

## **Public Financial Management Reform: Trends and Lessons Learned**

### **The Experience of Bosnia and Herzegovina**

#### **Public Administration Reform Strategy – a Framework Document for the Public Financial Management Reform**

The financial management reform in Bosnia and Herzegovina is being implemented within the framework of a more extensive public administration reform based on the Public Administration Reform Strategy from 2007 and its Action Plan 1.

Public Finance (PF) is an area that is closely linked to EU requirements, regarding the budget process, and the principles, standards and methods of public internal financial control (PIFC). In the pre-Strategy period, PF has been subject to various reforms, and the reports of the Audit Office of the Institutions of Bosnia and Herzegovina (SAI BIH) and the sub-national audit offices were a significant factor in determining needs for such reforms.

Strategy defined that, in order to promote a public administration that is open, efficient, effective and accountable, it would be necessary *to consolidate and further existing efforts in the PF sector; establish an efficient financial management system; and strengthen the control environment within which the administration operates.*

The expectations from the reform were multiple - to improve the policy aspect of public finance, to raise the efficiency and effectiveness of budget management; and to improve the accounting framework and the treasury system operations. Reform is expected to introduce PIFC in compliance with EU requirements; and to initiate specific activities to improve capacity in Ministries of Finance, and at the level of budget users and fiscal authorities.

The Strategy should be implemented in three stages, aiming to realize its short-term goals (by the end of 2007), medium-term goals (from the end of 2007 till the end of 2010) and the long term Strategy goals (from January 2011 till the end of 2014).

The public finance management system is defined by procedures through which resources are allocated and administered to secure fiscal discipline, observance of strategic priorities, and efficient use of funds. These procedures include the observance of fiscal discipline, by maintaining the expenditures within boundaries outlined by budget.

This process forces institution to set priorities and analyze policy options, to allocate resources in those areas that most greatly contribute to the accomplishment of government objectives (i.e., creating links between the annual budget process, mid-term expenditure framework, and national programs). It is also critical to enhancing the value of funds used for implementation of strategic priorities; by using funds efficiently (achieving relatively high results at relatively low costs), and effectively (achieving the expected results).

Public finance is an area of major EU expectations. There are no strict obligations for certain EU standards within a budgetary model. However, regarding management of funds from and to the EU budget, the *acquis* places indirect requirements on the formation of national budgets, especially in terms of Chapter 17 of the *acquis*, concerning economic and monetary policy, and Chapter 32 of the *acquis* related to the adoption of internationally-agreed and EU-compliant principles, standards and methods of public internal financial control (PIFC). As the EU provides funds for the development of its Members, it expects their use to be subject to adequate ex-ante, ongoing and ex-post controls or inspections; supported by independent internal audit, and central methodological co-ordination. A functioning and independent supreme audit institution of demonstrable impact is also required.

One of the major findings related to the public finances management reform, which actually yielded the idea of the necessity for this reform to be the part of a more comprehensive, public administration reform was that the domain of public finances was constantly undergoing changes, even in a pre-Strategy period. It is important to note that the external public sector audit was only introduced in BiH in 2000, when the first external financial audits took place. These audits provided a large number of findings and recommendations that were, among other things, used as basis for these reforms. However, in the beginning, these reforms were not approached in a strategic, comprehensive manner, but instead they were implemented randomly and ad hoc – based on the shortcomings within the system that were noted. In addition, audit recommendations and findings that were more 'systemic' in nature were, probably due to complexity of undertakings they required, put aside.

### **Improving the accounting framework and the treasury system operations**

The first major reform – the introduction of single account treasury systems – was initiated when the closure of the payment bureaus (PBs), necessitated a transfer of part of the PB's responsibilities (related to tracking revenues), to the Ministries of Finance. The reform reaped significant benefits for both national and sub-national levels of government. The Ministries of Finance were made responsible for all payments of the public administration; and this resulted in outright savings of public funds, and in an increasingly accountable and transparent public administration. The efficiency of the public administration has also increased, as the expenditure of public funds became more strongly tied to adopted budgets.

