

# BOSNIA AND HERZEGOVINA



## SYSTEMATIC COUNTRY DIAGNOSTIC UPDATE



**BOSNIA AND HERZEGOVINA**  
**SYSTEMATIC**  
**COUNTRY**  
**DIAGNOSTIC**  
**UPDATE**

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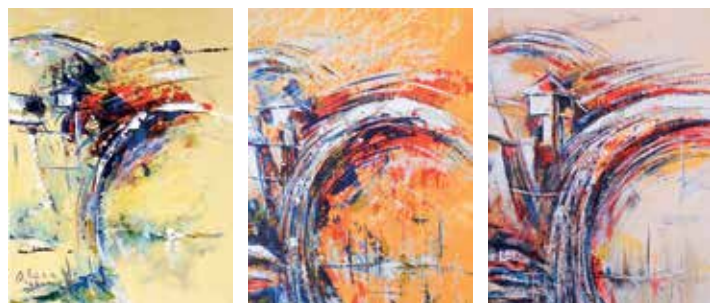
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## REBALANCING BOSNIA AND HERZEGOVINA: AN UPDATE

The Mostar Bridge, built by the Ottomans in the 16th century, is an iconic image of Bosnia and Herzegovina, its people, and their heritage. It spans the Neretva River to join the two sides of Mostar. It has been repaired or rebuilt many times over the years, but its distinctive identity is unchanged. It is time, now, to build and cross a new bridge to connect Bosnia and Herzegovina's past to its future; to bridge the differences that have divided people and separated them from the prosperity they can achieve.

Cover: Alica Jarikovic · Graphic design by: Kilka Diseño Gráfico

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## ACRONYMS

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<b>BHAS</b>	BiH Agency for Statistics	<b>PFM</b>	Public financial management
<b>BiH</b>	Bosnia and Herzegovina	<b>PISA</b>	Program for International Student Assessment
<b>EC</b>	European Commission	<b>PPP</b>	Purchasing Power Parity
<b>ECA</b>	Europe and Central Asia	<b>RS</b>	Republika Srpska
<b>EU</b>	European Union	<b>SCD</b>	Systematic Country Diagnostic
<b>FBiH</b>	Federation of Bosnia and Herzegovina	<b>SEE</b>	South East Europe
<b>FDI</b>	Foreign Direct investment	<b>SOE</b>	State-Owned Enterprise
<b>GDP</b>	Gross Domestic Product	<b>UNCTAD</b>	United Nations Conference on Trade and Development
<b>IEA</b>	International Energy Agency	<b>UN DESA</b>	United Nations Department of Economic and Social Affairs
<b>IFC</b>	International Finance Corporation	<b>WB</b>	World Bank
<b>IMF</b>	International Monetary Fund	<b>WDI</b>	World Development Indicators
<b>ICT</b>	Information and Communications Technology	<b>WGI</b>	World Governance Indicators
<b>KM</b>	Bosnian convertible mark	<b>WEO</b>	World Economic Outlook
<b>LFS</b>	Labor Force Survey	<b>WHO</b>	World Health Organization
<b>LITS</b>	Life in Transition Survey	<b>ZRS</b>	Republika Srpska Railways Company
<b>MSME</b>	Micro, Small, and Medium Enterprise		
<b>OECD</b>	Organization for Economic Cooperation and Development		



## BENCHMARKING COVERAGE AND COUNTRY ACRONYMS

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The analysis in this report relies heavily on comparisons with neighboring countries and subregions that are similar in size, transition, legacy, and reform requirements for continuing convergence and making progress toward European Union accession.

