievable in the short term, because they are designed to make the best use possible of the present constitutional and legal framework. The proposals concentrate on modifying incentives within existing structures. In fact, the JC did not have a mandate to consider or recommend any changes to the assignment of competences as set out in the state and entities' constitutions. The JC was tasked, instead, with assessing the existing system - including challenges posed by the current assignment of competences - and proposing improvements whose implementation could be carried out by the entities, local governments and cantons in their own jurisdictions.

BiH is composed of two entities that have very different and separate systems of local government. Therefore, the systems in each entity are discussed separately below. However, there are also some common issues and these are discussed first. In particular, BiH suffers from some country-wide demographic problems that pose a serious challenge to local governments in both entities and that can only be resolved through encouraging a joint/networked approach to economic development and greater cooperation between local governments in the provision of services in the same locality - including, sometimes, across entity boundaries. It is often difficult for local governments to overcome administrative and other barriers to cooperation on an individual basis so the Report makes recommendations on how local cooperation and collaboration could be facilitated and encouraged (without undermining the competences already assigned to the entities and cantons).

The JC was asked, in the first instance, to undertake a consultation with local governments across BiH and to try to identify areas where there is a common vision for reform. In this context, the JC undertook a comprehensive Survey of local-government opinion and those results are presented in Annex A (Throughout the Report, references to the Survey will use a capital "S"). The JC greatly appreciates the high level of participation in this process and hopes that this Report accurately reflects the opinions and concerns of local governments. Reforms are much needed and urgent and local government representatives will need to engage in an early

conversation on the need for systemic change. This conversation should, in turn, lead to the adoption of better service delivery across BiH and to meaningful improvements in the lives of citizens.

This Local Government Initiative (LGI) follows on the implementation of a Reform Agenda for 2015-2018 that focused on the need for socio-economic and other reforms in the state and entity institutions. As the Reform Agenda progressed, it became increasingly clear that many of the most difficult problems in BiH stem from poorly defined relationships and responsibilities at the level of local government. Therefore, the EUSR launched an initiative to help local governments across BiH to identify systemic problems in the way that they are organised and financed and to identify other systemic problems that undermine their ability to provide adequate services to citizens. The general economic climate has improved with the implementation of the Reform Agenda and this presents a unique opportunity to deepen reforms and to tackle long-standing problems at lower levels of government.

As a member of the Council of Europe, BiH has ratified the European Charter of Local Self-Government and is committed to guaranteeing the political, administrative and financial independence of local authorities. The EU principle of subsidiarity recognizes that decisions about people's lives are best made as close to those people as possible and BiH already reserves a significant proportion of government for its cantons, cities and municipalities. The EU will become an important supporter of reform in local government in BiH over the next decade but the process of introducing systemic change must be driven by local governments themselves. There is a need for significant consultation on the future of local government in BiH and this Report should help to inform that conversation. People may agree or disagree with the proposals in the Report but the most important thing is that they begin to jointly explore the potential for solutions to common problems.

# Table of Contents

<b>Summary of Main Findings and Recommendations</b>	<b>8</b>
<b>Chapter 1 General Considerations</b>	<b>12</b>
A. Introduction	12
B. Demographic Trends and Other Common Challenges	15
• Demographics Trends	15
• The Urban-Rural Divide	16
• The Cost of Government and Social Welfare	18
• External Debt Service	18
• Natural Resources	19
C. Thinking about Reforms—a Joint Network Approach	20
D. Overcoming Political Divisions and Corruption	22
• Political Divisions	22
• Corruption	23
• Participation and Public Accountability	26
E. Opportunities for Change	28
<b>Chapter 2 Local Government in the FBiH</b>	<b>31</b>
A. Main Features of the System of Local Government	31
B. Main Findings and General Recommendations	31
• The Sharing of Competences	32
• The Vertical Allocation of Resources	35
• The Horizontal Allocation of Revenues	38
• Planning and Accountability	42
• Public Administration Reform (PAR)	43
C. Focus on Municipal and Social Services	47
D. Focus on Local Economic Development	53
E. Focus on Fragmentation: the Health System and Public Order and Safety	60

<b>Chapter 3</b>	<b>Local Government in the RS</b>	<b>65</b>
	A. Main Features of the System of Local Government	65
	B. Main Findings and General Recommendations	67
	• The Implications of Demographic Changes	65
	• Financing Local Government	68
	• Public Administration Reform	72
	• Municipal Cooperation	73
	C. Focus on Municipal and Social Services	74
	D. Focus on Local Economic Development and Planning	76
<b>Annexes</b>		
	A. Summary of Survey Results	79
	B. Functional Agencies in BiH: <i>Potential Roles, Structure and Financing</i>	86
	C. Technical Notes on Possible Modes of Funding Municipalities and Cities	88
	D. Blockchain Technology: <i>The Potential Use of Digital Technology in BiH</i>	90
<b>Sources</b>		<b>93</b>

# Summary of Main Findings and Recommendations

Both systems of local government suffer from significant problems and are in need of fundamental reform. And this conclusion is shared by a large majority of the leaders of local governments<sup>1</sup>. The RS Government has opened a debate on the need for reform and a similar dialogue needs to begin urgently in the FBiH. The FBiH needs to create a forum or institution to conduct this discussion - perhaps, by creating a Ministry for Local Government that would also oversee improved collaboration. Local government - cantons plus municipalities - accounts for two thirds of public expenditure in the FBiH.

## Common Challenges

- The population is falling and aging and this is putting an increasing strain on local resources.
- Secondary cities are in decline and there is a growing urban-rural divide between the capacities of smaller and larger municipalities (and cities) to provide adequate services for their citizens.
- Local government administration is fragmented and often costly and, partly as a result of this, there are insufficient resources available for local economic development and social care.
- External debt service imposes a further burden on local government in both entities and the vertical allocation of resources is viewed as unsatisfactory by virtually all local governments.
- The horizontal allocation of resources is also controversial - especially in the FBiH where there is no consensus on a suitable balance between keeping local resources and sharing with others.
- The management and sharing of natural resources is often inefficient and this undermines the sustainable development of an important source of local government financing.

<sup>1</sup> Unless otherwise noted, the term "local" will be used in this Report to refer to the governments of cantons, cities and municipalities.

## A Common Approach

- The burden of government is already high and there is no scope for aggregate tax increases to resolve local financing issues. A more balanced sharing between levels of government might be appropriate but there is an overall need for significant administrative savings and greater efficiency in service delivery.
- To improve efficiency - and make resources available for much-needed economic development and social care - local governments need to significantly improve cooperation and collaboration.
- The cooperative actions of local governments need to be formalised in joint networks that would: (i) range across geographical areas that are large enough to deliver economies of scale; and (ii) have the necessary organisational features to preserve local autonomy.
- The term "regional" is used in the Report to describe the spatial dimension of this suggested approach but the approach would have different structures in each entity:
  - In the FBiH, given the allocation of competences, the canton is the logical unit to administer a networked approach (that should be agreed with municipalities). Canton governments need to adopt a stronger role in coordinating the provision of cantonal and municipal services and, because the cantons are all very different, their reforms will need to be tailored to their specific circumstances.
  - At the same time, cantons could achieve significant savings through improved cooperation among themselves - especially in the areas of health care and public order and safety.
  - In the RS, the government has proposed a multi-type system of municipalities (to replace the current mono-type system) and this could lead to a regional system of networked service delivery and economic



development based around the larger cities and towns.

- The regional approach would take different institutional forms for different types of services:
  - A hub-and-spoke approach to the provision of single-access services (like health care) where the consumer goes to the provider for individual attention and there are escalating tiers of service that would be provided by connected institutions in different locations;
  - A collaborative approach to the provision of pure-networked services (like water) where a common product is available on demand to all consumers and cooperating institutions can exploit economies of scale through shared infrastructure; and
  - An associated approach to the provision of grouped-network services (like economic development or transportation) where communities expect their local governments to work together. These services are often best provided by functional agencies that are jointly owned by governments and whose dedicated performance to a particular goal can be judged clearly.
- In a small country where two-thirds of municipalities in both entities border a municipality from the other entity, services will often need to be networked across entity boundaries.

## Political Challenges and Corruption

- The task of transforming local government is complicated by the associated problems of political division and corruption. Political divisions and ethnic affiliations reduce public scrutiny of the operation of governments, induce a lack of transparency and often openly facilitate corruption.
- The distribution of complicated grants on a discretionary basis, for example, is both a reflection and a cause of corruption and nepotism. In both entities, municipalities report that grants and transfers from higher levels of government are often disbursed in an ad-hoc fashion and largely on the basis of the local government's political affiliation with the granting authority. This undermines the ability to plan and initiate infrastructure projects and foment corruption.

- As a general rule, all grant schemes should be combined into a few block grants that are targeted to broad areas and leave full discretion to the local authorities on how to spend. The general areas could include: promoting local-government cooperation and innovation; providing for development needs; and providing social services, education and health care.
- These block grants would be allocated in a fully transparent manner - on the basis of a simple formula or upon completion of a simple task whenever possible - after consultation between selected Ministries. The Ministries could include those of Local Government, Finance and another sector Ministry covering specific activities or development. This would increase efficiency and reduce political risks (because ministries are often run by different parties).
- The introduction of credible systems for performance appraisal in local governments would permit voters to properly assess the performance of their local government and allow them to compare it to other local governments according to common criteria.
- And local governments in both entities suggest that the local and general election cycles be merged so that they do not have to face an effective election campaign every two years.

## Opportunities for Change

- The Reform Agenda for 2015-18 succeeded in putting BiH back on the path to EU accession and there is a significant chance that BiH will become a candidate country in the foreseeable future. The next stage of reforms needs to tackle long-standing problems at lower levels of government.
- There has recently been a return to economic growth and rising public revenues should be used to fund structural reforms - such as creating funds for the resolution of overstaffing and to make much-needed investments in modernisation - rather than to increase current expenditures.
- Ambitious plans are being implemented to improve regional connectivity and significant funding for transport infrastructure development was recently secured by an increase in fuel excises.

- The LGI Consultations found a strong consensus for change. The level of satisfaction with local government is greater in the RS than in the FBiH but only one in ten local governments across the country finds the overall situation to be good. And political differences are seen as the main obstacle to greater cooperation between local governments in both entities. Local governments want to cooperate but need to be given the appropriate instruments and the right incentives.

## Specific Issues and Recommendations in FBiH

- Most cantons think they have achieved a coordinated approach with their municipalities but the vast majority of municipalities disagree. There is significant confusion and frustration due to:
  - Joint and overlapping competences between the two layers of government;
  - A municipal perception that unfunded mandates are handed down to them; and
  - A failure to overcome latent inefficiencies in the assignment of responsibilities.
- To highlight and overcome these problems this Report suggests that cantons:
  - Produce rolling (3-5 year) Public Service Development Agreements (PSDAs) - covering primary education, social welfare, spatial planning and infrastructure - that would clarify local responsibilities and need to be approved and co-signed each year by municipalities;
  - Establish functional agencies - with joint canton/municipal ownership - to oversee specialised functions such as local economic development and to tackle bottlenecks created by the competing priorities of local governments with overlapping mandates; and
  - Draft cantonal network plans - to overcome the unusual and debilitating level of fragmentation in services such as health and public order and safety - that would adhere to a common entity methodology and allow them to be linked with plans from other cantons.
- A Ministry of Local Government should be established to oversee a revised and simplified grants system that puts the onus on cantons to resolve local problems with their municipalities and to oversee local economic development. Block grants would be awarded on the basis of simplified criteria that would include the satisfactory production of these coordination plans.
- There is widespread dissatisfaction with the vertical allocation of public revenues in the FBiH. The system could be reformed by allocating the responsibility for the servicing of external debt clearly to the entity level (with an offsetting reduction in resources for local government).
- There is some scope for introducing a municipal surcharge on the personal income tax (PIT) to compensate for planned reductions in parafiscal charges and fees and to increase fiscal accountability. Cantons should consider higher PIT and corporate income tax (CIT) allocations to municipalities in the context of agreeing the assignment of local responsibilities.
- The horizontal allocation of revenues suffers from a hybrid system that achieves none of its goals and is subject to near-universal resentment - especially from cantons. The system should be reformed and simplified according to clearly-agreed principles and the Report endorses a two-pillar approach proposed by the IMF that would replace the existing coefficients. CIT collection could be based on production centres instead of headquarters.
- Planning and accountability at all levels of local government needs to be improved, including public financial management (PFM) reform. A lack of vertical integration in budget planning leads to significant confusion and budget revisions. The grant system needs to be simplified and made more transparent to eliminate political interference and allow local governments to better plan for capital projects.
- Public administration reform needs to become a centrepiece of local government plans. Local government administrations are seen as overstuffed and inefficient and they severely retard local economic development. Local governments know this but are shackled by unsuitable laws - such as on the Civil Service and Public Procurement - that are seen as too rigid to allow reforms.

## Specific Issues and Recommendations in RS

- The RS Government adopted a Strategy for Local Government Development in 2017 that is closely aligned with the regional approach proposed in this Report. The Strategy proposes the introduction of a multi-type system of local government that would address the fact that some smaller municipalities cannot provide the full range of services that others can.
- This approach implies that municipalities - and the financing system - would need to adjust to a regional perspective that includes municipal cooperation and the sharing of facilities and services with neighbouring municipalities as a central element.
- Municipalities also need to become more efficient and, already, targets have been set to significantly reduce overstaffing in the coming years. PFM reforms will likely improve budgetary controls.
- The vertical financing system could be reformed by allocating the responsibility for the servicing of external debt clearly to the entity level (with an offsetting reduction in resources for local government). And the creation of a multi-type system of municipalities could be enhanced by the introduction of a municipal surcharge on the personal income tax (that could be offset at the entity level). Also, the property tax system could be significantly improved as its administration is devolved to municipalities over the next few years.
- The horizontal financing of municipalities relies heavily on giving assistance to less-developed and undeveloped areas. There is general support for this approach but it could be updated through a simpler system of block grants that would also be more transparent.
- The new regional approach in the RS will require greater cooperation between municipalities. The legal framework has already been established to facilitate municipal cooperation - both within the entity and between municipalities in different entities. There are already examples of successful cooperation in providing municipal services and the Strategy would extend this regional perspective to local economic development. Municipalities will need to begin to develop joint regional plans and the Report proposes a number of institutional vehicles that could be employed in this effort.

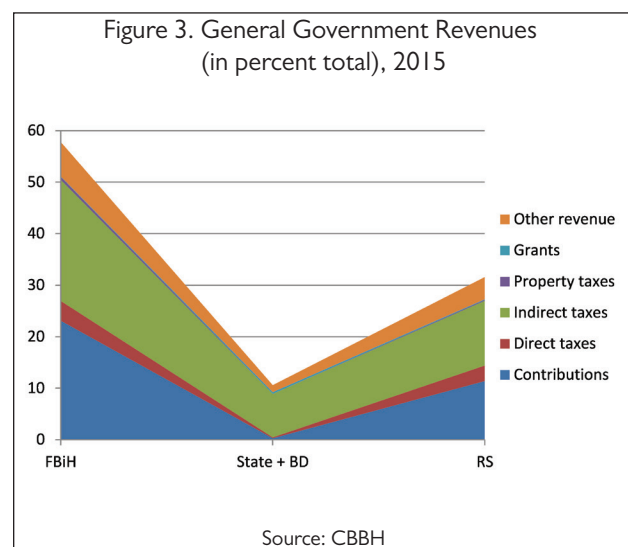
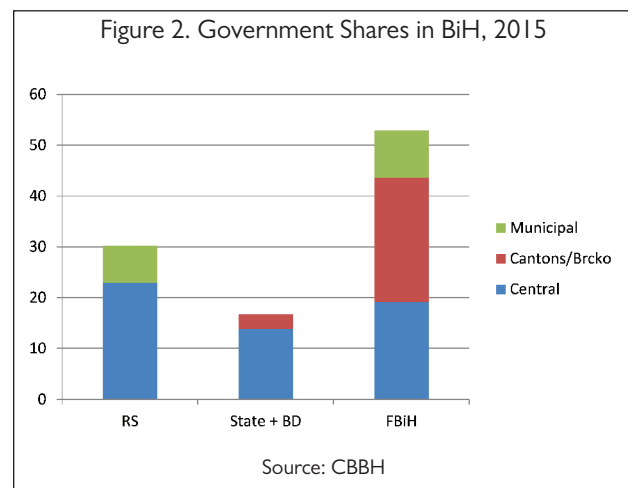
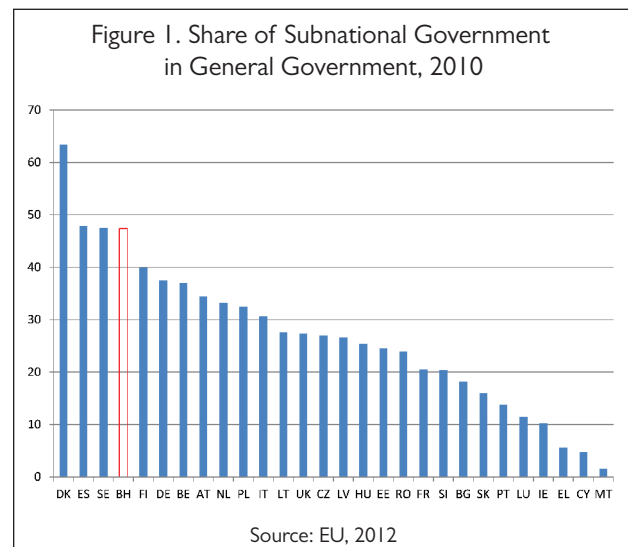
# Chapter I: General Considerations

## A. Introduction

The share of subnational government in overall government in BiH is unusually high - especially, given the size of the country. But it is not unique. In Denmark, for example, a larger share of public expenditure (excluding social transfers) is delegated to regional and local government (Figure 1)<sup>2</sup>. The State Institutions in BiH look after defence and foreign affairs and provide country-wide services such as border security, customs and VAT collection, intelligence services and higher-level judiciary. The entity and sub-entity governments provide almost all of the day-to-day services required by citizens.

Accordingly, the state institutions absorb just 15 percent of public revenues (Figure 2) while governments in the FBiH and RS absorb about 52 percent and 30 percent respectively. (The District of Brcko makes up the rest)<sup>3</sup>. BiH is unusual in the different types of government that sit below the entity level—and that are the focus of this Report. In particular, in the FBiH, central government is relatively small and the cantons and municipal governments account for most of the service provision. Municipal government in the RS is smaller and there is no intermediate/canton level.

Figure 3 identifies the sources of funding for all three sets of governments. Indirect taxes are administered at state level and shared between the state-level institutions and entities (based on estimates of where these revenues originated). Direct taxes, social contributions and many other local revenue sources are all set and administered by the entities or local governments. Because the entities differ markedly in administrative structure and financing, their features will be described and compared in detail in the body of the Report. The assignment of financing sources and competences are summarised respectively in Tables 1 and 2.



2 Data from Central Bank of BiH (CBBH) and European Commission. 2012. Report on Public Finances in EMU - 2012. By convention, the data used for these cross-country comparisons exclude social funds.

3 If social funds are included, the share of the state institutions drops to 10 percent and the FBiH and RS absorb about 60 and 30 percent respectively (as in Figure 3). Brcko is an autonomous District and was not a focus of this Report.

Table 1. Revenue Allocation to Local Governments in BiH

Taxes and Fees	Federation of BiH		Republika Srpska	
	FBiH Government	Cantons	Municipalities	RS Government
<b>Indirect Taxes (Customs, Excises, and VAT) 1/</b>	Allocates within FBiH. FBiH keeps 36.2 percent. Roads: 3.9 percent.	Cantons: 51.48 percent. Per capita allocation based on indicators of need and special coefficients.	Municipalities: 8.42 percent. Per capita allocation based on indicators of need and development.	Allocates within RS. RS keeps 72 percent. Roads: 4 percent.
<b>Personal Income Tax</b>		Flat 10 percent rate.		Flat 10 percent rate.
<b>Corporate Income Tax</b>	Regulates, collects and allocates to cantons on derivation principle.	Maximum 65.54 percent (at discretion of canton). 3/	Minimum 34.46 percent.	Regulates, collects and allocates to municipalities. on derivation principle
		Flat 10 percent rate		Flat 10 percent rate.
	FBiH: 100 % banks, power, insurance and telecomms.	Cantons: 100 percent of other companies, based on HQ.		RS: 100 percent.
<b>Social Security Contributions</b>		Separate flat rates for employees (31 percent) and employers (10.5 percent).		Flat 33 percent rate for employees.
		Cantons: 100 percent to social and health funds, based on derivation.		RS: 100 percent.
<b>Property Transfer Tax</b>		Base and rate established.	100 percent of revenues.	Base and rate established. 100 percent of revenues.
<b>Property Tax</b>	Secondary homes only.	Base and rate established.	100 percent of revenues.	Base and rate established. 100 percent of revenues.
<b>Pratfiscal Fees 2/</b>	There is no single system or clear rules regulating who can or how to stipulate the type, purpose and rate of fees and charges or the system according to which they are collected.			Mostly set at municipal level.
<b>Utility Charges</b>		Approved and subsidised.		Approved and subsidised.

1/ State institutions regulate, collect and allocate to entities and state institutions through ITA Single Account.

2/ Local government units responsible for enacting legislation on taxes, compensations, contributions and fees falling within the competence of the local self-government unit.

3/ Cantons can allocate more revenues to municipalities at their own discretion.

**Table 2. Selected Competences of Local Government in BiH**

Competences	FBiH Government <i>FBiH Constitution</i>	Cantons	Federation of BiH <i>Law on the Principles of Local Self-Government</i>	Cities and Municipalities <i>Law on the Principles of Local Self-Government</i>	RS Government <i>Law on the Principles of Local Self-Government</i>	Republika Srpska <i>Cities and Municipalities</i>
<b>Policing</b>	Combating terrorism, intercantonal crime, drug traffic and organized crime	Establishing and controlling police forces	Analysis of public order and safety of people and property	Primary health care centres	Police and security	Organisation of communal police
<b>Health</b>	Health	Hospitals	Assessing the work of institutions and service quality in health, social protection, education, culture and sport and providing funds to improve their work and quality of service in line with citizens' needs and capabilities of municipality	Selection of people eligible for distinct social programs	Civil protection (shared)	Health institutions, epidemics and extra care
<b>Social Welfare</b>	Social welfare policy	Execution of policy and provision of services	Assessing the work of institutions and service quality in health, social protection, education, culture and sport and providing funds to improve their work and quality of service in line with citizens' needs and capabilities of municipality	Building, funding and maintenance of primary school premises	Health policy	Social centres, monitor local needs and develop social protection programs
<b>Education</b>	Education policy	Education policy	Assessing the work of institutions and service quality in health, social protection, education, culture and sport and providing funds to improve their work and quality of service in line with citizens' needs and capabilities of municipality	Building, funding and maintenance of preschool premises	Social welfare policy	Primary, secondary and higher education
<b>Culture and Sport</b>	Cultural policy	Cultural policy	Assessing the work of institutions and service quality in health, social protection, education, culture and sport and providing funds to improve their work and quality of service in line with citizens' needs and capabilities of municipality	Transportation of pupils	Education policy	Primary, secondary and higher education
<b>Natural Resources</b>	Use of natural resources	Use of natural resources	Regulation of use of local natural resources and distribution of revenue from their use	Building, management, funding of cultural and sport premises	Cultural policy	Cultural policy: Building, management, funding of cultural and sport premises
<b>Transport</b>	Infrastructure for communications and transport	Infrastructure for communications and transport	Regulation of use of local natural resources and distribution of revenue from their use	Building, management, funding of cultural and sport premises	Cultural policy	Cultural policy: Building, management, funding of cultural and sport premises
<b>Housing</b>	Housing policy	Housing policy	Local roads and bridges	Transportation of pupils	Regional roads	Use of natural resources Transport Local roads and bridges
<b>Spatial and Environment</b>	Environmental policy	Environmental policy	Local roads and bridges	Building, management, funding of cultural and sport premises	Environmental protection (shared)	Housing policy Spatial planning and environmental protection policies
<b>Public Services</b>	Making economic policy, including planning and reconstruction, and land-use policy.	Regulation of local land use and zoning	Regulation of use of local natural resources and distribution of revenue from their use	Issuing of permits	Public services system	Control of use of land and construction land Issuing of permits
<b>Energy</b>	Energy policy and infrastructure	Regulation and provision of local public services	Regulation of use of local natural resources and distribution of revenue from their use	Prevention and protection from natural disasters	Public services system	Regulation and provision of local public services Detailed services as in the FBiH
<b>Business</b>	Regulation and promotion of local business and charitable activities	Regulation and promotion of local business and charitable activities	Regulation of use of local natural resources and distribution of revenue from their use	Water supply, wastewater disposal and treatment	Public services system	Regulation and provision of local public services Detailed services as in the FBiH
<b>Tourism</b>	Tourism policy and resources	Tourism policy and resources	Regulation of use of local natural resources and distribution of revenue from their use	Water supply, wastewater disposal and treatment	Public services system	Regulation and provision of local public services Detailed services as in the FBiH
				City cemeteries	Public services system	Regulation and provision of local public services Detailed services as in the FBiH
				Selection of dumping sites	Public services system	Regulation and provision of local public services Detailed services as in the FBiH
				Public sanitation	Public services system	Regulation and provision of local public services Detailed services as in the FBiH
				Parks	Public services system	Regulation and provision of local public services Detailed services as in the FBiH
				Enacting legislation on taxes, contributions and fees in the competence of local self-government unit.	Public services system	Regulation and provision of local public services Detailed services as in the FBiH
					Public services system	Regulation and provision of local public services Detailed services as in the FBiH

// Delegation differs in some cantons.

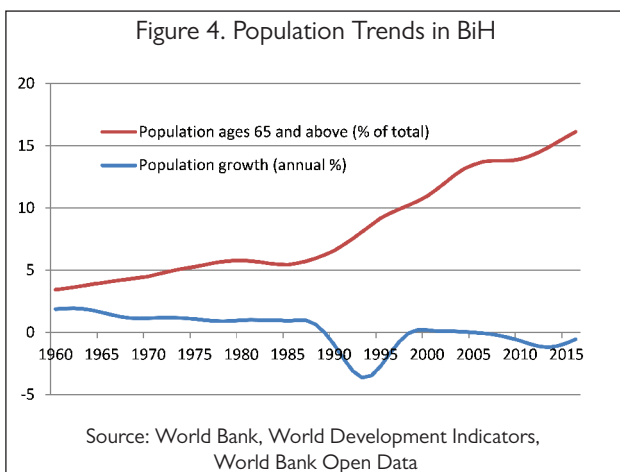


## B. Demographic Trends and Other Common Challenges

### I. Demographic Trends

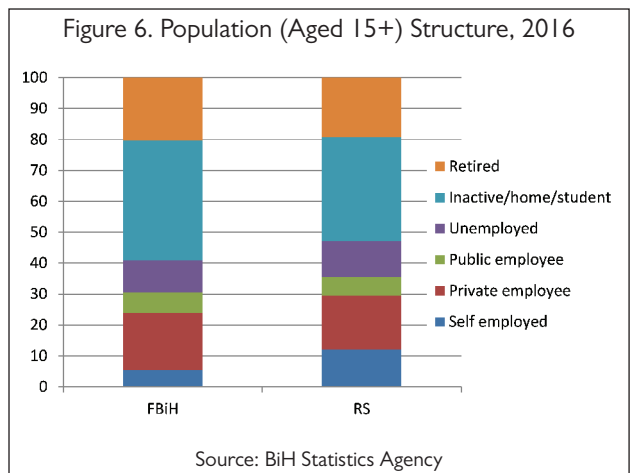
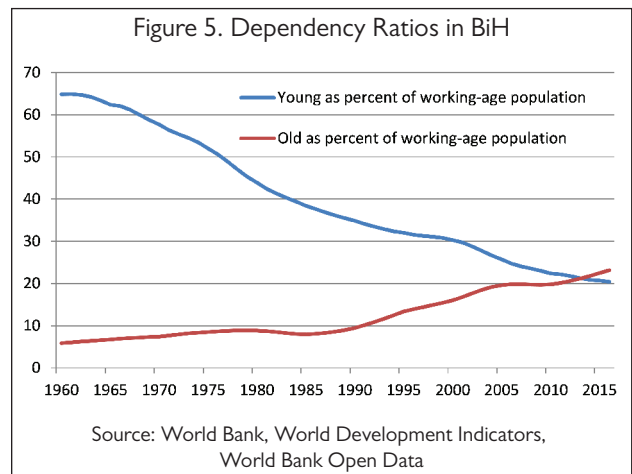
A significant population exodus during the war years has never been reversed in BiH. There has never been a sustained recovery to positive population growth rates (Figure 4) and, by some estimates, the country has lost one-third of its population since the disintegration of Yugoslavia<sup>4</sup>. In Europe today, there is virtually no overall population growth from natural increase - crude birth and death rates are essentially equal<sup>5</sup>. But BiH is one of the most extreme examples of countries that are continuously losing people.

And, of course, young people are the most inclined to leave the country; as they seek out opportunities elsewhere. An aging cohort is left behind and already measures 17 percent of the population. And the likelihood that these trends will continue is highlighted by the fact that, in recent years (and for the first time), the number of older people (65+) in BiH has exceeded the number of young (0-14) people (Figure 5). These demographic factors need to be seriously considered in any assessment of the future of government—including local government. Older people put an increasing strain on the working-age population including demands on pension and welfare systems and health care - and this burden is likely to fall on a diminishing number of young people in the future. Transfers from (mostly, family members) abroad make up 11-12 percent of GDP but even these large sums could decline (and, of course, are not easily



4 According to the UN, the population decreased by an average of 0.9% annually since 2010. See: UNFPA. 2017. The State of World Population: Worlds Apart – Reproductive Health and Rights in an Age of Inequality.

5 Kenneth M. Johnson, Layton M. Field and Dudley L. Poston, Jr. 2015. More Deaths Than Births: Subnational Natural Decrease in Europe and the United States.



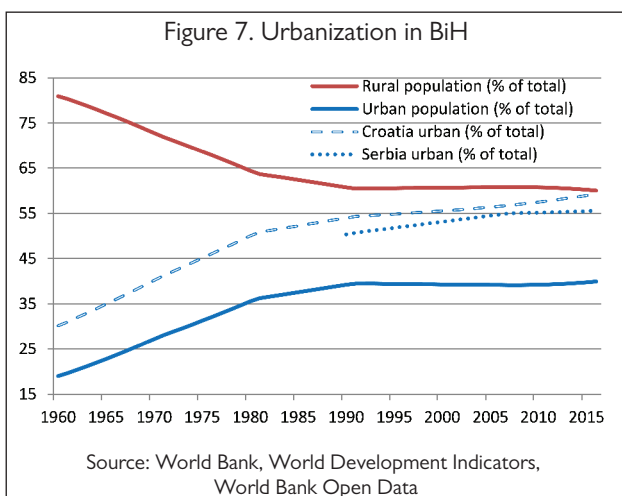
subjected to taxation)<sup>6</sup>. The grey economy further undermines the system and there is a growing wedge between the demands on government (including local government) to provide expensive services and the ability of government to fund these services.

Demographic changes - combined with a lack of economic opportunity - are already putting a burden on those in private sector employment, as demonstrated by the population structure for those aged 15+ (Figure 6). In the FBiH, private sector- and self-employed are just 24 percent of the population and have to support public-sector employment (6.6 percent), the unemployed (10.5 percent) and the inactive and retired (59 percent). The situation is somewhat better in the RS where a larger number of private sector and self-employed persons (30 percent of the population), support fewer public-sector employees (5.9 percent), a larger number of unemployed persons (11.7 percent) and a far smaller number of the inactive and retired (53 percent). The ratio of “dependents” to private-sector workers is 3.2 in the FBiH and 2.4 in the RS. And with demographic trends set to deteriorate further, this problem will only get worse.

6 See Table 3 in IMF Country Report No. 18/39, p:27.

## 2. The Urban-Rural Divide

Another important (and unusual) feature of the recent demography of BiH is the high share of the population still residing in rural areas. Urbanization came to an abrupt halt with the outbreak of the war and the share of the population in cities - both large and small - has stagnated at about 40 percent since then (Figure 7)<sup>7</sup>. By contrast, both Croatia and Serbia have seen 5 percentage point increases in the proportion of the population living in cities since 1990 (and both began from higher levels). There is a lack of economic dynamism in BiH that is compounded by emigration and people only relocate within the country if they feel very confident in a better future.



This phenomenon has created three economic tiers across the country: (i) the larger cities do offer opportunity and continue to attract people<sup>8</sup>; but (ii) secondary towns and cities are in near-universal decline and actually perform worse than rural areas on almost every economic indicator; while (iii) many people - who receive only a basic income (often from social or family transfers) - stay in rural areas where they can afford a (relatively) better life in villages where prices are lower and basic foodstuffs can be supplemented from domestic production. Municipalities can usefully be divided, then, into three groups - city, other-urban and rural - where the cities perform best, the other-urban perform worst, and the rural areas occupy an intermediate position but are still closely linked to the economic fate of the nearby urban centres.

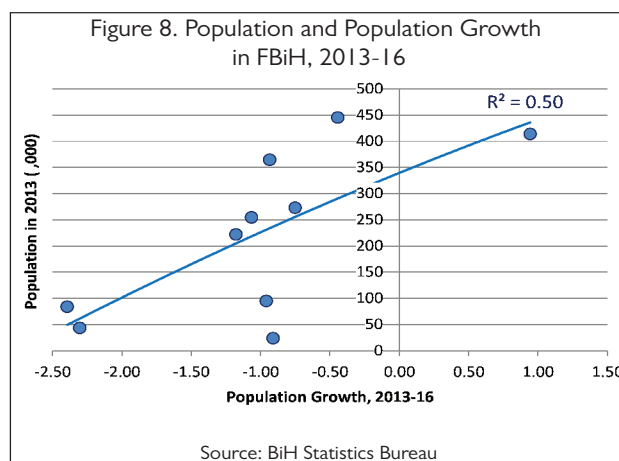
<sup>7</sup> BiH is one of the most rural countries in Europe. Only Montenegro, Ireland and Finland have a higher share of rural population. See: UNDP. 2013. Rural Development in BiH: Myth and Reality.

<sup>8</sup> Official statistics show that Sarajevo, Banja Luka and the four other big cities have almost 40 percent lower unemployment, 25 percent higher wages and over twice the per capita GDP of the rest of the country.

Table 3. Percent Population Growth in BiH, 2013-16.

BiH		-0.75
BD		-0.31
RS		-1.10
FBiH		-0.59
BPC	Bosnia-Podrinje Canton	-0.91
HNC	Herzegovina Neretva Canton	-1.18
C10	Canton 10	-2.39
PC	Posavina Canton	-2.30
SC	Sarajevo Canton	0.94
CBC	Central Bosnia Canton	-1.07
TC	Tuzla Canton	-0.44
USC	Una Sana Canton	-0.75
WHC	West Herzegovina Canton	-0.96
ZDC	Zenica-Doboj Canton	-0.93

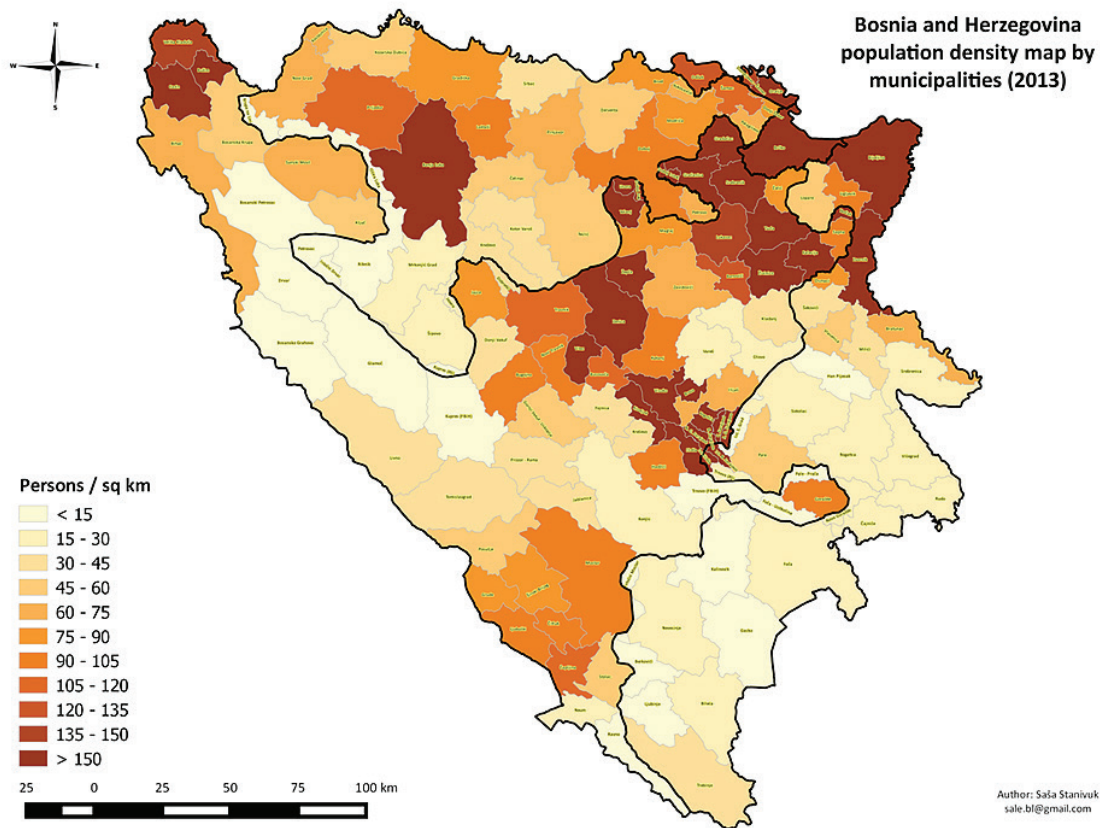
It is clear from the most recent data (in Table 3 and Figure 8, for example), that the smaller cantons (in particular) are still seeing the largest declines in population while Sarajevo is growing. But, in 2017, less than one percent of the population migrated within BiH. Many more emigrated. And the “main challenge for BiH, a middle-income economy where life expectancy stands at a relatively high 76 years on average and deep poverty remains rare, is to overcome the sense of stagnation that the country has fallen into over the last decade, reflecting a lack of economic opportunity and decent jobs<sup>9</sup>.”