The Public Administration Strategy, in a part referring to public finances management foresaw the introduction change to a single (harmonized) accounting model, including the accounting codes and methodology. Considering that the implementation of the Strategy is ongoing, it is rather a thankless duty to comment its achievement and shortcomings, and it is not possible to provide an overall assessment in terms of the lessons learned. The treasury system was introduced at several levels of administration, which is a significant step forward; however, it still does not cover all the levels of administration. It is important to encompass all the levels of administration by this system, since it operates as a service to the whole public administration; it is integral to reaching the objectives of transparent and accountable public administration, and no public funds will be exempt.

The International Accounting Standards (IAS) have been adopted at the sub-national, but not at the level of national institution. This means that the different administration layers do not apply the same accounting model. It is necessary to adopt the IAS for public sector as well as to provide for the adoption of the high quality accounting policies at the level of BiH institutions, especially having in mind that the budget users are not allowed to create their own accounting policies, considering that they are operating within the single treasury account system.

### **Mid-term Expenditure Framework**

The second large reform effort is an ongoing reform of the budget process, and the introduction and expansion of mid-term expenditure frameworks (MTEF) – the framework budget documents. The lack of coordination between the government agencies and the Ministries of Finance during the drafting of legislation, often results in legal acts that cannot be implemented – due to shortage of funds. The budget calendars, though closer than previously, are still not entirely coordinated across different government levels, and their fully harmonization will require amendments of legislative acts, some of which have been passed only recently. The MTEF process needs constant updating and strengthening. The yearly budgets are still sometimes not being adopted in a timely manner, while the program-based budgeting and the recording of expenditures by program are still at a very elementary stage.

### **The Fiscal Council**

The third significant reform, recently begun in the public finance field, is the introduction of a policy coordination mechanism in BiH - the Fiscal Council (FC). The importance of a functioning fiscal coordination mechanism, in a country where the authority for fiscal policy is spread across different levels of government, is significant for BiH to entering into the EU accession process. The FC, established in 2005, is a coordinating body for fiscal policy issues. It was expected to assist in the goals of attaining macroeconomic stability and reaching development targets.

Its main tasks are the formulation of fiscal policy objectives and criteria for the determination of expenditure ceilings – multi-year or annually based. These include: deficit targets and limits to reduce fiscal imbalances; the setting of targets for the consolidated fiscal balance; and its apportionments among the levels of government in BiH – using total deficit/GDP ratio and other defined parameters – as debt ceilings for government levels, or total debt and new borrowing, as compared to the estimated revenue capacity.

The FC will be instrumental in maintaining fiscal discipline. The information necessary for informed decision-making by the members of the Fiscal Council includes two major analytical tools. The first is the macro-fiscal framework for BiH, and the second is the consolidated government account.

The Fiscal Council is in charge of the adoption of the Global Fiscal Balance and Policy Framework in BiH. However, in 2010, it did not adopt the aforementioned Framework, but instead, it made a conclusion that the baseline to be used in order to establish the overall public expenditure framework in 2011 should remain the same as it was in 2010. In that regard, the audit pointed out that it is necessary to strengthen fiscal coordination via improved operations of the Fiscal Council of BiH. Timely decision-making by the Fiscal Council and the adoption of the Global Fiscal Balance and Policy Framework at the beginning of the budget cycle should enable for the more efficient and effective mid-term planning and the progress in terms of the overall macro-fiscal management in BiH.

### **Budget management and budget preparation**

The Strategy foresaw that the budget management process should become a seamless process: with the Budget Framework Paper and the yearly budget linking all the expenditures to policy goals of the Government, through program-based budget classification models. All the Governments in BiH will be operating on a harmonized budget calendar, working at the same or similar timing through the MTEF, and budget drafting and adoption processes. The Budget Framework Paper should have a common macroeconomic and fiscal outlook for all government levels (as far as indirect taxation revenue projections are concerned); and a part particular to each level of government, which would reflect the development strategy goals through different sectors. The budget departments are supposed to coordinate the budget drafting process with the budget users through the coordination meetings; ensuring the policy priorities of each institution are reflected in the adopted budget. The adopted budget and the budget execution reports, should transparently reveal government expenditures, and include efficiency targets for results measurement.