The regional aggregates and country acronyms used in this report are defined as follows:

- **Western Balkans (WB6):** Albania (ALB), Bosnia and Herzegovina (BiH), Kosovo (KOS), North Macedonia (MKD), Montenegro (MNE), Serbia (SRB).
- **Seven Small Transition Economies of Europe (STEE7):** Bulgaria (BGR), Croatia (HRV), Estonia (EST), Latvia (LVA), Lithuania (LTU), Slovak Republic (SVK), Slovenia (SVN).
- **European Union (EU28):** Austria (AUT), Belgium (BEL), Bulgaria (BGR), Croatia (HRV), Cyprus (CYP), Czech Republic (CZE), Denmark (DNK), Estonia (EST), Finland (FIN), France (FRA), Germany (DEU), Greece (GRC), Hungary (HUN), Ireland (IRL), Italy (ITA), Latvia (LVA), Lithuania (LTU), Luxembourg (LUX), Malta (MLT), Netherlands (NLD), Poland (POL), Portugal (PRT), Romania (ROU), Slovak Republic (SVK), Slovenia (SVN), Spain (ESP), Sweden (SWE), United Kingdom (GBR).



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# Executive Summary

**The citizens of Bosnia and Herzegovina (BiH) aspire to a future of rising living standards;** good jobs; better infrastructure and public services; a healthy, sustainable environment; and becoming members of the European Union (EU), but BiH is far from reaching these aspirations and faces the critical challenge of rapidly losing its population (arguably its most valuable resource). Every year, thousands of people emigrate seeking a better quality of life. The country cannot afford to continue losing its people, and creating the incentives for people to stay will require meeting their wish for a better quality of life for themselves and their families. This is achievable, but it requires decisive action by all stakeholders to address identified challenges.

**BiH's current development path will not create the opportunities that its population needs.** It has managed to maintain macroeconomic stability—posting fiscal surpluses and decreasing its debt levels—but this is not enough. Although economic growth has been stable in recent years at approximately 3 percent, it is too low to underpin a path to shared prosperity. Should BiH continue to grow at the same rate, it would take more than 100 years to reach living standards enjoyed in the EU. Moreover, even current growth cannot

be taken for granted, because it relies heavily on sources that are not sustainable in the long term (e.g., consumption and public sector spending). To secure the sustainability of growth, investment levels, currently at 18 percent of gross domestic product (GDP), need to increase, as does labor productivity, which is low and declining. BiH's integration with global markets is limited. Export levels, although slowly increasing, continue to be low for a small economy (38 percent), and two-thirds of exports are in low-value-added sectors. Foreign direct investment (FDI) is low and concentrated in energy sectors, with only 4 percent going to export sectors. Fiscal revenues, at 44 percent of GDP, are relatively high, but spending is not delivering quality public services and spending patterns (low public investment, high wage bill) undermine growth. Although other countries in the Western Balkans and Europe face similar development challenges and economic conditions, there is often a sense of deliberate policy effort to remove the obstacles to growth and prosperity in other countries. To a large extent, this is missing in BiH because of lack of substantive progress on much-needed reforms.

**Poverty remains a troubling prospect, with the conditions of the less well-off having de-**

**teriorated in recent years.** The poverty rate increased slightly from 14 percent in 2007 to 16 percent in 2015, and considerable effort is needed to reduce it. A decline in consumption in people in the bottom 40 percent of the income distribution is behind the recent increase in poverty; consumption for this group decreased 0.9 percent annually between 2011 and 2015. The poor are more concentrated in rural areas, working in the agricultural sector, which has among the lowest productivity of agricultural sectors in the region. Recent economic growth has not translated into more and better jobs, and unemployment is a major concern. Low labor force participation and high unemployment are in part the result of marked skill mismatches in the labor market, which is due to low-quality education that does not meet employers' needs. Several groups have limited access to economic opportunities, with long-term unemployment particularly high among young people and female labor force participation among the lowest in the region. Ending poverty and boosting shared prosperity will require more and better jobs and access to economic opportunities that can translate into higher incomes. Poor people have increasingly been receiving social assistance and pensions, which has prevented a greater increase in poverty, but the targeting of some social assistance programs is inaccurate, and coverage is low. Moreover, the social assistance system generates disincentives for formal employment. Improving the targeting, coverage, and design of these interventions could increase incentives to participate in the formal economy and increase their effects on poverty.

