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Bosnia and Herzegovina: Letter of Intent, and Technical Memorandum of Understanding

Press Release:
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October 28, 2013

October 9, 2013

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Supplementary Letter of Intent

Sarajevo and Banja Luka, Bosnia and Herzegovina

October 9, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Lagarde:

1. The Stand-By Arrangement (SBA) for Bosnia and Herzegovina (BiH) approved in September 2012 by the Executive Board of the International Monetary Fund (IMF) continues to be a valuable anchor for our economic policies. We remain committed to implementing the policies described in our Letter of Intent dated September 11, 2012, as well as to the policies described in our supplementary Letters of Intent of December 6, 2012, April 23, 2013 and June 12, 2013. This supplementary Letter of Intent provides information on our efforts and achievements since the completion of the third review under the arrangement in June 2013, as well as on the additional policy measures we plan to undertake during the remainder of 2013 and first half of 2014 to help ensure that the objectives of the SBA will be met.

2. The modest recovery since early this year is taking hold, with industrial production and exports continuing to perform strongly. Thus, we expect that our economy will grow by close to 1 percent in 2013, slightly higher than envisaged earlier. Inflation continues to be well contained at around 1 percent, and is expected to remain low, reflecting still weak domestic demand. Thanks to improving export receipts and steady remittance inflows, international reserves continued to rise and reached a record high in September 2013.

Program Implementation

3. We continue to make steady progress in meeting our program objectives. All quantitative performance criteria for end-June 2013 on the budget balances of the Institutions of BiH and the central governments of the Federation and the Republika Srpska (RS) were met with comfortable

margins (Table 1). Tax revenues were somewhat lagging, reflecting weak collection of gross indirect tax revenues exacerbated by rising VAT refunds. Nevertheless, spending controls helped us to meet the fiscal targets. We can also report that the Institutions of BiH and the central governments of the Federation and the RS did not see an increase in domestic arrears in the period through end-June 2013. We also did not contract or guarantee any new non-concessional short-term external debt, nor did we accumulate any external payment arrears through end-September 2013. Similarly, the indicative target on net lending by the general government (excluding foreign financing) for end-June 2013 was met and the changes in the stock of other accounts payable for the general governments of the Federation and the RS remained well below their respective ceilings through end-June 2013.

4. The outlook for meeting our end 2013 budget balance targets, however, remains challenging, but we still expect that we will reduce the overall deficit for BiH to 2 percent of GDP this year. Achieving this will require us to urgently improve indirect tax collection and reach an understanding on the dividend distribution from our electricity distribution company TRANSCO, while maintaining strict expenditure control.

5. Less-than-expected indirect tax collection so far has made it especially challenging for the entity governments to meet the end-year budget targets. In light of this, and given that indirect tax collection is largely outside the entity governments' control, we request a modest modification of the end-year fiscal targets to achieve a reallocation of fiscal space between the Institutions of BiH and the entities. Specifically, we request that the end-December 2013 performance criteria on the floor on net lending (excluding foreign financed projects) be lowered by KM 5 million for the Federation and by KM 15 million for the RS—as the latter was also adversely affected by the adjustment of the revenue allocation coefficients—and that correspondingly the floor on net lending for the Institutions of BiH be raised by KM 20 million. Moreover, in the RS, government finances have not only been adversely affected by the overall shortfall in indirect tax revenue collection and the adjustment of the revenue allocation coefficients, but also by the absence of receipts from the planned disposal of non-financial assets. Therefore—and also to offset a public sector wage increase effective July 2013 that partially reversed the earlier wage cut—the RS government adopted a rebalanced budget in early October to ensure that the program target for the budget balance for end-2013—as modified above—can be met (a prior action for this review).

6. To anchor fiscal policies over the medium term, we have adopted the Global Fiscal Framework for 2014-16, which envisages a further gradual reduction in the consolidated general government deficit in the coming years. The budgets for 2014 are still at the early stage of preparation and will be further discussed with IMF staff in November. We are committed to

safeguarding the progress we made so far with fiscal consolidation and to continue our policy of strictly containing current spending in 2014. In line with this, we are proposing indicative targets for the budget balances of the Institutions of BiH and the central governments of the Federation and the RS for end-March 2014 and end-June 2014 as presented in Table 1.