Through its activities, the audit however established that the activities related to the development of plans of operations of the institutions of BiH and the relevant reports on operations as well as activities related to financial planning, budget drafting and financial reporting still operate as two separate processes and are not aligned neither in terms of time nor in terms of their essence. The goals are still not being defined in a clear and measurable way while the plans and programs of operations still contain no information with regard to funds planned for their implementation. The reports on operations still make no reference on the goals reached and the related costs. The financial reports contain only data on costs by expenditure types (economic categories), but do not include activities that were implemented based on costs made. Therefore the audit continues to recommend the continuation and intensification of the activities related to the improvement of the budget planning process as well as establishing of the program based budgeting fully aligned with budget users' activities and the reporting that is based on the activities and goals accomplished that would include relevant costs.

As we already mentioned, it is rather a thankless job to assess the reforms that are ongoing, therefore we would like to point out positive aspects of the activities related to program based

budgeting, procurement of an information system for program based budgeting. It will provide technical prerequisites for program based budgeting. It should, however, be accompanied by other activities (even legal solutions), training of personnel, alignment of the processes of budgeting and development of work plans (plans of operations).

Similarly, the ministries of finance at all government levels have undertaken a set of measures in order to improve the budget planning process. Activities related to program based budgeting were initiated. Program based budgeting is based on goals and results of the activities implemented by budget users. The improvement of the planning process was strengthened by recruitment of professional staff (analysts) and that created prerequisites for the analyses of users' requests within the planning process and for the budget execution monitoring. These analyses and evaluations are of much higher quality compared to the previous period, however, they still did not reach the level of quality required in terms the assessment of outputs and program efficiency. Budget planning is mainly based on data on the execution from the previous year, explanations made by budget users and the ceilings established within the Framework Budget Document.

### **Introduction of PIFC in full compliance with EU requirements**

Public Internal Financial Control (PIFC) systems, and their implementation, have become a main requirement for EU candidate countries (Chapter 32 negotiations). The introduction of a PIFC system is usually based on: adoption of policy papers; adoption of PIFC legislation; designation of a central harmonization and control body/unit (CHU) for PIFC; introduction of an internal audit service to the public sector; and the introduction of sound financial management and control systems – based on common standards and practice.

Within this framework, BiH – due to its particular constitutional structure – had to make additional efforts to ensure the introduction of a PIFC system that was to harmoniously function across different levels of Government. As a first element, policy papers on PIFC introduction were drafted by representatives of different governments in BiH, outlining the elements of the PIFC system, and the timelines for their introduction. This was accompanied by the introduction of CHU and the internal audit and controls and this should enable BiH to provide strict control over the efficiency and effectiveness of public administration and provide for the transparent use of public funds.

However, in its recent report, the audit still reported that the internal controls system, generally speaking, did not reach a satisfactory level, therefore concluding that the further improvements are necessary, such as: to strengthen public accountability in terms of budgetary funds, to establish a high quality reporting system on the results (performance) planned and achieved; to fully introduce the system of public internal financial controls based on three pillars (financial management and controls system – internal audit – central harmonization units). The internal controls system should be developed in a way that would enable the control of the purposeful use of public funds. The majority of institutions do not even have the internal audit functions defined within their rulebooks currently; therefore a

more active role of the internal audit can only be expected in the future. In addition, changes and amendments to relevant legislation in the area of financial management and control in the institutions of Bosnia and Herzegovina and more detailed descriptions of subjects and their duties and responsibilities in terms of establishment and functioning of the financial management and control were adopted only recently, and only at some of the administration levels. This is a significant step forward, however, a further continuation and intensifying of these activities is necessary in order to establish an efficient and effective internal controls system within the institutions of Bosnia and Herzegovina.

### **Concluding remarks – further steps to be taken**

Public procurement area is the area of great importance and the audit has been, for years, warning about irregularities and shortcomings in this area. This domain is considered critical in terms of public expenditures, since this is the area where the large portion of public expenditures takes place and since this area in itself is prone to corruption and misuse. The existing Public Administration Reform Strategy did not address this issue in any of its parts – including those related to public financial management. It is the opinion of audit that the reforms within the public finances domain should be accompanied by appropriate reforms within the area of public procurement, considering the relevance of this domain in an overall budget and its importance in terms of responsible and transparent use and management of public funds.