**Demographic trends have increased the urgency to act.** BiH is rapidly losing its most valuable asset—its human capital. One-third of the people from BiH live outside of the country, and thousands are leaving every year, in search of a better quality of life for their families—including

better jobs, better education and healthcare, better public services, and a cleaner environment. With young people and families leaving the country, the remaining population is rapidly aging, and very low birth rates mean that this trend is likely to continue.

**BiH has a highly fragmented institutional structure that is expensive and inefficient.** This complex institutional setup has important and costly consequences in terms of slow progress in the economic transformation of the country, slow progress toward EU accession, and an unfavorable environment for business. The public sector suffers from a combination of limited skills and excess staffing, which limits the efficiency of spending and the quality of basic services. Lack of well-functioning mechanisms for public-private dialogue decreases the already low trust in institutions. A deficient business environment and an unstable political setting constrain entrepreneurship, encourage informality, and deter domestic and foreign investment. In this context, substantive reform of public administration to enhance its responsiveness and accountability to BiH's population is critical.

**BiH's current development model is unsustainable over the long term, and its institutions require upgrading,** especially because it is exposed to a number of risks that could interrupt its pursuit of economic growth and shared prosperity. It is vulnerable to environmental shocks, including drought, floods, and earthquakes, and is vulnerable to the ongoing coronavirus pandemic, which poses the most serious social and economic challenge to the country since the global financial crisis. It is testing healthcare systems, and measures to contain its spread are resulting in an economic slowdown and threaten the economic security of many of its citizens, particularly those with low incomes. The expected economic slow-



down and the associated potential loss of jobs and earnings will increase poverty in the country. Although it is not clear what toll the pandemic will ultimately take, a strong, coordinated institutional response will be required to contain its spread and ensure that the social and economic upheaval that the outbreak causes is not long-lasting.

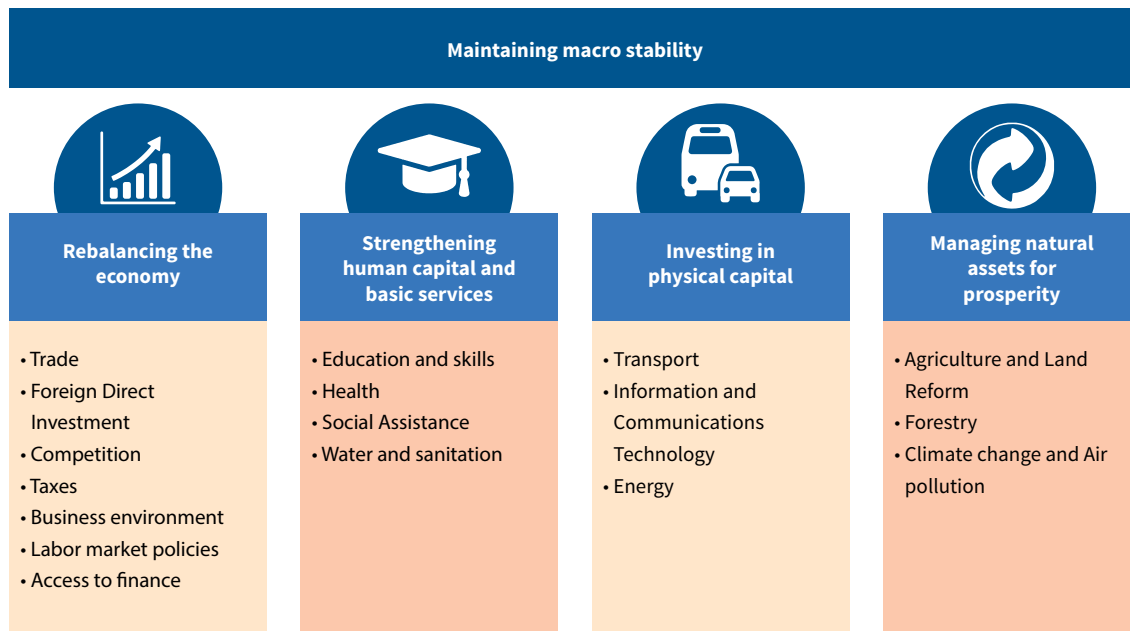
**The 2015 Systematic Country Diagnostic (SCD) identified the need to rebalance BiH's economy in three dimensions.** This update takes stock of progress and argues that, although some reforms have been initiated, progress has been well below expectations and that, to a large extent, the challenges identified in the 2015 SCD for BiH remain valid.