The most recent census (2013) demonstrated that large sections of the country now exhibit very low population densities and these present a particular challenge for local government (Figure 9):

<sup>9</sup> Fenger Wolfgang. 2015. Four lessons from Bosnia and Herzegovina on turning around demographic decline. Brookings.



**Figure 9: Population Density across BiH**

According to the World Bank, there are four key areas where policymakers need to act to secure a better future for the next generation—and all of these policy areas are of concern to local government<sup>10</sup>:

1. The main challenge is to revive cities. Though many people are rural, their opportunities actually depend on being connected to thriving cities and towns. The more vibrant the cities, the more jobs there will be for everyone, including those who still live in rural areas today. This suggests that policymakers need to adapt a hub-based approach to economic development; one where urban areas act as centres for growth (“hubs”) and are better connected to the hinterlands that provide human and other resources.
2. BiH needs to find a better balance between in-migration and out-migration. It is normal that talented people move elsewhere to gain international experience. However, successful emerging economies must find a way to either attract them back or to get talent from other parts of the world. Experience from other countries has shown that these trends can be reversed—often quite quickly—and that many people who go abroad would be willing to come back at some stage if living conditions and indigenous prospects improve.
3. Shrinking settlements need to be managed to ensure that they are still liveable and people have access to basic services. This may require a more-aggressive approach to urban planning and the design of utility and service networks that are integrated with the nearest hub.
4. More generally, service delivery mechanisms will need significant rethinking so that services remain accessible to people in smaller settlements and also affordable for local government. Innovations in fields such as tele-medicine and interactive distance learning are particularly promising for countries in demographic decline. Local governments in BiH will need to be innovative, face up to changing circumstances and think beyond their own local borders. Already, for example, the demand for education is falling sharply.<sup>11</sup>

The World Bank Country Partnership Framework (CPF, 2015, page 22) notes that “Improved public service delivery is particularly relevant for BiH given the need to respond to challenges of its shrinking and aging population. As in other European countries, aging means fewer working age people ... [re-

<sup>11</sup> Over the past five years, there was a 5.6 percent decrease in the number of children in primary schools and a 24 percent decrease of children in secondary schools in BiH. For more information see: BiH Ministry of Civil Affairs. 2017. Informacija o statističkim pokazateljima u obrazovanju u Bosni i Hercegovini.

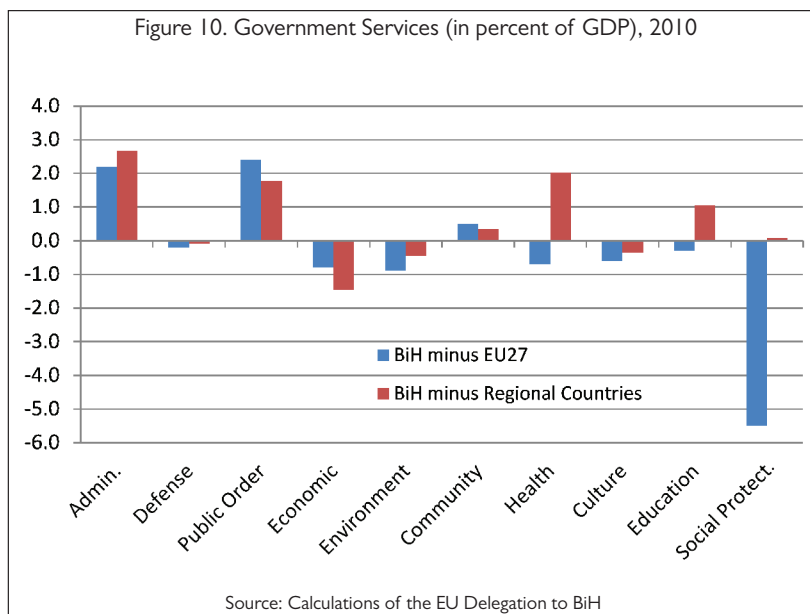
<sup>10</sup> Ibid.

quiring] ... shifts in public spending (more health, less education) and public service delivery .... In addition the large rural population poses a challenge for public service delivery and connectivity<sup>12</sup>.” As it currently stands, “basic infrastructure service delivery is weak given its cost. The municipal sector is mostly unreformed resulting in poor quality of services and financially unsustainable operation. Administrative service delivery has been enhanced at the local level ... [as] supported by donors ... [but there is a need to build] ... on these results by delivering additional services, streamlining service procedures, and introducing e-services [that] can increase access to services, reduce the administrative burden for citizens and businesses, and reduce opportunities for corruption. Many utilities have yet to implement commercial principles to ensure solid waste management sustainability” (CPF, page 23). There is a lot of work to be done and all of these issues are addressed in the Report.

### 3. The Cost of Government and Social Welfare

But it is very clear, even from a cursory look, that fragmented and inefficient government is using up resources that should be employed for economic development and the socially deprived. Figure 10 compares government expenditure in BiH to members of the EU. BiH spends 2 percentage points of GDP more on general administrative services and public order. Moreover, compared to eight countries in the region, BiH spends significantly more (relative to GDP) on general services, public order, health and education. All of these fields involve local government and public order and health are cantonal responsibilities in the FBiH (and are examined in the Report). This excessive expenditure on some services leaves far less money for social protection and BiH spends more than 5 percentage points of GDP less on social protection than EU countries. This problem became very evident during consultations when municipalities (in particular) from both entities lamented that they do not have the resources to provide adequate social care in their communities.

In the Survey, the vast majority of municipalities across the country said that they frequently end up bearing social costs that are not envisaged in the current legislation and that those costs are often not



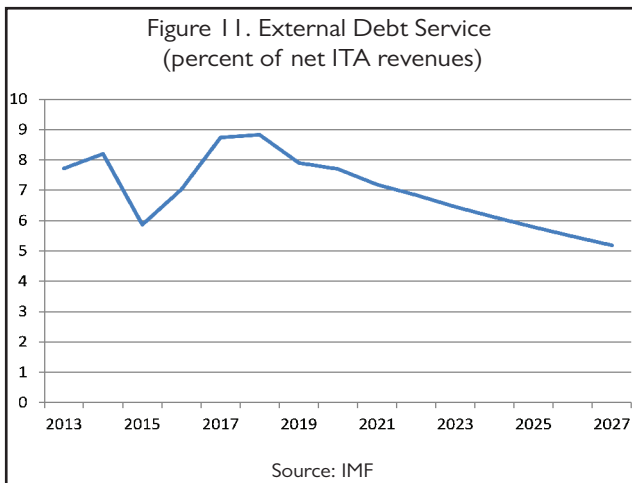
shared by higher levels of government. In the RS, one third of municipalities claim that this assistance for social expenditure makes up 2 percent of their total budget expenditures. But almost a fifth of surveyed municipalities say that they spend 7 percent or more of their budgets on uncompensated social assistance. In the FBiH, almost half of local governments say that they have to spend 2 percent of their budgets for unfinanced social welfare to vulnerable groups. And for another 14 percent of them, such assistance exceeds 7 percent of budget expenditures.

### 4. External Debt Service

Municipalities and cantons across BiH rely heavily on indirect taxes that are collected by the Indirect Taxation Authority (ITA) and transferred to the State Institutions and entity Ministries of Finance before being reallocated within the entities. VAT revenues make up: 30 percent of municipal budgets in the FBiH; almost 65 percent of cantonal revenues; and 50 percent of municipal budgets in the RS. And, in each case, the entity pays its external debts - using only VAT revenues - before the remaining amount is divided between the entity budget and municipalities and cantons according to pre-set shares (Table 1). This procedure means that the revenues of cantons and municipalities vary significantly with the level of debt service due in any particular year. And this leads to resentment in municipalities and cantons where officials complain that they have to service debts that they did not incur in the first place. They complain that they are “the last in line” to get their share of revenues from VAT.

Lower levels of government feel that they did not benefit from recent significant increases in VAT revenues and find it very difficult to project their revenue streams with any confidence. Debt service can indeed

<sup>12</sup> The World Bank Group. 2015. Bosnia and Herzegovina - Country partnership framework for the period FY2016-20. p.22-23.



be very volatile (see Figure 11) and there is a need for both Ministries of Finance to set out more clearly how the allocation of ITA revenues is conducted in each

year and to give municipalities (and cantons) clearer expectations regarding revenue projections. In fact, according to current IMF debt projections (and a conservative projections of ITA collections), the revenues available to lower levels of government should increase over the next decade. But this will not make the basic problem go away and the issue is discussed further below in the entity chapters.

## 5. Natural Resources

BiH is rich in natural resources, particularly in the areas of water, forests and mining. A similar legal framework applies in both entities: property rights are vested in the central institutions; management is assigned to ministries (and, in the case of FBiH, also to cantons); and municipalities benefit from the partial sharing of revenues. The resources are exploited either by publically-owned companies or on the basis

### Box 1: The Sharing of Revenues from Natural Resources

As is the case in most federal and decentralized systems, revenue raised from natural resources is partially shared, in both entities, with lower level governments. And this represents an important source of financing for many poor and underdeveloped municipalities. In the RS, fees from concessions are divided between the entity and local governments depending on their development levels. Developed municipalities and cities get 70 percent, while underdeveloped and extremely underdeveloped get 80 and 90 percent respectively. The draft Law on Concessions being discussed in the FBiH envisages that, for concessions allocated by the FBiH government, fees would be allocated as follows: 20 percent for the entity; 30 percent for the canton; and 50 percent to the cities and municipalities. The FBiH is currently discussing a draft Forestry Law that would grant 8 percent of forestry revenues to the local governments where the fees are generated.

The Survey asked what would be a fair percentage of revenue allocation from natural resources between the different levels. Municipalities in the FBiH (on average) said that they should receive around two thirds, with 20 percent going to the cantons and 15 percent to the entity. Not surprisingly, cantons would give themselves 40 percent but would still allocate 50 percent to cities and municipalities. In the RS, municipalities thought that they should receive 70 percent and 30 percent should go to the RS Government - basically in line with the current system.

In 2002, the FBiH adopted a Law on Forests and transferred the management of the forests to the cantonal ministries. Public companies responsible for the management of the forests were established in each canton and are, in most cases, 100 percent publicly owned (the exception being Tuzla Canton where a joint stock company was established). Frequently, these companies have an excessive number of employees and are under pressure to cut down more forests in order to meet their growing expenses. In the RS, there is a Forestry Department within the Ministry of Agriculture, Forestry and Water Management, which is responsible for forestry policy and the public company "Šume RS" manages the public forests.

In 2009, the FBiH Constitutional Court found that the FBiH Law on Forests violated the European Charter of Local Self-Government and the FBiH Law on Principles of Local Self-Government and this put the 2002 law out of force. Ever since, the FBiH Parliament has not been able to adopt a new law and 8 out of 10 cantons have adopted their own legislation (Hercegovina Neretva Canton and Bosnia Podrinje Canton being the exceptions). The legal vacuum has reportedly led to a significant increase in illegal logging and to an alarming level of deforestation. The FBiH Government is currently discussing a proposal that would put a cap on employment in the forestry companies, but it is facing stiff opposition from special-interest groups.

of concessions. There is often a significant overlapping of competences, particularly in the case of water in the FBiH where eight federal agencies and ministries play a role. In both entities, municipalities would like a larger role in the management of natural resources.

There is widespread disagreement in both entities about which level of government should benefit from the use of natural resources and how revenues should be divided. Typically, local governments make the point that the benefits should go to the territory on which the natural resource is located and higher levels talk about a joint ecosystem whose benefits should be felt across municipal (and other) boundaries. In the FBiH, the issue has been further complicated by a Constitutional Court ruling that negated the FBiH Law on Forests and eight of ten cantons have since adopted their own laws. (See [Box 1](#) for further details).

In the RS, the allocation of revenues from natural resources is higher for undeveloped municipalities. However, the use of these revenues is subject to significant restrictions in both entities. Typically, revenues must be used for investment purposes and this leads to complaints from many municipalities that see constraints on their ability to provide basic services. Revenues collected from water management fees, for example, are earmarked for investment in the water sector; such as financing the construction and maintenance of some water facilities or the elaboration of water management plans and other activities related to water management. Similar earmarking schemes apply to other natural resources.

## C. Thinking about Reforms - a Joint Network Approach

The high proportion of people living in rural areas puts a particular strain on local services and has the obvious implication that people from rural areas will often - and regularly - need to travel to larger centres in order to seek employment and health care, education and other services. It will not be possible to provide a significant range of opportunities or services in every small municipality and local governments will need to collaborate and cooperate in the provision of those opportunities and services. And this conclusion suggests a need to adopt an approach where local government units operating at the same level (municipalities or cantons) and at different levels (entities and cantons) need to operate as components of the same network. Outcomes (i.e. the provision of services and policies) will depend on the contributions of all of them (although with different roles and specializations). For example, a significant

centre will act as a hub for local interaction and the surrounding municipalities and towns will act as the spokes that provide human and other resources to the centre. This was the natural system that existed in the past - where market towns acted as local hubs - but it is now easier to travel longer distances and the smaller market towns are in obvious decline and must consider their dual role as both local centres and satellites to larger hubs.

Many countries have been confronted with this challenge over recent years and it is possible to think about implementing a spatial approach in a number of different ways. Moreover, the same concepts can be used regardless of the size of the geographical areas involved, just as long as the common problem is one of collaboration in the provision of services across a multi-jurisdictional collection of differently-sized units<sup>13</sup>.

Entity and local governments will need to give significant consideration to the most appropriate structures to adopt for the delivery of services in each geographical area and this is a central theme of this Report. Local governments will need to be imaginative and practical and, in this regard, it will be particularly important to consider that the most-efficient model for service delivery will not necessarily be the same for each type of service. The same hierarchical model will not be appropriate for the delivery of all services—as is often implied in current structures—and local governments will need to be flexible in the way they approach each sector.

[Box 2](#) lists three types of service that are best delivered by three different types of organisation or institution. In summary:

1. For the provision of a single-access service (like health care), where the consumer must go to the provider for individual attention and there are escalating tiers of specialisation, local authorities are best organised according to a hub-and-spoke or cluster model for the provision of services. Different localities will need to coordinate their individual activities - including providing for

<sup>13</sup> In Australia, for example, "regional capitals are central to Australia's regional development agenda. While the size of such capitals are as diverse as the cities themselves, they all share a unique role of providing a central point of access for local residents and those in surrounding towns and rural areas to essential infrastructure, services, business, employment and education. ... In the regional development policy space it is often left to local government to coordinate and produce the lion's share of the regional visioning, planning, engagement and budgeting required for development priorities and projects. This is often because local government is the closest governing authority to communities and as such will represent the ambitions and values of their regional areas." See: ACELG. 2015. Local Government Growing Regional Australia. p:9-10.



**Box 2: Types of Services and Structures for Delivery of Services**

1. Single access services, where there is an individual point of access to the service. The service can be provided on an individualised basis that must be determined by the provider, such as in the case of health. The service can also be provided on a collective basis, such a musical performance. The customer must in both cases, go to the service provider. And there are clear differences in access to the service depending on where you live. In the first case there are escalating tiers of service - depending on need - and this leads to a hierarchy of institutions (such as health centres and hospitals). These services are best provided by a hub-and-spoke system (and is mostly organised as a single, bureaucratic organization - such as a Health System). In the second case, a single institution can cover a wide area and provide the service to a plurality of users, because of the collective nature of the service.
2. Pure network services, where the service can be accessed from anywhere, such in the case of an electricity grid. Limited differentiation is possible but the service is available on demand and comes to the customer. Building the network infrastructure is essential for the provision of the service. Because of accessibility from any point, no hierarchy has necessarily to emerge. The service can be better provided jointly by cooperating institutions, exploiting economies of scale and, in some cases, economies of scope.
3. Network services with differentiated roles. The service is the same for groups/categories of people - so differentiated needs can be accommodated, such as high frequency at peak hours of commuters trains, or disposal of industrial waste - but people can choose the group they will belong to. The service requires combining network-shaped organisations (perhaps, with hubs-and-spokes).

Category:	Single Access	Pure Network	Differentiated Network
<b>Service type</b>	Individualised	Common	Groups
<b>Location</b>	Customer goes to the service	Service comes to the customer	Customer chooses a common service
<b>Delivery</b>	By referral	On demand	As scheduled
<b>Control</b>	Centralised	Joint/shared	Joint/shared
<b>Hierarchy</b>	Required	Not necessary	Sometimes
<b>Organisation/institution</b>	1. Hub-and-spoke 2. Consortium 3. Metropolitan cities	3. Joint Agency 4. Association of Municipalities	3 and 4 and 5. Association of Cantons and Municipalities
<b>Examples</b>	Health Social services Public safety	Water Sanitation Communication	Transportation Garbage disposal Local development

linkages between them - so that the benefits of specialisation and joint action can be exploited<sup>14</sup>.

14 A Hub-and-Spoke Model assigns a hub centre that has responsibility for co-ordinating services across one or more satellite or 'spoke' localities. Hub centres have their own leaders and spokes may be led by an individual centre manager. The hub may provide core services that are not available in spoke centres. A Cluster Model is one where a group of localities collaborate on a more or less formal basis (usually, in the same geographical area). Localities each have their own leaders but agree to collaborate on specific areas of work (or one locality may lead a specific piece of work which is then shared across the cluster). For more information see: Bostock Lisa and Britt Rachel. 2014. Effective approaches to hub and spoke provision: a rapid review of the literature.

2. For the provision of a pure-networked service (like water delivery), where a common product is available on demand to every consumer and cooperating institutions can exploit economies of scale in infrastructure provision (and/or economies of scope in activities such as billing), local authorities will do best to adopt a collaborative approach where, as appropriate, the same facilities can be shared or jointly operated.
3. For the provision of a grouped-networked service (like transportation or economic development), where communities will benefit from

sharing the same services but may have different expectations from them, communities will expect their local governments to work together (perhaps, at different levels) as partners and this associated approach is often implemented by dedicated functional agencies that are professionally run and jointly owned by governments and whose performance can be judged clearly.

Different versions of these models are suitable for different regions and for different service sectors in BiH and these differences will be discussed later. But to what extent is BiH prepared to even consider such a joint-networked approach across local authorities? This question has very different answers in the two entities and the irony is that, in the RS, there is a realization that the existing horizontal/flat system of local government will need to be replaced by a regional approach with different layers whereas, in the FBiH, the existing layered system within regions (cantons) has not been used to build an integrated and efficient system of mutual reliance between cities and municipalities. Instead, in the FBiH, cantonal authorities often govern as if municipalities and towns do not exist and try to “administer” their cantons rather than try to integrate their communities.

- The RS Government adopted a Strategy for Development of Local Self-governance (2017-2021) in 2017 that aims to carry out a comprehensive analysis and overview of the competences and tasks of local governments and to redefine the regional framework for cooperation. The Strategy recognizes that there is an obvious difference when it comes to the provision of public services (in terms of availability, content and quality) between local governments and that peripheral and rural areas are significantly lagging behind the central and urban areas. As a result, the RS Strategy aims to move away from the current ‘monotype concept’ where all local governments have the same competences regardless of their capacities and move instead toward a ‘multi-type concept’ where local governments would have different competences based on their real capacities and needs. This multi-type system would necessarily involve a regional hub-and-spoke approach and is discussed in Chapter 3.
- The FBiH is based on ten cantons, but it does not, in general, operate as a hub-and-spoke system or integrated regional system. Few canton governments actively engage their towns and municipalities in a holistic regional approach to local government that is based on integrating local communities or provide a strategic vision

for mutual reliance and development. Instead, most municipalities complain: that they are not consulted by their canton governments on regional strategies; that cantons are often more of a hindrance to their operations than a help; and that they often find themselves responsible for unfunded responsibilities at the local level because their citizens do not have effective access (including transportation) to services that could be expected in regional centres. Canton governments are regarded by many as bloated, sclerotic and inefficient and many of the cantons, in turn, complain about a lack of ability to deal with their own bloated bureaucracies or to effect real change. Cantons have become preoccupied with their own administrations and, for example, only three cantons grant a larger share of taxes to their municipalities than the minimum set out in the law. There is little sense that the local authorities within individual cantons are collaborating efficiently and this is discussed in detail in Chapter 2.

## D. Overcoming Political Divisions and Corruption

The task of transforming local government in BiH is complicated - and made more urgent - by the associated problems of political division and corruption. These are both discussed here - in particular, as they apply to local government - along with the potential for greater citizen political participation to overcome them:

### I. Political Divisions

Political divisions and ethnic affiliations reduce public scrutiny of the operation of governments, induce a lack of transparency and often openly facilitate corruption and nepotism. The distribution of complicated grants on a completely discretionary basis, for example, is both a reflection and a cause of corruption and nepotism. In both entities, municipalities report that grants and transfers from higher levels of government are often disbursed in an ad-hoc fashion and largely on the basis of the local government’s political affiliation with the granting authority. This undermines the ability to plan and initiate infrastructure projects and foments corruption.

In these circumstances, there is a need for far greater emphasis on cooperation and collaboration between authorities. But it is very difficult for hard-pressed and small municipalities to overcome practical obstacles to cooperation when they are already finding it difficult to survive on a daily basis. Most mayors have

no objection to improved collaboration - even across entity boundaries - but say they simply do not have the time to engage in such activity. Almost half of the respondents to the Survey in both entities said that political differences are the main obstacle to greater cooperation between local governments, while on average around 13 percent point to legal constraints.

Organizational innovation - particularly, the creation of functional or other agencies with multiple participation across local governments - could increase the transaction costs associated with corrupt deals and nepotism. However, the task of instituting reforms that could reduce political divisions is complicated by the political divisions themselves. They undermine the agreements necessary to establish the network approach that local government needs to adopt. The two entities have separate local government systems that do not always encourage cross-entity cooperation and collaboration and, at the same time, two-thirds of municipalities in both entities have a border with a municipality from the other entity. This often means that a municipality is “cut-off” from part of its natural catchment area. Economies of scale are undermined as a result and service provision is weakened. This is particularly true for the provision of municipal services and for health care. The lack of inter-entity activity is highlighted by the miniscule level of migration from one entity to the other.

Because cross-entity collaboration is not actively promoted, it will often be very difficult to undertake in practice. Municipal (and cantonal) collaboration within entities is easier but is still time-consuming and difficult. In the FBiH, cantons exacerbate the fragmentation of some public services (like policing and health) and undermine potential economies of scale without necessarily harnessing the opportunity to instigate a regional approach for some other services (as discussed above). Often, collaboration requires administrative innovation, such as creating joint enterprises for local economic development or utility provision and negotiating service contracts for health care. Collaboration is possible but the exceptions (who do collaborate) prove the rule (that it is difficult to undertake).

And this is at a time when collaboration between local governments is a growing trend worldwide. O’Donnell (2012), for example, “reviews a number of cases of strategic collaboration in different countries ranging from loose cooperative efforts to formal partnerships. She notes that collaboration is not easy and requires commitment, leadership and an ability to identify and overcome challenges. [Moreover], forms of consolidation may vary, from ... shared ser-

vices to regional collaborations<sup>15</sup>.” This approach is essential in BiH.

Municipalities (and cantons) need to be actively encouraged by higher levels of government to overcome obstacles to cooperation - through the provision of grants dedicated to promoting cooperation and creating of-the-shelf institutional arrangements that will make cooperation easier. These possibilities are discussed in the body of the Report and are crucial to the capture of economies of scale and for enhancing strategic thinking at a regional (and local) level. Economies of scale increase the capacity of municipalities to undertake new functions and deliver new or improved services that previously were not possible. Collaboration helps municipalities to shift their focus towards a more strategic view of their operations - a perspective that transcends individual local government and political boundaries and encourages them to operate in a broader context. It also facilitates the pooling of knowledge and expertise and would help municipalities to relate more effectively to central governments<sup>16</sup>.

## 2. Corruption

Since the 1980s, local governments have acquired greater powers of decision making, implementation and oversight in BiH. Both elected and appointed officials have to deal with separating public duties from private interests and corruption is perceived as a serious problem at all levels of government. This is exacerbated at the local level by the fact that many officials have greater vested interests based on family, friendships and business ties that can influence decision-making. In addition, remuneration at the local government level is low in comparison to the national level (in many cases) and the institutions that are designed to hold public officials to account are not always adequate to perform their duties and to uphold public sector integrity<sup>17</sup>.

In 2012, Transparency International compiled a transparency index of local self-government units in BiH, based on an analysis of the work of local councils and administrations, cooperation with civil society, cooperation with local institutions and an assessment of the existence of anti-corruption mechanisms. The analy-

<sup>15</sup> Boyle Richard. 2016. Re-shaping Local Government: Overview of Selected International Experience with Local Government Reorganisation, Mergers, Amalgamation and Coordination. p:5.

<sup>16</sup> Aulich Chris, Sansom Graham and McKinlay Peter. 2014. A Fresh Look at Municipal Consolidation in Australia.

<sup>17</sup> Transparency International BiH. 2015. Local Integrity System Assessment in BiH.

sis found that a vast majority (81 percent) of cities and municipalities are 'partially transparent', while the City of Banja Luka was the only local self-government unit that was deemed 'transparent'. Some 27 local governments were deemed either 'non-transparent' or 'extremely non-transparent'. There were no significant differences between the entities and anti-corruption mechanisms were found to be generally deficient<sup>18</sup>. Local governments were found wanting when it came to their cooperation with the private sector and local institutions (such as community councils; the "mjesne zajednice").

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<sup>18</sup> Transparency International BiH. 2012. Rezultati istraživanja o transparentnosti jedinica lokalne samouprave u Bosni i Hercegovini.

There are particular concerns about the appointment of officials and undue political influence in the appointment and recruitment of public sector officials is widely regarded as one of the main causes of pervasive corruption. Existing regulations to ensure that hiring and career advancement are based upon open competition and professional merit are not sufficiently comprehensive. Moreover, even when these laws do apply, they are regularly circumvented. Following the 2010 elections, for instance, more than 200 high-level office holders in public institutions and companies were replaced. There is also significant evidence of a lack of transparency in public companies (see [Box 3](#)).



### Box 3: Transparency in Public Companies

In April 2018, Transparency International BiH published a Report on 'Good Governance in Public Companies in BiH: An Analysis of Transparency, Responsibility and Integrity of Public Companies.' It was supported by the British Embassy in Sarajevo and the key problem was identified as political control. Government-owned enterprises are in the hands of the ruling political parties, which use the companies' resources to maintain their grip on power. "This is achieved by illegal employment and by the withdrawal of profits, due to which citizens do not receive the kind of services they should expect," the authors said. They added that it was necessary to strengthen the mechanisms of accountability and transparency in public enterprises and to reform the appointment process. The Report conducted a survey on a sample of 100 companies and made the following main findings:

1. Transparency
  - There is a solid legal framework in place but a wide-spread practice of breaching laws. Transparency on the organizational, managerial and ownership structures is at a very low level.
  - Many public enterprises, especially at the local level, do not have their own web sites that would provide sufficient information to the public on how they conduct their business. Public companies do not publish information on the work of assemblies and supervisory boards, so it is almost impossible to get information on what has been discussed and how decisions were made.
  - A register of public companies in the FBiH has not been established and there is only an estimated number of companies. The RS Register only has basic information.
2. Independence and Accountability
  - Most appointments of management and boards are significantly influenced by politics - despite the provisions of legal frameworks - and this negatively affects their business operations.
  - Conditions and criteria for selection and appointment are very general. The criteria for candidate ranking are not disclosed to the public and are based on the subjective assessments of commission members (invariably, from interviews).
  - Nominally, municipal councils appoint members of supervisory boards and managers of public companies, but in practice these appointments depend mostly on agreements between political parties. Politicization is linked to the process of decision making and priorities are often based on political goals—the maximization of employment and salaries and maintenance of low tariffs.
3. Integrity and Anti-Corruption Mechanisms
  - Anti-corruption mechanisms in public companies are generally very weak and include weak mechanisms to prevent nepotism and clientelism.
  - More than 90 percent of public companies surveyed for the Report confirmed they do not have policies for identification, monitoring and management of conflict of interests.
  - The financing of political parties by public companies is prohibited but the legal framework does not provide proper mechanisms for the prevention of an abuse of resources or the indirect financing of political parties' activities.
  - The principle of prohibiting a revolving door between public companies and government, or between the public and private sectors, is completely undeveloped in BiH.

According to the World Bank “Ease of Doing Business” index (from 2018), BiH ranks 86 out of the 190 economies. The country’s ranking is particularly poor with regard to starting a business and dealing with construction permits (175th and 166th place respectively) - two areas that chiefly involve interaction with the public administration. For example, starting a business in BiH requires an average of 12 procedures and 65 days, well above the regional average. Excessive and complicated regulations such as these (i.e. red tape) are known to be a potential source of corruption, as they give public officials leverage to elicit illegal gifts by using their discretion to facilitate or hinder administrative processes. This certainly seems to be one of the main drivers of corruption in BiH where, according to a UNODC (2013) study, the most common reason for paying bribes cited by businesses in BiH was precisely to “speed up business-related procedures” (30 percent of all bribes). The same study also presents revealing evidence regarding BiH citizens’ exposure to bribery. It showed that 20 percent of the adult population had experienced, either directly or indirectly, an episode of attempted bribery involving a public official in the 12-month period prior to the Survey. However, only 2 percent of respondents reported having refused to pay the bribe, which suggests that a vast majority of citizens tacitly accept the practice.

### 3. Participation and Public Accountability

The introduction of credible systems for performance appraisal in local governments would permit voters to properly assess the performance of their local government and compare it to other local governments. These processes could gradually help to identify those who are inefficient or corrupt. Under the current system, service providers often lack incentives to improve their performance. They get little feedback from citizens and there is no incentive system to reward better performers. There are no publicly available performance benchmarks – so that citizens cannot hold providers accountable and providers have scant information on what they need to do to improve user satisfaction. However, it is encouraging that almost nine out of ten local governments in both entities agree that they need to undertake more regular and systemic performance benchmarking of municipal services, including the communication of regular reports to the public.

Assessing the performance of local governments will be a crucial building block of the reform pro-

cess<sup>19</sup>. Performance assessment serves two purposes. When disseminated in the media, assessments allow citizens to check on the actions of their government and to exert pressure for change and foster competition at election time. Second, performance assessments can provide upper levels of government with information for an objective and efficient allocation of grants.

Performance is usually assessed with two distinct and complementary sets of periodically updated indicators. These are: (i) indicators and/or measures of the quality/quantity of outcomes and of the capacity to improve them; and (ii) indicators of users’ satisfaction. The first information set originates from the providers of services (i.e. from local governments themselves) but requires control and validation by another agency; not necessarily situated at an upper level. Information about satisfaction is collected with surveys that are costly to undertake because statistical significance (i.e. a sufficient number of respondents) is required for each local government unit.

Improvements in governance are secured through a gradual, sustainable approach based on relatively small information requirements. When used for grants allocations, performance assessments must be undertaken by a separate agency from the one responsible for the allocation. In the case of BiH, the Associations of Municipalities and Cities could be involved with the technical support of another, private or public, agency. Finally, when used for grants allocations, assessments should be undertaken for the overall performance of local governments, even if the grants apply to individual sectors of activity.

A 2009 World Bank Report found that, in the absence of formal support for cooperation, “horizontal peer-to-peer relationships appear to be a strong driver for reform.” And this sense of a willingness to cooperate and collaborate was confirmed during consultations across the FBiH.

More than 90 percent of cities and municipalities agree that Ministries of Finance and sector ministries should work with local governments to design performance-based grants that will complement the revenue allocation system, encourage better service delivery, and ease the difficulty of reform measures. Even a greater majority (93 percent) believes that higher-level government transfers to municipalities

<sup>19</sup> It is also a challenging one, as shown by international experience, where failures or partial achievements outnumber successes. See: Lockwood Ben and Francesco Porcelli. 2011. Incentive Schemes for Local Government: Theory and Evidence from Comprehensive Performance Assessment in England and Game Chris. 2006. Comprehensive Performance Assessment in English Local Government.

should be introduced that would be based on increased performance monitoring and the delivery of minimum services. [Box 4](#) gives an example of one recent initiative to improve citizen participation.

ger direct participation of citizens in the activities of local government. Strategic goals include the strengthening of civic participation and influence in decision-making at the local level, as well as ensuring

#### Box 4: Innovative Novo Sarajevo Municipality

Municipalities have to make their budgets accessible to citizens. Nowadays, most municipalities publish their budgets on their website. However, Novo Sarajevo municipality found that citizens did not really understand what a budget is and how it should be questioned. Therefore, it started to present an illustrative “Budget for Citizens” (Budžet za građane) in a modern and citizen-friendly way (see

<http://www.novosarajevo.ba/administracija/opcinske-sluzbe/124-sluzba-za-oblast-privrede-i-finasija/21973-budzet-za-gradane-2017-godine-2>).

Following the Mayor’s introduction and explanation, citizens find answers to ten questions:

1. What is the municipal budget?
2. Who approves the budget?
3. When is the budget available?
4. What is the budget (financial) year?
5. How is the budget composed?
6. What is a balanced budget?
7. What happens if the budget is not balanced?
8. What happens if the budget is not approved in time?
9. How is the budget financed?
10. Where can I find the municipal budget?

Furthermore, the budget process and the budget are presented in a very user friendly way. Via the municipal website, Novo Sarajevo citizens can comment on the budget on-line, and they find information on the dates and places of the public presentation of the budget in Novo Sarajevo local communities.

The FBiH Law on Local Self-Government does foresee processes such as hours for citizens in assemblies and other forms of participation and many municipalities do organize town hall discussions, and/or discussions with local communities (the “mjesne zajednice” or MZs). MZs represent the sub-municipal governance level, the neighbourhoods that interact with the municipality. MZs vary in size and according to their environment, be it a sparse rural settlement or an urban context. MZs are self-governing communities within a municipality; they are territorially organized; and they may take over service provision functions from the municipality<sup>20</sup>. Entity laws on Local Self-Government define the operation of the MZs as a form of engaging citizens in local governance. And, often, the actions of MZs demonstrate that supportive neighbourhoods can overcome divisions and engage together in local governance.

The RS 2017-2021 Strategy for Development of Local Self-governance highlights the need for stron-

efficiency and accountability of local government in managing local development. With regard to these goals, the RS Strategy views the role of MZs as an opportunity to transfer certain activities to them. Transparent processes, user friendly information and citizen involvement in local development are means to strengthen the sense of belonging and to motivate citizens to contribute to improving their own quality of life.

In some regions, MZs have experienced a revival and become indispensable partners of local governments. MZ councillors and presidents know the people of their community. They share observed needs and concerns with the centres for social work and with their contact person at the municipality. With the support of international donors, the 18 MZs of Trebinje municipality have elaborated an “identity card,” which gives a clear and up-to-date picture of the living conditions of the population and makes vulnerable and marginalized groups visible. Such information is the basis of MZ action plans, allowing for direct implementation of small infrastructure projects and social activities. The identity cards are also an important instrument for planning local development at the municipal level. Trebinje has nominated an MZ coordinator at the municipality who should guarantee a continuous information flow between MZs and

<sup>20</sup> There are 2,587 formally established MZs in Bosnia and Herzegovina (1,451 in FBiH, 1,058 in RS, 78 in the Brčko District). In the FBiH, local communities are legally defined local governments, while in Republika Srpska they do not have a defined legal status and in Brčko District they have the status of an association of citizens.

municipality. Community demand for adequate information pushes local governments to more transparency and accountability. Municipal representatives increasingly meet on a regular basis with MZ Councils, for exchanges on current plans and concerns.

MZs give marginalized people a voice and are themselves an important ground for civic participation. Women do not refrain to stand as candidates for MZ Councils. Active MZ Councils are essential partners for local CSOs and NGOs and they cooperate and support each other. MZs seek to become more attractive for youth organisations. As one participant in a civil society meeting put it: “If MZs don’t meet, people are left alone.” See [Box 5](#).

tion of short-term fixes. Local government leaders called for the combination of both cycles into one; such that both sets of elections would take place at the same time (every four years).

## E. Opportunities for Change

The Reform Agenda for 2015-18 succeeded in putting BiH back on the path to EU accession and there is a significant chance that BiH will become a **candidate country** in the foreseeable future. The Reform Agenda was focussed on securing financial and fiscal stability at higher levels of government and this should be enough to secure a return to growth rates of 3-4 percent and higher revenues over the

### Box 5: Enhancing Mjesne Zajednice’s (MZs) Role in Vertical Accountability

Entity laws on Local Self-Government define MZs as a form of engaging citizens in local governance. In the FBiH, MZs have some specific competences, namely: adopting spatial plans in the area of local communities; the development of the economy and social affairs; care for those in need of assistance and cooperation with the professional bodies in areas of social protection; development of culture and sport; preservation and protection of nature and man-made values in human environment. MZs receive some funding from their municipality, but depend mostly on donations, gifts and payments for services. The primary purpose of MZs is direct citizens’ participation. MZs often play the role of mediator between citizens and municipal authorities. In smaller and rural areas, MZs may perform small communal and administrative tasks, and thus have a role of providing services to citizens.