7. Further progress has been made in advancing our structural reform agenda in the last few months:

- The new law on privileged pensions in the Federation was put into effect. Benefits for existing beneficiaries that were not receiving the minimum benefit have been reduced. Audits to verify the eligibility of these beneficiaries are continuing unhindered throughout the Federation and we have addressed temporary interruptions in some cantons. We will also amend the Law on Audits as needed to ensure that this process will continue. Instructions for the process of certification of new beneficiaries have been unified and tightened to minimize the risk of fraud, and sufficient administrative resources have been made available to ensure that the screening of new entrants will be completed within the prescribed deadlines.
- The new law on budgets for the Federation—developed with the assistance from the IMF—has benefitted from a consultative process with all stakeholders, including cantons and municipalities, as well as parliament, and is expected to be approved by end-November 2013 (a new proposed date for this end-September structural benchmark). This new law will significantly enhance fiscal policy coordination in the Federation, promote stricter fiscal discipline, strengthen the Federation central government’s oversight over lower levels of government, extra-budgetary funds, and public companies, and improve the timeliness and accuracy of fiscal reporting.
- The pension reform strategy for the Federation and an action plan, prepared with the assistance of the World Bank, have been adopted by the Federation government after consultation with the social partners. To achieve the overarching objective of ensuring the financial sustainability of the pension system, the strategy aims to increase the number of contributors and raise the effective retirement age, including by tightening early retirement criteria, raising early retirement decrement and late retirement bonuses. Parliamentary approval of the strategy and the action plan is expected by end-October 2013. The process of adapting the relevant legislation to implement the strategy is expected to be completed by early 2015.

- Amendments to the RS Banking Agency law have been adopted by parliament, bringing the treatment of confidential information in line with EU practices (a structural benchmark for end-June 2013). With the same process already completed in the Federation, this will help us to enhance our cooperation with foreign bank supervisors, including by the signing of Memoranda of Understanding with them.
- Amendments to the banking laws of both entities to limit the duration of provisional administration to one year with a possible six month extension have also been approved by respective parliaments (structural benchmarks for end-June 2013).
- In the RS, progress was made with creating a one-stop process for business registration, with the legislation and regulations that focus on a reduction of costs having been adopted and come into effect September 1, 2013, while those relating to the registration process itself will enter into force on December 1, 2013 (an end-September 2013 structural benchmark; see below).

Further Reforms

8. As noted, gross VAT collection has been lagging the pick-up in economic activity. This, together with growing VAT refunds and less-than-expected collection of excise taxes on cigarettes, is adversely affecting our budgets, forcing us to reduce spending within already tight budgets. Therefore, improving indirect tax collection is at the top of our agenda. Specifically, we will:

- Implement the recently approved Rulebook on the Organization of Work Posts of the ITA, which will enable the ITA to function more efficiently. In this context, we will mandate the ITA to shift more qualified staff to the large taxpayers unit and to the units focusing on the detection and prevention of VAT fraud.
- Strengthen the control of VAT refunds, notably by adopting a risk-based approach for the selection of refunds for audit, with the selection criteria focusing more on the claimant, including the claimant's compliance record, registration data (ownership and location), and business activity, as well as the claimant's data reported to other tax agencies.
- Enhance transparency by publishing a list of the 100 largest tax debtors to the ITA (a new structural benchmark for end-December 2013). To this effect, amendments to the Law on Indirect Taxation Procedure, which will explicitly provide the ITA with such authority, have been submitted to the BiH parliament, and are expected to be approved before end-December 2013.