1. BiH must move from growth driven by public sector spending to growth led by private sector competitiveness and productivity. The public sector is too large (often crowding out the private sector) and often not efficient. Meanwhile, although some companies in BiH have demonstrated ability to compete in global arenas, the overall private sector is small and uncompetitive, often hampered by a difficult business environment, a small and shrinking labor force, and infrastructure deficiencies.
2. BiH must move from an economy based on consumption to one based on investment. Consumption has contributed to economic growth but has been largely fueled by remittances. Investment is essential to sustaining growth and increasing the potential of BiH's economy to create shared prosperity, more opportunities, and better jobs, but uncertainty, bureaucracy, and often unfair competition from state-owned enterprises (SOEs) has stifled investment.
3. BiH must move from an inward-looking economy to an export-driven one. Its economy and population are comparable in size with

those of a mid-size European city. Economies of scale and better jobs and opportunities will only come from exporting to larger markets, but BiH's economy is inward focused. Exports are low and of low added value, and most formal jobs are in sectors that do not compete internationally (e.g., public sector, SOEs, construction, retail, local transportation). Although these sectors have produced new jobs in recent years, those jobs are often poorly paid and provide limited opportunities to leverage the talent of BiH youth.

**To achieve higher, sustainable, equitable growth, interventions will be needed in four areas: (i) rebalancing growth, (ii) investments in physical capital, (iii) stronger human capital, and (iv) natural resources management (Figure ES1).** The challenges and opportunities identified to reduce poverty and achieve shared prosperity in the 2015 SCD (World Bank 2015) for BiH are similar to those identified in this update. The public sector and consumption continue to drive growth, and the country has seen only a slight shift in its orientation to the outside. The complex institutional structure prevents decisive action in implementation of needed reforms, and concerns about the effect of demographic trends on the country's development have increased. Efforts will be needed to achieve equitable growth. Poverty increased after the global financial crisis, and inequality remains unchanged. A large share of the labor force is active in the informal sector. Youth unemployment is high, and women have limited economic opportunities. BiH's energy sector depends heavily on coal, and that dependence is likely to increase, raising concerns about sustainability of growth. The previous SCD categorized priorities according to the likelihood that they would support the SCD objectives. In this update, to clarify what interventions are needed, priorities have been grouped according to the need

FIGURE ES.1: AREAS WHERE INTERVENTIONS ARE NEEDED TO ACHIEVE SUSTAINABLE, EQUITABLE GROWTH IN BOSNIA AND HERZEGOVINA



to rebalance growth and improve management of the country's assets to generate income (physical, human, natural capital): (i) rebalancing growth along the dimensions mentioned in the previous paragraph, with greater reliance on the private sector and exports, (ii) larger, more efficient investment in physical capital, (iii) improvements in human capital and basic services, including managing the additional challenges of ongoing demographic changes; and (iv) managing natural assets for prosperity, all discussed below. Underpinning these core objectives is the need to preserve macro stability, which is imperative to address the structural bottlenecks identified in this update. Maintaining a strong focus on macro stability will also be instrumental in navigating the rising uncertainties over the near to medium term.

**Rebalancing growth: pivoting to private investments and exports.** Some companies in BiH have been able to thrive in highly competitive in-

ternational arenas. BiH's professionals and trade workers are in demand in advanced economies, where they excel in a wide range of sectors, but at home, an unnecessarily cumbersome business environment characterized by costly, time-consuming administrative processes of numerous government agencies constrains companies. These constraints limit the competitiveness of firms, discourage entrepreneurs from entering the market, and encourage participation in the informal economy. Unleashing the potential of the private sector will require a change in the focus of authorities from regulating and controlling firms to encouraging their growth. A more competitive private sector will also create more and better private sector jobs, meeting the desires of citizens for better employment and creating incentives for people, particularly youth, to stay in BiH.