Research shows that citizens are aware of participation opportunities through the MZ. It is among the most frequently used participatory mechanisms; 81% of citizens who participated in local community activities, described local community council meetings as the most useful form of local level involvement.<sup>1</sup> Citizens most frequently contact MZ representatives for infrastructural (water, roads, lighting) and administrative issues, and for social, cultural and sports events. The most common contact with the MZ is attendance of an MZ event.

The same research showed the importance of cooperation between centres for social work and MZs. Providing information to centres for social work, coordinating and meeting on a regular basis, alerting centres for social work to cases of persons in social need and, in some cases, domestic violence, appears to be one of the core activities of MZs throughout the country.

In the same vein socially engaged NGOs and CSOs confirmed during LGI meetings that they can often count on MZ support. MZs cooperate with local organizations, they may make their facilities available to them, include and use them for own activities, and support their work otherwise. This cooperation has proved its effectiveness in recent emergencies.

<sup>1</sup> See: Mirna Jusic. 2014. *Local Communities in Bosnia and Herzegovina: Challenges and Prospects for Institutional Development*. Analitika – Center for Social Research

Local government leaders from across the country complained of the disruptive effect of having separate four-year election cycles for the general and local elections. General elections are held two years after every local election and local governments are, as a result, thrown into an election campaign after just two years of their term. This undermines their ability to make and implement plans for the full length of their terms and often leads, instead, to the adop-

tion of short-term fixes. Local government leaders called for the combination of both cycles into one; such that both sets of elections would take place at the same time (every four years).

<sup>21</sup> See table I. in IMF Country Report No. 18/39, 2018, p:25.

corporate and bankruptcy laws, to combined efforts to fight the grey economy and streamlining business registration procedures - and this momentum should be employed to explore possibilities for greater collaboration in the provision of public services between local governments in different entities. Often, this collaboration could be based on the purchase at cost of specialised services from one entity to the other.

**Growing public revenues at all levels** should be used to fund structural reforms - such as creating funds for the resolution of overstaffing and to finance early retirement in local governments and SOEs - instead of leading to staff increases. Creation of Federation and/or Cantonal Funds for absorption of overstaffing and promotion of mobility and to finance early retirement is an opportunity to provide financial incentives to cooperation and to institutional innovation. Access to these funds, particularly to an Early Retirement Fund could be made conditional, or linked, to cooperation projects, such a joint venture for a disposal site. Also, the Absorption of overstaffing and mobility Fund would rest on an electronic market, a digital platform, where municipalities would insert lists of needed positions and receive information about positions in excess. The Fund would cover a share of the salary cost and of contributions for personnel hired from these lists. This would be a varying share determined by the platform according to demand and supply. A mobility allowance would foster mobility.

According to the World Bank's Country Partnership Framework, it is particularly important to tackle "the large and inefficient public sector in BiH [that] is holding back the country's growth and prosperity. It crowds out the private sector and suppresses its development, both in terms of domestic and export performance, by capturing physical and human factors of production and using them in inefficient way. Making the public expenditures more efficient while maintaining the macroeconomic stability can save significant resources, relieve the burden on the economy, support overall competitiveness (and hence facilitate improvements in exports), and at the same time improve the quality of the services that the authorities provide to its citizens."<sup>22</sup>

In addition, ambitious plans are being implemented to vastly **improve regional connectivity** in BiH. In a recent paper, the IMF looked at the level and quality of public infrastructure in the region, finding that shortages of core public infrastructure can be a significant obstacle for higher economic growth and

faster income convergence. Amongst other things, it found that inadequate transportation networks and the insufficient or unreliable provisions of basic utilities (for example, water and energy) can restrict production capacity and undermine an economy's attractiveness for foreign and domestic investors<sup>23</sup>.

Following the adoption of an increase in fuel excises in December 2017, BiH managed to secure important funding for its infrastructural development. Already in February 2018, the EBRD signed a Memorandum of Understanding with the authorities to invest more than €700 million in the country's infrastructure. With the already committed funds, including from the European Investment Bank, this will be enough to complete the country's Corridor Vc – a significant boost to the country's economy and competitiveness. According to the EBRD Feasibility Study of Corridor Vc, savings based on a reduction in travel time represent the most important item in the structure of direct benefits from construction of a motorway, along with the savings of vehicle operation costs. Other benefits will include a significant increase in investments, reduced road accidents and its consequences and higher generated traffic. Obviously, the improved road network will also enhance the ability of local communities to cooperate more on a regional level.

As part of this Initiative, a Survey was sent to all cities and municipalities in BiH; asking them about the main issues and opportunities for change. A vast majority of local governments took the opportunity to respond (as set out in Annex A) and, in general, the results confirmed the main problems that were identified during consultations. The responses to the Survey also demonstrated a great desire for reform in both entities and the following are particularly encouraging:

- **The Survey provides a strong mandate for change:** Although satisfaction with the current state of local government is greater in the RS than in the FBiH, only one in ten local governments across the country find the situation to be good. Half of the local governments in the FBiH and around a third in the RS assess the current situation as either bad or in crisis. And political differences are still seen as the main obstacle to greater cooperation between local governments in both entities.
- **Local governments want to cooperate but need the right incentives:** A vast majority of them support the idea of giving priority to grant applications that are jointly submit-

<sup>22</sup> The World Bank Group. 2015. Bosnia and Herzegovina - Country partnership framework for the period FY2016-20. p:18

<sup>23</sup> IMF 2018. Public Infrastructure in the Western Balkans: Opportunities and Challenges.

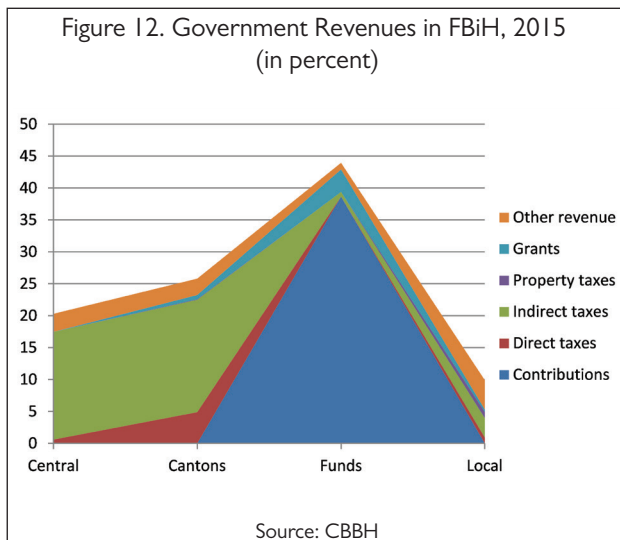


ted by two or more cities and municipalities. Moreover, almost nine out of ten local governments across the country feel that recent floods and fires demonstrated an urgent need for improved cooperation between different municipalities to enhance civil protection. And half of the respondents in the RS and 60 per cent in the FBiH believe that cities and municipalities should collaborate in the provision of services and encourage utility companies to provide services across municipal boundaries.

- **The financing system of local governments needs to be reconsidered:** Out of 111 local governments surveyed in BiH, only one completely agreed with the statement that the horizontal and vertical allocation systems are currently fair. Most local governments think that the system needs to be revised and, in general, cities and municipalities are more dissatisfied with the vertical than the horizontal allocation of revenues. Insufficient financing for legally assigned duties and an outdated system for sharing public revenues with local governments are identified as the main problems in both entities.
- **Local government wish to invest more:** However, they see unfunded mandates as the most serious obstacle to reducing current expenditures and increasing fiscal space. In addition, political interference in spending decisions appears to be a particular issue in the FBiH.
- **There is a need to rethink civil service legislation:** More than two thirds of local governments across the country believe that there is a need to change civil service laws to allow greater flexibility in hiring and firing, even if this undermines job security for municipal employees.
- **Local economic development needs to be better coordinated amongst the different levels:** A third of cities and municipalities feel that the main obstacle to promoting local economic development is the lack of coordination from the entity governments or realistic entity strategies. But municipalities are willing to make sacrifices to attract private investment and there is a widespread belief that the lowering of para fiscal fees would encourage investments.

# Chapter 2: Local Government in the FBiH

## A. Main Features of the System of Local Government



The system of government in FBiH is based on: a relatively small central government (with some 20 percent of **revenues**); ten cantons (that share 25 percent of revenues); and 79 municipalities and cities (that share some 10 percent of revenues). A set of large social funds secure about 45 percent of revenues and are dominated by pension and disability funds (with 25 percent of overall revenues) and separate health and employment funds in each canton (that share almost 20 percent of total revenues). As is clear from Figure 12, the central government, cantons and funds rely heavily on a limited number of taxes and contributions while the municipalities and cities depend on a wide array of smaller revenue sources (including self-generated revenues).

The FBiH has a three-layered system of territorial government, comprising the Central Government, the Cantons and Municipalities and Cities<sup>24</sup>. **Cantons** execute a number of functions that would more-typically be carried out by the state or provinces in smaller European countries. These include separate systems of education, policing and broadcasting. Moreover, the cantons share responsibility with the central government in the provision of health care and social welfare services and oversee the operation of most health services (through appointing the administration of cantonal health funds). The Cantons' size is much smaller than most

European regions or states, however, and this leads to significant costs associated with political organs and a frequently-bloated bureaucracy. Canton governments report that they spend 50 percent of their budgets on administration, 35 percent on the provision of social welfare, and about 5-6 percent each on public safety and economic development<sup>25</sup>. Overall, cantons spend about 60 percent of their budgets on salaries.

Cantons oversee the regulation of local land use, including zoning, and have responsibility for cultural policy and implementation. Cantons also have legislative powers - some of them concurrent with the federation - and have limited regulatory power vis-a-vis the municipalities. For example, they can delegate functions to municipalities. They provide, together with the federation, the legal framework for all municipal functions. Concurrent legislation often leads to a lack of clarity in the assignment of functions, while delegation of tasks to municipalities originates unfunded mandates.

In addition to the usual municipal services, municipalities help facilitate health and education services; as the founders of local health-care and educational facilities, they contribute to the upkeep of buildings and the provision of basic equipment, but the ultimate responsibility for providing health and education rests with higher levels of government<sup>26</sup>. Municipal governments report that they spend 50 percent of their budgets on administration, 15 percent on housing and community development, 10 percent on economic development and about 5 percent each on culture, education and social welfare<sup>27</sup>. Municipalities spend about 35 percent of their budgets on salaries.

## B. Main Findings and General Recommendations

The existence of cantons creates a distinct set of **challenges related to:** (i) the fragmentation of service delivery (and potential economies of scale) across ten cantons; (ii) the coordination of service

<sup>25</sup> Based on data reported by functional classification.

<sup>26</sup> For a detailed description and assessment of the operation of cities and municipalities, see: The World Bank. 2009. From Stability to Performance: Local Governance and Service Delivery in Bosnia and Herzegovina.

<sup>27</sup> Based on data reported by functional classification.

<sup>24</sup> The division of competences is set out in Table 2.

delivery between central government, cantons and municipalities (especially in the presence of shared competences); (iii) the design of a common system where the largest canton is almost 20 times the size of the smallest; and (iv) the equalisation of fiscal capacity across very different areas (with average gross wages, for example, varying by a factor of 1.55 between Central Bosnia Canton and Sarajevo Canton).

Surveys of the opinions of cantons and municipalities confirmed a prevailing sense from consultations that there are serious deficiencies in the operation of the current system of local government in the FBiH. More than half of respondents assessed the state of local government as either bad or in crisis. Two thirds of respondents said that there is not sufficient financing for legally assigned duties and objected to an outdated system for sharing public revenues. Moreover, in a system that is complicated and often opaque - and where citizens are often confused as to who should be responsible for various services and laws from various levels often contradict one another and complicate the simplest of operations - most interlocutors throughout the consultations felt that the system: (i) does not allocate resources to the appropriate level of government; (ii) is open to political manipulation and cronyism; (iii) does not allocate resources “fairly” across different cantons and different municipalities; and (iv) suffers from fragmentation and a lack of coordination.

The FBiH Association of Municipalities and Cities (hereinafter, FAMC) adopted a comprehensive Development Strategy in 2015 that complains of a complex system of government with a large number of stakeholders who do not comply with their obligations and a lack of systemic laws and frameworks at the entity level. It also highlights an “unclear division of jurisdictions and a discrepancy between municipal responsibilities and their capacities and financial resources” and “disrespect for the principle of the sufficiency of revenues and the transfer of competences without the appropriate transfer of financial resources.”

Overall, the system suffers from a lack of clarity in competences, objectives and principles and this leads to a general sense of frustration and unfairness that is difficult to overcome in the interests of better coordination and collaboration. There are few if any incentives to collaborate in the provision of services and there are, on the other hand, many psychological and political obstacles. There is a sense that everyone is trying to keep their head above water in their own small pool - and there is no time to consider improvements and coordination.

It is possible to identify **five main sources of problems** (as below) and five approaches to solutions to them:

### 1. The Sharing of Competences

The FBiH Constitution (1994) assigns competences to cantons (and central government) and the Law on Principles of Local-Self Government (LLSG, 2007) assigns tasks to municipalities and outlines (a loose) “framework” for the delegation and sharing of competences and for cooperation between institutions. Article 10 of the LLSG allows federal and cantonal authorities to delegate specific competences to local governments subject to the provision of “funds required for their efficient completion” and to previous consultation. Half of local governments point to the discrepancies between the FBiH Law on Principles of Local Self-Government and sectoral legislation as a serious problem. Furthermore, 29 per cent of the cities and municipalities believe that with shared competences, the responsibility usually falls on them, even if they are not financed.

There are no legal obstacles to the resolution of competence issues between institutions (through full delegation, for example) or to collaboration in executing joint competences. However, there are three sets of issues that seriously complicate the delivery of services:

- **Joint and overlapping** competences can lead to confusion regarding who has ultimate responsibility for the provision of a service. The difference between them is purely legal: while joint competences derive from the same legal instrument (such as the Constitution of FBiH), overlapping competences derive from the combination of the provisions of two distinct legal documents (such as the Constitution and the LLSG). They create frustration at both levels when priorities are not shared. This applies, for example (see Table 2), to: (i) issues of spatial planning, where zoning is carried out by cantons but municipalities issue building permits; and (ii) garbage collection, where disposal is assigned to municipalities but selection of the dump site to the canton. More generally, these interdependent assignments can lead to bottlenecks when dealing with potential investors. And municipalities, in particular, are often frustrated that they cannot get the appropriate permits in a timely fashion. This generates confusion and undermines the pursuit of local economic development.



- Joint and overlapping competences can also lead to **unfunded mandates**<sup>28</sup>. These can arise from two sources. First, cantons can delegate responsibilities downwards and sometimes do not provide sufficient resources to meet them<sup>29</sup>. This is the case, for example, with students' transportation in some cantons. On the other hand, cantons sometimes assume responsibility for kindergartens. Second, it is natural that citizens will first come to the lowest level of government when seeking services and these will be difficult to refuse, even if the resources have not been fully provided at the higher level. This is particularly true for social care (and some health care)<sup>30</sup>. Despite not being in their competence, almost half of municipalities said that they spend at least 2 percent of their total expenditures providing health and social welfare services to socially vulnerable groups. Social centres situated at the municipal level decide on eligibility for services and can end up bearing the costs even though the canton should bear some or all of the responsibility. (This also leads to municipalities inflating the number of beneficiaries). Hence it is not surprising that the need to compensate for unfulfilled responsibilities by higher level is identified as the most serious obstacle to increasing fiscal space and reducing expenditures (by 35 percent of municipalities).
- Administrative boundaries in the FBiH were often drawn with political considerations in mind and this has, inevitably, led to many examples of an **inefficient and fragmented assignment of responsibilities**. This applies to some services that would, in most countries, be provided on a wider geographical basis and by a higher level of government - such as health care and policing. Health services are split between a dozen (mostly cantonal) Funds, portability is restricted

and cooperation is limited. And there are 14-16 fragmented policing budgets with few incentives to cooperate in pursuit of greater efficiency. At lower levels, political considerations have led to some cases where the area of jurisdiction is either isolated from part of its natural catchment area or, otherwise, does not correspond to the area that could potentially benefit from a service. The assignment of water supply to municipalities, for example, often leads to diseconomies of scale and problems of non-equivalence (where the area of potential benefit does not correspond to the area of jurisdiction). This, in turn, leads to problems in the pricing of water, the pricing of connections, water catchment and the disposal of used water (and treatment plants). Examples where these problems have been resolved through cooperation and coordination are the exceptions that prove the rule - that it is very difficult to resolve these issues on an individual basis and without help.

This confusion over competences is not unique to the FBiH and there is often interplay between the competences assigned to different levels of government and the effective powers/resources necessary to carry out those competences. In practice, the execution of functions is often influenced as much by the assignment of resources as by the legal assignment of responsibilities and there will always need to be some accommodation between the two<sup>31</sup>. And the ideal result will not necessarily be the same in every instance. In FBiH, given disparities in the composition of cantons - with the number of municipalities ranging from three to thirteen - there could well be a need for different arrangements in different places. But the important thing is that a proper discussion takes place on who should do what - and many municipalities complain that they are not adequately consulted.

So, whatever the assignment of competences on paper, there will be wide variations in the ability of municipalities and cantons to undertake these competences and the same solution/sharing will not be appropriate in all circumstances. It will usually be necessary for the local authorities to resolve these issues in their own local circumstances and to put a local interpretation on the general assignment of competences. There is a need for a "framework for action" to translate functions - as defined on paper - into effective competences. "The idea, for each func-

28 In our Survey, cities and municipalities were asked if they have to fill expenditure gaps left by higher levels of government, notably in health and education. Only 5 percent stated that they do not have such expenditures. However, in 29 percent of the cases, these expenditures amount at least 3% of total municipal expenditures, while in every tenth municipality they can go up to even 20 percent of their total expenditures.

29 Since Cantons have competence over the legal discipline and the provision of local services, they have the authority to delegate to municipalities.

30 The municipality is usually the lowest level but in Bosnia-Podrinje Canton, for example, the municipalities and city do not have the resources to meet these requirements and the canton government feels that it has the ultimate responsibility.

31 See: Study of the European Committee on Local and Regional Democracy. 2007. Local Authority Competences in Europe.

tional area of responsibility, is to correlate the subject matter of the power, i.e. the sphere of action, on the one hand and the resources that the local authority can bring into play in order to act on the other<sup>32</sup>.” The LLSG already provides for this approach but does not activate it.

Cooperation and coordination is very poor in most cantons; either between the canton and municipalities or between municipalities themselves<sup>33</sup>. A vast majority of cities and municipalities (85 per cent) either strongly agree or agree that cantons need to spend more time coordinating the delivery of municipal services and otherwise encouraging collaboration between municipalities; perhaps through the targeting of subsidies to those municipalities who share municipal-service providers. More generally, there is a need to create dedicated instruments or facilities to promote coordination and, perhaps, to incentivise collaboration. Local governments need to consistently think of competences as a joint responsibility that should be discussed.

A dedicated **Ministry for Local Government in the FBiH** could be established to promote the joint network approach that was discussed in Chapter 1. Promotion would be facilitated by the allocation of specific grants aimed at covering the cost of the inception phase - those associated with the creation of joint ventures or mergers or setting up functional agencies. Grants should operate as incentives and will be allocated to single projects with declining intensity and without permanent funding of recurrent expenditure to avoid the creation of rents. The following institutions would be supported:

- i. In order to address the need for a coordinated and professional approach to local economic development—and to help overcome bottlenecks created by competing priorities from governments with overlapping mandates—cantons would be provided with grants by the FBiH Ministry for Local Government (in consultation with other concerned ministries) to establish and operate professional Development Agencies. These **functional agencies** would be jointly owned by the canton and municipalities and would have the effect of unifying responsibilities in one institution, with the involvement of the relevant authorities (and, perhaps, NGOs) as appropriate to their resources<sup>34</sup>.

<sup>32</sup> Ibid. p.67.

<sup>33</sup> All canton governments think they have good cooperation with their municipalities but-with just one or two exceptions-their municipalities do not share this perception.

<sup>34</sup> Functional Agencies are discussed further in Section D of this chapter and in Annex B.

The use of functional agencies in local economic development “has proved to be very popular in a wide range of countries and locations” over the past 25 years<sup>35</sup>. These vary widely in size, scale and function and can be adapted to local circumstances. They would create a target for special grants from higher government levels and could attract other funding<sup>36</sup>. And there is a wider range of options for allocating grants. Moreover, grants could be used to incentivize other organizational options, such as the merging of public companies and joint ventures between municipalities and between municipalities and cantons.

- ii. Cantons could be required to develop rolling **Public Service Development Agreements** (PSDAs, for 3-5 years) and would need to report on their progress each year in order to be able to receive the relevant grant from the Ministry for Local Government. These PSDAs would be different from the usual set of strategies because, crucially, they would need to bear the signatures of all (or, perhaps, most) municipal mayors each year before the grants could be awarded. Therefore, there would be an incentive for cantons to fully consult municipalities on the way forward and on the coordination of activities. Citizens would be made aware of who has responsibility for what functions. And the cantons could, in turn, use these Agreements (and subsidiary grants) to encourage municipalities to collaborate in the provision of some public services or to create/employ common public utilities.
- iii. In some areas, these PSDAs would need to take the form of **canton-wide network development plans** - such as in health (where plans for the development and integration of health centres are often not operational) and in the area of public order and safety (where local civil defence units are often not fully integrated into policing and plans for regional firefighting are often missing). And, while these cantonal network development plans are important in themselves, they are also a crucial first step toward broader entity-wide network plans that would strive for greater efficiency in the use of resources. And

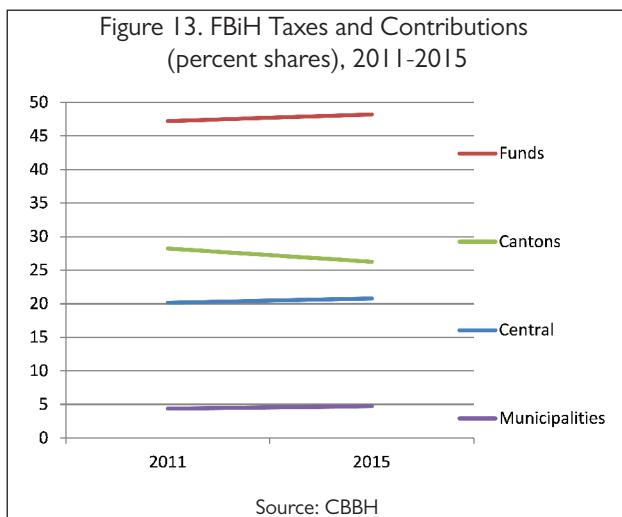
<sup>35</sup> OECD/Mountford D. 2009. Organising for local development: The role of local development agencies. Summary Report. p.2.

<sup>36</sup> Every canton reports that it has a Local Economic Development strategy in place, but almost all municipalities said they were not properly consulted in the development of these strategies and most strategies are, in effect, “sitting on shelves.” Five Regional Development Agencies were established in early 2000, and most of them are still active in some sense.

because they would feed into entity level networks, these plans would need to be developed in consultation with the relevant sector Ministry. Such plans are sadly lacking in the areas of health and policing (as discussed further below).

**2. The Vertical Allocation of Resources**

There is widespread dissatisfaction with the vertical allocation of resources between the central government, cantons and municipalities. Over 80 percent of local governments do not think that the vertical allocation is fair. During consultations, most municipalities protested that they are not given sufficient resources to carry out the competences allocated to them. Moreover, while cantons have a well-defined revenue base with almost 90 percent collected from taxes (direct and indirect, and the remaining 10 percent gathered in local administrative fees and penalties), municipalities receive just 40 percent of their revenues from taxes administered at higher levels, collect almost 10 percent from property-transfer taxes and generate the remaining 50 percent from their own efforts and resources (including charges and fees). On average, the ratio of cantonal revenues to combined municipal revenues is about 2.5:1, with the result that cantons dominate the service agenda. And cantons give virtually no grants directly to their municipalities (although they often co-finance capital projects)<sup>37</sup>.



It is difficult to provide a comprehensive analysis of the fairness of the vertical revenue allocation in the FBiH. Quite simply, the system is not uniform enough to permit such analysis. And, as discussed in the last section, there needs to be a fundamental conversation between each canton and its municipalities regarding the local allocation and financing

of services - as would be included in the proposed PSDA. There is already ample evidence of variation across cantons - with some cantonal governments assuming responsibility for more (or fewer) services than others and three cantons granting more than the minimum allocation (34.46 percent) of the personal income tax (PIT) to municipalities - at their own expense.<sup>38</sup> Ultimately, it is best that the vertical allocation of revenues within cantons be resolved at that level. It is worth noting (Figure 13) that municipalities have seen a slight increase in their share of general revenues from taxes and contributions over the period 2011-15, even as cantons suffered a two percentage point decline in their share. But there are three systemic issues regarding the vertical allocation of resources in the FBiH that do need to be addressed at the entity level:

**i. Revising the Servicing of Foreign Debt**

There is a strong objection - from both cantons and municipalities - that the servicing of foreign debt is deducted from indirect taxation revenues (as collected by the state-level Indirect Taxation Authority, ITA) before the remaining revenues are allocated by the entity government to the two lower levels of government (and to the entity itself). The lower levels of government object that, as a result, they are forced to repay debts “that did not benefit them in the first place.” Through this mechanism, cantons suffered a “shortfall” in revenues of almost KM 300 million in 2016 (more than 10 percent of total revenues) and municipalities were “denied” about KM 40 million (about 5 percent of total revenues). In 2016, the repayment of such debt effectively reduced the cantonal share of overall ITA revenues from (the legislated) 51.5 percent to 43.2 percent and lowered the municipal share from (the legislated) 8.4 percent to 7.1 percent. Moreover, this debt-servicing procedure adds volatility to annual cantonal and municipal revenues (that are already somewhat unpredictable). When debt servicing requirements are high, the amount left for lower levels is necessarily reduced (and this largely explains the drop in the cantonal share of revenues and the higher central share in Figure 13).

In line with the proposals of other international institutions, it would make more sense to service debt from the entity’s share of ITA revenues. This would make the system simpler and more transparent and

38 Six out of ten cantons use the prescribed sharing of the PIT (that is 65.54% canton – 34.46% municipality). Four cantons have different shares: Western Herzegovina Canton: 50% canton – 50% municipalities; Central Bosnia Canton: 60% canton – 40% municipalities; Herzegovina Neretva Canton: 60.99% canton – 39.01% municipalities; and Sarajevo Canton: 98.21% canton – 1.79% municipalities.

37 Grants from higher levels of government make up just 4 percent of municipal revenues.

reduce revenue volatility.<sup>39</sup> However, the entity central government does not have a tax base that is different from the lower levels of government and, therefore, the entity government will need to take a larger share of revenues if it is going to service debts on its own. And Table 4 (below) contains an illustrative proposal of how this might work. If, for example, debt service measured 15 units out of 115 units of ITA revenues allocated to the FBiH, the current procedure would deduct the 15 units before allocating the remaining 100 in the appropriate shares - 36.2 percent to central government, etc. Under the new system, the central government is allocated a larger share of revenues (44.5 percent instead of 36.2 percent in New System I the example below) to allow it to service foreign debt and the other recipients would have their shares reduced accordingly. The negotiation of the new shares would, of course, have to consider the appropriate share for servicing debt and fix it.

The new coefficients in Table 4 are designed to achieve revenue neutrality for the central government. But the reform of the system will also present an opportunity to eliminate an anomaly in the current system. Under the current system, some cantons and municipalities have to service some foreign debts through end-user agreements with the central government, even though the same repayments are already recovered through the initial foreign debt reduction (of “15” in the example in Table 4 above). Thus, in effect, cantons and municipalities service this portion of the debt a second time each year. Assume

that the double payment amounts to “2” units in the example in Table 4. The anomaly could most simply be removed by preserving the end-user agreements but “deducting” this double payment from the allocation for central government under the new system. If this were done, the percent allocations to cantons and municipalities would again be higher (at 45.9 and 7.5 percent respectively under New System II in Table 4). This would amount to a moderate increase in the overall allocation of ITA revenues to sub-federal governments.

Of course, the negotiation of the new system would present an opportunity to consider other questions related to the efficiency, transparency and equity of the revenue allocation system. And this will include questions of horizontal allocation (as discussed in section 3, below). Significant thought will need to be dedicated to this exercise and significant technical assistance from the IMF and others may be required before a satisfactory solution is reached. However, the opportunity to remove the anomaly of the double payment (discussed above) would at least ensure that cantons and municipalities would make net gains from any new system and this should facilitate the overall negotiation of a new financing package for local government.

**Table 4: Vertical Allocation of ITA Revenues in FBiH**

	Current System		New System I		New System II	
	<i>percent</i>		<i>percent</i>		<i>percent</i>	
Total ITA transfer to FBiH	115		115		115	
Foreign Debt Deduction	<u>15</u>		<u>--</u>		<u>--</u>	
Net revenues	<u>100</u>	100	<u>115</u>	100	<u>115</u>	100
Allocation to central government	36	36.2	51	44.5	49	43.0
Allocation to roads/highways	4	3.9	4	3.4	4	3.4
Allocation to cantons	51	51.5	51	44.5	52	45.9
Allocation to municipalities	8	8.4	8	7.3	9	7.5
Allocation to Sarajevo City	1	0.2	1	0.2	1	0.2

39 The FBiH PFM Reform Strategy recognises that “strengthening finances of lower levels of government requires an improved and more transparent system of distribution of revenues in the Federation of BiH, with special regard to arrangements for external debt servicing from revenues from indirect taxes.” See: FBiH Ministry of Finance. 2017. Strategija reforme upravljanja javnim finansijama u Federaciji Bosne i Hercegovine. p:10.



## ii. Reducing Parafiscal Fees and Charges

A proliferation of parafiscal fees at local government level over the past 10-20 years is probably due to a scramble for resources - especially at municipal level. Municipalities feel particularly strongly that they do not have sufficient funding to meet their ongoing commitments and have very few resources to devote to investment expenditure. On the other hand, potential investors complain that these fees are targeted at businesses and are onerous and unpredictable - making them an impediment to private investment<sup>40</sup>. In response to investors' concerns, these fees have recently been collated and registered (to improve transparency, see [Box 6](#)) and almost 85 percent of cities and municipalities now agree that a lowering of parafiscal fees is necessary to encourage greater investment.

But the reduction in parafiscal fees would, at the same time, limit municipalities' access to an independent source of local revenues - especially for development projects. Ultimately, any shortage of funding at municipal level leads to a failure to execute capital projects and less than 70 percent of planned expenditures are actually executed in any given year. Capital expenditures make up less than 15 percent of annual outlays at municipal level (and 2-3 percent at canton level) but most of this is dedicated to the upkeep of buildings and roads.

If current plans to curtail the number of parafiscal fees are enacted, municipalities would suffer a shortfall in revenues of some 3-4 percent (on average). This is significant but the loss to independence is probably more important than the amounts involved. And one way to make up the shortfall in independent funding would be for municipalities (and cantons) to have the

### Box 6: Dealing with the Issue of Parafiscal Fees and Charges

In the FBiH, there is no single system or clear rules regarding who can and how to establish the type, purpose and rate of fees and charges or the manner in which they are collected. Over the last three years, USAID's Fiscal Sector Reform Activity (FAR) undertook the task of mapping and analysing the current situation with regards to the collection of fees at all three levels of government. According to their most recent data, there are a total of at least 350 different fees in effect - some 35 fees on average per canton and 20 fees on average for each municipality and city.<sup>1</sup>

As part of the project, USAID established a Register of Fees that gives a comprehensive overview of all fees to be paid by businesses and natural persons, in order to provide these persons with information about non-tax charges and the business environment they can expect. The Register shows the level of fees, their calculation procedure, the determination of the tax base, as well as legal regulations that are not harmonized amongst the cantons in the FBiH. It also reveals that there is a problem with the continuous introduction of new fees at all levels of government. This, in turn, has an extremely negative effect on businesses and potential investors.

In order to enhance the business environment and attract investors, FAR identified 10 fees for elimination/rationalization and 4 sets for consolidation into one.<sup>2</sup> These pertain to all three levels of government in the FBiH. According to FAR estimates, businesses would save BAM 65 million annually.<sup>3</sup> Following the elimination of these fees, cantons would lose BAM 22 million and municipalities would lose over BAM 23 million annually.<sup>3</sup>

In order to provide a sustainable and systemic solution to the proliferation and non-transparency of fees, FAR proposes to regulate the field of fees and charges by an umbrella law at the FBiH level. The Law would stipulate and define the types and competences for the introduction of fees and charges, including principles on which they should be based. These would be entered in the Register of fees that would be kept at the FBiH Ministry of Finance and no fee outside of the Register could legally be raised. Cantons and local self-governments would then be allowed to decide on the rates/tariffs of fees in their competence that they would charge. The obligation that fees and charges be introduced exclusively by law will add legal security to them.

<sup>1</sup> For more information, see: USAID's Fiscal Sector Reform Activity, *Report on the Implementation of the Reform of Fees in the FBiH (2017)*.

<sup>2</sup> The fees slated for elimination are: general water fee, tourist board membership fees, company sign fee, special fee for protection from natural and other disasters (two fees, detachments fee and fee for construction and maintenance of public shelters).

<sup>3</sup> The calculation takes into account the actual fees, bank fees as well as the time required for their payment.

<sup>40</sup> This is repeatedly raised as a concern in the annual "White Book" published by the Foreign Investors Council in BiH.

choice of imposing a surcharge on the personal income tax (PIT).

### iii. Options for a PIT Surcharge

There is a need in FBiH to expand local tax autonomy and, with it, the fiscal accountability of local governments. This is presently missing and all debate is focused on getting a higher share of centrally distributed revenues. This is divisive. An important first step toward more revenue autonomy would be a PIT Surcharge. In the medium term, serious consideration should also be given to the introduction of a recurrent tax on residential property, as already levied in the RS.

A surcharge on the personal income tax is an increasingly popular local tax instrument. Federal, regional and unitary countries use it for financing their regional and local governments<sup>41</sup>. Surcharges have a few distinctive characteristics that make them increasingly popular. With reasonably low tax rates, surcharges can generate substantial revenues, given the size of the tax base. Subnational governments would have autonomy in the determination of their own, marginal tax rates. This creates accountability at the local level; allowing governments to adjust the tax burden according to changes in their perceived expenditure needs. And accountability requires that surcharges should be borne by residents of the local jurisdiction to which the revenues accrue. This requires the identification of taxpayers according to their residence. Administration of the personal income tax in FBiH already fulfills all the pre-requisites for a well-functioning local surcharge on personal income tax. For further explanation, see Annex C.

In the medium term, the introduction of a surcharge (to a maximum of 2-3 percent), could be used to finance the expansion of the range and quality of services, allowing taxpayers to compare, at the margin, the benefits from expenditure with the money taken out of their pockets. This would induce competition between municipalities and prompt taxpayers to pay more attention to municipal/cantonal spending plans. In the short term, a PIT surcharge could compensate, with more efficiency and equity, for the loss of revenue from parafiscal fees. Revenue generated by a one per cent surcharge would be about equal (KM 23 million) to the revenue that would be lost under current plans and with no overall increase in the burden on taxpayers.

<sup>41</sup> Among them Canada, Denmark, Switzerland, Spain, Italy and Korea.

## 3. The Horizontal Allocation of Revenues

There is widespread dissatisfaction with the horizontal allocation of resources that is regulated by the FBiH Law on Allocation of Public Revenues. Two thirds of municipalities and cantons either “agree” or “strongly agree” that the allocation is unfair. And it was clear from consultations with different cantons (in particular) that they had very different understandings of what the system was intended to achieve and what financing principles the law is intended to implement. These principles could include: (i) derivation (where revenues are returned to the original source of collection); (ii) revenue equalisation (where local fiscal resources should be equalised, despite differences in the tax base); (iii) expenditure equalisation (where higher demographic or other service costs are compensated for); and (iii) development needs (where poorer areas receive more resources to allow them to catch up)<sup>42</sup>. In truth, the system currently used to allocate ITA revenues is a mixture of all of these principles and it is often not clear in what proportions these principles are intended to be implemented<sup>43</sup>. Another issue of contention is that the Corporate Income Tax (CIT) is allocated to the Canton where the headquarters of the organisation is based and this canton (often, Sarajevo) is not necessarily the location of the organisation’s productive activity.