- Closely monitor the accumulation of tax arrears and tax debt. The Governing Board of the ITA will mandate a comprehensive review of existing tax arrears, focusing on the largest debtors, and subsequently adopt an action plan for collecting and preventing tax arrears, with specific targets and timelines. As a first step, the ITA will aim to collect at least KM 30 million (about 10 percent of the end-July 2013 stock of VAT arrears) by the end of 2013. In addition, the ITA will publish monthly information on the stock of indirect tax arrears and the stock of rescheduled debts, starting in December 2013.
- Fully harmonize the excise rates on fine-cut tobacco products with those on cigarettes. The recently proposed rate increase in fine-cut tobacco products has not been enough to discourage smuggling and tax evasion. Excise rates on fine cut tobacco will be fully harmonized with those on cigarettes by end-December 2013, while rates will continue to be adjusted gradually in the coming years to achieve convergence with EU levels.
- Continue to adjust the indirect tax revenue allocation coefficients on a quarterly basis, and reach timely understandings on the settlement of any outstanding obligations.

To guide our efforts, we propose to set indicative targets on the gross collection of indirect tax revenues by the ITA, starting in the fourth quarter of 2013 (Table 1).

9. In addition, in the Federation we are pressing ahead with a modernization program of the FTA, with the assistance of the IMF, aiming at promoting voluntary compliance and implementation of a risk-based approach. The revised Rulebook on Tax Administration is expected to be adopted in November 2013 and equips the FTA with sufficient authority for its organizational design—including the establishment of a Large Taxpayer Office—and human resource management. We are committed to providing the necessary resources from the budget to support this important reform.

10. Moreover, the four tax agencies (ITA, FTA, RSTA, and BDTA) have signed a Memorandum of Understanding to facilitate the sharing of taxpayer information, and thus to also help improve enforcement and reduce VAT fraud. A working group for this purpose has been set up, and work is under way to coordinate the necessary legal and technical steps that need to be taken to allow the FTA, RSTA, BDTA, and ITA to have permanent, unfettered, and automated access to each other's taxpayer data, starting January 1, 2014.

11. The preparation of a new corporate income tax law for the Federation is at the final stage. The law is expected to be submitted to parliament by end-December 2013 following technical assistance from the IMF, also to ensure its consistency with other laws. We will continue to work with IMF staff to ensure that this new law will: (i) broaden the tax base while reducing deductions and tax

expenditures; (ii) ensure consistent treatment across different sectors; and (iii) clarify the tax treatment of loan loss provisioning by banks to encourage provisioning. The RS will also review its tax treatment of loan loss provisioning to achieve the same objective.

12. In the RS, the base for health and pension contributions was broadened in January 2013 but its implementation has fallen behind. We will complete the classification of individual agricultural workers by end 2013, and adopt the new rulebook, linking the payment of agricultural subsidies with recipients' registration with the health and pension funds.

13. We will continue to strengthen the public procurement framework in BiH by adopting a new procurement law that has been drafted with the assistance of the OECD and the EU. This law will be adopted by the BiH Council of Ministers and submitted to the BiH parliament soon. We expect parliamentary approval of the law, which will be fully in line with EU legislation, by end-December 2013.

14. Fiscal reporting is essential in formulating and coordinating fiscal policy and enforcing fiscal discipline. Despite steady progress, significant room for improvement remains. Thus, we will:

- Prepare or update the by-laws needed for the implementation of the new law on budgets in the Federation. We are committed to enforce the reporting deadlines and requirements as prescribed by the new law, and to apply penalty clauses as warranted.
- Start the full implementation of the instruction for budget users to enter commitment due dates into the Treasury system, effective January 1, 2014, in the Institutions of BiH, as well as the entities.
- Establish by end-October 2013 a common definition of arrears in the Institutions and both entities, with any amount that is not paid within 90 days after the due date considered to be in arrears.
- Continue to extend the coverage of our treasury systems. We expect the treasury system in the RS to cover the health sector by end-March 2014, which is expected to strengthen spending control and to facilitate audits. Also by end-March 2014, the treasury system in the Federation will be expanded to cover all extra-budgetary funds. In the Federation, efforts will also continue to integrate municipalities into the treasury system.
- Further strengthen the consolidation process, especially at the Federation and general government of BiH levels, by the Federation Ministry of Finance and the Fiscal Council,

respectively, with the aim to improve the quality and timeliness of consolidated reports, including by expanding coverage to capture public companies for roads and highways and projects financed from foreign loans and grants.