**Investing in physical capital.** Well-prioritized investments in enabling infrastructure will

be needed to increase connectivity and provide public services. Deficiencies in infrastructure for connectivity undermine the competitiveness of the economy. Energy production remains dependent on highly polluting coal, and the potential for cleaner, cost-effective renewable energy is not being tapped. Insufficient investment in facilities and their operations has limited the quality, coverage, and sustainability of public services. Deficiencies in digital connectivity limit the private sector and communities. The government collects extensive revenues through taxes, but not enough is put back into the economy. Strategic, well-prioritized use of existing resources would address many existing investment gaps.

**Strengthening human capital and basic services.** Improving healthcare and education is essential for supporting productive lives for people in BiH. Human capital is being lost even for those who stay in BiH, with close to 40 percent of the lifetime productivity of people in BiH lost because of deficiencies in healthcare and education. The quality of healthcare services is lower than in other countries that spend less. In education, deficiencies result in a large gap between skills and competencies in demand in the labor market and those taught at schools. Inefficient spending, including on large numbers of nonteaching staff at schools and administrative staff at hospitals, limits the quality of education and healthcare. Healthcare and educational reforms are possible by focusing on governance, quality of services, and relevance of programs. The COVID-19 pandemic is placing an already fragile healthcare sector under considerable additional strain, particularly in maintaining essential community services while responding to the surge of coronavirus-related cases and minimizing risks for patients and healthcare personnel. Widespread school closures in response to the pandemic will also lead to learning loss, posing long-term risks to human

capital accumulation. Disadvantaged and low-income students are particularly vulnerable, as they may have a harder time coping with remote learning strategies and are more likely to drop out at the secondary and tertiary education levels. School closings also increase the burden on parents who need to stay home or make childcare arrangements, decreasing the labor supply. Overcoming these challenges will require managed continuity of services, including through further digitalization of learning, support for teachers to deliver quality instruction, and greater flexibility in curricula and organization of instruction.

**Managing natural assets for prosperity.** By better leveraging its natural resources, BiH can help create opportunities for its population while enhancing environmental sustainability. BiH has valuable natural resources, from some of the most pristine forests in Europe to very fertile land. Forestry and agriculture have been major sources of employment and contributed substantially to the economy, but BiH's exports have been limited to low-value-added products, from raw timber to generic crops, and the jobs in these sectors frequently offer low wages and limited long-term prospects. Better leveraging of natural resources will require upgrading production processes, moving up value chains, and developing enabling infrastructure. Poor environmental management can have serious health and economic effects, which are most visible in very high levels of air pollution and their damage to health. Climate change is damaging BiH's economy and is predicted to affect the country significantly in the future, primarily through the agricultural, water, and hydropower sectors.

**The objective of this update of the 2015 SCD is to increase the World Bank's understanding of how to most effectively and sustainably reduce poverty and boost share prosperity in**






TABLE ES.1: SUMMARY OF REFORM PRIORITIES

<b>Rebalancing growth, pivoting to private investments and exports for growth</b>
<b>Putting BiH to work:</b> reforming the labor market, reducing the cost of labor, increasing social protection
<b>Making it easier to do business:</b> improving competitiveness, entrepreneurship, and the investment climate; maintaining financial stability and expanding access to finance
<b>Creating an efficient and effective public sector:</b> reducing the size of the public sector including state-owned enterprises, while ensuring fiscal sustainability and improving public service delivery
<b>Investing in physical capital</b>
<b>Investing in economic infrastructure for growth and inclusion:</b> powering and connecting BiH to the world
<b>Strengthening human capital and basic services</b>
<b>Boosting brains:</b> improving education services and labor market skills
<b>Supporting healthy lives:</b> improving healthcare services and sustainability of healthcare system
<b>Managing demographic change:</b> adapting to and mitigating effects of aging, shrinking population
<b>Managing natural assets for prosperity</b>
<b>Cleaning BiH:</b> reducing pollution and protecting the environment
<b>Better leveraging natural resources for growth:</b> agriculture and forestry
<b>Building resilience:</b> helping BiH cope with adverse natural events