### i. Horizontal Allocation of VAT Revenues to Cantons

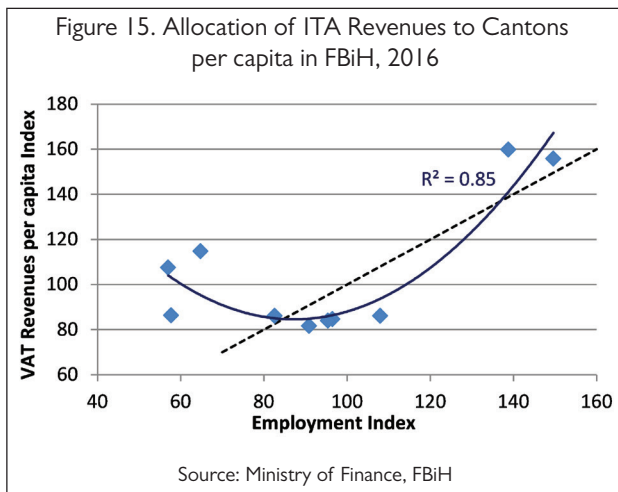
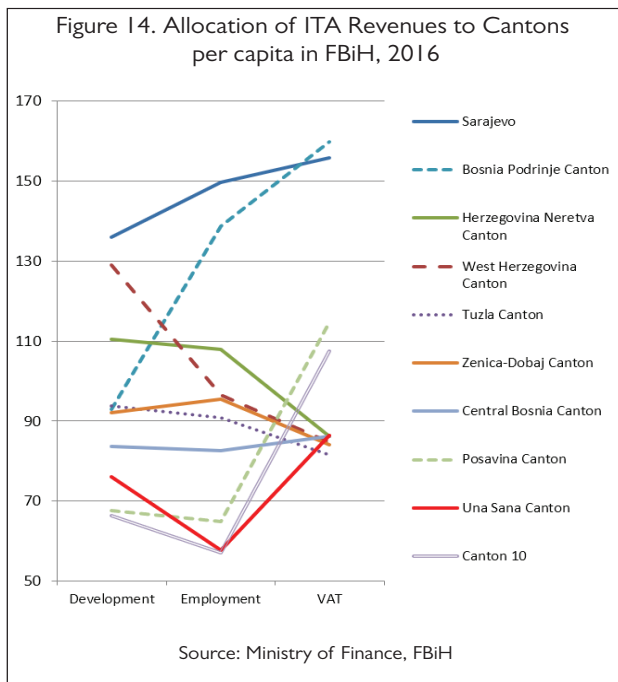
Figure 14 traces the scores of all ten cantons using three indices - the development and employment indices used by the Ministry of Finance and an index of relative VAT revenues per capita (where 100 is the average allocation of VAT revenues per capita across the whole of the FBiH)<sup>44</sup>. It is clear that the allocation of VAT revenues often appears to augment differences in capacity (rather than lowering them). The lines diverge significantly for two cantons - thus, augmenting differences - whereas they converge for most of the others and tend to lower differences in fiscal capacity.

This feature of the system is further examined in Figure 15, where VAT revenues per capita are more

<sup>42</sup> The Association of Municipalities and Cities argues that that the uneven development of local communities is an example of an unfair distribution of resources to different LSGs.

<sup>43</sup> The current system allocates VAT revenues between cantons using: (i) a formula based on population, area and numbers of school children—measures of need; that is (ii) augmented by special coefficients for four cantons reflecting their economic size (a measure of derivation) or underdevelopment. Similarly, municipalities share revenues based on population, area, the number of school children and level of development.

<sup>44</sup> Note that this does not mean that the scores for the ten cantons average 100. In fact, they average 105.



directly compared to the employment index. The correlation between the two sets of data is striking but only when using a polynomial function that is relatively flat at lower values and becomes steeper at higher values. This implies that revenue capacity (as measured by the employment index) is equalised for cantons with lower capacity (especially, for the three “weakest” cantons). But the strongest two cantons (who lie close to the dashed line) do not contribute to this equalisation.<sup>45</sup> This suggests that the allocation system is loosely based on an equalisation principle over lower ranges of capacity but is based on a derivation principle over higher ranges of capacity - especially for the strongest two. In other words, the relevant allocation principles change over different ranges of capacity.

<sup>45</sup> In Figure 15, the dashed line would represent an allocation of ITA resources according to capacity whereas a full equalisation of revenues would put all cantons on a horizontal plane at a value of (close to) 100.

This strange result is due to the use of special coefficients that largely dictate the final allocation (and favour, in particular, the two strongest cantons in Figure 15). So, the complicated allocation system is not only unclear as to which principle of allocation is used but it even appears to switch principles - from equalisation to derivation - over different ranges of capacity. And this lack of transparency has given rise to almost universal dissatisfaction with a complicated system. Overall, the system contravenes a basic standard of public finance - that there should be clarity and confidence in the manner in which public monies are distributed.

Some cantons (notably Sarajevo, see [Box 7](#)) argue that their existing allocation is well below their contribution to the pool of indirect taxes subject to redistribution. Others argue that the system does not achieve sufficient equalization across cantons and they object, in particular, to the augmentation coefficients that the current formula grants to some cantons.<sup>46</sup> Ultimately, the criticism is rooted in the lack of clarity and transparency of the current system. The current formula is not transparent because three different principles, all a priori justifiable (returning revenues to the place where they are collected on a derivation basis, horizontal equalization, and special entity objectives regarding the number of cantons) are bundled in a single instrument.

As a result, there needs to be a simplification and renegotiation of the revenue sharing formulae and mechanisms between cantons. In line with a recent IMF set of recommendations, and in an attempt to clarify the calculations that underlie the system, the current system could be replaced by two pillars: **Pillar 1** would, in so far as possible, allocate revenues according to the derivation principle and **Pillar 2** would be dedicated to reducing the fiscal gap - between expenditure needs and revenue capacity - across cantons. The current system of **coefficients would be eliminated** and, instead, a system of **special grants** would be created to: (i) compensate for some special spending needs (like the expenses incurred by the capital city); (ii) provide for entity-wide priorities including, perhaps, to secure a minimum allocation for smaller cantons; and (iii) promote the development and implementation of the instruments/institutions proposed in section I (above) to overcome problems with the allocation of competences. These instruments/institutions would

<sup>46</sup> The Law currently provides three cantons with special augmentation coefficients reflecting their special circumstances and national objectives. These are Bosnia-Drina Basin Canton (1.8), Canton 10 (1.1), and Posavina Canton (1.5). Sarajevo is awarded a coefficient of 2.0 to reflect its status as a capital city and to reflect the larger amount of revenues collected there. (The other six cantons have a coefficient of 1.0).

**Table 5: Horizontal Allocation of ITA Revenues to Cantons**

	<b>Current System</b>	<b>New System</b>	
Allocation to cantons	<b>100</b>	<b>100</b>	Allocation to cantons
<i>Divide by sum of coefficients</i>	12.4	<u>15</u>	Deduct grants (say, 15%)
= Unit of allocation	8.1	<u>85</u>	Allocation to pillars
Allocation to 6 cantons (6.0)	48.4	59.5	Allocation to Pillar 1 (say, 70%)
Allocation to Sarajevo (2.0)	16.1		--allocated on derivation basis
Allocation to BP Canton (1.8)	14.5	25.5	Allocation to Pillar 2 (say, 30%)
Allocation to <u>Posavina</u> (1.5)	12.1		--allocated for fiscal need
Allocation to Canton 10 (1.1)	<u>8.9</u>	<u>   </u>	(perhaps, with minimum)
	<u>100</u>	<u>85.0</u>	

include functional agencies, Public Service Development Agreements and Sector Network Plans.

An illustration of how the new system would differ from the current system is set out in Table 5 (which is based on the simplifying assumption that populations are equal in all cantons). The current system: (i) makes some minor adjustments for area and numbers of school children; (ii) then, effectively, divides the total allocation by 12.4 (the sum of the coefficients); and, (iii) finally, distributes the monies according to those coefficients. The final allocation - in practice - is very close to the relationship between the original coefficients<sup>47</sup>.

The new system would: (i) first, deduct some revenues to be used for special grants (as discussed above); then (ii) allocate the remaining revenues between the two pillars in some proportion (that would need to be negotiated and agreed); and (iii) allocate the resources under each pillar according to some agreed measures of derivation and fiscal gaps. Table 5 assumes that 15/100 would be used for grants and that the derivation and equalisation pillars would be funded in the ratio of 70 to 30.

The renegotiation of the allocation system between the cantons will be difficult (to put it mildly) and it is beyond the scope of this Report to propose a final solution. However, the following criteria and suggestions should be considered when undertaking the negotiations:

<sup>47</sup> The relationship between the allocations for Sarajevo and Tuzla in 2016, for example, was 1.91/1; which is very close to the relative coefficients of 2/1. This shows that the adjustments for area and pupils only count for about 5 percent of the final allocation. In other words, the coefficients determine most of the allocation across cantons.

- a) There may be a need for a transitional phase to cushion the impact of any net reallocation;
- b) It might be advisable to gradually change the allocation between pillars over the course of several years;
- c) The simplicity of the system should not be compromised through the last-minute introduction of quick fixes (as happened with the existing coefficients - that were supposed to be temporary);
- d) The increased allocation of ITA revenues proposed under section 2 (above) to eliminate the double repayment of debt - and which amounts to about 1.5 percent of ITA revenues in the case of cantons - could be used to ensure that the negotiations on the new system would be a positive sum game. The FBiH government may wish to increase the allocation to cantons and municipalities even further in an effort to secure agreement;
- e) The grants system would be negotiated at the same time as the allocation to pillars 1 and 2 and cantons could be given a way to maximise revenues through intending to vigorously pursue grants;
- f) The option of a PIT surcharge could be introduced at the same time; and
- g) The geographical allocation of CIT revenues (see below) could be revised at the same time.



### Box 7: Canton Proposals on ITA Revenue Allocation

#### Derivation vs. Equalization: Illustration of the Different Viewpoints

In 2016, the Government of the Sarajevo Canton commissioned a study titled 'Assessment of the Position of the Sarajevo Canton in the Allocation of Revenues from Indirect Taxes in BiH'. The following year, the Government of the Zenica Dobož Canton commissioned a similar study dedicated to its position in the revenue allocation.

The two studies offer a very vivid and symbolic example of the different perspectives that dominate the debate on public revenue allocation in the FBiH. It boils down to a debate on the underlying principle that should dominate the allocation of revenues. One side advocates for the derivation principle meaning that the revenues should be returned to the cantons that paid the taxes, while others advocate for more equalization and reallocation from the wealthier to the poorer cantons. This latter position, as advocated in the Zenica study, is supported by Tuzla and other cantons.

The basic principle stressed by the Study commissioned by the Sarajevo Government, is to spend tax revenues where expenditures have occurred reasoning that the 'the burden of indirect taxes undoubtedly falls onto the end consumer', which is why revenues should be returned to those who actually paid them. Only after this principle has been met it argues, it would be acceptable to reallocate revenues to the extent necessary for meeting some other principles.

The Study points to the example of Germany, which recognizes the need to reallocate funds from wealthier to poorer provinces, but not as to 'permanently diminish the financial capacity of the wealthier provinces'.

According to the Study, the Sarajevo Canton receives 29% of all indirect tax revenues belonging to the cantons, yet its share in final consumption is 40%, while its share in the GDP of the FBiH is 37%. Consequently, it proposes an allocation criterion that would either focus on each canton's share in the FBiH's GDP, or the total amount of indirect taxes paid by the end consumer in each canton, which would put it in an even better position than is currently the case.

On the other side, the study Commissioned by the Zenica Dobož Canton focuses on the 'fundamental principles of fiscal federalism' which are: fair allocation of public goods, long-term macroeconomic stability, proportionality of assigned competences in relation to the available public resources, and support to jurisdictions with fewer resources with the aim of a more balanced economic growth.'

The Study objects to the special coefficients of the Sarajevo, Bosnia Podrinje and Posavina Canton. In the case of the Sarajevo Canton, it objects to the very basis of having the special coefficient, given that the only justification provided in the Law on Public Revenue Allocation is that it reflects the 'special expenditure needs' of the Sarajevo Canton, without giving any further details. However, the Study is not opposed to the horizontal equalization and support to less developed cantons per se, but to the fact it is currently based on a single criterion, namely revenue from the (old) sales tax in per capita terms.

Furthermore, the Study objects to the criteria that are used for the horizontal allocation of indirect tax revenues between the cantons, which are dominantly based on demographic parameters – population and number of pupils in primary and secondary education. Hence, it does not take into account the specific situation in each of the cantons such as its fiscal capacity, economic development, number of unemployment, the average salary, as well as the number of pensioners.

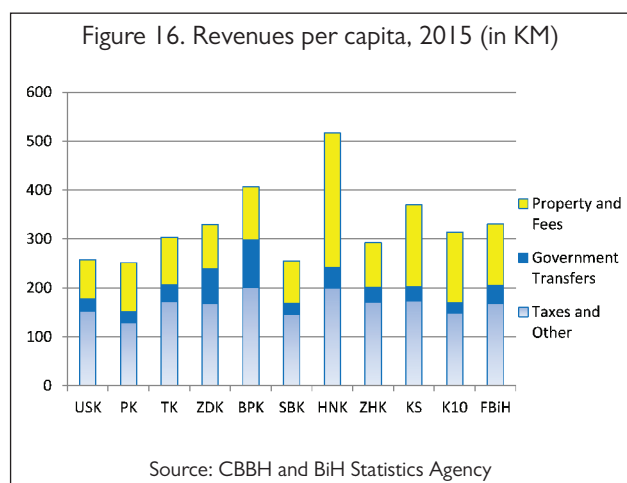
The Study also points to the difference in the collection of direct tax revenues, such as the corporate income tax, which additionally favours the economically stronger cantons. Therefore, the Study proposes allocation criteria that would be based on the 'resource strength index' of each canton advocating for greater equalization and points to the system currently in place in Switzerland.

Obviously, the negotiation of a revised system of revenue allocation in the FBiH would be a significant task and should be undertaken in consultation with international financial institutions and others. But, in general, the revised approach should aim to reduce the complexity and opacity of the allocation formula. The appointment of a Minister for Local Government would be useful to oversee these negotiations and to oversee the allocation of some of the special grants to be introduced.

**ii. Horizontal Allocation of VAT Revenues to Municipalities**

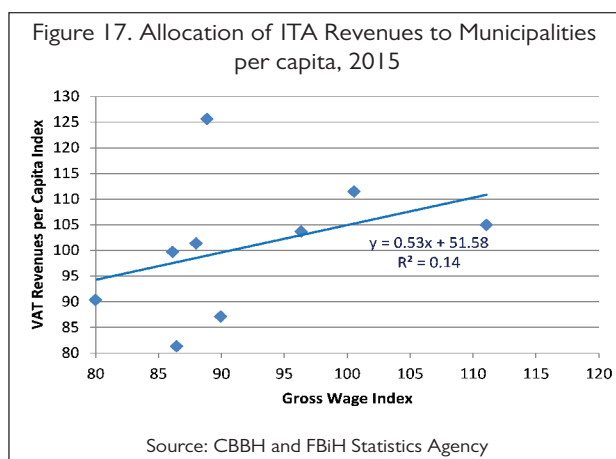
Economic, demographic and other disparities are even more pronounced across municipalities than across cantons and this complicates the choice of an appropriate formula for horizontal revenue allocation. There are 79 municipalities and cities in the Federation, with wide differences in size, population, economic base, and public service needs. The inequality in fiscal capacity is also very large, with PIT revenues concentrated in canton capitals and urban areas. Overall, tax revenues in municipalities (including property tax) per person in 2015 averaged KM 170 in the FBiH and this ranged from KM 130 in Posavina to KM 200 in Herzegovina-Neretva and the Bosnia-Drina Basin (see Figure 16). Transfers from other government levels differed widely but the main difference in revenues came from property income and the imposition of fees.

These patterns reveal some very different priorities and differences in inter-government relations across cantons. They suggest, once again, that many questions related to the allocation of competences and the financing of municipalities should be addressed at the cantonal level (where cantons already have the ability to award higher shares of PIT and CIT revenues to their municipalities). Where there are differences in revenues across municipalities in particular cantons, it is not clear that an equalisation exercise at



the entity level would be able to overcome these. In any event, the design of a formula that could be applied to all municipalities would need a more extensive consultation and in-depth analysis than is feasible for this report.

From an entity-wide perspective, the allocation of VAT revenues is carried out according to a complicated formula that is calculated each year by the Federation Ministry of Finance<sup>48</sup>. This takes both expenditure and development needs into account and the disbursement of revenues is far more equal than for cantons. Average revenues across municipalities differ by a factor of 1.5 from the highest to the lowest (compared to a factor of 2.0 for cantons) and there is less correlation between revenues and fiscal capacity - as measured, for example, by average gross wages in the canton (see Figure 17)<sup>49</sup>. However, it would be desirable to introduce a formula based on the same approach used for cantons. For illustration, a two-pillar formula could be applied to the municipalities, with a 10 percent weight for the derivation pillar and 90 percent for the equalization pillar. See Annex C for further details.



48 Revenues are determined pursuant to a formula based on the following ratios:

- 68 percent based on the population of a local self-government unit;
- 5 percent based on the territory of a local self-government unit;
- 20 percent based on the number of pupils in primary education;
- 7 percent based on the development level of municipalities, defined through the development index.

The formula shall include a coefficient to reflect special expenditure needs of local self-government units whose population exceeds 60,000. This coefficient shall equal 1.2. The formula shall also include a coefficient to reflect special expenditure needs of local self-government units which are responsible for the material costs of primary schools. This coefficient shall equal 1.5 and shall be applied to the number of pupils in primary schools.

49 That excludes Sarajevo because municipalities have a different role.

### iii. Making CIT Revenue Evenly Spread Among Cantons and Accessible to Municipalities

The FBiH assigns revenues from CIT - other than those raised on institutions such as banks, insurance companies and the electricity sector - to the Cantons. It gives cantons the option of sharing, at their full discretion, part of their revenue with their municipalities. This option is, however, not exercised by most cantons (and CIT makes up less than 0.04 percent of municipal revenues).

But CIT has important revenue potential and provides incentives to foster local growth. Entitling municipalities to receive a predetermined share of CIT would help to rebalance tax revenue between cantons and municipalities, and increase the capacity of the latter to face their policy responsibilities, particularly with regards to growth-promoting policies.

Rebalancing would also provide the opportunity of modifying the allocation to Cantons. Presently, companies file their corporate tax returns in their headquarters and revenues benefit only the Cantons where headquarters are located to the exclusion of the areas where the production and generation of profits takes place and the costs of production are borne. This leads to a spatial concentration of revenues and impacts negatively on equity, neglecting the contribution of some cantons to production.

A more efficient and equitable system would be based on the allocation of CIT according to the place of production. This can be achieved by sharing collections according to the total amount of wages and salaries paid in each plant or office location of the companies and/or according to the corresponding number of employees. This system is widely used in a number of countries for the allocation of business taxes and requires information already available at companies.

Allocation among individual municipalities of the share of CIT accruing to them could be based on similar principles, combining derivation with a more equitable distribution of revenue. As an indication, one third of the total municipal share could be allocated to the municipalities where production takes place and the remaining two thirds could be distributed among all municipalities according to population, or the inverse of the development indicator, or some combination of the two.

## 4. Planning and Accountability

There is room for significant improvements in planning and accountability in local government in FBiH.

### i. Challenges

In addition to confusion over competences, there is a lot of frustration that the lack of coordination between budgets at different levels of government leads to delays in the approval and delivery of project co-financing, with the result that projects are often delayed and cancelled after significant investment in planning. There is also a perceived lack of transparency in the process of approving grants and co-financing from higher levels and a general perception that the approval process is politically motivated. It is worrisome that 28 percent of cities and municipalities identify political interference in spending decisions as the most serious obstacle to increasing fiscal space and reducing expenditures. More generally, budget execution often differs markedly from planning documents and this undermines confidence in the planning process itself.

Weaknesses in the budget execution process often lead to breaches in the fiscal rules that are applied by the central government (and there is little or no sanction for this). According to the World Bank, the management of public finances is impaired not only by chronic fiscal deficits, but also by the sizeable presence of arrears in all parts of the public sector in BiH. And while the precise size of arrears is unknown, there are indications that they are large, especially at the lower tiers of government. Arrears stem from the formulation of unrealistic budgets and poor cash flow management, weaknesses in the fiscal reporting system, as well as poor management of SOEs. Accumulated arrears threaten the sustainability of public finances through unexpected bills and higher costs for goods and services. Reporting and monitoring of expenditure arrears is weak and the World Bank is undertaking field work at the cantonal level in FBiH to help the authorities properly account for and classify arrears.<sup>50</sup>

Additional problems arise from inconsistencies in legislative provisions. For example, the FBiH Law on Principles of Local Self-Government states that in case the municipal council fails to adopt a budget within 90 days of the start of the year, the head of unit shall enact the budget. This possibility, however, is not envisaged by the FBiH Law on Budgets.

Delays in co-financing are compounded by a Public Procurement Law that is generally regarded as being overly-rigid and not adapted to the circumstances of FBiH. In particular, the strict procurement cycle - when disrupted by inevitable delays in funding - often needs to be repeated and causes further delays;

<sup>50</sup> The World Bank Group. 2015. Bosnia and Herzegovina - Country partnership framework for the period FY2016-20.

even when the funds become available. In addition, disqualifications from the tendering process are regarded as overly burdensome - they often disqualify local providers - and are not well understood. Staffs are not able to work on public procurements in a qualitative and effective way that provides the most efficient use of public funds. Municipalities complain that the Public Procurement Law (PPL) needs to be improved and the BiH Public Procurement Agency (PPA) agrees that it is necessary to eliminate ambiguities and shortcomings. Municipalities report major delays due to the approval process and the handling of procurement complaints. Projects are often delayed by frivolous appeals.

The procurement process is regulated by a PPL that applies to all levels of the public sector in Bosnia and Herzegovina. In 2017, 84 percent of tenders were advertised on the public procurement portal of the PPA. Contracting authorities also publish procurement plans and tender documents on their own websites.

More generally, there is no established system of performance appraisal for local governments and it is difficult for the public (who are often confused as to which services are the responsibility of which level of government) to assess the performance of their local government and to make informed decisions at elections. This is partly due to difficulties with budget planning that make comparisons between budgets and eventual outcomes somewhat meaningless. And there is no system to compare the performance of municipalities with their peers - a system that could reveal excesses and mistakes as well as achievements. This is despite the fact that 90 percent of municipalities would welcome such a system.

And the general lack of systems of accountability leads to a perception of endemic corruption that undermines the good work that might be undertaken by most officials and allows others to undermine the system as a whole. It is simply not possible to separate the good from the bad. Public enterprises are a particular source of difficulty. Cantons and municipalities spend 3-4 percent of their resources on (explicit) subsidies for public companies and this average amount probably reflects a wide disparity of experiences. Implicit subsidies often emerge later as arrears. As discussed further below, most utilities have great difficulty in collecting fees and are caught in a difficult cycle in which they are subsidised by municipalities that are unable to invest in the necessary improvements to infrastructure.

## i. Recommendations

The appointment of a Minister of Local Government would act as a focus for improvements, including the introduction of a municipal performance appraisal system against established goals/targets and clear strategies for the fight against corruption. In this regard, the grants system could be streamlined and made more transparent. The system for awarding grants needs to be de-politicised and made as transparent as possible.

More than half of cities and municipalities believe that there is a need for significant reform to public financial management in the FBiH, including greater FBiH Government control over municipalities and stricter limits on borrowing. They strongly believe that adherence to fiscal rules - such as balanced budgets, repaid arrears and borrowing within limits - should be rewarded. The FBiH Government intends to strengthen control over borrowing by lower levels of government, inter alia, by the adoption of a new Law on Debt, Borrowing and Guarantees. Furthermore, "with the assistance of the World Bank, the Federation of BiH will prepare a document on the status of arrears at lower levels of government, including the establishment of a reporting system that include arrears in the health sector and outstanding obligations at lower levels of government."<sup>51</sup>

A new Public Financial Management (PFM) Reform Strategy was adopted in 2017 and will attempt to improve budget coordination and execution. In this context, "the introduction of the BPMIS application at the cantonal level is one of the planned activities within the USAID FAR project under which the BPMIS implementation at cantonal level is scheduled for 2018. If the process runs according to plan, it is expected that budget framework papers for 2019-2021 and cantonal budgets for 2019 will be prepared through the BPMIS application<sup>52</sup>." (See [Box 8](#)). The BPMIS system will later be rolled out to municipalities and the PFM Strategy envisages that all levels of government and extra-budgetary funds will regularly publish monthly, quarterly and annual reports.

A working group within the PPA plans draft changes to the Law during 2018 and the new draft would then be sent through the necessary procedures. The final goal is to exclude political or any other influence in public procurement procedures and also to minimize corruption and fraud. Local governments should actively engage

51 FBiH Ministry of Finance. 2017. Strategija reforme upravljanja javnim finansijama u Federaciji Bosne i Hercegovine. p:10.

52 Ibid. p:29.

**Box 8: E-Budget and BPMIS**

The cantonal Budget Management Information Systems (BPMIS), also known as the “E-Budget” system, was launched in March 2018 and will enable all FBiH Cantons to prepare their budgets on an up-to-date, state-of-the-art platform.<sup>1</sup> All cantons are automatically linked into the FBiH Ministry of Finance’s budget planning system and this will greatly facilitate, speed up and standardize cantonal budget preparation processes. BPMIS will enable uniformity in budget planning between all cantons and a direct link with the FBiH Ministry of Finance. It is a first step toward establishing full transparency in assessing the fiscal position in FBiH. It reduces the possibility of errors and enables real-time difference analyses of changes in individual measures in the budget adoption process. It will have a long-term positive impact on the quality of public finances in FBiH and will help monitor cash flows in the budgetary system.

<sup>1</sup> The system received significant technical assistance from USAID’s projects on Fiscal Sector Reform Activity (FAR) and the Strengthening Government Institutions and Processes (SGIP). USAID FAR provided software, hardware and training to all 10 cantonal Finance Ministries and the FBiH Ministry of Finance. USAID SGIP’s Financial Impact Assessment module will enable real-time data entry that will be available for public scrutiny.

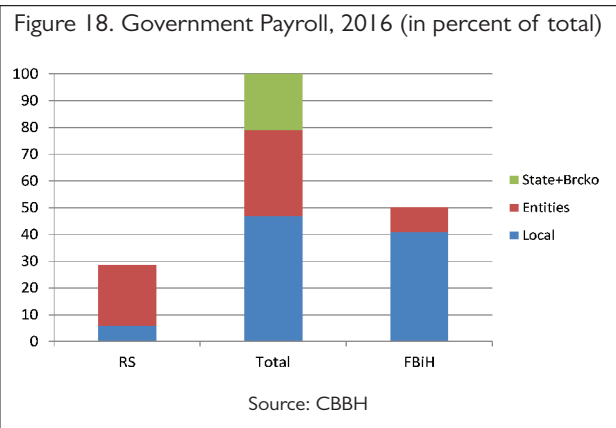
in the process of amending the Law and ensure that their concerns are heard and considered. The PPA should review the efficiency of existing complaints procedures.

**5. Public Administration Reform (PAR)**

Public administration reform is a priority for BiH, in order to ensure fiscal sustainability and a more effective government. A renewed engagement on reform as part of the Reform Agenda reopened the debate on the organization, staffing and effectiveness of the broader public sector and there is growing recognition of the need to reduce public sector employment and create the right conditions for the growth of the private sector. A number of short-term measures were introduced under the Reform Agenda - including a halt on new hiring and freezing salary step increases in the cantons - but these measures do not address the core problem of overstaffing in large sectors such as education, health and policing, and weak employment controls over the health institutes, the extra-budgetary funds, and the cantons and municipalities.

The World Bank reports that BiH has a bloated and underperforming public sector. It has one of the highest shares of government wages to GDP in the region and scores lower on the Worldwide Governance Indicators’ (WGI) Government Effectiveness index than other countries in the region<sup>53</sup>. In BiH, local government accounts for almost 50 percent of the public sector wage bill (Figure 18) and, in the FBiH, this figure climbs to a whopping 80 percent (because of the role of cantons). Therefore, PAR is mostly a problem for local government in the FBiH and local government must be the focus of reform.

<sup>53</sup> For more information, see the Worldwide Governance Indicators published by the World Bank.



**i. Challenges**

Institutional fragmentation - especially in the FBiH - is a major contributor to high wage bills. Overlapping competences and fragmentation lead to the overlapping and duplication of staffs. Moreover, it is generally accepted that the main driver of a bloated and underperforming public sector is political - through patronage and factionalism (that extends to public sector companies). Moreover, consultations revealed widespread public frustration with ineffective bureaucracies. But the fact is that most cantonal Prime Ministers and Municipal Mayors are themselves deeply critical of their own staffs and those they encounter in other areas of public administration. The FAMC Development Strategy recognises a significant lack of capacity at the local level, a lack of good governance practice, and a great need for professional development and training.

Local governments complain that they are unable to deal with overstaffing or the need to rotate unqualified staff out of key positions. They complain that overly-strict Civil Service Laws prevent local



managers from hiring or firing in a timely manner. Almost three quarters of local governments believe that there is a need to change civil service laws to allow greater flexibility in hiring and firing, even if this undermines job security for municipal employees<sup>54</sup>. Local governments know that they are overstaffed and inefficient but, in most cases, these staff are inherited from the deep past and cannot easily be removed, retrained or reassigned.

As a concrete example, a recent informal review by an expert from an EU-funded project (February 2018) in a large municipality concluded that some heads of units and departments “suffer from a lack of necessary competences for staff in managerial positions. On the other hand, the legal framework protects them from major disturbances in terms of their status.” When the expert recommended a reduction in the number of staff and/or rotation of staff, the Mayor expressed his frustration about the implementation of the recommendations due to the strict federal legal framework related to civil servants and employees in local administration. The expert noted “the strong need for simplification of the current federal legal framework.”

All appointments and dismissals have to be approved by a severely under-resourced Civil Service Agency that has a backlog of some 3 years. Dismissals are generally regarded as impossible - there need to be two consecutive negative performance appraisals (i.e. two years) before the process can even begin - and under-qualified staff members are, in many cases, content to see out their jobs until retirement. Many managers reported a complete inability to discipline unproductive staffs who often block much-needed initiatives. More generally, it is extremely difficult from a political perspective to initiate large-scale layoffs where private sector unemployment rates are already very high.

In December 2015, the FBiH Government introduced amendments to the FBiH Civil Servants Law that would facilitate the removal of the top layers of administrative positions from the civil service and make them subject to regular review and reappointment. The Law diluted some of the protections afforded to these civil servants and, while the stated aim of these amendments was to introduce greater flexibility and accountability, it also risked further politicisation of the civil service. Cantons are not obliged to adopt an entity-level civil service law but six cantons quickly adopted laws similar to the new FBiH law in an attempt to introduce greater flexibility.

54 The Reform Agenda for 2015-18, approved by all levels of government, made a commitment to “introduce greater flexibility in working arrangements.”

ty. However, the new FBiH law was declared unconstitutional and a new political agreement has yet to emerge.

There is no Public-Private Partnership (PPP) Strategy at any level in BiH and there is no unified regulatory framework for PPPs. Each level of government has its own set of laws. The regulatory framework consists of 8 laws on PPPs and 14 laws on concessions. FBiH has a draft version of a Law on PPPs but is awaiting public hearings to finalize it. Meanwhile, eight cantons have enacted their own PPP legislation. Approvals are given by several bodies, starting with the sector line ministry, a high-level Commission, the local government and the Ministry of Finance. The approval process for PPPs is complex because it involves several different bodies and municipalities complain of complicated procedures for PPPs and concessions that have discouraged private sector investment. As a result, relatively few projects have materialised (compared to the RS).

Internationally, it is common practice to have a central PPP unit or agency that deals with the assessment of PPP proposals at a technical level and recommends projects to a higher decision-making body. Under the entity and cantonal laws, a Commission for Concessions functions as an inter-departmental committee. The Commission evaluates proposals in line with a decree for assessing and approving PPPs. However, the absence of a technical team to challenge and validate the business case means approvals are based on inadequate analysis. In terms of capacity, the Commission for Concessions is the only team with significant relevant experience for such projects but this is quite limited as the Commission has only three members.

## ii. Recommendations

Clearly, there is a need for a better balance between employment protections for civil servants and ensuring their accountability to elected officials. Many OECD countries have also struggled to achieve a balance between ensuring that senior civil servants are responsive to the political will of the government while preserving the ideal of a professional public service which provides for the continuity of the administrative system<sup>55</sup>. There needs to be an urgent introduction of consistent and reasonable legislation across all cantons and central government in the FBiH. The FAMC advo-

55 Many OECD countries (like the USA and Sweden) give discretion to politicians in the appointment and dismissal of senior civil servants while in others (like Denmark and the UK) the process is entirely administrative. Others have a hybrid system, where an administrative agency prepares a shortlist of candidates for the minister who then makes the final selection.



cates the adoption of a separate law for the employees of local government.

There is a need to conduct a broad functional review, at the level of each Entity, to identify overlap and duplication of structures and the potential for rationalization. This will require in depth engagement on horizontal (at each entity level and the state level and in selected cantons) and vertical functional reviews of selected ministries and cantons. Growing public revenues should be set aside to provide funds for layoffs at all levels of local government (including funds to provide for unpaid contributions in SOEs).

A number of concession agreements have already been delayed by the failure to enact an FBiH PPP law. This needs to be agreed and enacted and cantonal laws need to be harmonised with it. PPP laws at cantonal level seek to comply with EU regulations but the main problem is their failure to recognize that concessions and PPPs are treated in unified legislation in most countries - i.e. that a concession is a form of PPP.

It is also extremely important to improve anti-corruption legislation and practices in all aspects of local self-government operations. To this end, the FAMC has committed to support activities related to development and adoption of a Code of Ethics for local governments and will provide professional support to members by promoting good relevant practices. These concerns extend to the prevention of all forms of discrimination. The FAMC recently undertook an initiative on the prevention and suppression of corruption during 2017.

## C. Focus on Municipal and Social Services

### I. Description of the System

Municipal governments exclusively provide local roads, water, sanitation, and waste removal<sup>56</sup>. In most municipalities, a Communal Services Department in the administration oversees public works, and municipal councils set tariff structures. Typically in larger urban areas, a single utility supplies water and sewerage, but in smaller municipalities, these utilities also manage other services. The utilities finance their operations through user fees, but depend heavily on local and higher-level government co-financing for capital investments. Municipalities are entirely responsible for district heating in 25 municipalities and cities with populations over 25,000.

Municipalities vary significantly in size, population, and resources. Municipal territories range from 10.2

<sup>56</sup> The only exception is Sarajevo canton, where those services are provided by cantonal utilities.

to 1,232 square kilometres, while population size ranges from 62 to 225,000. But most of the population lives in reasonably-sized municipalities. Although the level of economic development is not the key determinant of the level and the quality of public services, it is nevertheless a good approximation. According to the Federal Institute for Development Programming, there are 11 “extremely underdeveloped” municipalities in the FBiH and a further 16 are classified as underdeveloped (out of a total of 79 cities and municipalities). Therefore, in at least a third of municipalities, the economic context in which local governments operate is precarious and the potential for improvement in local services under current circumstances is limited. The FAMC Strategy sees the uneven development of local communities as an example of an unfair distribution of resources across municipalities.

Collaboration between local and cantonal governments is limited. In recent years there has been a greater focus on collaborations, partnerships and outsourcing as a means to improve efficiency and productivity of local governments across Europe<sup>57</sup>. This captures “the advantages attendant upon scale, but without the adverse democratic and economic effects of consolidation<sup>58</sup>.” In the FBiH, however, “intergovernmental interaction and cooperation is minimal and formal” despite the fact that, in both entities, “laws provide for cooperation, supervision, and monitoring among higher-level authorities and local self-government<sup>59</sup>.” The FAMC Strategy proposes a legal framework that would regulate cooperation and encourage local governments to jointly pursue their strategic goals, in order to provide better services to their citizens and improve their living conditions.

### 2. Findings of Consultations

Local service delivery outcomes are extremely uneven across municipalities and sectors, access to services is poor, and overall user satisfaction is low. Municipalities frequently lack resources and need to increase their fiscal space in order to expand access to basic services. This is especially true for rural areas and among municipalities with low per capita revenues. The major obstacle to improved municipal services, according to 60 percent of the

<sup>57</sup> O'Donnell Orla. 2012. Strategic Collaboration in Local Government: A review of International Examples of Strategic Collaboration in Local Government.

<sup>58</sup> Dollery Brian, Kortt Michael and Grant Bligh. 2012. Options for Rationalizing Local Government Structure: A Policy Agenda. p:1.

<sup>59</sup> The World Bank. 2009. From Stability to Performance: Local Governance and Service Delivery in Bosnia and Herzegovina. p:27 and p:29

respondents in the Survey, is insufficient financing for legally assigned duties. This problem is followed by contradictions between local government laws and sector legislation (19 percent) and a lack of clarity in legal responsibilities (16 percent).

There were constant complaints during consultations about the mismatch between the allocation of responsibilities and funds - leading to under-funding of local governments and the poor provision of public services. Municipalities complained that, while they don't have formal obligations regarding health, they have to finance and provide ad hoc support, once-off allowances (e.g. for homeless) and social welfare services for those who cannot get help at the cantonal level. Municipalities explained that it is not possible to refuse help to people in need and that it is often not practicable (or rewarding) to refer constituents to cantonal services.

A lack of predictability of funding - especially with regard to grants and transfers from higher levels of government - leads to delays in project completion. There are frequent reports of unfinished projects that drag on for years despite completion having been expected within a given year. Delays are attributed to unpredictable revenue streams and are compounded by an inflexible Public Procurement Law. Delays in capital transfers are often attributed to political differences with the granting authority.

Municipalities complain that it is not easy to cooperate with other municipalities and this experience is borne out by the lack of a significant number of successful examples. Yet, almost 60 percent of local governments surveyed during the Initiative believe that they should collaborate in the provision of services and encourage utility companies to provide services across municipal boundaries. Almost 15 percent say that they already cooperate in such a scheme. And 85 percent of local governments believe that it would be a good idea to give priority to grants applications that are jointly submitted by two or more municipalities.

Many municipalities have serious problems with the financing and operation of utilities<sup>60</sup>. Larger municipalities have specialized firms but, in smaller municipalities, utilities provide a basket of services. Utilities finance their operations through charges for their services and regular utility fees, as well as funds from the budget. Fee levels are determined by the service provider but require the prior approval of the municipal council and, in many cases,

fees are maintained at lower levels for political (and social) reasons. If the municipal council determines a lower price than proposed by the provider, the municipality has the obligation to compensate for the difference.