15. Our financial sector has weathered the challenges of the last several years well, although credit growth has remained subdued and the quality of banks' loan portfolios has continued to deteriorate. As part of our continuing efforts to strengthen our oversight of the banking system the members of the Standing Committee on Financial Stability, supported by IMF staff, are in the process of establishing detailed contingency plans describing the responsibilities of and the coordination between responsible institutions in the event of financial sector difficulties. We expect these plans to be completed by end-December 2013 (a structural benchmark). As part of this, we will adopt a more proactive approach in dealing with any problem banks, in order to limit potential costs to public finances and the economy while ensuring adequate safeguards to financial sector stability. In this context, we will require those banks that have been under intensified monitoring by the Banking Agencies in 2013 to hire reputable external auditors by end-2013 to conduct thorough asset quality reviews (a new structural benchmark for end-December 2013). The reviews would be expected to be completed in the first half of 2014.

16. Work has started to improve the resolution framework for non-performing loans, as well as the comprehensive review of our banking laws to bring the latter fully in line with EU legislation and the requirements of Basel II and to ensure consistency between the entities. The overhaul of the banking laws will also enable us to expand the tool-kit for dealing with problem banks and clarify the procedures for doing so. We will seek technical assistance to assist us with these undertakings with a view to submit draft legislation to the entity parliaments by mid-2014 (structural benchmarks for end-June 2014).

17. We remain committed to combat money laundering and terrorist financing, to help safeguard the integrity and stability of our financial markets. To this end, both entities and the Institutions of BiH have closely worked together to prepare a new Law on AML/CFT seeking compliance with FATF recommendations. We expect the BiH parliament to adopt this Law by end-December 2013. Furthermore, we will review and amend as necessary related legislation, as well as the BiH Criminal Code, to ensure full consistency with the new Law.

18. Job creation remains one of the greatest challenges facing BiH and outdated labor laws continue to hinder employment growth. In this context, we have started the process of drafting new labor laws, both in the Federation and in the RS, with a view to creating an environment more conducive to job creation while safeguarding workers' rights consistent with ILO labor standards and

EC labor directives. We have started extensive consultations with stakeholders, with a view to building a broad consensus and to improving the design of the new labor laws, including by strengthening the process for collective bargaining and increasing penalties for labor law violations. We aim to have the new labor laws adopted by the respective parliaments by end-December 2013 (structural benchmarks). This will also pave the way for eliminating the take-home pay protection in the RS (a structural benchmark for end-December 2013).

19. To facilitate job creation, we are also working closely with the World Bank to improve the business environment. In the RS, as noted above, all legislative changes needed for the establishment of a one-stop-shop for business registration (an end-September 2013 structural benchmark) have been adopted and the process of staffing and IT upgrades is almost completed. We will further simplify the process of business registration by enabling full functional implementation of online e-registration by end-June, 2014. This will enable a cheaper and faster process for starting a business, thereby reducing unemployment. Toward the same objectives, work is well advanced in the Federation on preparing new laws on companies, registration, and inspections, as well as the law on offense proceedings. We expect all these laws to be approved by the Federation parliament by end-December 2013.

20. We have continued to make progress in discussions on WTO accession. In particular, we will sign a bilateral agreement with the USA shortly. However, bilateral discussions with some WTO members are proving to be more challenging than expected and this is likely to delay our WTO accession. Following Croatia's accession to the EU on July 1, 2013, our trade with the country has become regulated by the Interim Agreement on Trade and Trade-related Issues with the EU. We are conducting discussions with the EU on additional protocols to the agreement to increase our export to the EU. At the same time, we are working to harmonize our standards and administrative procedures on agricultural products with EU requirements. To diversify our trade, we are also discussing with Serbia and Turkey possible cooperation on third markets.

Program Modalities

21. We believe that our economic program continues to be on course and that our policies set forth in our Letter of Intent of September 11, 2012, and supplemented by the policies described in the supplementary Letters of Intent of December 6, 2012, April 23, 2013, June 12, 2013, and this supplementary letter remain adequate to achieve the objectives of our program. We stand ready, however, to take any additional measures that may be needed to achieve the objectives of our economic program. We will consult with the IMF on the adoption of additional policy measures and in advance of any revision to the policies contained in our economic program, in accordance with

IMF policies on such consultation. We will continue to provide IMF staff with the necessary information for assessing progress in implementing our program and will maintain a close policy dialogue with IMF staff.