**BiH.** SCDs focus on what is most important for a country's development agenda, discussing opportunities for and constraints on rapid, inclusive, sustainable growth and implementation of identified reforms and interventions (**Table ES.1**). SCDs also help foster candid dialogue between the World Bank Group and a country's authorities and inform the World Bank's programming exercise by identifying priorities for engagement. Progress in addressing the constraints and seizing the opportunities identified in the 2015 SCD has been limited. Accordingly, the development agenda (in terms of opportunities, constraints, and priorities) in this update remains largely the same as in the 2015 SCD, with four significant differences. First, demographic trends (an aging population and high outward migration) have created a greater sense of urgency to develop opportunities and improve quality of life (including better health-care and education) so that people can remain

in BiH and have productive lives. Second, risks to BiH's sustainable growth have evolved, with significant risks related to the COVID-19 pandemic having recently emerged. Third, environmental risks and their effects on lives and the economy have become more prominent, so this update analyses them separately from other vulnerabilities. Fourth, this update has taken renewed stock of knowledge and data gaps. One knowledge gap that has closed since the BiH SCD was released is related to SOEs and better education outcome data, where the analytical bases are improving. Recent analysis of SOEs has underpinned the renewed emphasis in the Update on the role of the public sector in the economy (See section I.C on the state of economic transformation), and improvements in data on education outcomes have allowed for more precise identification of challenges in the sector (See section III.C on strengthening human capital and basic services).



**This update develops earlier findings and priorities, reviews progress, and employs new data and analyses.** It is structured in four sections. Section I describes BiH's current situation, focusing on cross-cutting, foundational themes and distinct characteristics that could shape development outcomes. Section II describes current economic trends and key outcomes. Section III considers development constraints and how they can be overcome with respect to private sector-led growth, physical capital, human capital, and natural assets and their management. Section IV offers an updated set of priorities—developed in consultation with other stakeholders—to chart a path for strong, lasting, inclusive growth.



# I.

## Country Context: Where Is Bosnia and Herzegovina Today?

*Five years have passed since the first Systematic Country Diagnostic (SCD), and there has been limited progress in overcoming the identified obstacles to growth and shared prosperity. Fundamental obstacles that held Bosnia and Herzegovina (BiH) back then are still present: the country's unique institutional setup and resulting governance challenges, demographic decline, and the unfinished economic transformation. The obstacles are difficult, but they are surmountable if there is enough commitment to overcoming them. The European Union (EU) accession process could have been better leveraged as an anchor for comprehensive reforms.*

### A. Unwieldy Institutions and Inefficient Public Administration

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BiH's complex, fragmented institutional structure has reduced the quality of governance; the efficiency and accountability of the public sector; and the efficacy of policies.

#### **BiH has a cumbersome institutional structure.**

The constitution created a highly decentralized country with a Council of Ministers at the central level (often referred to as “the State” level). It delineated a governmental structure comprised of two Entities: the Federation of Bosnia and Herzegovina (FBiH) and Republika Srpska (RS). FBiH has 10 cantons each with its own government, and 79 municipalities, while RS has 63 municipalities. Fi-

nally, the constitutional architecture also includes the autonomous Brcko District. This structure is overlaid on a small country of only 3.2 million people—less than the population of many European cities. Such an unwieldy institutional structure would be as heavy a burden for any country.