Most often, when it comes to price setting, there is an avoidance of 'full cost recovery' pricing. In the Survey, around two thirds of local governments said they have to subsidize utility companies because they find it politically difficult to raise prices and because they do not have sufficient control over their operations. However, the creation of regulatory agencies at the cantonal level is only supported by 40 percent of municipalities. Almost half of local governments do not think that regulatory agencies at the cantonal level should be responsible for establishing utility fees. Some ideas and proposals on how to alleviate this problem are provided in [Box 9](#).

<sup>60</sup> According to the FBiH Institute for Statistics, as of April 2018, there were 94 active utility companies in the FBiH employing 8,805 people.

### **Box 9: A Regulatory Framework for Tariff Setting in Water Supply and Sewage Services in BiH**

The key problems faced by water utilities are high network losses, inadequate tariff rates, a low ratio of collection of receivables, and staff numbers with low expertise. Currently, several water utilities are under bankruptcy and many survive from day to day. They are not able to invest in their equipment, infrastructure maintenance, or development. They also lack performance-based management systems and rarely assess public satisfaction with their services.

There is widespread consensus that the current regulatory framework for water supply and sewerage utility services does not provide the necessary level of self-sustainability of these services. In 2013, UNDP (together with the Water Governance Facility at the Stockholm International Water Institute) began a project devoted to examining the “Regulatory Framework for Tariff Setting in Water Supply and Sewerage Services in BiH”. The main objective was to develop a draft tariff-setting methodology for water supply and sewage services in BiH. The methodology was published in 2015 and defines tariffs so as to enable the recovery of all costs, including operating and investment-maintenance costs, as well as capital investments costs. The proposal was accepted and supported by key stakeholders and is flexible enough to be adjusted and applied to tariffs for all other utility services. The project also aims to develop a proposal on the best administrative positioning of a Regulatory Body for tariff setting of communal services like water supply and waste water collection and treatment services.

However, due to the varying competences of the different levels of government in the FBiH, there has been no agreement so far on which level to establish such a Regulatory Body and what its powers would be. Given the fact that it would require significant legislative changes at many different levels, the idea will need greater political support to be enacted.

### **Box 10: The Issue of Unpaid Utility Bills**

Courts in the FBiH are currently clogged with a large backlog of cases and 80 percent of these (1.7 million cases) are claims for unpaid utility bills. The stock of claims is constantly growing and many claims are small and relate to properties that have been abandoned but not removed from official registers (and that will never be paid).

The World Bank recently examined the issue and recommended that the FBiH Government reinforce the current commercial departments in the FBiH Courts instead of creating new commercial courts (for reasons of efficiency and cost-effectiveness). An EU workshop was held in September 2017 to help develop an action plan on reduce the backlog of unpaid utility bills and small value cases. Furthermore, IPA projects aimed at building the economic and financial expertise of judges on commercial cases are currently in preparation.

The FBiH Government is now expected to propose amendments to the FBiH Enforcement Procedure Laws and to establish a system for the non-judicial collection/settlement of utility debt and small claims. The FBiH Ministry of Justice is going to form a working group. Cantons are also expected to undertake actions aimed at resolving this issue.

There is also a significant problem with collection rates - although many utilities reported that collection rates increased significantly when they improved their services. Collection rates vary widely between municipalities and are undermined by a slow court system (see [Box 10](#)). It is estimated (by the MDF Achievement Fund) that the collection rate for billed water production in the FBiH is 86 percent<sup>61</sup>.

As essential public service providers, local governments continue to struggle with user satisfaction, quality of service, sustainability and access - with the latter concern particularly relevant in rural areas. At present, less than 40 percent of the country's population is connected to the public sanitation system and 90 percent of collected wastewater is released into the watercourses without treatment - resulting in serious contamination of both water and soil. In addition, most of the water utilities in the country are not financially sustainable, which poses a long-

61 UN MDG Achievement Fund. 2011. General Assessment of the Water Supply Sector and Its Human Development Function in Bosnia and Herzegovina.

term risk to water supply.

Although communal services (such as heating and water supply) are a municipal responsibility, the ownership of the physical assets - such pipes and pumps - is often not clearly defined. Utility companies use the infrastructure without feeling responsible for its maintenance and the cost ultimately falls on the municipality. This, in turn, affects the quality and reliability of services. A Report published in 2011 by the MDG Achievement Fund found that an average of 64 percent of the water produced in the FBiH is lost due to leakages<sup>62</sup>. There is an urgent need to address issues concerning the maintenance of the communal infrastructure (see [Box II](#)).

### 3. Recommendations

Most of the obstacles to improving municipal and social service delivery in the FBiH stem from a failure to collaborate and cooperate more efficiently with governments at higher levels or at the same level. This includes confusion over the sharing of competences and the consequent evolution of unfunded mandates that reduce the fiscal space available to address more-standard competences and needs. It is clear that many municipalities find it difficult to get by on a day-to-day basis and have very few resources and very little time available to them to even consider improved methods of service delivery and economic development. The system needs to be fundamentally changed so that municipalities have an improved set of mechanisms and means available to them to be in a position to: secure a better understanding with canton governments on who should provide and pay for certain services; embark on cooperative initiatives with other municipalities that will improve economies of scale and save resources that can be used other purposes (like social welfare); and engage with canton and other municipal governments in regional plans for the development of services and the local economy. Municipalities need greater clarity on their position in the canton - especially in the context

<sup>62</sup> Ibid.

#### **Box II: The Municipal Environmental and Economic Governance (MEG) Project**

To address challenges to the maintenance of communal infrastructure, the Government of Switzerland launched the Municipal Environmental and Economic Governance (MEG) Project in 2016 (implemented by UNDP). It aims to improve the quality and availability of public services and utility infrastructure and to improve living conditions for at least 700,000 citizens from 18 local self-government units across the country. The Project is envisaged to last 12 years and will be implemented in three phases. The first phase runs until 2020. It takes a comprehensive approach - from establishing the regulatory framework to technical assistance to public utility companies. Consultations have been provided as well as equipment (including the training on its use).

The Project further supports the sustainability of utility companies, which may be achieved only by doing business according to market principles. Local self-government units, as the founders, concluded bilateral agreements on the provision of public water services with public utility companies, thus regulating mutual relations in the sector. Agreements define the steps which need to be taken for public utility companies to become economically sustainable, such as applying cost-based pricing and proper job classification. Public utility companies received equipment such as water flow meters and leakage detection devices, which will be of assistance in repairs and reducing the non-revenue water percentage.

At the same time, the Project makes sure that no one is denied access to clean drinking water. Therefore, special attention is paid to improving the living conditions of vulnerable groups in BiH. The project has, therefore, introduced subsidies to be provided by local governments to the vulnerable population so that they could afford to pay water bills. The recipe for implementing subsidies is fairly simple and based on the active involvement and partnership of several stakeholders: local governments define in their decisions the criteria for obtaining subsidies and provide the funds; social work centres approve subsidies and provide monitoring; and water utility companies collect bills using the adjusted accounting software that takes subsidies into account.

of persistent migration - and on what resources are available to them.

In Section B (above), three sets of instruments were proposed to achieve these aims:

- i. **Functional agencies** designed to unify responsibilities in one institution and jointly owned by the canton and municipalities. In particular, the use of functional agencies in local economic development would integrate municipalities into a shared plan for the future that includes their input and perspective. In this context, the pursuit of local economic development would be less time-consuming,
- ii. Rolling multi-year **Public Service Development Agreements** (PSDAs) that would: need to bear the signatures of mayors; chart a way forward for the development of services in a coordinated manner; and clarify who has responsibility for what functions and how individual municipalities can contribute to improvements.
- iii. **Network development plans** for some service - such as health care - where cantons: offer a clearer picture of the contributions municipalities can make to the development of an overall system; clarify their plans for the development of the network; and set out how the system fits in with other networks in the FBiH.

In this context, there would be clear multi-year plans for the use of cantonal grants for capital investments over the horizon of the strategy (to combat the current practice of allocating grants on an annual basis - often too late to be included in municipal plans). Grants could be prioritised for joint infrastructural projects that are agreed (with the canton) between two and more municipalities.

In the context of a review of commercial court procedures, utility fees should be reclassified as “debt owed to public bodies” so that public utilities can collect accounts receivable with the help of tax authorities, thus avoiding long court cases and uncertain outcomes.

Finally, semi-annual town hall discussions should be organized between members of the local governments, managements of utility companies and citizens to discuss achievements, shortcomings and make necessary adjustments in the delivery of public services. These discussions would be far more meaningful if conducted in the context of operational PSDAs, functional agencies and clear network plans.

Box 12 discusses some of the unique characteristics of the provision of municipal services in Sarajevo canton and how these will need to change in the near future (because of certain court rulings).

### Box 12: Specifics of the Sarajevo Canton

Sarajevo Canton has the second biggest population (after the Tuzla Canton) in the FBiH. It is the most developed of the ten cantons, providing jobs for 28 percent of all employed people in the FBiH and is home to one fourth of all its business entities. It has double the augmentation coefficient (2) of most other cantons but it argues that its existing allocation is well below its contribution to the pool of indirect taxes that are subject to redistribution. In 2016, Sarajevo Canton got BAM 377 million in indirect tax revenues, while Tuzla Canton – as the most populous canton – received BAM 209 million.

Sarajevo also has a special arrangement when it comes to the sharing of the personal income tax. According to the FBiH Law on Public Revenue Allocation, cantons are entitled to no more than 65.54 percent of the personal income tax paid in each canton (while a minimum of 34.46% goes to the local self-government unit where the tax was collected). In the case of Sarajevo, the canton gets 98 percent. This is because the canton has significantly more competences than other cantons.

Unlike in other cantons, Sarajevo Canton is fully responsible for preschool and primary education (and runs a total of 72 institutions that together employ 3.820 people and cost the canton around 100 million KM annually. In addition, Sarajevo is the only canton in which utility services are provided by cantonal (instead of municipal) utility companies. According to the Canton Government, most of these are significantly overstaffed and drain a lot of resources. According to the FBiH Institute for Statistics, there are currently 94 active utility companies in the FBiH and they employ 8.805 people. More than half (4.856) are employed in the nine utility companies in the Sarajevo Canton (according to the FBiH Tax Administration). While the Cantonal Public Utility Company “RAD” has been singled out by the World Bank in 2009 as a positive example of what can be achieved through cooperation, the company is nowadays facing serious financial problems.

Municipalities complain that many of the municipal services provided by Sarajevo Canton are inefficient and expensive and, as a result, they asked for competences to be returned to them. The FBiH Constitutional Court has ruled on several occasions that their right to local self-governance has been violated by the Sarajevo Canton and comprehensive efforts have begun to resolve the issue of competences. There were eight amendments to the Cantonal Constitution in mid-2017 and the Canton is in the process of decentralising public utilities to the municipalities. A number of laws still need to be adopted and the whole process needs to be handled with care, given that it has serious implications for property issues, financing and the destiny of more than 8.000 employees. Because of their proximity and interconnectiveness, the new Cantonal Constitution offers the four municipalities comprising the City of Sarajevo the option of voluntarily entrusting the Canton with managing utilities in the areas of water supply, heating, waste management and transport.

The Cantonal Government is in the process of adopting a new Law on Local Self-Governance and this needs to be followed by the adoption of a new cantonal Law on Public Revenue Allocation.



## D. Focus on Local Economic Development

### I. Description of the System

#### i. Rural Areas Face Higher Development Challenges

People are twice as likely to be poor in rural areas of BiH as in urban areas. And this presents a particular challenge because the population - unlike in other emerging economies - remains majority rural (60 percent)<sup>63</sup>. The main burden of local economic development often falls on rural municipalities that face significant financing challenges. And rural municipalities are, by their very nature, fragmented and dispersed. There are very big differences from municipality to municipality and some rural areas are experiencing significant depopulation. This suggests that regional trends need to be closely analysed and that rural development needs to be an important element of policy at higher government levels. Both entities adopted rural-development strategies that are substantially similar regarding broad objectives—but that reflect their respective landscapes and agro-climatic situation<sup>64</sup> - and these were recently included in a country-wide strategy.

The rural population in BiH has limited access to basic local services and this often perpetuates the underlying problems of poverty and a lack of economic development<sup>65</sup>. Not surprisingly, services requiring higher fixed costs and investment - such as local roads and water and sanitation - are the most problematic<sup>66</sup>. Therefore, municipalities need more capital investment to expand access to basic services, especially in rural areas and among municipalities with low per capita revenues.

Regions such as entities and cantons depend upon one another for trade and development and transport is crucial for market access for people and goods. But BiH's transport infrastructure is rated as the poorest among SEE and CEE by the World Economic Forum (WEF)<sup>67</sup>. Upgrading rural and regional

transport infrastructure has been shown globally to boost activity and incomes. Therefore, the recent agreement on a country-wide transport strategy in BiH is very welcome and other broad strategies - such as energy - would also expand connectivity.

#### Collaboration and Integrated Strategic Planning Creates Considerably Synergies

Inter-municipal and cross-entity cooperation and development initiatives have a large potential to foster non-agricultural development in semi-rural areas and could receive more dedicated support. For example, the BEAR development and COBEAR project focus on investment promotion and “territorial marketing” in the municipalities of Teslić, Tešanj and Žepče and have established One Stop Shops in all three municipalities for SME support (see [Box 13](#)).

Vertical cooperation (between entity, canton and municipality) can target common use facilities (such as, research laboratories and specialised processing facilities) that can benefit clusters of SMEs in an area that crosses several administrative divisions. For example, a new Centre for Entrepreneurship in the Una-Sana Canton will support business and increase the competitiveness of the local economy in collaboration with local municipalities and universities. But BiH—and particularly the FBiH—is lagging behind peer countries in facilitating business and SME support. According to the World Bank's “Doing Business” (DB) 2017 Report, it is a very difficult in BiH to start a business, get electricity, approve construction permits and pay taxes. Moreover, investors often do not have sufficient confidence in government institutions to invest in long-term sectors like agri-processing or tourism. And many of the processes and conditions necessary to do business in BiH require dealing with authorities at a local level. Local administration can sometimes waste resources on projects that do not meet business needs and priorities.

Government fragmentation in BiH has led to numerous examples of disparities in business standards. For example, the construction industry is extremely fragmented and this creates significant additional costs and inefficiencies for businesses. The same building codes and material standards are being used throughout BiH but the licensing of works contractors and engineers varies per entity and even per Canton. Some Cantons recognise Federation licenses as equivalent. And the fragmentation of public administration is a major barrier to the working of an efficient and effective labour market. Social benefits are not transferable, qualifi-

63 The World Bank Group. 2015. Rebalancing Bosnia and Herzegovina: A Systematic Country Diagnostic.

64 Ibid.

65 “One-third of rural households must use water from unsafe sources ... [and] only 36 percent of households have regular waste removal services.” For more information see: The World Bank. 2009. From Stability to Performance: Local Governance and Service Delivery in Bosnia and Herzegovina. p:11.

66 The World Bank. 2009. From Stability to Performance: Local Governance and Service Delivery in Bosnia and Herzegovina.

67 The World Bank. 2016. World Bank – Bosnia and Herzegovina Partnership Country Program Snapshot.

### Box 13: The Power of Cooperation – The BEAR Micro-region

The municipalities of Tesanj and Zepce (in the FBiH) and Teslic (in the RS) established a Business Excellence Area (BEAR) in 2012 with the support of the GIZ Prolocal programme (and co-financed by the EU). The micro-region is designed to strengthen inter-municipal structures for effective and sustainable local economic development. The activities include creating a business friendly environment, improving economies of scale by implementing jointly coordinated programmes for investment and export promotion and creating attractive training and employment opportunities for all citizens. Since 2014, the programme has been extended - under the name Competitiveness of Business Excellence Area (COBEAR) - to focus on increasing the level of competitiveness of export-oriented enterprises in targeted sectors and in the BEAR micro-region and increasing productive employment. The implementation is coordinated by the local development agencies of Tesanj and Zepce and by the Business Center Jeljah -Tesanj.

The BEAR micro-region offers: professional support services provided by the local governments to businesses and investors; a favourable location with good infrastructure and easy access to EU markets; access to major local and international companies operating in the region; and a competitive and professional labour force. By late 2016, the 33 companies that were included in the project from the beginning recorded a 25 percent increase in turnover, more than a 40 percent increase in exports, and a 14 percent increase in employment.

### Box 14: The Integrated Local Development Project (ILDLP)

The Integrated Local Development Project (ILDLP) – financed by the Swiss Agency for Development and Cooperation and implemented by UNDP – aims at harmonising integrated and inclusive strategic planning at the local level. It made significant contributions in the standardisation of planning and development management approaches at the level of municipalities and cantons. Foundations were created for the establishment of strategic planning systems at the entity level, including financing mechanisms which provide targeted support to the implementation of local development priorities country-wide.

ILDLP activities included the establishment and implementation of a **Methodology for Integrated Local Development Planning in Bosnia and Herzegovina (miPRO)**. miPRO is a conceptual and practical tool intended to guide local development planning through a structured and systematic approach meant to improve quality of local strategic planning work country-wide.

cations are often not recognised across boundaries and there is no effective exchange of information on vacancies between Public Employment Services in different cantons and entities.

At lower levels, municipalities need to collaborate on integrated local development planning (see [Box 14](#)). Financial incentives can be used to promote collaboration, but increased investment must be based on systematic sectoral approaches. Municipalities with a sector strategy and clear priorities always do better. Small municipalities with integrated strategies for waste and water, for example, perform better than big municipalities that lack strategies<sup>68</sup>. The rate of unemployment is particularly high in the 17 urban municipalities that do not contain a major city, and the economic plight of these medium-sized towns calls for urgent attention. These towns, instead of offering economic opportunities to the

surrounding countryside, are often in even worse economic shape than the surrounding countryside. Cantonal development policies need to target these towns and inject new life into them<sup>69</sup>.

## 2. Findings of Consultations

The Survey clearly identified the major obstacles to better economic development, from the perspective of municipalities in the FBiH, as being due to a lack of joint strategies and cooperation. This included: the lack of a realistic entity strategy (33 percent); the lack of clearly defined responsibilities across government levels (26 percent); and a lack of shared objectives or cooperation between cantons and municipalities (21 percent). Only 3 percent identified political differences as a major obstacle and only 17 percent identified insufficient funding.

<sup>68</sup> The World Bank. 2009. From Stability to Performance: Local Governance and Service Delivery in Bosnia and Herzegovina.

<sup>69</sup> UNDP. 2013. "Rural Development in BiH: Myth and Reality."

### Box 15: Issues with Spatial Planning in FBiH

A lack of spatial plans at BiH and FBiH level creates confusion over objectives at lower levels. BiH does not have a national spatial planning document that would ensure the integration of space and a correlation of interests that would strengthen economic, social and territorial cohesion. While global standards in spatial planning promote organisation based on geographical, financial, economic or historical criteria, the spatial organisation of BiH is a result of political agreements. The result is a reduction in territorial cohesion and in competitiveness at lower levels.

Types of spatial plans in FBiH			
Spatial plan of FBiH			
Cantonal spatial plans			
Special purpose spatial plans	Municipality Spatial plans/Urban plans		
	Regulatory plans	Zoning plans	Urban projects

In FBiH, spatial planning is governed by the Law on Spatial Planning and Land Utilization ("Official Gazette of the FBiH," Nos. 02/06). Although, the spatial plan of FBiH was drafted for the period 2008-2012 it was never adopted by the government and created a gap in the planning process. The absence of a vision and common objectives that would be provided in an entity plan resulted in a variety of cantonal plans that often diverge from each other. Some cantonal plans, such as in Tuzla Canton, were developed even before the FBiH plan was drafted. Also, there is no formal mechanism for cooperation between cantons to harmonise planning or the implementation of plans, resulting in a loss of possible complementarity and synergies in sharing resources and opportunities.

Permits required for construction projects		
Urban Permit	Construction Permit	Use Permit
A 'planning' permit confirming what the owner may build on its land. It is issued in accordance with spatial planning documents.	A technical permit confirming how the owner will and may construct an approved object.  Requires providing a land registry excerpt as proof of registered ownership or construction right	A confirmation that the building has been constructed pursuant to the issued permits and other regulations and that the building is ready for use

Investors who propose projects that are not foreseen in spatial plans face particular difficulties in obtaining an urban permit because of: overlapping competences between the local and federal level; complications arising from the involvement of other federal ministries; and a potential lack of accurate spatial planning data. In some cantons, such as Sarajevo and Zenica, there are examples of cases that took up to ten years to resolve. In cases involving the sale of public land to investors, the Law on Public Procurement further complicates and slows down the process.

In the same vein, 45 percent of local governments identified complicated and burdensome business regulations as the main impediment to greater private sector investment, followed by political instability (22 percent) and a lack of sufficient funds for investment promotion/incentives (19 percent). High tax rates were found to be the least important impediment (identified by only 14 percent). In case local government got significant new funds for economic development, around two thirds would spend it on business zones to attract outside investments, while 26 percent would invest in infrastructural develop-

ment and only 12 percent would use the funds for education and vocational training for the unemployed or to provide incentives for local entrepreneurs.

The consultations found that problems with spatial planning have a profound impact on local economic development. A more effective use of space would reduce the costs of logistics, land and utilities. Moreover, smart, coordinated and transparent spatial plans would empower investment promotion and provide a basis for long-term business planning. Several specific problems were identified in this area and are set out in [Box 15](#).

The FBiH Law on Property Rights has had a negative impact on business development at the local level. Some municipalities with abundant unused land developed a practice of offering land at below the market price to attract investments. However, this practice was prohibited in 2013 by the Law on Property Rights of the FBiH (Official Gazette of FBiH, Nos. 66/13 and 100/13). According to the law, land must be put up for auction, and there is no possibility of a direct agreement with an investor. Hence there are no guarantees that the investor will purchase the desired land. It appears that one of the reasons that the Law on Property Rights is so rigid is the lack of bylaws that should accompany the law. Local authorities such as the City of Tuzla recently submitted a draft bylaws proposal to the Federal government, and if accepted, they would grant exceptions and allow below-market valuation of land as an incentive to prospective investors. As a temporary remedy, some municipalities are offering land for leasing at a lower cost instead of offering it for sale. For example, the land owned by Kreka municipality for the area of the business zone Kreka Sjever was leased to the investors for KM 400 per plot.

Databases with geodetical and land registries information are not updated. The main problems facing municipalities in urban planning include an extensive and inconsistent legal framework not applicable in practice; problems related to property rights; and disorderly public records, cadastre and land management, and inventory. And, in almost all municipalities, there is an urgent need to update geodetic and cadastral maps. The law prescribes the preparation of planning documents in analogue and digital form. But a large number of municipalities have not completed the digitisation of these media, mainly due to a lack of trained staff and lack of funding for equipment and programming software. Double land registries from different land surveys - that are not aligned with each other - further complicate the issuing of construction permits and the construction process.

To regularise spatial planning and improve services, the law on spatial planning envisions the development of an integrated spatial information system in FBiH. Once established, the system would connect all stakeholders that have data relevant to spatial planning: entity-level ministries, municipal authorities, utility providers, development and scientific organisations and other institutions. The law further specifies ten types of spatial planning documents and the information that such a system should register. However, there are no further instructions in the law or in the follow-up ordinances that would guide implementers on the institutional process to be used

for the development of such a system; this requires coordination and common standards.

### 3. Recommendations

#### i. A Better and More-Integrated Business Environment

The Reform Agenda put the spotlight on many of the problems with the business environment and agencies such as USAID and IFC have helped to improve the transparency of parafiscal fees and encourage municipalities to adopt more-business-friendly practices. Sarajevo Canton was used as a pilot project in many of these efforts and has significantly improved its business environment over the past three years. These efforts should be further encouraged and extended to the other cantons. And USAID (together with a Swiss Agency for Development and Cooperation and GIZ) has worked with many municipalities in the Business Friendly Certification for South East Europe (BFC SEE) programme. The programme introduces internationally recognized standards of efficient and transparent local administration aimed at the creation of a favourable business environment and clearly identifies municipalities who have reached tough standards. This sends a clear signal to potential investors and the programme also actively promotes peer-to-peer exchange in BiH and in the region<sup>70</sup>. More generally, a structured and systematic dialogue between local administrations and companies, business associations and academia can improve policy and generate more effective measures to improve business conditions on a sustainable basis.

The harmonisation of licensing requirements across cantons, for example, would be an important step towards creating one single “construction space” in FBiH. This would allow a more efficient use of public resources and create the financial space at the local level to consider other important initiatives. Moreover, a solid system of academic and professional qualifications - recognised country-wide and at international level - would allow BiH professionals to exploit the benefits of mobility. (See [Box 16](#)). A fully integrated database containing all job vacancies could permit the best possible matching between job-seekers and job opportunities across the country.

<sup>70</sup> For more information see: BFC SEE. 2018. Certification of Business Friendly Cities and Municipalities in South East Europe (Brochure 2018).



### Box 16: Investment Climate Project (ISCRA) and Local Investment-friendly Environment (LIFE)

ISCRA, funded by SIDA and implemented by IFC, focuses on regions and localities with strong business activity, in order to achieve notable reductions in the administrative burden. Municipal, cantonal and entity licensing and permits create administrative burdens for all businesses; they represent a significant burden for farmers, medium and large retailers, agribusiness sector (and sub-sectors), and SMEs in general. Furthermore, project activities ensured that over 1,000 business related procedures are streamlined and improved, in order to enable attracting investment and improving business environment.

As a continuation of these efforts, IFC (in cooperation with the British Embassy in Sarajevo) launched the LIFE project in late 2015, with the aim of supporting local authorities in strengthening their competitiveness and boosting private sector growth. The program lasts until January 2019, and is being implemented in 20 local communities across the country. Amongst other things, the project aims to increase competitiveness of private sector by reducing costs for businesses (direct costs by \$7 million, and 20 percent reduction in indirect costs), improving the Distance to Frontier measure (as related to Doing Business report), particularly with regards to the long-standing issues of registering property, getting electricity and construction permits before project. As a result, \$10 million in investment should be generated, facilitated and retained one year following the Project.

## ii. The Management of Economic Development

The cantons need to fully assume responsibility for the coordination of economic development on their territory and not rely on entity and state level governments. They should develop and strategically lead development initiatives together with the municipalities and where necessary, in cooperation with other regions. In particular, they should:

- Improve local economic management practices:
  - Revise local/cantonal strategies to include new approaches (see below) and be ambitious but realistic about resources (not only financial, e.g. capacity building takes time). The FAMC Strategy notes that a large number of municipalities have adopted their own development strategies but that, in order to provide for a high quality of implementation of these strategies, all of the development strategies at all government levels need to be harmonized. More resources and a harmonized approach to strategic planning (horizontal and vertical) are the prerequisites for further development of local governments.
  - Establish pro-active and professional operational management of economic development using the concept of functional agencies. Such agencies can address co-ordination failures arising from fragmented and overlapping competences such as in case of natural resource management (See [Box 17](#) on Functional Agencies dedicated to Economic Development). Develop a tailor-made strategy for attracting private-sector investments (domestic and foreign) to be managed by the functional agency. Establish a fund for business development that is linked to the strategy and administered by the investment agency and promote it aggressively.
- Develop a branding strategy for the municipality/canton based on a well-defined and specific set of advantages and attractive features. Consider teaming up with nearby or other complementary municipalities that share the potential for related industries (e.g. wood resources – wood processing tradition and capacities).
- Use new technologies to manage funding and information sharing.
- Open a platform to engage local/regional talents: run business development ideas competitions and fund the best ideas. In this regard, development partners may also have instruments for support.
- Make development grants conditional on cooperation between municipalities:
  - In May 2017, the FBiH Law on Development Planning and Development Management entered into force. Article 13 of the Law envisages the establishment of Cantonal Councils for Development Planning and Development Management composed of the cantonal prime ministers and all the mayors from the respective canton. Their role is to provide advice during the process of defin-

### Box 17: Comparative Advantages of a Functional Agency Dedicated to Economic Development

Economic development interventions are thought to be best managed by business-like rather than municipal organisations and can better be delivered through a corporate, rather than a municipal, structure. Development Agencies and their tools are seen to add real value to the implementation of economic development strategies because they are able to:

- i. Aggregate otherwise disparate economic development efforts within one body that can generate real expertise and track record of delivery.
- ii. Increase the pace of the canton's/city's response to investors/developers and enhance the reputation and credibility of the region's 'negotiators,' giving an external investor confidence in the process of decision taking.
- iii. Enlarge the scale of implementation that is possible, often by enabling delivery on multiple programmes and projects simultaneously and by commissioning additional resources quickly.
- iv. Find appropriate means to share costs and risks between those promoting developments and investments.
- v. Develop mechanisms for value and benefit capture, enabling some of the fruits of economic development to be recycled within canton/city budgets and programmes.
- vi. Devise wholly new sources and instruments for investment, perhaps in partnership with private financiers.
- vii. Improve the investment-readiness of key canton/city projects, developing the propositions to make them more attractive to external investment.
- viii. Overcome 'co-ordination failures' arising from fragmented jurisdictions.
- ix. Promote and market the city or sub-region better, overcoming information gaps and asymmetries and building a clearer image and identity.
- x. Provide a location to clarify roles and responsibilities for advancing complex local economic development projects.

ing, implementing, monitoring and evaluating development projects in the canton. All cantons were supposed to establish their Councils by the end of the year.

- Financial incentives could be provided only to those projects that have the unanimous support of the Cantonal Councils for Development Planning and Development Management. They would be inserted in the revenue equalisation system, where grants would be awarded also with consideration of joint economic development projects.
- Adopt a pro-active approach to economic development:
  - In the context of the new pro-active role of the cantons, understand each region's advantages and constraints in a wider context of FBiH/BiH. Investors are already evaluating opportunities in the same way. Cantonal strategies should evolve from sector-based advantages to the development of market systems – think of a canton as a growth hub.
  - Promote full transparency of all transactions. Allow open and fair competition for regional resources and contracts. Employ technology such as social networks to establish and maintain communication with stakeholders.
  - Promote competition in ideas. Develop a set of incentives for the public and private sectors to work together on the region's development. Create innovation funds at FBiH and canton level that can be accessed by all.
  - Open canton/municipality planning to the young generation. Design programmes for the retention of highly educated local youth – they provide high value for money.
  - Reduce risk and complement funding by engaging development partners to help creatively address constraints – co-financing, additionality, cooperation and participation.



- Engage in creating micro-regions to increase competitiveness:

Creating micro-regions to increase economies of scale and focus incentives for the region to improve performance is a very effective method. The most efficient way of supporting local firms and attracting investment is through targeting the constraints that inhibit their success, including: regulatory barriers and the lack of access to markets; access to business development services and finance; physical workspace; and qualified and mobile labour market forces. In this context, parafiscal fees would be addressed in the context of maximising the competitiveness of the micro-region rather than only from the fiscal perspective. There is a considerable economy of scale in offering these services and, therefore, it would only be meaningful if offered on a regional basis: between cantons or between municipalities (as in the example of BEAR).

- Create joint business infrastructure projects in support of (micro) regions:

In most cases, local business infrastructure (business zones, business incubators, roads) was created without a clear idea as to how they would be used. Despite the expanding volume of capital investments in local business-related infrastructure, the lack of feasibility studies or a regional/inter-municipal approach to ensure economies of scale minimises the value of financial investments and leads to reduced, if any, economic effect. Plans for business infrastructure should be combined with business development services.

### iii. Spatial planning

Three areas need particular attention:

- Adopt an FBiH spatial plan and encourage joint planning projects between cantons and between municipalities:
  - It is necessary to adopt the FBiH spatial plan and to reform the corresponding legislation in the areas of agricultural land, waste management, waters, and forests to ease its implementation. The Law on Property Rights should be amended to allow more flexibility for the local authorities in the implementation of development projects. And the FAMC highlights the need for the adoption of a new Law on Survey and Real Estate Registration and for harmonizing the Law on Construction Land with the Law on Property Rights.
  - Encourage cooperation between cantons and municipalities on joint spatial planning projects. The rulebooks of the cantons and municipalities should be amended to estab-

lish mandatory working teams that would address larger projects. Cooperation could also lead to a more flexible approach to implementation of the current rules and strengthen the leverage of the local communities at the federal level in resolving priority urban planning issues.

- Update geodetic and cadastral maps and land registries:
  - Finalise the updating of geodetic and cadastral maps and land registries and integrate them into a GIS-based information management system. Such a computer system would be designed to connect all participants in the spatial planning process and capture, store, manipulate, analyse, manage, and present a variety of spatial and geographical data. The Ministry of Spatial Planning should be equipped with the methodology to coordinate the production, amending, monitoring, implementation and compliance of the different levels of spatial plans. It should be a central coordination body that facilitates the implementation of all spatial plans with key horizontal ministries such as the Ministry of Agriculture, Water and Forestry and the Ministry of Environment
  - Alternatively, introduce new digital technology for local governance—in particular, blockchain options. Introducing new technologies is an alternative solution to the development of a spatial management system and would significantly advance the storage and management of spatial data. The maintenance of registers and cadastres is the bedrock of these activities, but keeping them up to date is typically a difficult, complex and costly task. But blockchain technology offers a set of innovative and easier options (see Annex D). It refers to a family of technologies and organisational principles to create a ‘trustless public ledger’ - an immutable public registry that is not under control of any single agent. This aspect of the blockchain makes it particularly appropriate for the decentralised management and storage of public data as a ‘commons’. In the public sector, blockchain is being used increasingly for electronic property registration in the Baltics and the FSU countries. Its use is also expanding in the private sector. Countries with younger institutions and procedures may be able to introduce blockchain more easily because there is less that needs to be dismantled.

- Capacity building and public debates on spatial planning:
  - Provide capacity building to the spatial planning community at the local level to improve their abilities. Spatial planners at a cantonal and municipal level should provide quality and timely service to citizens and businesses in issuing permits, but also become critical thinkers and contributors towards solving the practical issues arising from local spatial planning decisions and processes.
  - Facilitate public debates for more inclusive decision making and design zoning plans with flexible regulatory elements that could be tailored to the needs of specific projects.

## E. Focus on Fragmentation: the Health System and Public Order and Safety

The FBiH is unusual in decentralising two large sets of services that are usually performed at a higher level of government or in far larger regions. Both health care and significant parts of public order and safety - including most of the police service - are executed at the cantonal level. Both sets of services can be quite specialised. In the terminology suggested in Box 2, they are single access services that would benefit from centralisation and a hierarchy of service levels. To overcome the unusual degree of fragmentation in the services, cantons should develop network plans in both areas that could be integrated into an overall joint network plan for the FBiH.

### Health Services

#### I. Description of the System

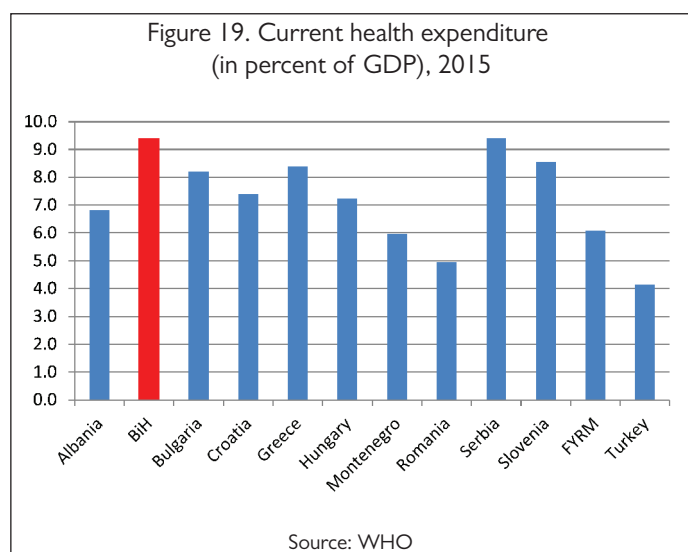
The health service is financed by 10 cantonal insurance funds (HIFs) and a Federation Solidarity Fund (in addition, of course, to funds in the RS and Brcko District). These fragmented systems are asked to service cantons that range in size from 23,500 to 443,000 people. Tertiary care is provided by clinical centres in four locations throughout the FBiH. The Solidarity Fund was established to serve as an equalization mechanism among cantons and current legislation would allow it to finance and ensure equitable access to basic health services and disease programs. Currently, all cantons contribute about 10 percent of their revenues to the Solidarity Fund but these are only used to purchase high-cost drugs for tertiary care and to provide for specialised care in foreign countries.

There are mechanisms for HIFs to reimburse one an-

other for services provided in another entity or canton but health insurance is not easily portable; apart from emergency and tertiary care (where individual cantonal HIFs have contractual agreements with one or more clinical centres). Primary health centres are founded, maintained and operated by boards appointed by municipalities but most of their expenses are met by the cantonal HIF. Municipalities may (co-) finance the maintenance of facilities and, sometimes, medical equipment. Hospitals are founded, maintained and operated by boards appointed by the cantons. This fragmentation has consequences for the quality and equity of health insurance coverage and also for labour mobility.

Health network optimization plans were developed for both the RS and FBiH a decade ago but were never implemented. Therefore, neither entity has an operational health network plan, which would help optimize the provision of both primary care as well as hospital services. This leads to both higher costs and lower service quality<sup>71</sup>. IT tools are not up-to-date and not compatible, within and among cantons. Moreover, access to secondary and tertiary health care is often difficult due to large distances, bad roads and political (entity) borders.