22. As the consideration of this fourth review was delayed, we request the Executive Board to approve waivers of applicability of the end-September 2013 performance criteria on the budget balances for the Institution of BiH, and for the central governments of the Federation of BiH and the RS, and on the accumulation of domestic arrears by the Institutions of BiH and the central governments of the Federation and the RS for which data are not yet available and for which there is no evidence that these were not observed. In addition, we request the modification of the end-December 2013 performance criteria on the budget balances for the Institutions of BiH and the central governments of the Federation and the RS as described in paragraph 5. We furthermore request the Executive Board to complete the fourth review under the SBA and approve the fifth purchase under the arrangement in the amount of SDR 42.275 million.

23. We authorize the IMF to publish this supplementary Letter of Intent and its attachments, as well as the related staff report on the IMF's website following consideration of our request by the IMF's Executive Board.

/s/

Vjekoslav Bevanda
Chairman
of the Council of Ministers
Bosnia and Herzegovina

/s/

Nermin Nikšić
Prime Minister
Federation of Bosnia
and Herzegovina

/s/

Željka Cvijanović
Prime Minister
Republika Srpska

/s/

Nikola Špirić
Minister of Finance
and Treasury of
Bosnia and Herzegovina

/s/

Ante Krajina
Minister of Finance
Federation of Bosnia
and Herzegovina

/s/

Zoran Tegeltija
Minister of Finance
Republika Srpska

/s/

Kemal Kozarić
Governor
Central Bank of Bosnia and Herzegovina

Table 1. Bosnia and Herzegovina: Quantitative Performance Criteria and Indicative Target Under the 2012–14 Stand-By Arrangement, 2013–14

(Cumulative flow since the end of the previous year; in millions of KM)

	2013						2014 3/	
	End-June		End-September		End-December		End-March	End-June
	EBS/12/161	Act	EBS/12/161	Act	EBS/12/161	Modified		
Performance Criteria								
Floor on the net lending of 1/								
Institutions of BiH	-15.0	51.9	-20.0	...	-25.0	-5.0	1.5	30.2
Federation central government	60.0	154.7	120.0	...	179.0	174.0	49.8	65.1
RS central government	10.0	83.3	30.0	...	120.0	105.0	32.1	80.5
Ceiling on contracting and guaranteeing of new nonconcessional short-term external debt by								
Institutions of BiH	0	0	0	0	0	0	0	0
Federation general government	0	0	0	0	0	0	0	0
RS general government	0	0	0	0	0	0	0	0
CBBH	0	0	0	0	0	0	0	0
Ceiling on accumulation of domestic arrears by								
Institutions of BiH	0	0	0	...	0	0	0	0
Federation central government	0	0	0	...	0	0	0	0
RS central government	0	0	0	...	0	0	0	0
Ceiling on accumulation external payment arrears by 2/								
Institutions of BiH	0	0	0	0	0	0	0	0
Federation general government	0	0	0	0	0	0	0	0
RS general government	0	0	0	0	0	0	0	0
CBBH	0	0	0	0	0	0	0	0
Indicative targets								
Floor on the net lending of the general government of BiH 1/	-24.6	58.4	-97.1	...	-17.1	-17.1	-8.8	56.4
Ceiling on changes in the stock of "other accounts payable"								
Federation general government	100.0	-94.7	100.0	...	100.0	100.0	100.0	100.0
RS general government	160.0	-32.2	160.0	...	160.0	160.0	100.0	100.0
Floor on the ITA gross revenue collection					...	6,056.0	1,395.0	2,957.0
1/ Excluding foreign financed projects as defined in TMU.								
2/ Continuous.								
3/ Indicative targets.								