**Despite the structural shortcomings, much of the system’s dysfunction can be traced directly or indirectly to a lack of political will.**

Highly complex systems of power-sharing can work if certain norms prevail, such as a common commitment to maintaining the system, a cooperative culture, etc. Goodwill and resolution could help to overcome the structural problems, but political agreement and cooperation have been difficult to broker. Decision-making is characterized by lengthy deliberative and legislative procedures fraught with bargaining and uncertainty. Some of the costliest consequences of this institutional structure have been insufficient progress in transforming the economy, slower progress toward European accession than its neighbors, and an unfavorable environment for businesses.

**The public administration is overstuffed, under resourced, and unaccountable.**

**Public administration suffers from inefficient spending, limited skills, and lack of accountability.**

Deficiencies in human resources stemming from hiring practices under which patronage can supersede professional qualifications and merit limit the effectiveness of public administration (**Figure 1**) (SIGMA 2017; EC 2019; BTI 2018). Deficiencies in performance management systems in public institutions—including professional goal setting, rewards, promotions, disciplinary measures, and training—undermine the responsiveness and accountability of public servants. Unclear reporting lines between ministries and other government institutions and duplication of functions dilute responsibilities and

limit accountability to citizens. Inefficient spending also restricts the effectiveness of the public sector. A high wage bill because of the oversized public sector and limited public spending limit the efficiency of spending and decrease citizen satisfaction with services (**Figure 2**) (See section II for a detailed discussion of how public finances have failed to contribute significantly to growth.) Lack of well-functioning, inclusive mechanisms for public-private dialogue means that many segments of society do not have a way to express their views, decreasing trust in institutions (Appendix A) (Balkan Barometer 2019).

**Deficiencies in the business environment impede the potential of the private sector.**

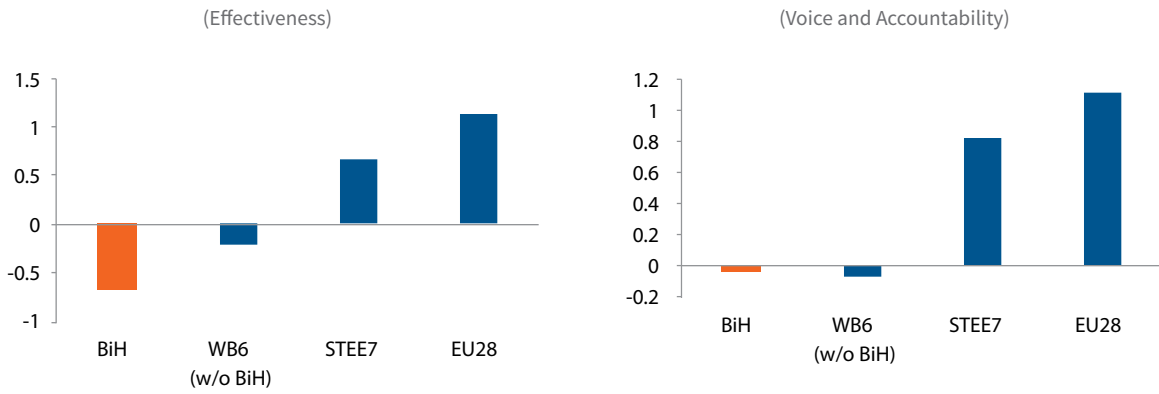
Creating a business environment conducive to growth is a critical responsibility of government. Many of the countries in the region have renewed efforts to improve the business environment, but authorities in BiH have failed to achieve significant results. BiH is one of the most difficult jurisdictions in Europe in which to do business because of unnecessarily cumbersome regulatory and administrative processes. This undermines entrepreneurship, encourages participation in the informal economy and corruption, and unnecessarily increases costs for the private sector. Deficiencies stem from a multiplicity of regulatory processes (e.g., the more than 700 licenses and permits that businesses may be required to acquire to operate) and lack of consistency in application of laws and regulations. There are only six countries in the world where it is more difficult to register a new business than in BiH (World Bank 2019a). (See section III.A on rebalancing growth for a detailed discussion of the business environment.)