The World Bank finds that public spending on health is high relative to GDP and health outcomes (see Figure 19). “Despite reasonable life expectancy, many health outcomes are poor; particularly with regards to non-communicable diseases ... While progress was made in primary health care, hospital service provision remains inefficient. Health centres and



hospitals are accumulating debts and arrears which

<sup>71</sup> Ideally, the network plan for the RS should take into account services provided in Federation, and vice versa, particularly to avoid duplication of expensive tertiary services (such as cardiac surgery) or diagnostic equipment.

may be sizable, while costs of pharmaceuticals and medical devices remain high<sup>72</sup>.” Although the number of hospitals in the Federation of BiH is comparable to regional norms, hospital service provision is inefficient, with low bed occupancy rates (on average); relatively high average length of stay; unnecessary admissions of cases that could be treated at primary levels; and limited accountability or autonomy by hospital managers to improve efficiency or quality and to stay within budgets. Citizens report that the health sector is the most corrupt that they encounter<sup>73</sup>.

## 2. Findings of Consultations

HIF directors complain of: an overall ignorance of the health system and its needs by political authorities; a lack of results-oriented planning and management in the health sector; and overstaffing in hospitals while, at the same time, there is a lack of doctors. Moreover, there is a wide variety of health-delivery systems in place and this undermines attempts to introduce a networked plan. Herzegovina-Neretva Canton will introduce a (Diagnosis Related Group) DRG-based financing system that will pay for services when delivered instead of when budgeted. A first e-module covering diagnostics, prescriptions and bills will be available in 2018. This switch to performance related payments will serve as a model for the other cantons and, if universally implemented, could serve as the basis for improved portability in health insurance.

Changes in financing models and the introduction of e-modules (that have also been introduced elsewhere) will improve the optimisation of services; including the *more efficient use of primary health-care centres* (PHCs). Some HIFs expect that PHCs should take over 80 percent of service provision - including outpatient services - and thereby unburden hospitals. PHCs are less expensive to operate than hospitals and their services can be provided more cheaply than hospital care. There is a need for other measures to reward family doctors and to strengthen the family medicine system in PHCs. And the potential for community nursing needs to be better exploited (see [Box 18](#)).

But, as of now, hospitals are accumulating significant arrears and staff morale is extremely low (with frequent strikes). There is no realistic plan to settle debts (but the World Bank is trying to generate proper records). Instead, ad hoc measures are introduced to make savings - including freezing salaries - and this

leads to dissatisfaction among healthcare staff. It is not obvious that those measures really contribute to tackling urgent issues and experienced doctors and nurses are leaving the public health institutions.

Because more than 80 percent of HIF revenues are from wage-based social contributions, and because gross wages vary significantly across the FBiH, HIF revenues and per capita expenditure vary by a factor of 2 from the poorest to richest cantons. As a result, the health benefit package also varies significantly between cantons. In addition to the inequality in service that this implies, the differences in benefit packages undermine attempts to improve portability. Hospital beds are sometimes underutilised in some jurisdictions while patients have to wait for beds in others.

The purchasing and procurement of medicines is highly fragmented, resulting in higher costs and lower availability. There is no pooled purchasing of off-patent medicines among Cantons. The BiH Law on Medicines stipulates that the Council of Ministers should adopt an essential drugs list for all of BiH, which would be monitored by the National Medicines Agency. But this never happened. As a result, the RS, Brcko District, and the FBiH all have different essential drug lists - and the Cantons do not harmonize their drug lists within the FBiH<sup>74</sup>. This results in inequitable access to medicines, contributes to fragmentation in the medicines market and seriously undermines market power when buying drugs. The provision of drugs is uneven and is deficient in many places due to dispersed and politically influenced procurement (that favours local producers). And this also explains the fact that basic medicines often cost twice/three times as much (or even more) as in neighbouring countries.

An integrated health information system is also being developed in some cantons. Establishing national health information systems for monitoring of public health and cross-border communicable diseases is among the EU aquis related to the health sector. Establishing common information systems and data structures to facilitate compiling, sharing, and the analysis of health information would strengthen health system performance and accountability across entities and within the Federation. Some key elements of an integrated information system are already in place at primary care level, but networking and use of information for policy and management decision-making need to be strengthened.

<sup>74</sup> The RS centralized the purchasing and procurement of most medicines but there is no joint purchasing with the FBiH. Within the FBiH, only the purchasing of high-cost medicines is undertaken centrally (by the Solidarity Fund).

<sup>72</sup> The World Bank Group. 2015. Bosnia and Herzegovina - Country partnership framework for the period FY2016-20. p:22

<sup>73</sup> United Nations Office on Drugs and Crime. 2011. Corruption in Bosnia and Herzegovina. Bribery as Experienced by the Population.

### Box 18: Reforming the Health System - Strengthening Nursing in Bosnia and Herzegovina

Globally, nurses are seen as critical to the delivery of cost-effective health services and to strengthening the health system. A Swiss-funded project implemented by the Foundation fami and the Geneva University Hospital (in cooperation with the Ministry of Civil Affairs of BiH, ministries of health and education of both entities and HIFs) is focused on improving the regulation and education of the nursing profession and the introduction of community nursing services. The project has contributed to the standardisation of nursing services and consequently to better quality and patient-safety of nursing care in 23% of primary healthcare centres (covering some 1.3 million people). Over 45,000 of the most vulnerable and previously underserved persons have benefited from the services provided by community nurses in ten municipalities and four out of eight public nursing faculties have adopted a new competence-based curriculum in line with EU standards.

However, nursing potential is still underutilized and further improvement in working conditions for nurses in BiH is of utmost importance for the performance of the system. Enabling nurses to competently provide health promotion and disease prevention services will greatly benefit patients—in particular, socially excluded and underserved groups with limited access to healthcare. Currently, the project is focused on:

- Developing a licencing system for nurses and a nurses' registry
- Introducing standards of nursing care at all healthcare levels
- Developing a nomenclature of nursing services that reflects the actual contribution of nurses
- Enhancing Nurses Associations' capacity to respond to the needs of their members
- Introducing Community Nursing models in an additional 12 municipalities
- Initiating the reform of secondary nurse education
- Supporting access to higher education (Master and PhD levels) in nursing for BiH students

See [http://www.fondacijafami.org/ProSes\\_english\\_.html](http://www.fondacijafami.org/ProSes_english_.html).

### 3. Recommendations

There is a need for significant reforms to the management, organization, and financing of hospitals and the World Bank is already preparing a reform programme that could be adopted. A new funding system for the health sector is needed and better treasury systems are required to ensure improved financial discipline. There needs to be a better flow of information within health systems to facilitate policy reforms and promote innovation and quality assurance. The challenge of managing the high public costs of healthcare should also be addressed, including measures to make pharmaceutical procurement more efficient. The following specific recommendations are also proposed by the World Bank:

- Each entity needs to update its *health network plan* and implement it; preferably linked to the process of resolving the problem of health sector arrears. The plans should be developed in consultation between the two entities and Brcko District, in particular to ensure adequate access of BiH citizens to essential services and to avoid costly duplication of tertiary services.
- Within existing legislation, the role of Federation Solidarity Fund could be expanded to allow it to play an *equalization* role in financing and services among cantons. Savings through reforms to reduce costs and better prioritize high-cost medicines could free up funds to ensure better access to basic medicine. It will be important to ensure that financing is adequate for this expanded role.
- A more fundamental reform for the FBiH would amend the law on health insurance and related laws to allow full *portability* of health insurance and ensure a basic benefit package in all Cantons. This could be done in parallel with a rebalancing of health sector revenues, bringing in more financing from excise taxes and general revenues (particularly to cover the unemployed and/or the informal sector) while reducing the current heavy reliance on payroll taxes. It could be possible to develop and strengthen protocols to allow some portability of coverage between entities and Brcko District.



- The FBiH should seek to *harmonize essential drugs lists* among cantons. It might also be possible to initiate a process to define and adopt an essential drugs list at a country-wide level in order to maximise purchasing power. Within the FBiH, the Solidarity Fund could take on an expanded role for the central procurement of a wider range of hospital medicines on behalf of cantons, using framework contracts (which provide the benefits of increased pooling and competition, even if payment responsibility would still rest with cantons or facilities).
- For high-cost and patented drugs, the RS and FBiH could strengthen collaboration to: (i) strengthen Health Technology Assessment, to make better informed decisions about what expensive drugs to include on HIF reimbursement lists and for what indications; (ii) explore undertaking joint negotiations with manufacturers of patented medicines using innovative purchasing arrangements, which could be expanded to include other countries in the region. But the FBiH needs to improve internal collaboration before this can happen.

**Public Order and Safety**

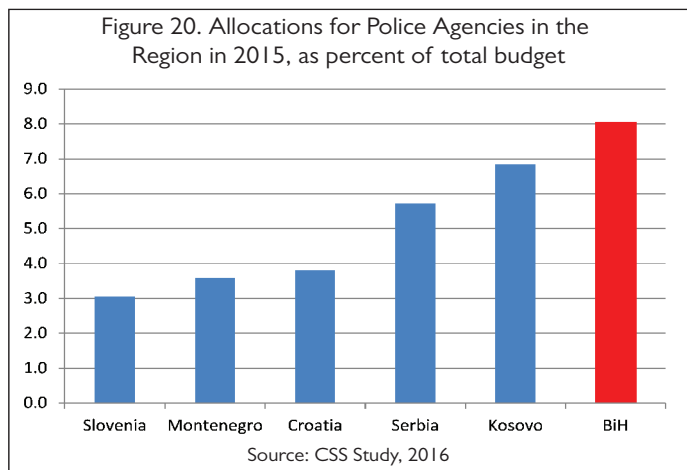
**I. Description of the System**

The constitution of BiH largely vests judicial and law-enforcement competences with the Entities as part of their general powers<sup>75</sup>. In the FBiH, the system is further fragmented and there are 11 different law-enforcement agencies and 11 ministries of interior. These are intended to service cantons that vary in size from 23,500 to 443,000 people. As a consequence of this complex political and constitutional context, the relationship between the many police systems is not very clearly defined and, in the absence of a clear hierarchy, there can be different interpretations of laws. This, in turn, can lead to ongoing disputes in the judiciary and in the police. Mobility is limited by differences in qualifications and requirements. To date, reform ambitions (both local and international) have been retarded by a failure to address common problems from a common perspective and by a similar failure to try to collaborate in the provision of some expensive and specialised services.

<sup>75</sup> As interpreted by the Constitutional Court of BiH, the State may, however, have limited powers to regulate the judiciary and law enforcement; mainly related to war-crimes and international or inter-entity organised crime and corruption. The country has therefore four separate judicial systems (the state, two entities and Brcko District) with different internal structures.

**2. Findings of Consultations**

The large number of police services has meant that policing is very expensive in BiH compared to other countries in the region. A recent study shows that Ministries of Interior account for 8 percent of budgetary resources in BiH compared to 5.7 percent in Serbia and 3.8 percent in Croatia (see Figure 20)<sup>76</sup>. These expensive services crowd out resources for other needs. Sixteen police services are financed independently with virtually no cross planning concerning the use of resources or inter service cooperation. This leads to the duplication of some services and extensive cost inefficiencies. Moreover, there is no hierarchical control system in place for policing services. This leads to fragmented and politically distorted cooperation at all levels. This competence was entrusted in 2008 to the Directorate for Police Cooperation but it has never been allowed to function effectively as a coordination body.



As regards emergency response services for disaster management (floods, forest fires, etc.) there is evidence of very poor cooperation between services from municipalities and cantons (and entity authorities). There is widespread agreement from the Survey that recent floods and fires demonstrated an urgent need for improved cooperation between different municipalities and cities. This percentage is even higher (95 percent) when it comes to the need to cooperate with the cantons to enhance civil protection. Many municipal and cantonal authorities said that the procedures for declaring an emergency are too rigid and cumbersome and often delay much-needed responses.

**3. Recommendations**

As long as a consensus for more radical and structural reforms does not exist, the only avenue open is to ex-

<sup>76</sup> Hadžović Denis and Plevljak Benjamin. 2016. How Much Does Public Safety Cost Us? An analysis of budget items of police services in Bosnia and Herzegovina.



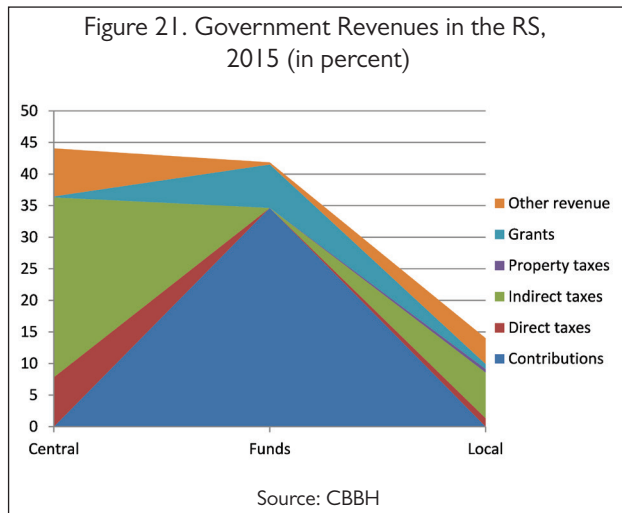
plore areas where fragmentation could be addressed on a more pragmatic basis. In other words, where attempts to combine the BiH-authorities have failed, the only alternatives are to promote cooperation and establish uniform standards and practices to the extent possible. It could even be possible, on an operational level, to share certain institutions to make them more efficient and cost effective (e.g. forensic labs). These proposals would need to begin at the cantonal level where cooperation would be facilitated by the development and harmonisation of network plans by cantons.

The following specific recommendations are offered (with input from the Rule of Law Section of the EUSR and the Centre for Security Studies):

- **Police Oversight:** There are 14 Independent Boards and Public Complaint Boards within BiH, which select, oversee and receive complaints. The Boards are small units working independently from each other and are open to constant political pressure. A coordinated system with greater communication between boards could assist in reducing political interference and strengthening integrity.
- **Police Recruitment, Retention, Appraisal and Review:** Sixteen police agencies all have different personnel policies and practices. These could be harmonised to promote professionalism.
- **Police Purchasing:** There is a State level Police Support Agency whose terms of reference are to coordinate the purchasing for all police bodies. This should include items like vehicles, IT equipment, uniforms, etc. The Agency is barely used at the State level and could be further empowered as a cost-saving bulk-purchase mechanism.
- No consideration has been given to joint purchasing in Cantons and the Federation but there could be large savings achieved. Conducting joint public procurement for material and technical equipment of police institutions, where it is possible, would generate financial advantages while contracting larger amounts of goods, resources or services
- **Forensic Services and Scene of Crime Investigation:** The State and entities independently develop their own capacities with no coordination and cooperation in service provision. This leads to duplication in overall services and an inability to develop specialised teams and expertise that could be shared.
- There is a need to conduct qualitative analysis of existing systematizations of work positions in all police institutions and consider the possibility of outsourcing for specific activities—for example cleaning of workplaces, maintaining vehicles, forensic examinations;
- Develop adequate strategies and specialized organizational units for human resource management and education in order to employ, assign, and use human potential depending on the basis of needs, trends in criminal activity, etc.
- Examine possibilities for using new information and communication technologies, in order to advance, modernize and reduce costs in the field of human and material resources of all police structures in their jobs and tasks.
- **Special Police for Public Order:** Fourteen different units throughout BiH are on standby 24/7 waiting for public disorder. These units are not employed effectively and a review of their use could lead to more police being available for other tasks.
- Review procedures for the declaration of emergencies and the coordination of civil defence units to maximise the ability to respond to emergencies. The FAMC proposes the adoption of a new Law on Protection and Rescue.

# Chapter 3: Local Government in the RS

## A. Main Features of the System of Local Government



The system of government in the RS is based on a relatively large central government (with about 44 percent of **revenues**), 7 cities and 57 municipalities (that share some 14 percent of revenues). A set of large social funds secure the other 42 percent of revenues and are dominated by pensions, disabilities, health, road and employment funds. As is clear from Figure 21, the central government and funds rely on a limited number of taxes and contributions while the cities and municipalities have a wide array of smaller revenue sources (including self-generated)<sup>77</sup>.

## B. Main Findings and General Recommendations

Consultations with local governments in the RS confirmed that there are significant challenges in the operation of the system but 57 percent of Survey respondents said that the state of their local governments is satisfactory (while 26 percent said that it is bad). Insufficient financing for legally assigned duties was identified as the biggest issue by 70 percent of respondents. And local governments are more concerned by the vertical allocation of revenues than the horizontal allocation - only a quarter of Survey respondents in the RS agree that the ver-

tical allocation is fair whereas half of respondents agree that the system of horizontal allocation is fair. Political differences are seen as the main obstacle to greater cooperation between local governments.

The RS National Assembly adopted a Local Self-Government Development Strategy for 2017-21 (the RS Strategy) in July of 2017. Its aim was to:

- carry out a comprehensive analysis and overview of the competences and tasks of local governments;
- analyse the possibility of introducing new revenues for local governments through joint projects and donor funds;
- analyse the scope to transfer public services to the private sector (and identify relevant areas);
- establish an effective and efficient control system for public service provision; and
- analyse the level of cooperation between local governments and, based on those findings, redefine the regional framework for cooperation.

The approach adopted in the RS Strategy matches very closely with the areas of concern identified in consultations with local governments and set out in the remainder of this chapter. Moreover, the general recommendations in this chapter align closely with the six goals outlined by the RS Strategy for the development of local government over the next five years (see [Box 19](#)). These issues are discussed in the remainder of the chapter and include: recognising the need for multi-level municipalities that provide different levels of services; providing greater autonomy in local government funding (including devolving the administration of the property tax); improving the efficiency of local government through the reform of public administration; and putting a greater focus on municipal integration and cooperation (including, across entity lines). These proposals are also consistent with taking a wider/regional approach to economic development and the provision of services and with putting a greater stress on development needs, including sharing resources with underdeveloped municipalities.

<sup>77</sup> The social funds appear to be far smaller in the RS than in the FBiH and the central government appears to be larger. But this is because the pension fund, in particular, is included with the central budget in the RS (but is separate in FBiH).

**Box 19: RS Strategy Implementation and Goals****1. Ensure the effective exercise of competences of local government units**

- 1.1. Establish the concept of multi-type local government
- 1.2. Improve the territorial organisation of the Republika Srpska
- 1.3. Determine the concept of functional decentralization and redefine the competences of local government units
- 1.4. Improve the forms and areas of mutual cooperation of local government units
- 1.5. Strengthen the capacities of local government units

**2. Achieve stability in financing of local government units**

- 2.1. Improve fiscal responsibility and the long-term fiscal stability of local government units
- 2.2. Increase the efficiency of local government units in collecting own revenues
- 2.3. Improve the system of support for underdeveloped and extremely underdeveloped local government units
- 2.4. Improve the provision of public services through public-private partnership model

**3. Ensure availability and quality of public services to all citizens**

- 3.1. Transfer a part of public services to the private sector and specialised organizations
- 3.2. Improve the public service control system
- 3.3. Improve the development of e-Government and management of the quality system in the provision of public services
- 3.4. Develop mechanisms for the regular examination of citizens' satisfaction with the quality of public services
- 3.5. Improve the provision of public services through the public-private partnership model

**4. Ensure efficiency and accountability of local government units in managing local development**

- 4.1. Improve mechanisms for creating a favourable business environment, the development of small and medium enterprises and entrepreneurship, and strengthening cooperation with the business community
- 4.2. Strengthen the identification and promotion of the potential of local government units
- 4.3. Improve the system of planning and implementation of development documents based on development priorities
- 4.4. Harmonise and update spatial plans of local government units with the Spatial Plan of RS
- 4.5. Introduce quality management standards in local government units
- 4.6. Strengthen cooperation with the diaspora

**5. Improve incentive measures for demographic policy**

- 5.1. Provide additional funding to support birth rate increase
- 5.2. Provide additional family support programmes
- 5.3. Ensure additional support programmes for employment and self-employment
- 5.4. Strengthen cooperation with the diaspora

**6. Strengthen civic participation and influence in decision-making at the local level**

- 6.1. Encourage direct participation of citizens in the decision-making process
- 6.2. Strengthening the role and position of local communities (MZs)
- 6.3. Improve publicity of the work of the city or municipal administration
- 6.4. Improve platforms for e-participation of citizens

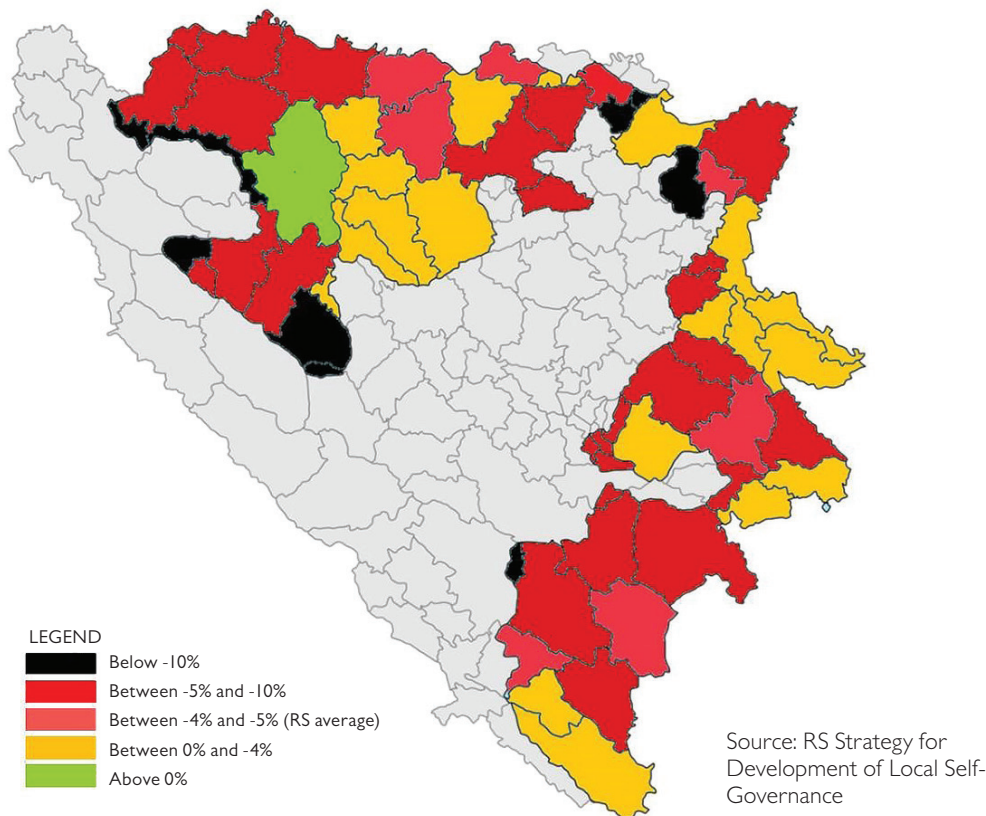
The main findings of the consultations (and of the RS Strategy) are discussed under four headings:

### I. The Implications of Demographic Changes

The RS Strategy directly addresses the reality of demographic change and its consequences. Figure 22 (which is taken from the RS Strategy) demonstrates that the vast majority of - especially smaller - municipalities are experiencing a significant decline in population and that only larger municipalities (in

particular, Banja Luka) have any chance of growing. The problem is partially mitigated in larger municipalities and cities through the movement of people from surrounding small municipalities, but the general trend is of significant concern. The most-isolated municipalities have experienced a devastating decline in population which impairs their economic development and their efforts to secure sufficient funds for their administration and the full discharge their responsibilities. There is a need for further development assistance in many cases.

**Figure 22. Population Change by Municipality in the RS**



But the Strategy also recognizes that there is an obvious difference when it comes to the provision of public services across municipalities - in terms of their availability, content and quality - where peripheral and rural areas are significantly lagging behind the central and urban areas. More generally, the RS Strategy is based on the principle of financial sustainability and aims to limit the share of administrative expenditures while increasing the share of expenditure on development. Ultimately, the RS Strategy aims to move away from the current “monotype concept” of local government - where all municipalities have the same competences regardless of their capacities or size - and toward a “multi-type concept” of local government - where different municipalities would have different competences that are based on their real capacities and needs. Smaller rural municipalities would be better integrated

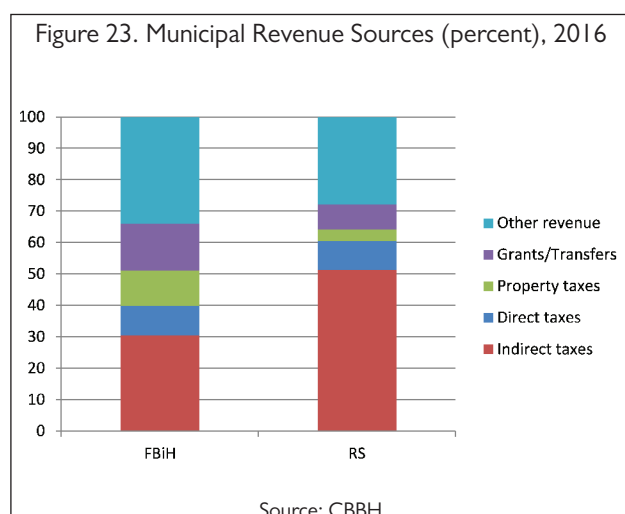
with their larger local counterparts - in a hub-and-spoke system.

These changes might require significant legislative adjustments and a territorial reorganization of the RS that are beyond the scope of this Report to consider. But the RS Strategy sets the scene for a productive conversation and adopts a pragmatic approach that will guide the consultation that needs to take place. The Strategy recognises that it will not be possible to reverse recent demographic trends and that the only viable approach is to adapt the system to the realities of the modern world. Moreover, it establishes proper guidelines for a consultation with local governments - including on the topics of: financial sustainability; the general availability of services to citizens; greater accountability in local government; and greater civic participation in decision making.

The Survey found that there is significant support for many elements of the RS Strategy, including the proposal of a “multi-type concept” of competences. Almost 90 percent of respondents agree (either strongly or partially) that the current “monotype” concept where all local government have the same competences regardless of their capacities should be abandoned in favour of the “multi-type” concept where local governments have difference competences based on their real capacities and needs. And 85 percent of local governments agree on the need for a regional approach (involving five to ten municipalities and cities per region) that would necessitate agreeing regional plans for economic development and the provision of some social services.

## 2. Financing Local Government

Indirect taxes account for about half of total revenues of municipalities in the RS compared to 30 percent in the FBiH (see Figure 23). Direct taxes provide about 9 percent of revenues (on average) in both jurisdictions. CIT revenue is not shared with municipalities in the RS and the municipal share of PIT varies with development needs - a measure intended to make the horizontal allocation of revenues more equitable. Municipalities in the RS derive a far lower share of revenues from property taxes (4 percent) than in the FBiH (over 11 percent), even though there are property taxes on primary residences in the RS. This is because property transfer taxes in the FBiH are far higher. Finally, municipalities in the RS get fewer grants and transfers (on average) than their counterparts in the FBiH and rely less on other/individual sources of income.



Municipalities in the RS are tasked with the provision of a similar set of services as in the FBiH but their responsibilities—especially, their financial responsibilities—for these services go further than in the FBiH. This applies, in particular, in the fields of education,

social assistance, communal police, and local roads. In the FBiH, cantons bear some of the financial burden for these services. As a result, the average level of municipal current expenditure per capita in the RS was almost exactly KM400 in 2016 while expenses in the FBiH were only KM300 per person. (The levels of capital expenditure per capita were, respectively, KM63 and KM47)<sup>78</sup>.

### i. The Vertical Allocation of Resources: VAT and Debt

Partly because there are only two layers of territorial government in the RS (and expenditure per capita is higher), local governments receive a higher share of ITA allocations than in the FBiH - 24 per cent compared to 8.4 percent (see Table 1). However, municipal governments have a similar objection as their counterparts in the FBiH to the fact that external debt service is deducted from ITA revenues (by the RS Ministry of Finance) before the shares are allocated. They object that they are “forced to pay for debts that they did not contract” and that they are “at the end of the line” when it comes to the allocation of resources. Because of this factor, the effective municipal share of ITA revenues in 2016 was actually 19.3 percent (as opposed to 24 percent) and municipalities were “deprived” of potential revenues amounting to about 12.5 percent of their budgets.

But, as discussed with reference to the FBiH (see Chapter 2, section B.2), this issue is not as simple as it first seems. First of all, the shares were initially determined based on the understanding that debt service would be deducted before those shares were allocated. If this had not been the case, the entity would have been allocated a larger share in the first place - to allow it to service external debt - and the municipalities would have had a smaller share. The real issue has to do with how external debt service has increased over time and the fact that volatile levels of debt service add volatility to municipal revenues.

And it is true that the share of external debt service from ITA revenues increased significantly in recent years - debt repayment (not including interest payments) doubled in the RS between 2012 and 2014 (from 8 to 16 percent) and was still at a high level (17 percent) in 2017 - and this did significantly reduce the municipal share of revenues<sup>79</sup>.

<sup>78</sup> Source: CBBH. It is difficult to make further comparisons between municipal expenditures across entities because expenses are classified differently. Also, in the RS, a far larger proportion of expenses are recorded on the municipal budgets (and are not recorded as transfers to other institutions—such as social centres—as they are in the FBiH).

<sup>79</sup> See tables 5d and 5e in IMF Country Report No. 16/291, p:27 and 28.



### **Box 20: The RS Grant System to Undeveloped and Extremely Undeveloped Municipalities**

According to Article 76 of the RS Law on Local Self-Government, the distribution of revenues to local self-government units is based on their level of development. The development level, in turn, is determined by the RS Government, based on the criteria defined by the RS National Assembly every three years.

In 2016, the RS National Assembly adopted a Decision on the Criteria for Assessment of the Development Level of Local Self-Government, according to which cities and municipalities are classified as developed, medium-developed, undeveloped and extremely undeveloped. The criteria taken into account are:

- Total per capita revenues of registered companies in the previous year at the level of the local self-government unit;
- Total budget revenues in the previous year at the level of the local self-government unit;
- The unemployment rate - the percentage of unemployed in the total workforce at the level of the local self-government unit;
- The density of population;
- Total number of registered vehicles at the level of the local self-government unit in relation to the total number of registered vehicles in the RS;
- The number of pupils attending primary school in relation to the population at the level of the local self-government unit;
- The rate of natural growth at the level of the local self-government unit;
- The number of business entities at the level of the local self-government unit in relation to the total number of business entities in the RS;
- The value of completed works by type of construction objects and housing construction at the level of the local self-government unit in relation to total value in the RS.

Once local self-government units are classified into the four groups, the RS Government provides special grants to those that are undeveloped and extremely undeveloped, which in 2018 amount to BAM 2.3 million. The criteria for the allocation of these grants are defined by the 2015 Rulebook on Criteria and Procedure for Granting Funds to Undeveloped and Extremely Undeveloped Local Self-Government Units and are as follows:

- 35% of total funds based on total per capita revenues of registered companies in the previous year at the level of the local self-government unit;
- 25% of total funds based on total budget revenues in the previous year at the level of the local self-government unit;
- 20% of total funds based on the density of population;
- 20% of total funds based on the unemployment rate - the percentage of unemployed in the total workforce at the level of the local self-government unit.

Many other grants are provided in the following areas: production, export, founding and development of SMEs; agricultural production and rural development; environmental protection; construction, reconstruction and maintenance of utility infrastructure, health, social and youth protection; education and sports; culture; civil protection and tourism.

But, as pointed out in Chapter I (section B), debt service is projected to decline over the next ten years. And, of course, the Entity Government will have to rely on the same tax base as the municipalities. Therefore, while it may make sense to deduct debt service from the entity share (especially to reduce the volatility of ITA revenues for municipalities, as suggested for the FBiH in Chapter 2, section B.2), the negotiation of this change in the arrangement

between the entity and municipalities would require the allocation of a larger share to the entity.

The RS Strategy recognizes that the budgets of local governments have a relatively high share of costs for administration, infrastructure maintenance and social benefits. This leaves only a limited amount dedicated to development. Moreover, the RS Strategy (as one of its goals) aims to ensure “the availability and quality of public services to all citizens.” The Strategy intends

to explore a number of options to achieve this goal, including the adoption of a multi-type model of municipalities (as discussed above) and the involvement of the private sector in providing services. And the Strategy puts a strong emphasis on cutting costs, improving accountability and ensuring the financial sustainability of municipalities. Ultimately, this approach amounts to a recognition that the issue of the vertical allocation of resources in the RS needs to be examined again and that the solution - and the allocation of resources - will not be the same for all cities and municipalities. This will be a very welcome consultation and exercise.

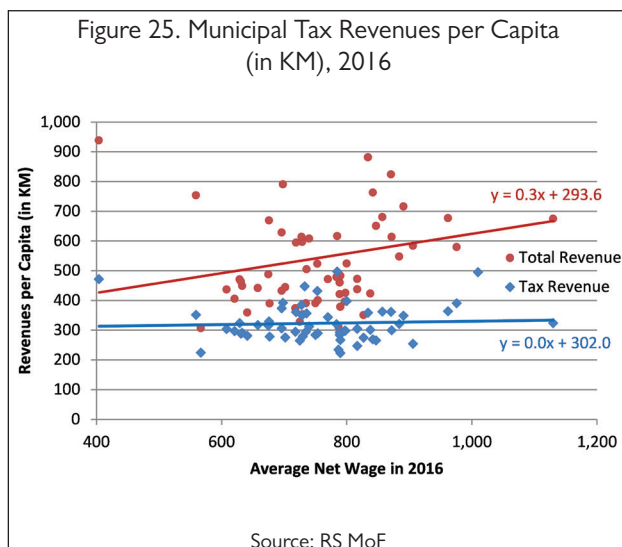
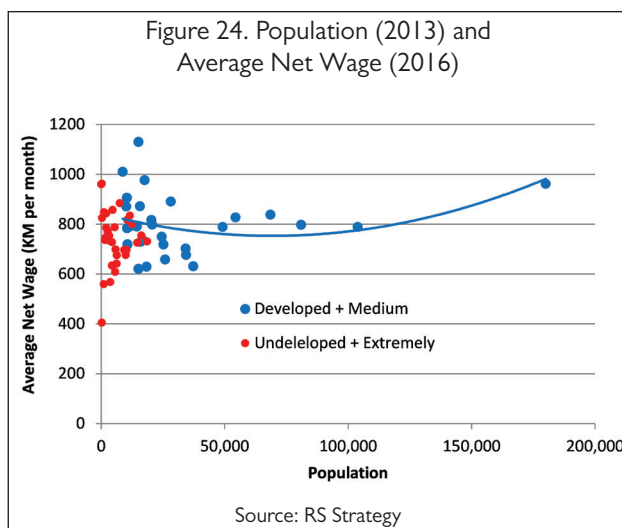
**ii. PIT and CIT**

As proposed for the FBiH (Chapter 2, section B), both the personal and the corporate income taxes present further room for rebalancing the assignment of revenue between the upper (entity) and the lower (cities and municipalities) level of government. A surcharge on PIT would increase accountability and compensate for the revenue loss arising (for example) from the abolition of parafiscal charges and fees. Also the Government of the RS could provide room for the surcharge and mitigate the increase of the burden on taxpayers by making the surcharge paid to municipalities deductible from the PIT paid to the Entity. Various alternatives are presented above in Chapter 2, section B2 (iii) and in Annex C.

Similar potential for rebalancing would be provided by the allocation, on a derivation basis, to municipalities of a share of CIT revenue. This would compensate municipalities where plants and offices of companies are located for the costs incurred by the location of economic activities. The sharing of CIT revenues would also provide incentives to foster local development. Various alternatives are presented above in Chapter 2, section B3 (iii).

**iii. The Horizontal Allocation of Resources: The Principle of Equal Development**

The RS Strategy aims to “ensure the availability and quality of public services to all citizens” and to help “local government units in managing local development.” But the fiscal capacity of municipalities varies very significantly (see Figure 24). The distribution of net wages per month ranges through a factor of three - from KM 400 to KM 1,130 - and there is no simple indicator of fiscal capacity available. Most municipalities that are classified as undeveloped are small but, at the same time, there is a large variation in the fiscal capacity of smaller units. Currently, the system of financing in the RS aims to partially correct for this imbalance in fiscal capacity by giving greater assistance



to undeveloped and extremely undeveloped municipalities. Three financing mechanisms are employed: (i) poor municipalities (situated in areas of special concern) are entitled to a share of 50 percent of local PIT revenues while the standard share is 25 percent; (ii) poor and smaller municipalities, in areas of special concern, benefit from special grants from the Solidarity Fund; and (iii) poor and mountainous municipalities benefit from higher shares of fees from the use of natural resources.

Figure 25 charts total revenues and tax revenues per capita across municipalities according to their average net wage<sup>80</sup>. It is clear that the allocation of tax revenues does not depend on fiscal capacity and is almost fully equalised. The difference between total revenues and tax revenues is mostly due to non-tax revenues which do increase with fiscal capacity. Special grants to underdeveloped municipalities are also welcome but the system of allocation is probably too complicated (see [Box 20](#)). It is not clear, for exam-

<sup>80</sup> A few smaller municipalities were excluded to make the graph clearer but this does affect the overall picture.

ple, why grants are not allocated directly on the basis of an index of development (instead of using an additional four criteria related to expenditure need). And there is also a very complicated system for allocating sector-specific grants (for production, export, the founding and development of SMEs, agricultural production and rural development, etc.). It would be far simpler and more transparent to allocate a single block grant to underdeveloped areas.

The allocation of fees from the use of natural resources (including forests and mines) is also influenced by concerns over equalization and poor/mountainous municipalities benefit from higher shares (while water fees are shared with no special provisions for underdeveloped municipalities). Fees from natural resources are an important (but not predominant) source of revenue for small and poor municipalities but their effective contribution to funding expenditure is reduced by the constraints applied to their use. In particular, all of the resources from these fees must be used to fund development projects (see section iv below).