Table 2. Bosnia and Herzegovina: Structural Conditionality		
Actions	Test date	Status
Prior action		
1 Adopt by the RS government a rebalanced budget to ensure that the modified program target for the budget balance for end-2013 can be met		Met
Existing structural benchmarks		
1 Continue to adhere to the Currency Board Arrangement as constituted under the law	Continuous	Met
2 Refrain from introducing new privileged or special rights for retirement	Continuous	Met
3 Publish on the web site of the Institutions of BiH quarterly consolidated general government accounts with a 6 week lag	Quarterly	Met with delay
4 Carry out eligibility audits for war benefit recipients; publish results (quarterly within 4 weeks after the end of each quarter) of audits (Entities)	Quarterly	Met with delay
5 Amend the banking law in the Federation to limit provisional administration to one year with a possible six month extension	End-June 2013	Met with delay
6 Amend the banking law in the RS to limit provisional administration to one year with a possible six month extension	End-June 2013	Met
7 Amend the legal frameworks related to the treatment of confidential information in the Federation and the RS to align them with EU requirements	End-June 2013	Met
8 Adopt a new law on budget in the Federation that improves data reporting and enhancing control over lower level governments, extra-budgetary funds, and public companies	End-September 2013	Not met; proposed to reset to end-November
9 Establish a one-stop shop process for business registration in RS	End-September 2013	Partially met
10 Amend legislation in the RS to eliminate the take-home pay protection for public sector employees	End-December 2013	
11 Adopt by the Federation parliament a new labor law with a view to facilitating job creation	End-December 2013	
12 Adopt by the RS parliament a new labor law with a view to facilitating job creation	End-December 2013	
13 Prepare the contingency plans for crisis preparedness and management in line with paragraph 10 of the supplementary Letter of Intent of June 12, 2013.	End-December 2013	
14 Submit legislation in line with IMF staff recommendations regulating the establishment and supervision of asset management companies to the Federation parliament	End-June 2014	
15 Submit legislation in line with IMF staff recommendations regulating the establishment and supervision of asset management companies to the RS parliament	End-June 2014	
16 Submit to the Federation parliament a new draft law on banks and other lending institutions in line with IMF staff recommendations	End-June 2014	
17 Submit to the RS parliament a new draft law on banks and other lending institutions in line with IMF staff recommendations	End-June 2014	
Newly proposed structural benchmarks		
1 Publish a list of the 100 largest tax debtors to the ITA	End-December 2013	
2 Hire reputable external auditors to conduct thorough asset quality reviews of the banks that have been under intensified monitoring by the Banking Agencies in 2013	End-December 2013	

Addendum to the Technical Memorandum of Understanding on Definitions and Reporting Under the 2012–2014 Stand-By Arrangement

1. The Technical Memorandum of Understanding (TMU) on Definitions and Reporting Under the 2012-14 Stand-By Arrangement dated September 11, 2012 and the Addendums to the TMU dated December 7, 2012 and April 23, 2013 shall remain in effect except for the amendments below:

2. A new Section G shall be introduced, reading:

“G. Floor on the collection of gross revenues by the Indirect Tax Authority (ITA) of Bosnia and Herzegovina (Indicative Target)

Definition

34. Gross revenues of the Indirect Tax Authority are defined as the sum of revenues collected from (i) value added tax; (ii) customs duties, customs registration fees and levies; (iii) excise duties on imported products; (iv) excise duties on domestic products; (v) levies (toll) on oil derivatives; (vi) other proceeds and fees; (vii) sales tax; and (viii) unclassified revenues. Gross revenue collection will be defined, for each test date, as the cumulative sum of gross revenues collected since the beginning of the current year.

Application of the performance criterion

35. The floor on the collection of gross revenues by the ITA will be measured quarterly on the basis of cumulative end-of-quarter data. Thus, if at the end of any given quarter the cumulative amount of gross revenues collected since the beginning of the current year falls below the corresponding floor, the indicative target will be missed.

36. **Reporting requirements:** Data on gross and net revenues will be transmitted on a monthly basis by the Indirect Tax Authority within two weeks of the end of each month.”

3. Paragraphs 34, 35, 36, and 37 shall be renumbered 37, 38, 39, and 40 respectively.