There could be an argument for introducing a more-elaborate equalization system in the RS. For example, as proposed for a second pillar in the FBiH (Chapter 2, section B3 (ii)), to allocate indirect tax revenues with the aim of reducing the fiscal gap between expenditure needs and revenue capacity. Currently, in the RS, the horizontal allocation of indirect tax revenue to municipalities is undertaken only according to expenditure-needs criteria—with weights given to population (75 percent), area (15 percent) and the number of pupils in secondary schools (10 percent). Of course, municipalities complain that their revenues are not adequate to cover their expenditure needs, and a new system would go some way to addressing these concerns. But it is also clear from consultations in the RS that the current equalisation system - largely based on development needs - is generally accepted. In the Survey, 85 percent of local governments in the RS agreed that undeveloped local governments should receive a greater amount of tax revenues (even though only half of the municipalities are currently classified as undeveloped or extremely undeveloped). This is a strong consensus for the existing system of equalisation.

#### **iv. Constraints on the Use of Revenues from Natural Resources**

While there is some economic and environmental rationale to having constraints of the use of fees from natural resources by municipalities, the current full earmarking of the use of these fees for investment purposes imposes an excessive burden. This is particularly true for the small and underdeveloped

municipalities where revenue from fees is a major (if not the main) source of revenue. Often, the absence of sufficient projects means that the revenues are not secured at all. So, at least half of this fee revenue should be spent with no constraints (and used, for example, for social expenditures) while upper-level government could foster more environmental projects to be implemented by municipalities with the provision of co-financing for projects of high priority and with co-financing shares scaled up according to the level of underdevelopment of municipalities.

#### **v. Property Taxes**

Property taxation, both on transfers and on the ownership of real assets, represents an important - though largely unexploited - source of own revenue. In 2016, property taxation contributed just 4 percent of total municipal revenue in the RS, indicating the existence of a largely-untapped potential source of revenue. This will become particularly important after January 2019 when the determination of tax rates, the tax base and (even more importantly) tax administration and collection will begin to be devolved to municipalities.

A fully-fledged property tax system can lay the basis for a more effective provision of local public services and for sustainable access to credit for public investment. It can also be used to signal occupancy rights for specified periods of time, which is critical for household access to credit and the upgrading of living conditions. Based on international experience, a conservative potential yield from property tax should be at least 1 percent of GDP. Much of the potential lies in urban areas—particularly in the large cities—and is critical for local services and investment.

Municipalities will find it difficult to implement this reform and political officials are concerned about taxpayer opposition. However, devolution represents not only a huge challenge, but also an opportunity. It will increase the political accountability of local government. One has to consider in this respect that all activities undertaken by local government are capitalized in property values. For example, the values of residential property are consistently higher in neighbourhoods with easy access to good quality services.

Presently, the administration of the property tax in the RS is rather poor, with a large proportion of properties reportedly still excluded from the tax net and with valuations of properties for tax purposes that are far from realistic. The RS is using the traditional ownership-valuation model but cadastres are often out of date or incomplete and their use is often complicat-

ed by uncertainty regarding ownership. Municipalities should consider the adoption of simpler methods for the determination of values and employ modern digital technologies for managing registers of properties. A viable alternative to the present valuation system would be a flat tax based on the key parameters of properties. With a flat tax, the tax liability is determined through the application of a unit tariff (for example a number of KM) to indicators or parameters of property size, location and use value. This is a common practice across the world.

The self-declaration of such parameters (but not of the value of properties) by taxpayers - as largely applied around the world - circumvents problems related to a lack of information and administrative capacity. The accuracy of the declaration can be easily checked with the use of digital technology for building and managing registers. (See Annex D). Also, the use of satellite digital technology would help greatly. Most innovative options will be made more practicable, particularly for small municipalities, by concerted action in a framework of inter municipal cooperation.

It is encouraging that most local governments feel ready to assume the administration of the property tax and believe that it would lead to an increase in tax revenues. According to the Survey, some 70 percent of local governments agree (either strongly or partially) that they are ready to assume the administration of the property tax. Moreover, 43 percent believe that this could lead to a 20 percent increase in revenues.

### 3. Public Administration Reform

The RS Strategy includes the strategic goals to “ensure the effective exercise of competences of local government units” and to “ensure the efficiency and accountability of local government units in managing local development.” Moreover, it recognizes that certain competences are not clearly delineated between the local and central level, that they are treated differently in some sectoral strategies, and that local governments sometimes do not have sufficient freedom to implement certain activities within their own jurisdiction. There is an overall objective to resolve these difficulties and to improve efficiency with a view to dedicating more resources to investment. Moreover, local governments themselves feel strongly that their budgets are not sufficiently development oriented. In the Survey, almost 75 percent of respondents agreed (either strongly or partially) that the budgets of local governments are mainly directed towards current expenditures—with a relatively high share of costs for administration—leaving only a limited amount dedicated to development.

Entity control over the finances of local government will be enhanced by the incorporation of municipal budgets into the entity Treasury System over the next few years. This should institute better spending and borrowing practices and reduce the problem of accumulating arrears. Moreover, it will improve the financial coordination between the entity government and municipalities. The RS Government is in the process of preparing a new Public Financial Management (PFM) Reform Strategy.

There is a strong focus in the RS Strategy on the importance of having professional staff and efficient management at the municipal level. But most municipalities are overstaffed and do not necessarily have the qualified and competent staff they need. The 2016 Law on Local Self-Government established the appropriate staffing level as having 3 civil servants per 1,000 inhabitants but some municipalities have up to 3 or 4 times this number. According to the SWOT analysis in the RS Strategy, there is an opportunity to “bring in line the number of employees with the criteria defined in the law” and the adjustment of staff numbers has to be completed by June 2019.

Municipalities are aware of the new law and the adjustment process has started. The first options are early retirements and, if possible, reassigning staff to other jobs (in agencies, etc.). But funding for absorbing the effects of permanent layoffs is lacking and most mayors are not sure how to tackle the issue. There is a feeling that some solution may emerge and the Association of Municipalities and Cities (AMC) is negotiating for a longer delay. The Law already provides for higher staffing levels (above the 3/1,000 threshold) for smaller municipalities (that need to have a minimum number of qualified staff to operate) but some mayors think these should be revised. Most mayors agreed that this will be a difficult and most painful process for them.

Municipalities have to reorganize their staffs and layoffs are unavoidable. But the sharing of staff between municipalities or the outsourcing of certain functions doesn't seem to be receiving much consideration. Moreover, the law calls for the hiring of professional staff and for managerial efficiency, but it doesn't foresee mechanisms or criteria to achieve this. It has been left up to the municipalities/mayors to develop the appropriate criteria (including performance assessment, etc.).

Just as in the FBiH, mayors and municipal officials in the RS expressed a general level of frustration with the Public Procurement Law. Public procurement procedures are regarded as cumbersome and not suited to the realities of local government. In effect, they clash with some other guidelines for government and are very difficult to implement. And, because of these dif-



facilities, purchasing decisions can often be haphazard and inefficient.

#### 4. Municipal Cooperation

The RS Strategy concludes that, although there is a good basis in current law for cooperation between municipalities and cities (including regional and cross-border cooperation), the biggest constraint is a lack of incentives and funds, as well as a lack of financial instruments dedicated to joint projects. On the other hand, RS Law on Local Self-Government (2016) includes a special chapter dedicated to the cooperation of local self-government units—not only in the RS, but also entity and international boundaries. It includes clear provisions with regard to establishing such cooperation, its possible forms, as well as possible financing mechanisms and supervision.

A proposal to establish cooperation may be filed by the mayor or by one-third of representatives in the assembly, as well as by citizens and associations of citizens through civil initiatives or public or private companies. In general, such cooperation agreements should specify: the rights, obligations and responsibilities of all parties to the agreement; the necessary financial resources; and the establishment of a coordinating body and supervision. The draft cooperation agreement is submitted to the competent sector ministry in order to give its opinion.

Cooperation can be achieved by: establishing a joint working group; founding a joint public company; es-

tablishing a joint public institution; public-private partnership; pooling financial, material and other resources; through joint projects; and by performing certain duties of a local self-government unit for another (or multiple) local self-government unit(s). For instance, two or more local self-government units could establish working groups to consider issues of common interest falling within their bodies' competences.

With regards to the cooperation of local self-government units with the FBiH and Brcko District, the Law envisages: establishing joint working groups; pooling financial, material and other resources in order to realise joint projects; the collaboration of associations of local authorities; and joint activities directed to the protection and rescuing of humans and goods as well as elimination of consequences caused by natural disasters and other accidents. In addition, local self-government units may establish cross-border and international cooperation by joining international associations of local authorities, directly or through in-country associations of local authorities, and by establishing cooperation with local self-government units of other countries, in order to exchange good experience and practices. In the case of international cooperation, a positive opinion of the RS Ministry of Economic Relations and Regional Cooperation is required.

There are already important examples of municipal cooperation in the RS, including across entity boundaries (see [Box 21](#)).

#### Box 21: Development of Regional Waste Management Systems

Solving the situation in the field of waste management is one of the most important tasks in the environmental sector in Bosnia and Herzegovina. A few years ago, in the northern part of Bosnia and Herzegovina, the capacity of the landfills, which did not comply with legislative standards, were about to be exhausted. In addition, there was an uncontrolled proliferation of illegal dumps or landfills and a poor waste management system that negatively affected the environment and harmed human health.

As a result, numerous municipalities from both entities decided to cooperate in the establishment of regional landfills. At the end of 2016, the regional landfill 'Crni vrh' Zvornik began operations with the support of a \$5 million World Bank loan started. The founders of the regional landfill are seven local governments from the RS (City of Zvornik, Bratunac, Srebrenica, Milići, Vlasenica, Osmaci i Šekovići) and two from the FBiH (Kalesija and Sapna). A joint company was formed and is responsible for the repayment of the loan, which is guaranteed by all municipalities and cities involved. All nine local governments have one vote in the Supervisory Board, while their respective shares in the Governing Board are based on relative populations. This share is also used in the allocation of the company's profits. According to the Director of the company, all decisions so far have been taken unanimously.

In general, and over the last ten years, the World Bank helped sustain and expand the concept of regional landfill development in the waste management sector. It invested around \$33 million in seven regional landfills throughout the country and this led to the closure of 145 wild dumps (12% of the estimated total). Before the project, in 2010, 75 percent of households in the targeted areas were not served by a formal waste management system. Today, this figure is down to 36 percent.<sup>1</sup>

<sup>1</sup> The World Bank, 2017, *Implementation Status and Results Report: Second Solid Waste Management Project (PI07998)*.



## C. Focus on Municipal and Social Services

### I. Description of the System

The provision of municipal and social services in the RS is simpler than in the FBiH, because there is no intermediate layer of government, but the demographic context is the same and many of the problems are the same. City and municipal governments exclusively provide local roads and bridges, water, sanitation, and waste removal.<sup>81</sup> Typically in larger urban areas, a single utility supplies water and sewerage, but in smaller municipalities, these utilities also manage waste, maintain roads, clean streets, remove snow, maintain gardens and parks, and operate funeral services and parking lots. The utilities finance their operations through user fees, but depend heavily on local and higher-level government co-financing for capital investments. Municipalities help facilitate health and education services - as the founders of local health-care and educational facilities, they contribute to the upkeep of buildings and the provision of basic equipment, but the ultimate responsibility for providing health and education rests with the RS government.<sup>82</sup> Of the seven cities in the RS, only one (East Sarajevo) has (4) constituent municipalities. Any municipality with a population of more than 50,000 can become a city and this would enhance its legal status, facilitating the collection of taxes and charges and fees (including the collection of arrears).

Social-aging is already an expensive phenomenon for municipalities. Many municipalities report that they spend a significant share of current expenditure (15 percent in Banja Luka and 10 percent in Trebinje, for example) for social protection services that are provided either in kind and as cash transfers. Part of this expenditure is refunded through grants from higher levels of governments, but the ultimate responsibility of funding falls on municipalities. Deciding of the eligibility of beneficiaries is a big problem because it is undertaken, practically without control, by the municipalities. Depending on the type of services, general practitioners and committees, operating within Social Centres, proceed to the selection of beneficiaries on the basis of normative criteria and with no consideration of financial constraints. This originates mismatches between budgeted resources and the expenditure implied by the selection of beneficiaries, leading either to queues, the presentation of claims by excluded beneficiaries, or to the need of readjustments in the budget.

81 Table 2 sets out the division of competences.

82 For a detailed description and assessment of the operation of cities and municipalities, see: The World Bank. 2009. From Stability to Performance: Local Governance and Service Delivery in Bosnia and Herzegovina.

### 2. Findings of Consultations

Seven out of ten local governments in the RS said that the major obstacle to improved municipal services is insufficient financing for legally assigned duties. Local service delivery is uneven but this reality is accepted and there is widespread support for the proposed solutions outlined in the new RS Local Self-Government Development Strategy. In particular, nine out of ten local governments believe that there is an obvious difference in capacities for the provision of public services in terms of availability, content and quality - where peripheral and rural areas are significantly lagging behind more-central and urban areas. Most respondents think that the current 'monotype' concept should be abandoned in favour of a 'multi-type' concept.

Nine out of ten local governments agree with the RS Strategy that the biggest constraint on greater inter-municipal, regional and cross-border cooperation is the lack of incentives and funds, as well as a lack of financial instruments dedicated to joint projects. Furthermore, almost everyone believes that it would be a good idea to give priority to grants applications that are jointly submitted by two or more municipalities. Therefore, the new RS Law on Local Self-Government has a good foundation for its implementation (as described above).

As is the case in the FBiH, a majority of local governments believe that their utility companies should provide services across municipalities in order to save on expenses and share expensive infrastructure and two out of ten local governments report that they already collaborate in such a scheme. The issue of having to subsidize utility companies because it is politically difficult to raise prices (or because local government to not have sufficient control over their operation) exists in the RS but appears to be less acute than in the FBiH. Finally, as in the FBiH "only" 40 percent of local governments support the establishment of a regulatory agency that would be responsible for establishing utility fees at a higher level.

Again, as in the FBiH, there is a serious issue with covering unfunded social costs. Almost all local governments in the RS said that they frequently end up bearing social costs that are not envisaged in the current legislation and where costs are not shared by the central government. For a third of them, such assistance makes up 2 percent of their total budget expenditures. One fifth of municipalities report having to spend 7 percent or more of their total expenditures in this way.

There is widespread recognition of the need to undertake more regular and systemic performance

benchmarking of public services, including the communication of regular reports to the public, and 80 percent of municipalities believe that RS Government transfers to municipalities should be introduced that would be based on increased performance monitoring and the satisfaction of minimum service standards.

Four out of ten local governments in the RS believe that 10 percent of currently provided public services should be transferred to the private sector. Public-private partnerships (PPPs) are governed by the Law on Public-Private Partnership. The law provides a legal framework for PPP projects by defining: the scope, principles, manner, and forms of public-private partnership; requirements for the establishment of a public-private partnership; elements of an agreement on public-private partnership; and other issues relevant to public-private partnerships.

According to the law, an eligible public partner in a PPP can be:

- the RS (or RS Government) through a line ministry or public institution established by the Government
- a state-owned company, majority-owned by the RS
- a local self-governance unit (i.e. a municipality or city) or a public institution established by a local self-governance unit, and
- a state-owned company, majority-owned by a local self-governance unit.

The object of a PPP may be: the (re)construction, use, maintenance and operation of infrastructure facilities for the fulfilment of public needs; the management of ecological and solid waste; and other fields of interest for the RS Government and local self-governance units. Contractual forms of PPPs include concessions and private finance initiatives. Concessions are also governed by the provisions of the Law on Concessions. A private finance initiative is a contractual form whereby the private partner finances, executes, maintains and operates a public building or another object for the needs of the public sector, and charges a fee for those services mostly from the public sector.

The most common PPP projects are those in infrastructure. There is a large gap between the need for infrastructure investment in RS and the ability of governments to pay for those investments. PPPs can help bridge that gap. However, private sector perception of risk is often the biggest challenge and very few PPP projects manage to control risks successfully across the entire lifecycle of a project. Risks include

the project environment and the implementation of the law can suffer from complicated relationships and long approval procedures. An inefficient organisation can result in increased costs to the project and a lack of definition and transparency in government processes can increase uncertainty and delay projects. An unfavourable environment can discourage private sector investors and the market for PPPs in RS has still not reached its full potential.

### 3. Recommendations

The proposal for a multi-type concept of municipalities is welcome and municipalities should be fully consulted as the proposal is further developed. Of course, there will be financing implications that will need to be fully discussed. Also, in this context, the focus on improved municipal cooperation in the RS Strategy and Law is important and necessary. A lot of work still needs to be done but the parameters of the conversation have been well established. A determination of the appropriate institutional framework for the provision of services on a regional basis should consider the different types of services that would be provided as set out in Box 2.

There is a need to reformulate the eligibility process for social welfare, either by making it more inclusive (with the participation in the selection committees of municipal finance officials) or by allocating the full budget to the committees. This issue needs to be fully discussed with the Ministry of Health and Social Protection.

Some of the issues to be considered with regard to PPPs by the RS authorities at the entity and local level include:

- *Early identification of public entities that need to be involved in the project.* It needs to be clear from the outset of each project which combination of entity-level ministries and local authorities have to be involved in the decision-making process. Establishing relevant relationships starts already at the planning and design phase where full transparency and open discussion about potential constraints and risks needs to take place.
- *Clear determination of powers to award contracts.* A power to award the contract may be divided between authorities or assigned to an authority that is different than the sector ministry (for example, Ministry of Finance often has the power to award contracts for road infrastructure). Also, projects of a certain size may need cabinet approval.

- *Analyse the law and prepare amendments to the regulations governing public-private partnership.* Follow the recommendations from the new RS Strategy to improve the provision of public services through a PPP model.
- *Raise awareness of PPP benefits.* The Strategy further recommends to promote the concept of public-private partnership and raise awareness among all stakeholders about the potential and benefits.

## D. Focus on Local Economic Development and Planning

The RS Strategy recognizes that there is often a lack of capacity for local governments to manage local development.

### i. The management of Economic Development in the RS

The current management model in the RS treats all municipalities the same and implicitly assumed that they would look after their own economic development. This led to: fragmentation in the decision-making process; a lack of integrated strategic plans at the level of regions that often have complementary resources; and a constant struggle to fund municipal services and development projects. The model favours larger municipalities and towns - such as Banja Luka, Bijeljina, Prijedor, Doboj and East Sarajevo - but leaves few development options for the smaller municipalities. The sustainability problem is even more pronounced in municipalities that were established at inter-entity boundary lines as a result of political divisions. Some of the most extreme examples of struggling municipalities include: Kupres (RS) (population 300); New Gorazde (population 300); and East Drvar (population 79). Many of them cannot perform even basic functions.

Economic hardship is the key reason for the massive migration of the population over the past twenty years. It is taking place simultaneously at two levels: first, from less developed municipalities to the more developed; and, second, migrations from the RS to other countries. Foreign migrations have been increasing in the last few years and the testimonies of mayors during consultations revealed that, increasingly, whole families are emigrating together. This leaves little prospect for their future return.

The consequences of fragmentation in decision making are significant in several other areas:

- Planning and the availability of resources for implementation of projects

- Growing poverty and an ageing population require an increased focus on citizens' social needs and these absorb potential resources for economic development.
- The development priorities of local government units are often inconsistent with the priorities defined in the sectoral development documents of RS; with more conflicts than synergies between projects and initiatives.
- Capacity to attract investments and support entrepreneurship
  - The capacities of the local government units are often insufficient to attract local international investments as they lack qualified human resources for the preparation and management of development projects.
  - The lack of updated spatial planning documents and ownership records in the local government units discourage investors.
  - There is a low quality of labour force in general and especially in small municipalities. Some companies are already offering higher salaries for more qualified workers but lower-skilled workers get left behind.
  - Incentives for entrepreneurship and SME development are low, especially in smaller communities that lack economies of scale and local financial resources and are unable to offer support to investment.
- Releasing synergies through cooperation
  - Most (especially, smaller) municipalities have insufficient financial resources to fulfil responsibilities in economic and social development on their own.
  - However, there are limited institutional and financial instruments to stimulate cooperation between local government units on joint projects.

To address these issues the RS Strategy proposes measures to increase the efficiency and accountability of local governments in the management of local economic development and to increase regional cooperation between municipalities. The following proposals would advance this initiative:

- Create economic zones to enable closer cooperation between centres and periphery. The proposal would create economic development zones based on the new territorial organisation of RS that granted city status to seven cities: Banja Luka, East Sarajevo, Bijeljina, Doboj, Prijedor, Trebinje and Zvornik.

These more-developed towns would, according to this concept, become regional centres that would undertake the role of a champion for the economic development of their regions. The legislative framework for local government already supports cooperation (as noted earlier). In addition, the Law on Small and Medium Enterprises (SMEs) allows for close cooperation between the Agency for Development of SMEs and members of local communities and inter-municipal agencies for development of SMEs, and facilitates the creation of a support network to SMEs through better connectivity between the RS and local administrative bodies.

- Professionalise the management of economic development. The next step would be to establish an institutional framework for the management of economic development in the regions. One of the possibilities is to establish Functional Agencies (FA) that could professionalise the management of economic development and manage development activities for the region. There are a number of reasons why FA model could improve local development activities and services (also, see Annex B):
  - FAs can offer a unique means to assemble both the resources and the authorities required to undertake certain development activities or local service provision. In these roles, FAs can become the means to overcome most of the administrative constraints between local and entity levels where there are overlapping competences, unfunded mandates and (sometimes) an inefficient assignment of competences. For example, FAs would help the regional centres, smaller municipalities in its region and entity government to work together and the development agency can play a role in pooling resources between different tiers and between departments, agencies, authorities, commissions, educational institutions and others.
  - FAs can play an important role in bringing together public, private, and civic sectors through an array of different mechanisms including joint ventures, partnerships, service agreements, compacts or other vehicles.
  - FAs offer a politically acceptable form of co-investment vehicle for development partners and other interested parties. FAs can easily be held to account through various forms of joint ownership and control.

- FAs can promote their region's projects - and initiate healthy competition for funds and other resources - and back them up with professional management and joint efforts with other regions to create a higher level of synergy. They could engage in more-effective advocacy to defend the interest of the regions at entity level.

## ii. Spatial Planning in the RS

A Spatial Plan was adopted in 2007 and revised in 2012 to be put in line with the emerging development needs of municipalities. In 2010, the government adopted a Law on Spatial Planning and Construction followed by an Ordinance on the required content, development and enactment of spatial planning documents. Furthermore, all municipalities were obliged to adopt the Ordinance on construction and spatial planning.

Consultations with municipalities and the business community revealed a general dissatisfaction with the functioning of the current spatial planning system. Most of the problems are linked to unsatisfactory geodetic and cadastre databases and access to information, including:

- The centralisation of the cadastre at the RS Administrator for Geodetic and Property Affairs that was previously hosted by municipalities. The Administrator provides information to municipalities as a service but this leads to long response times and higher costs for municipalities.
- Geodetic and cadastral maps are not updated and the information is often inaccurate; creating the potential for complicated ownership disputes in the future and a reduction in the attractiveness of some major PPP projects.
- There is no automated IT-based system for storing, accessing and analysing geodetic information or information systems that link geodetic and cadastral information with population and other socio-economic data and projections for better spatial planning. As a result, the issuing of construction permit can be delayed and the information is often inaccurate, creating a potential for complicated ownership disputes in the future.

There are a number of recommendations to help resolve these issues:

- Implement a recommendation from the RS Strategy to *update and harmonise the spatial plans of local government units with the Spatial Plan of the RS*. This would reconcile lower level

planning documents with higher level planning documents and eliminate obstacles to - and open up opportunities for - better management of local development.

- *Develop digital maps.* In all municipalities, the lack of updated cadastre maps and other geodetic information limits the preparation of quality spatial plans and efficient spatial management. The RS Administrator for Geodetic and Property Affairs is planning to introduce digital maps and develop an information system that would better connect all users and integrate spatial data. However, this process is slow and municipalities regard it as unsatisfactory.
- *Introduce a GIS-based management system.* At the local government level, the district local plans are legal documents that become the basis of development guidelines and control. These plans contain such details as land-use zoning, development density, building height and plot ratio and require detailed information on each plot. The task of preparing and analysing this information can be speeded up and made easier with the help of a Geographic Information System (GIS, which is a framework for gathering, managing, and analysing data.). A zoning plan, for example, covers a large area that contains various land uses. GIS allows for the selection of suitable locations for social amenities and different sizes of housing as well as facilitating the evaluation of their potential environmental impact.
- *New digital technology for local governance and blockchain options.* Introducing new technologies is an alternative solution to the development of a spatial management system and would significantly advance the storage and management of spatial data. They offer a novel way to get around a difficult, complex and costly task. (See Annex D for a description of this option).

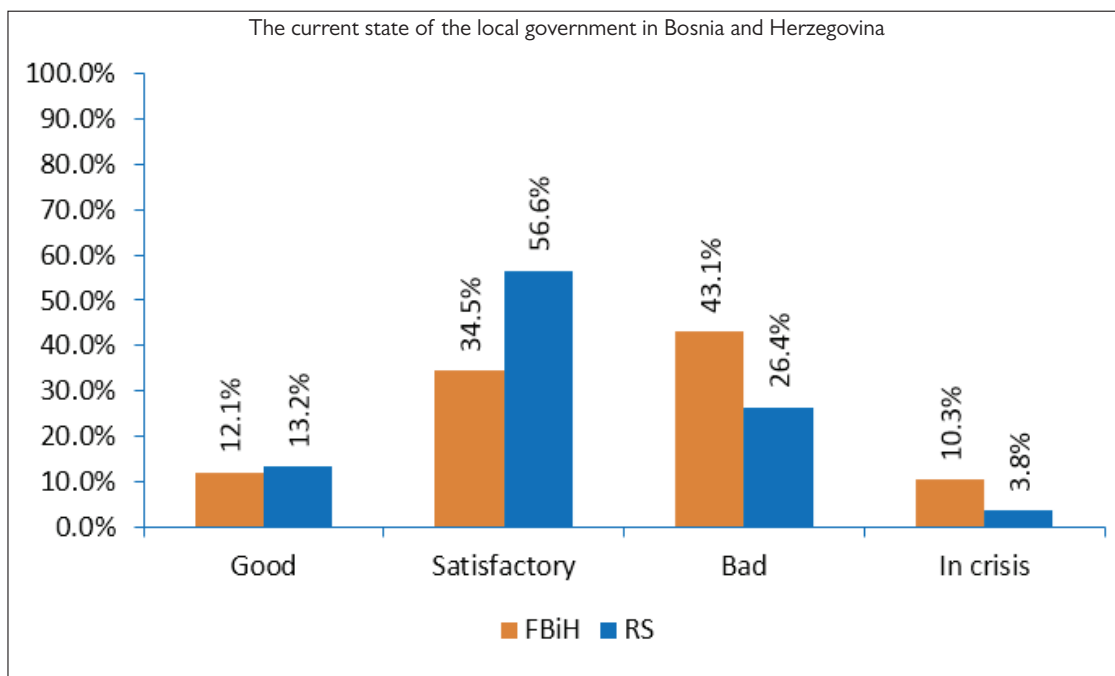


## SUMMARY OF SURVEY RESULTS

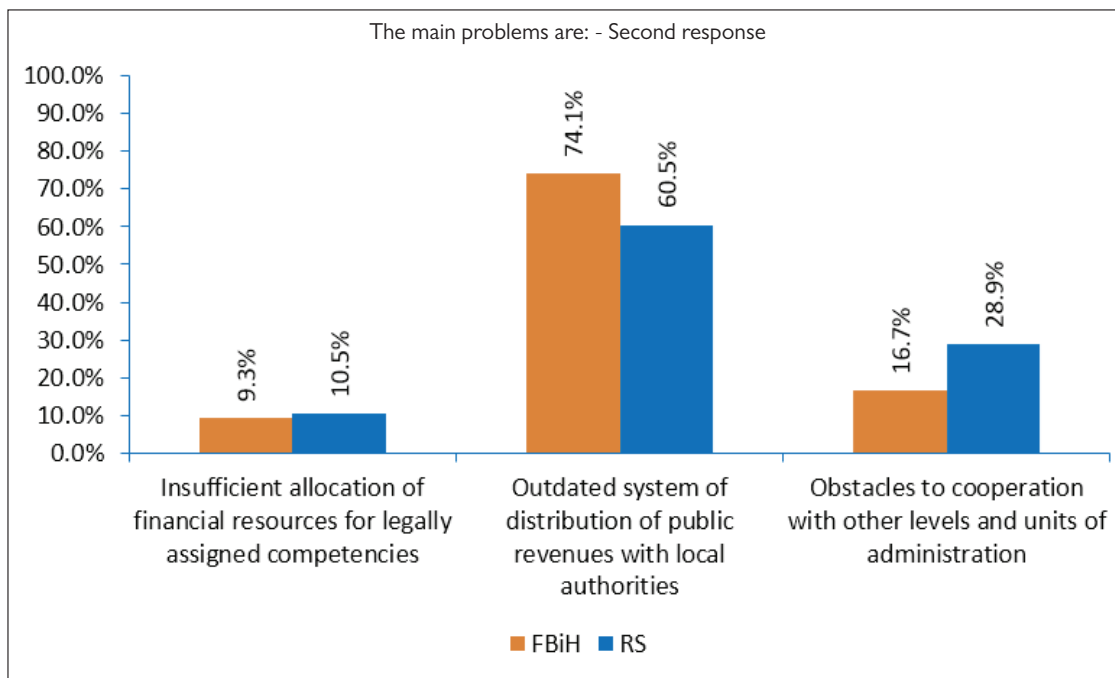
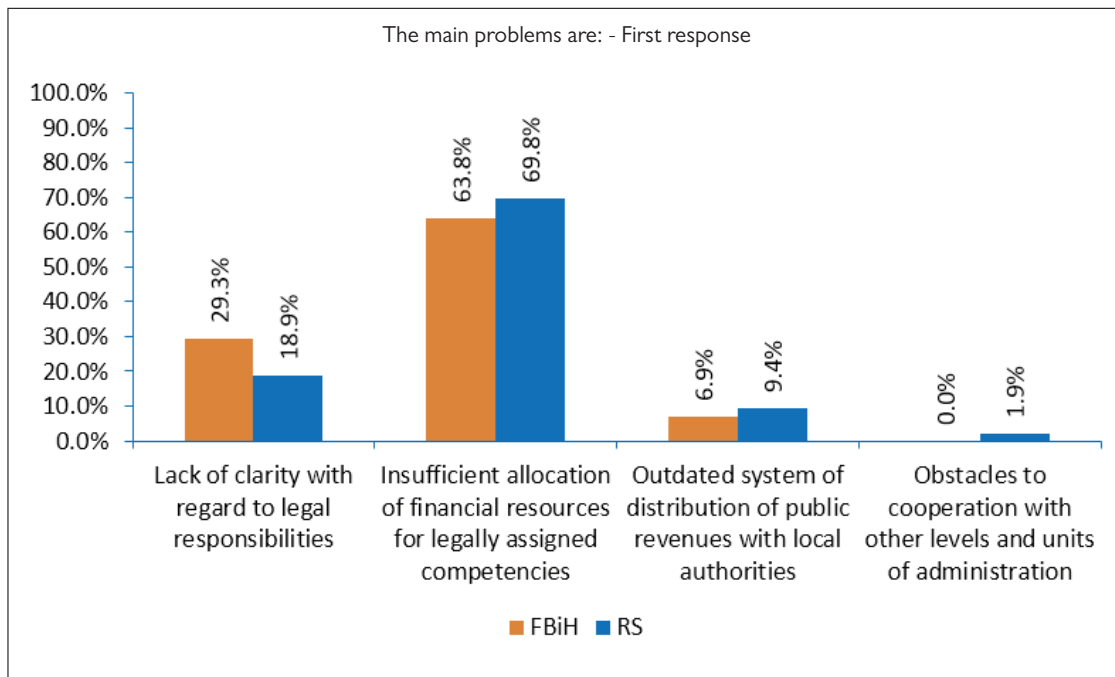
In the context of the LGI, a Survey of local government leaders in all cantons, cities and municipalities was conducted across BiH (between February and May 2018). Out of 79 cities and municipalities in the FBiH, 58 took part in the Survey (or 73 percent), while in the RS 53 out of 64 local governments responded (83 percent). This Annex discusses some of the main conclusions of the Survey, while all results as well as the questions will be published on the website of the Delegation of the EU to BiH at [www.europa.ba](http://www.europa.ba).

### i. General Situation and Main Problems

- Satisfaction with the current state of local government is greater in the RS than in the FBiH. Almost one third of municipalities in the RS consider the current state of local government to be either bad, or in crisis. In the FBiH, this figure is 53 percent. On the other hand, two thirds of cantons consider the current state of local government to be satisfactory, which reflects the different perceptions that were encountered during the consultations.



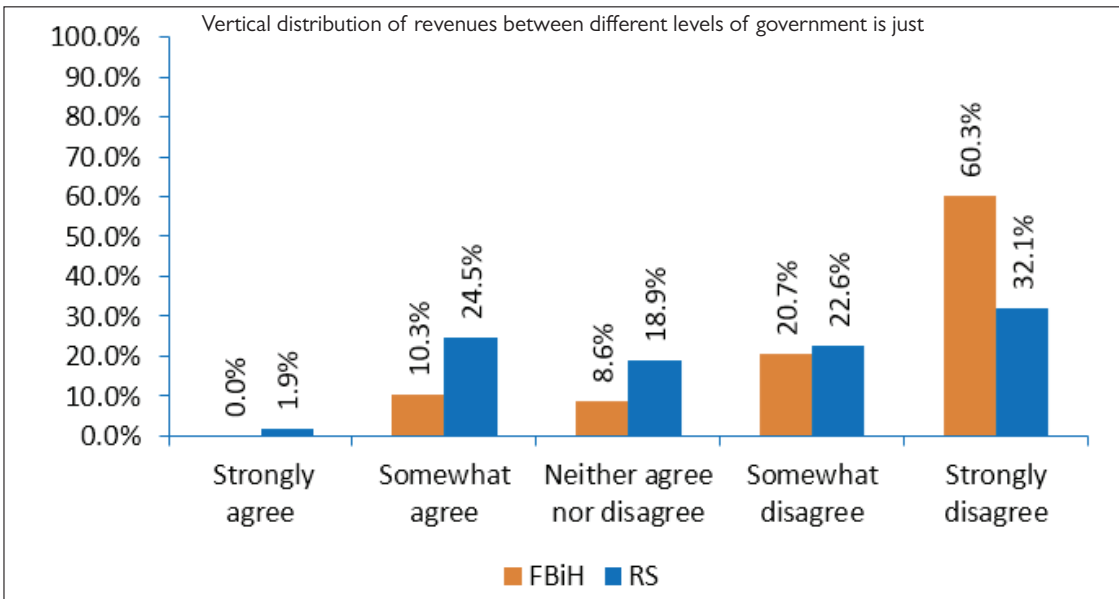
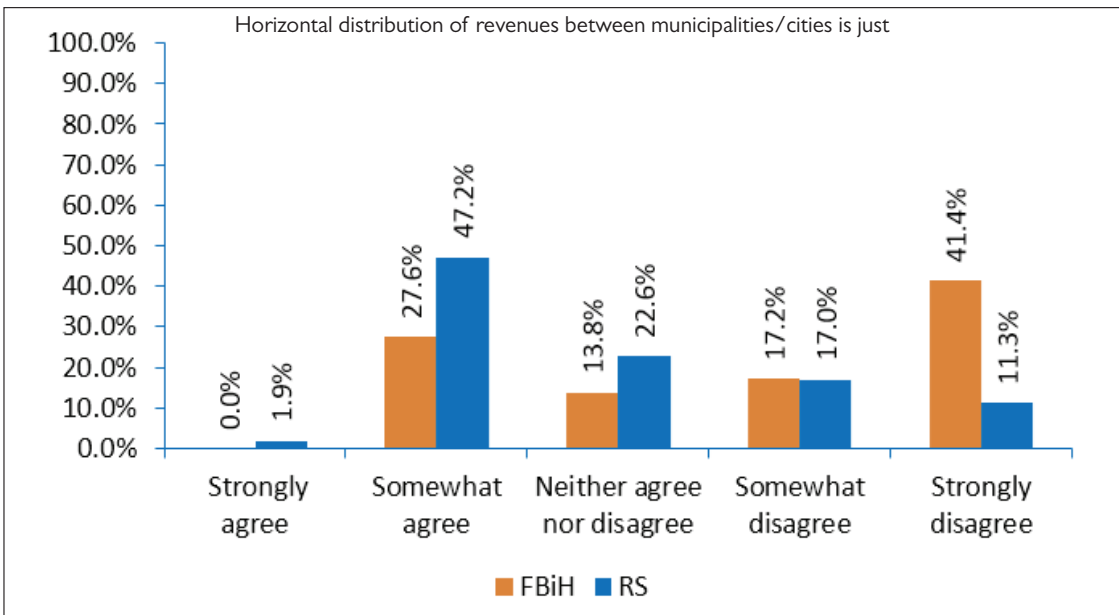
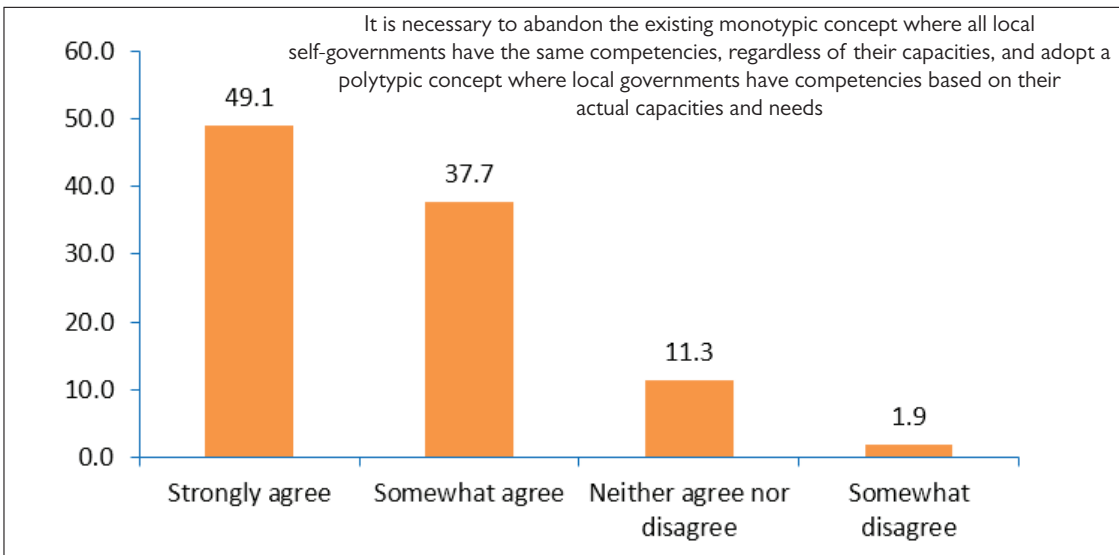
- When asked to identify the main problems, the response is almost identical in both entities, namely insufficient allocation of financial resources for legally assigned competencies. As the second biggest issue, local government across BiH highlight an outdated system of distribution of public revenues with local authorities.
- When it comes to the confusion concerning the distribution of responsibilities, local governments in both entities said that the two main problems are the contradictions between laws on local self-government and sectoral laws, as well as the situation whereby with shared competences, responsibility usually falls to lowest level even when not funded. Most cantons are aware of this issue, however one third said that they have never hear such complaints from their local governments.
- It is worrisome that due to unclear roles and responsibilities, cities and municipalities eventually end up filling expenditure gaps of higher levels. For almost one third of local governments in both entities, such spending presents 3 percent of total spending, while for one fifth it even amounts to 10 percent.



- Nine out of ten local governments in the RS agree that there are obvious differences in the provision of public services in terms of accessibility, content and quality, where peripheral and rural areas are significantly lagging behind central and urban areas. Almost the same number deems that it is necessary to abandon the existing ‘monotype’ concept where all local governments have the same competences, and adopt a ‘multitype’ concept where competences are based on actual capacities and needs.

**ii. Financing and Interaction between the Different Levels**

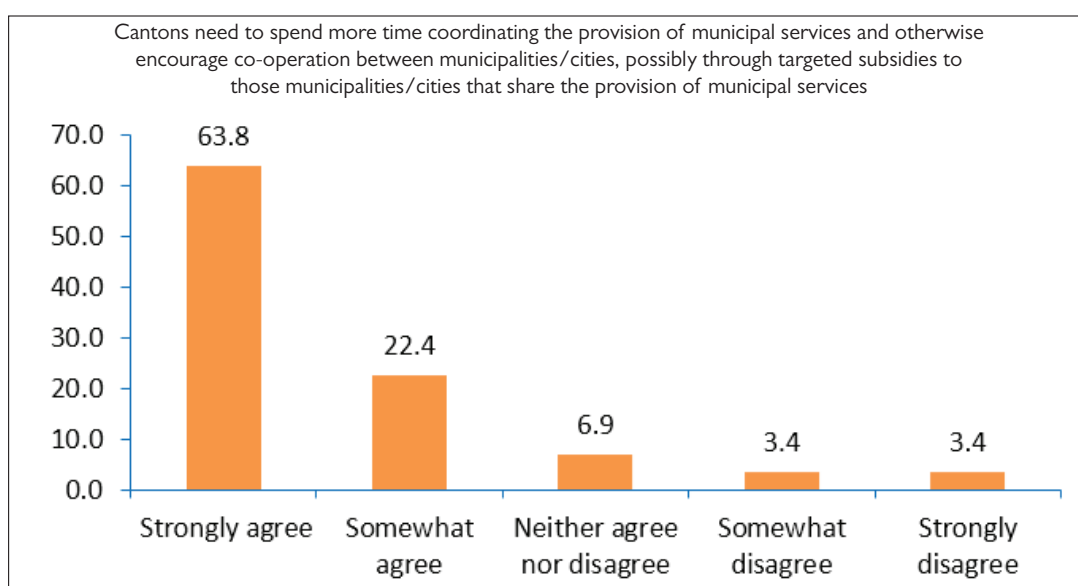
- With regards to revenue allocation, the vertical allocation between local governments and higher levels is a greater cause of concern than the horizontal allocation across cities and municipalities. There is much greater dissatisfaction with both systems in the FBiH than in the RS. With regards to the cantons, horizontal and vertical allocation is found to be almost equally unfair.
- Eight out of ten local governments in the RS endorse the current system whereby underdeveloped municipalities receive a larger share of tax revenues, even if only half of municipalities are currently classified as underdeveloped or extremely underdeveloped.



- Half of the cantons agree that the current system of distribution of indirect tax revenues between them is non-transparent and that it needs to be revised, while 60 percent believe that it is subject to political manipulations. Two thirds believe that the coefficients that reflect the specific expenditure needs of certain cantons should be abolished and replaced by special grants of the FBiH Government to account for special cantonal needs.
- As the biggest obstacle to increasing fiscal space, local governments in both entities highlighted the need to compensate for unfulfilled responsibilities of higher levels of government. However, it is worth noting that political interference in spending decisions is a serious problem in the FBiH, while this issue is virtually non-existent in the RS. Around two thirds of cities and municipalities across BIH say that they would significantly redistribute their spending if it were possible.
- Eight out of ten local governments in both entities agree that the reduction of parafiscal fees would be useful for attracting greater investment. Due to a lack of fiscal autonomy, municipalities and cities are obviously under pressure to maintain these fees, and some of the recommendations from this Report could help in solving this issue.
- Three quarters of local governments in the FBiH believe that the introduction of a property tax is feasible over the next 3 to 5 years and that it would be an efficient way to collect their own revenues. In the RS, 7 out of 10 municipalities and cities deem that they are ready to take over the administration of property tax collection, and a majority of them believe that it would lead to an increase in tax collection of at least 20 percent. Finally, half of them agree that the RS Government should be responsible for determining the tax base and taxation criteria, in order to avoid exceptions in local governments.

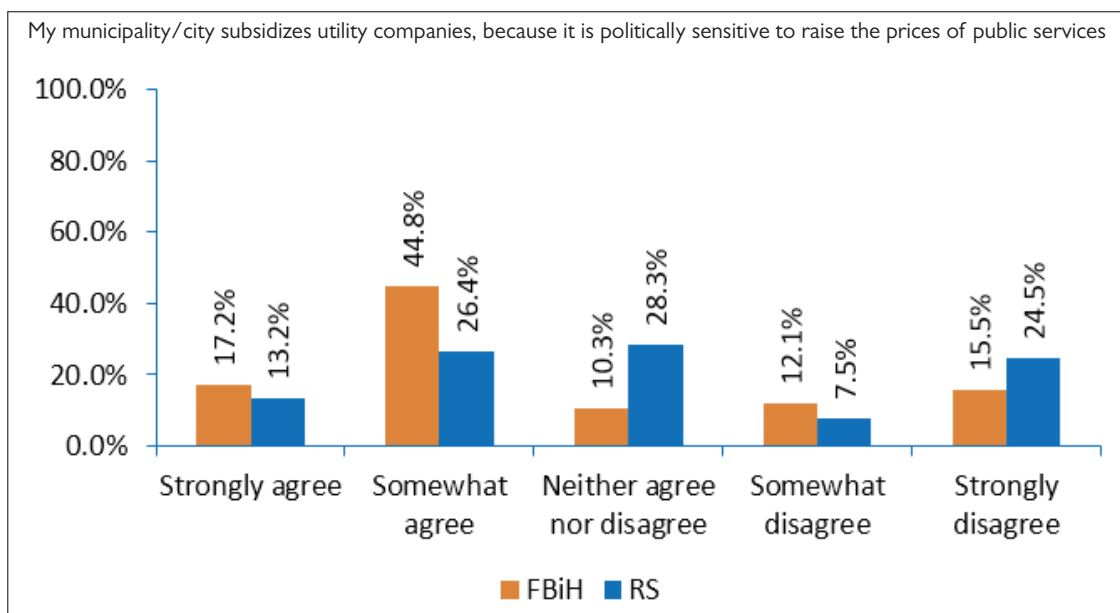
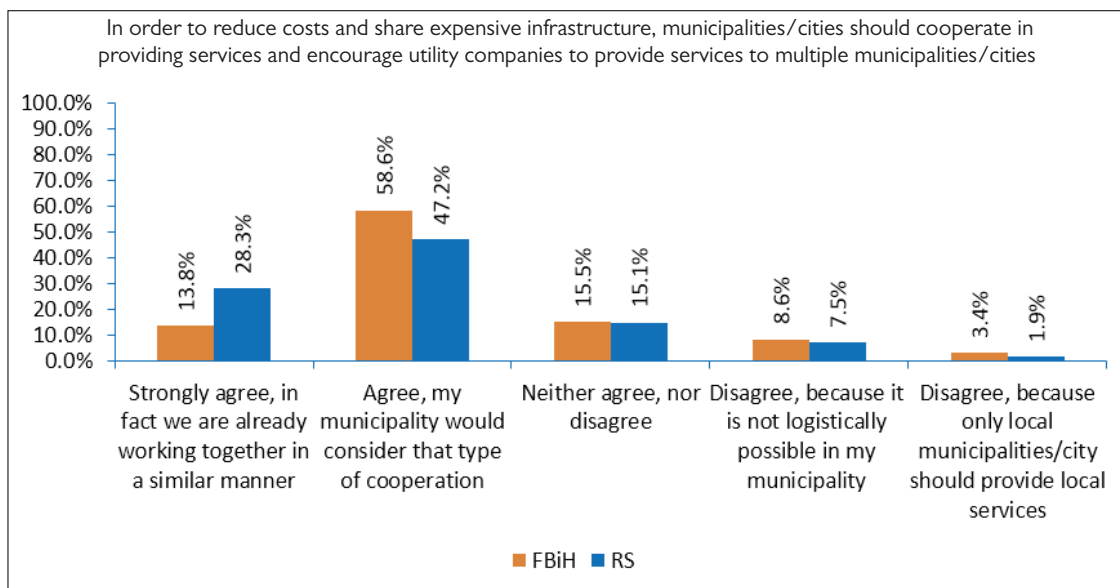
**iii. Coordination in Service Provision**

- In general, there are numerous indications that local governments are ready for mutual cooperation if it was incentivized. For instance, 90 percent of local governments in the RS agree that the biggest obstacle to stronger inter-municipal cooperation is the lack of stimulating resources and funds, as well as financial instruments for joint projects.
- Almost nine out of ten local governments in both entities agree that recent floods and fires have shown an urgent need for better cooperation between different cities and municipalities in order to improve civil protection.
- 85 percent of municipalities and cities in the FBiH agree that cantons need to spend more time coordinating the provision of municipal services and otherwise encouraging cooperation between municipalities, possibly through targeted subsidies to those local government that share the provision of municipal services. On the other hand, only half of the cantons somewhat agree with this statement.



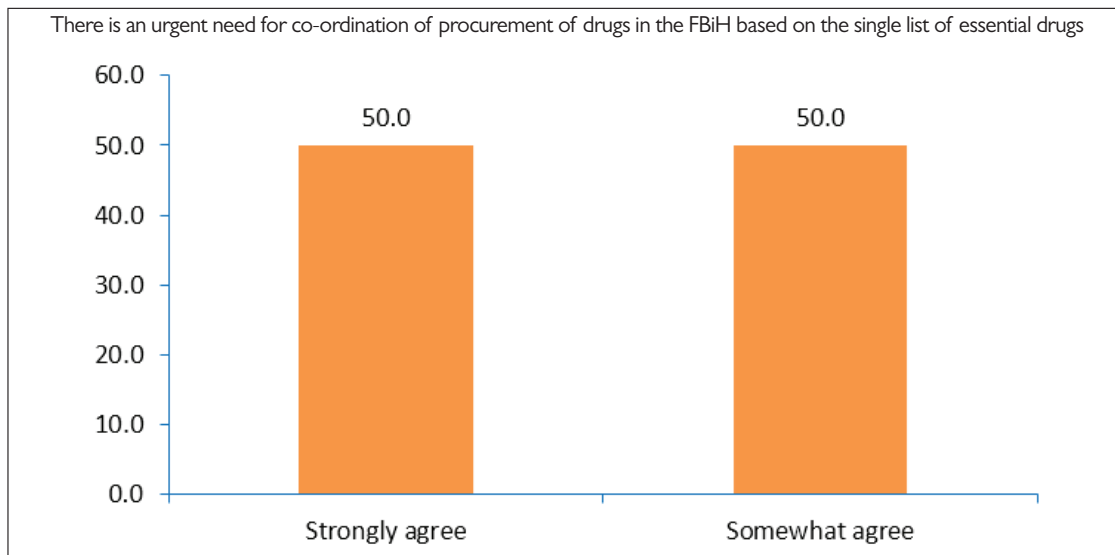
- Municipalities and cities in the RS almost unanimously agree that it would be a good idea to give priority to grant applications submitted jointly by two or more local governments. In the FBiH, nine out of ten local governments support this idea.

- However, when asked about the main reason for the lack of stronger cooperation between local governments, the response is almost identical – almost half of the municipalities and cities in both entities identify political differences before legal and administrative restrictions, as well as a lack of time. On the other hand, cantons primarily refer to legal and administrative restrictions.
- Three out of four local governments in both entities agree that municipalities and cities should cooperate in providing utility services in order to reduce costs and share expensive infrastructure. In the RS, one third of respondents said that they are already cooperating in such an arrangement.
- On the other hand, six out of ten local governments in the FBiH agree that they have to subsidize utility companies, because it is politically sensitive to raise the prices of public services, while in the RS 40 percent agree with this statement. At the same time, there is no majority support in either entity for setting up a regulatory agency at the cantonal level (FBiH) or entity level (RS) that would be responsible for determining utility taxes and fees.



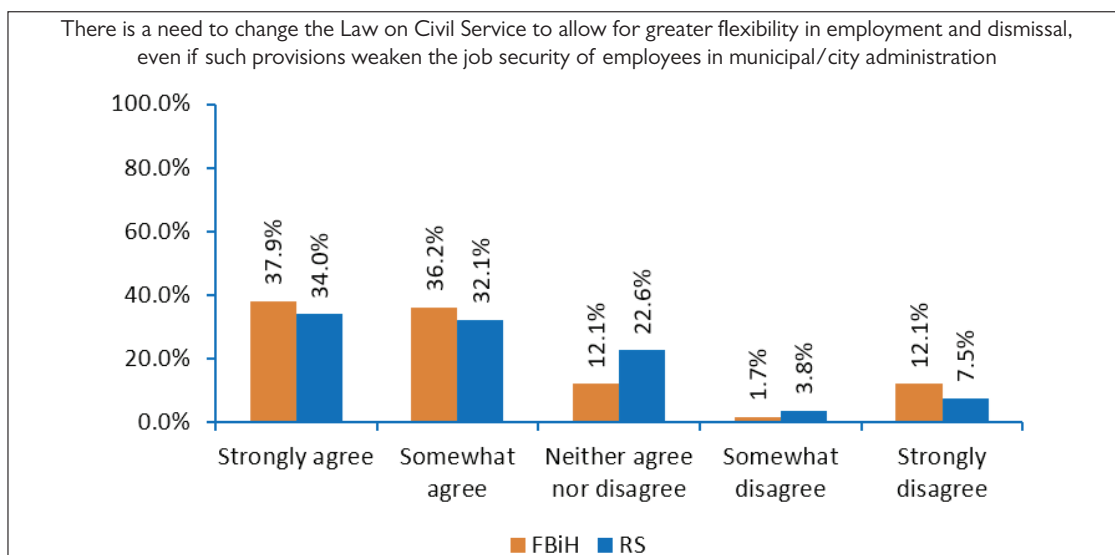
- Two thirds of cantons agree that they should share specialized police and judicial institutions, such as forensic laboratories (on a cost recovery basis). All cantons agree that there is an urgent need for coordination of procurement of drugs in the FBiH based on a single essential drugs list.





**iv. Public Administration**

- Two thirds of municipalities and cities in the FBiH and RS agree that there is a need to change civil service laws to allow greater flexibility in hiring and firing, even if this undermines job security for municipal employees. Half of the cantons agree with the same statement.



- With regards to public financial management, almost half of local government in the FBiH agreed that the entity should provide special grants to municipalities and cities that meet existing fiscal rules (balanced budgets, paid debts, and borrowing within the limits).

**v. Economic Development**

- A third of municipalities and cities in both entities see the lack of coordination from entity government and unrealistic entity strategies as the main obstacle to better local economic development. In the FBiH, insufficiently defined responsibilities between the various levels are identified as a serious concern, while local government in the RS sees insufficient funding for legally assigned competences as a serious obstacle to better local economic development.
- As the main obstacle to greater private investments, municipalities and cities in the FBiH highlight complex and burdensome business regulations, while local governments in the RS point to insufficient funds to promote and stimulate investments. A quarter of local governments in both entities point to the problem of political instability

- Local governments in both entities would use new funds for economic development primarily for business zones in order to attract foreign investments, followed by the development of infrastructure. Only one out of ten local governments would use the funds to provide incentives for local entrepreneurs, or professional development of the unemployed.

**vi. Measuring performance**

- There is significant support in local governments across BiH for the need to conduct regular and systematic measurement of performance, including the communication of regular reports to the public. In addition, a vast majority agrees that it is necessary to introduce transfers from higher levels to municipalities and cities that are based on better performance measures and minimum service standards. Only a third of cantons deem that current performance and efficiency measures of local governments are adequate.

**vii. Management of Natural Resources**

- Concerning the allocation of revenues from natural resources, local government in the RS would on average retain 71 percent and in the FBiH 65 percent, probably due to the fact that resources are divided amongst three levels. On the other side, cantons would retain 40 percent, give around 50 percent to local governments, while the rest would go to the FBiH.
- Three quarters of municipalities and cities in the FBiH agree that there should be a unified criterion that regulates the maximum number of employees in the cantonal forest companies based on the forest area and planned volume of logging. Even a greater number of respondents agree that the FBiH should be allowed to set a yearly volume of logging across cantons in order to preserve the joint ecosystem. Although in a smaller percentage, a majority of cantons also agrees with this statement.

## FUNCTIONAL AGENCIES IN BIH: *Potential Roles, Structure and Financing*

A Functional Agency (FA) is an independent government-linked agency that works with (but outside) the regular institutions of government and that is dedicated to the delivery of a clearly identifiable objective - such as local economic development or the delivery of a particular service. FAs can deliver local development activities or local services in ways that overcome weakness in the institutional and political framework.

### Positioning within the system of local development

FAs cannot succeed without other institutions and should be equipped to collaborate effectively with other bodies in the local development or service-delivery system. Several activities will help FAs to a position within the range of other local bodies and organisations:

- FAs often create a capacity to **coordinate activities at the multi-agency scale**, involving the full range of key partners. FA should adopt a **networking approach** and create multiple entry points into municipal, cantonal and entity government administrations and not just rely on formal structures and leaders.
- **Formal alignment around common/shared objectives.** Partnership agreements can be one way to strengthen key relationships at the local level and reduce risk from structural and systemic issues present in the entity and cantons current governance arrangements.
- **A limited public image.** The FAs should be perceived to have no real power, either economic or political. A low profile and non-threatening position help FAs to gain more confidence in the regions where they operate.

### Governance

Functional agencies are compatible with different institutional/organizational arrangements: associations of municipalities, consortiums of municipalities with the participation of cantons, purely public agencies or agencies with the involvement of the private sector or other actors. A prerequisite is that the executive body is selected according to technical/managerial skills. Examples include:

- **Public company.** The FA is wholly public-sector owned and funded and its balance sheet is tightly controlled by the public sector through detailed control of budget lines and project finances or through annualised budgeting processes.
- **Public company - commercially oriented.** The FA is wholly public sector funded and owned but has freedoms to vary the use of capital receipts, trading income, fees, and levies (for example) to generate an 'internal financial engine' which is subject to public sector accounting rules but provides for a complementary commercial strategy to help achieve public policy goals<sup>83</sup>.
- **Public-Private Partnership.** FA is funded from a range of public and private sector sources, and there are clear rules and processes for setting financial strategy and for reapportioning of income and expenditure to different sponsors.
- **Private ownership.** FA is largely, or wholly, private-sector funded and operates principally as a not for profit business with extensive control over its internal financial strategy.

### Potential roles

Local governments and stakeholders should consider using FAs when the services can be delivered more efficiently through a corporate, rather than a municipal, structure. Use of the corporate structures to pursue local development and provision of services is, in most cases, a means to optimise and coordinate use of resources to overcome some of the limitations within the prevailing institutional framework, whatever its features may be.

FAs operate in a single area of responsibility but the area can also be defined in terms of a mission, which widens their scope. For example, special economic zones refer to many activities, such as providing infrastructure

<sup>83</sup> OECD/Mountford D. 2009. Organising for local development: The role of local development agencies. Summary Report.

and services to firms and residents. Provision of social services may include a diverse set of activities including coordination of civil society organisation, complex funding arrangements and others.

**The roles of the FAs may include a combination of the following:**

<b>Strategic roles</b>	<b>Asset and investment roles</b>	<b>Innovation, skills, and employment roles</b>	<b>Promotional roles</b>	<b>Capacity building roles</b>
Foster coalitions for economic growth and quality of life initiatives	Land and property (re)development and management	Promotion of technology, creativity, and innovation in all local activities	Branding of the canton/municipality or a city	Sector and cluster development programmes
Coordination/leadership of local actors	Fund management and direct lending/investment in firms or public companies and/or municipal investment projects	Employment creation and job brokerage	Marketing and facilitation of foreign investment	Workforce development, skills development and technical assistance for other local organisations
Co-ordination/leadership of regional, national and international private sector partners and donors	Other forms of financial intermediation and income/resource generation	Fostering entrepreneurship and SMEs	Project management and design of major projects	Identification of good practices and learning models, cross-border, inter-regional, and international co-operation
Strategic planning for economic and local development	Management of grant aid for targeted joint projects and programmes		Marketing for retention of the relevant workforce and minimise migrations from the canton/region.	
Infrastructure and investment advocacy				

## Rationale

There are four main reasons why FA model could improve local development activities and services.

- (i) FAs offer a unique means **to assemble both the resources and the authorities** required to undertake certain development activities or local service provision. In these roles, FA can become the means to overcome complex administrative geographies in BiH and related difficulties in overlapping competences, unfunded mandates and inefficient assignment of competences. For example, the neighbouring local and cantonal governments can work together through the FA where the agency may play a role in pooling resources between different 'tiers' and between departments, agencies, authorities, commissions, educational institutions and others.
- (ii) FAs can play an important role in **bringing together public, private, and civic sectors**, either through joint ventures, partnerships, service agreements, compacts or other vehicles.
- (iii) FAs offer a politically acceptable form of co-investment including investment from BiH development partners and other interested parties. FAs can be held to account include various forms of joint ownership and control.
- (iv) Almost half of the local governments do not believe that they have sufficient flexibility in expenditures, while 63 of them would reallocate expenditures significantly if it was made possible. However, there are ways in which financing can become more flexible: contributions from owners, fees from services and management, attracting sponsorships, return on investment and local taxes such as property tax. Greater revenues could be secured by better managing municipal assets. However, two thirds of all local governments has not even developed and adopted a rule-book on asset inventory, while only 10 percent have a comprehensive property register in place.

## TECHNICAL NOTES ON POSSIBLE MODES OF FUNDING MUNICIPALITIES AND CITIES

### Personal Income Tax (PIT)

Administration of the personal income tax in FBiH already fulfills all of the pre-requisites for a well-functioning local surcharge on personal income tax. The present tax is collected according to the principle of residence. More precisely, when individual tax payers fill out their annual declaration (*Godisnja prijava poreza na dohodak*) they declare their municipality of residence. Also firms record the tax withheld on salaries and wages according to the residence of their employees. Tax due - both in the case of self-declaration and tax withholding - is sent to the single account of the Canton of reference and the Canton re-allocates the relevant share to each municipality.

A local surcharge on personal income provides a very convenient solution for expanding own-revenues for local governments. And it will become even more convenient with the approval, by the FBiH parliament (expected for 2018), of new law on PIT that mandates a substantial expansion of the tax base with the inclusion of income from financial assets. With a surcharge (or piggy back) a local government would be allowed to apply its self-determined tax rate to the tax base determined by the central tax administration.

Surcharges are administered and collected by the central government and the collections generated in each subnational government are transferred back to them (based on the derivation principle). This allows economies of scale in collection and better use of information on a broad basis. Subnational governments can be, and frequently are, involved in the collection and control process and can provide their own sources of information for cross-checking.

A municipal surcharge would require: a) the determination of the tax rate by the municipal council (and/or the canton) that intends to levy it; b) the communication, by proper means, to taxpayers of the selected tax rate; and c) the insertion of an additional line in the annual tax declaration dedicated to the determination by the taxpayers of the tax due to the municipalities. If a deduction of the surcharge from the ordinary (entity) PIT is also introduced, then one or two additional lines need to be inserted in the tax form. As a matter of fact, a PIT surcharge may also be an instrument to rebalance revenue from cantons/entity to municipalities. Rebalancing would operate through the deduction of the surcharge (the tax due to municipalities) from the PIT that is set by the entity. It would amount to a transfer from the canton/entity to the municipalities.

**Table I. Options for PIT Deductions**

Deduction from tax	Option 1		Deduction from taxable income	Example
	Example 1: 100%	Example 2: 50%		
Taxable income	100	100	Taxable income	100
Rate of municipal surcharge	3%	3%	Rate of municipal surcharge	3%
Municipal surcharge due	3	3	Municipal surcharge due	3
Entity tax rate	10%	10%	Entity tax rate	10%
Gross tax	10	10	Entity tax base	100 - 3 = 97
Net tax to entity/cantons	10 - 3 = 7	10 - 1.5 = 8.5	Net tax to entity	97 * 0.1 = 9.7
Share to canton/entity 70%	4.9	5.95	Share to canton/entity 70%	9.7 * 0.7 = 6.79
Share to municipality 30%	2.1	2.55	Share to municipality 30%	9.7 * 0.3 = 2.91
Total tax paid	10	11.5	Total tax paid	12.7
Total PIT to entity/canton	4.9	5.95	Total PIT to entity/canton	6.79
Total PIT to municipality	3 + 2.1 = 5.1	5.55	Total PIT to municipality	3 + 2.91 = 5.91

There are two options (see Table I):

Option 1: A deduction from the entity level tax. This would have a very strong rebalancing impact with no increase in the total tax burden. It is likely to be opposed by cantons because their tax share would be smaller.



However, the deduction can also be partial—as in example 2 in Table 1 (with 50%).

Option 2: A deduction of the surcharge from taxable income. This is widely used in federal countries (like the USA and Canada). In this case, the rebalancing effect (from one level to another) would be smaller but there would be a bigger increase in the total tax burden.

### Tax equalisation across municipalities in the FBiH

There is a need for more equalization across municipalities than across cantons due to their more unequal starting point. Inequalities are mainly due to large disparities in PIT revenues. However, the horizontal allocation of indirect tax revenues could be used to partially make up for these differences.

If a two-pillar system was introduced—similar to that system proposed for cantons - the first pillar would be based on derivation. Revenues would be closely linked to the fiscal capacity of each municipality and the criterion for allocation among individual units would be the existing PIT. The second pillar would be targeted to equalization - based on both expenditure needs and fiscal capacity. Expenditure needs would be based on a small number of basic indicators, such as population, the share of elderly population and the elevation of municipalities. (The last factor is quite important in BiH). Collections of PIT will measure fiscal capacity.

A simple numerical example is offered in Table 2. An equalisation grant would be used to benefit poor municipalities but would also take into account their expenditure needs. For example, a municipality situated at a high elevation and with a large share of elderly population would receive a higher per capita grant. Also, a municipality that is very poor would get a higher grant, even if it had lower expenditure needs because of low elevation and lower elderly population. (Compare, for example, municipality A with municipality B in Table 2).

**Table 2: Simulation of an Expenditure-Needs and Fiscal-Capacity Based Equalisation Grant.**

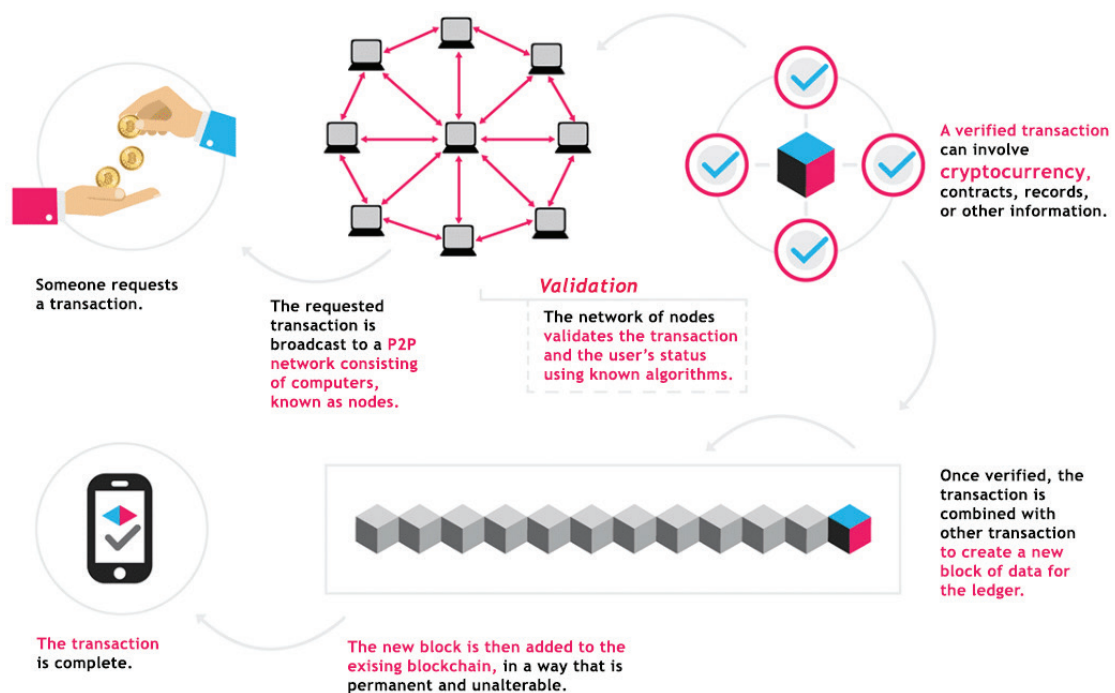
	Municipalities			Total
	A	B	C	
<b>Expenditure needs determination</b>				
Present total expenditure	126	24	175	325
Total population (p)	100	50	175	325
Present per capita expenditure	1.26	0.48	1.00	1.00
Population under 65	85	40	150	275
Population over 65	15	10	25	50
Weighed (factor of 2) elderly population	30	20	50	
Population weighed by age (a)	115	60	200	375
Elevation over sea level	1500	500	750	
Weights to elevation (b)	0.2	0.0	0.1	
Population weighed by age and elevation $c = a \times (1+b)$	138	60	220	418
Per capita expenditure needs ( $e = c / p$ )	1.38	1.20	1.26	
Total expenditure needs (ep)	138	60	220	418
<b>Fiscal capacity determination</b>				
PIT collections (t)	85	30	170	285
PIT per capita collections	0.85	0.60	0.97	0.88
<b>Total grant needed (ep - t)</b>				
Equalization grant = Expenditure needs minus fiscal capacity (ep - t)	53	30	50	133
Grant per capita	0.53	0.60	0.29	0.41

## BLOCKCHAIN TECHNOLOGY: *The Potential Use of Digital Technology in BiH*

Improved management and storage of public data with the use of digital technology is an essential ingredient of local governance. This applies in practice to any activity, going from the registration of property ownership, to the issuance of certificates, the transfer of revenue between government accounts, and rentals and sales of public assets. Spatial planning and property taxation could really benefit - maintaining registers and cadasters is the bedrock of these activities but keeping them up to date and in a safe and secured platform is typically a difficult, complex and costly task.

Now, **blockchain technology** offers a set of innovative options<sup>84</sup>. It is an innovative distributed digital platform. Digital platforms are information systems consisting of a network of computers passing messages between each other to achieve a common goal. In technical terms, a blockchain is simply an append-only data structure, consisting of a chain of data blocks linked together by cryptographic hashes. A number of countries are undertaking blockchain-based land registry projects for example. The Republic of Georgia and Sweden recently made a deal to develop a blockchain system for property titles. Land registries tend to be susceptible to fraud, as well as costly and labor intensive to administer.

By applying blockchain mechanism it becomes possible to bring everyone to the highest degree of accountability without human interference. No more missed transactions, human or machine errors, or even an exchange that was not done with the consent of the parties involved. Above anything else, the most critical area where Blockchain helps is to guarantee the validity of a transaction by recording it not only on a main register but a connected distributed system of registers, all of which are connected through a secure validation mechanism.



85

In the context of spatial planning and management the blockchain would work by:

- **Validating new blocks:** A cadastre or register could be set up as a 'permissioned blockchain': a small number of trusted parties would be responsible for validating new blocks. These could be government

84 For more information on this see: Nakamoto Satoshi. 2008. Bitcoin: A Peer-to-Peer Electronic Cash System; Vitalik Buterin. 2014. A Next Generation Smart Contract & Decentralized Application Platform; and The Government Office for Science. 2016. Distributed Ledger Technology: Beyond Block Chain.

85 The picture was taken from the website: [www.blockgeeks.com](http://www.blockgeeks.com)

agents or private parties. The level of trust that needs to be placed on these validators is minimal - the possibility of changing and updating data is not under full control of the validators. However, a certain amount of control over the blockchain remains in the hands of the validators. They can agree to 'censor' certain operations; for example, if a private key is compromised, they can refuse to allow any updates signed by that key.

- **Access and safety:** 'Write access' to the blockchain database are regulated by 'public key technology', and rules for access are hardcoded in the software. This is a very potent system, in which access to data can be assigned in a very fine-grained way.
- **Controlling access to write data:** This should be granted depending on the usage of the system, and the business model to be developed. A classical conservative solution, one could imagine that a central authority - the cadastral institute itself - assigns (and if necessary, retracts) the permissions to write data to specific areas to specific agents. For example, depending on organisational and legal context, it could assign the right to transfer property in a given municipality to that municipality only - or reserve the right for finalising a transfer to a central authority. This system can arbitrarily be extended to include the taxpayers themselves.
- **Storing large amounts of data:** The fact that data is duplicated is one of the reasons that the blockchain is resilient. It also means that it is not the right medium to store large amounts of files. Photographs, scans of documents, etc. are not stored on the blockchain itself, but in a separate system. These documents can then be notarised on the blockchain via their 'hash' - a number that uniquely identifies the document.

The main features of the blockchain technology:

- **All Data is notarised.** Blockchain data is immutable and time-stamped with a unique verification code (called a hash). Thus, data cannot be changed. Amendments are marked with the time the change was made. This means that data cannot be tampered with. Corrupt officials cannot change the official records or make a property transaction disappear.
- **Accountability and access control.** Each time data is added a new block is added to the chain which is both time-stamped as well as digitally signed by the person (or software) initiating the transaction. These signatures cannot be faked. This mechanism provides verified access control, limiting which data can be changed by whom. The signature also provides mathematical proof of the origin of a transaction. What this means in practical terms is that all data in the database is marked with a mathematical proof of its origin. Together with the immutability and time-stamped properties, this effectively means that all data on the blockchain is notarised.
- **Data is distributed.** Blockchain also solves (or facilitates) the problem of public availability. The decentralised nature of the blockchain database means that there is no single point of failure: each 'full node' contains a complete copy of all the data that is constantly updated as new data is added, and as long as a single of such nodes exist, the service and the data will remain available. Blockchain technology is a suitable way of sharing - and editing - a database between different departments or branches of government - say between the cadastral service and the tax administration, or between the latter and the treasury (see EU (Ahmad, Brosio and Gerbrandy), *Property taxation Economic features, revenue potential and administrative issues in a development context*. Brussels, 2018 forthcoming, for use of blockchain for property tax administration).
- **Private information on the blockchain:** The blockchain itself is public, but that does not mean that all data written on the blockchain is publicly available. For example, while general cadastral data (location of the property, who owns it) is usually public, personal information that may be sensitive (such as payment of tax on time) may not be. By encrypting such data it is possible to save data on the blockchain that is readable only by selected parties - for example, a civil registry certificate may be visible only to (those who have access to the private key) the person who has demanded it and the agency. Similar confidentiality options would characterize access to patient data in a health care systems.
- **New institutional and organizational forms are possible,** or even new business models known as decentralized autonomous organizations. This could have implications for the design of tax administrations as well as budget and treasury systems, spatial planning agencies, and the like, revolutionizing the flow

of information across levels of governments. Municipalities could have their own copy of the blockchain for guaranteed and fast access, but so could, for example, banks or other private companies. All these copies of the data add to the resilience of the system: they make it faster to access and less likely that data will be lost.

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