**Digitalization of administrative processes can help improve relationships between government institutions, the business sector, and citizens.**

Many countries in the region have migrated face-to-face interactions between citizens



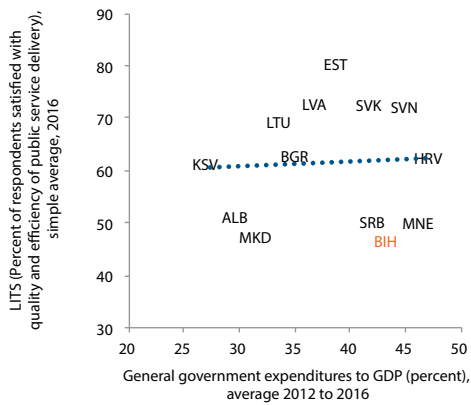
FIGURE 1. GOVERNMENT EFFECTIVENESS AND ACCOUNTABILITY LIES BELOW BENCHMARKS



Source: WGI 2019.

FIGURE 2: SATISFACTION WITH PUBLIC SERVICES IS LOW RELATIVE TO SPENDING LEVELS.

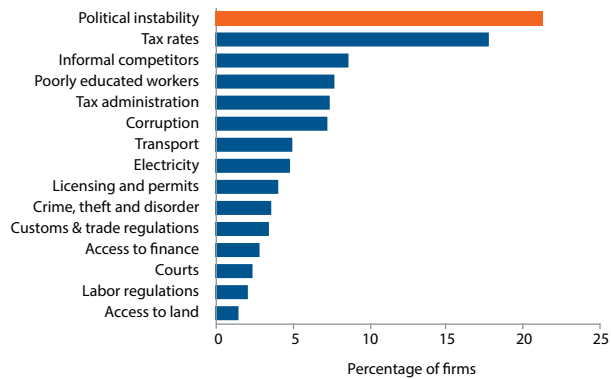
(Percent of respondents satisfied with quality and efficiency of public service delivery)



Source: EBRD LITS III, IMF WEO and WB staff estimates.

FIGURE 3: POLITICAL INSTABILITY IS THE MOST IMPORTANT CONSTRAINT TO INVEST IN BIH.

(Ranking of top business environment obstacles for firms)



Source: Enterprise Survey 2019.

and authorities to online platforms, which reduces time and money spent on administrative processes, eliminates duplication of steps, removes opportunities for rent-seeking, and expedites responses. In BiH, attempts have been made to digitalize by providing one-stop shopping for business registration, but progress has been much slower than expected.

**Political instability reduces domestic and foreign investment in the country.** Uncertainty associated with an unstable political environment can reduce investment and the pace of economic development. In BiH, firms have identified political instability as the most important constraint on investing in the country (**Figure 3**). Long delays in forming a government after elections in October 2018 slowed much-needed reforms. Political

squabbling creates a negative perception of the country, which undermines its attractiveness as a destination for foreign direct investment (FDI) because international investors seek political stability when deciding on investment destinations. (MIGA 2011).

**Deficiencies in public financial management undermine the effectiveness of public expenditures.** Public financial management (PFM) systems are important because they allow governments to translate policies into public goods and services. Weak PFM systems constrain governments' ability to provide good-quality public services. Such systems in BiH are inadequate, and laws are poorly implemented (EC 2019). Public finance and budget planning are weak, despite some improvements in the legislative framework. The public investment management system is poor, with limited links between budgets, investment plans, and strategies at all government levels. Procedural integration, data consolidation, and auditing are weak. There is no strategic framework for public administration reform and PFM for reform implementation, which could limit BiH's ability to benefit from EU support.

**Deficiencies in the judiciary limit access to justice to individuals and harm the business environment.** Judicial institutions are vital to the development of any country because they play a critical role in fostering a healthy business environment, enhancing growth, increasing access to public services (particularly for the poor), curbing corruption, restraining abuse of power, and protecting individuals' rights (World Bank 2017).

The complex institutional and procedural framework in BiH reduces the judiciary's efficiency and fairness.<sup>1</sup> As a consequence, trust in the independence of the judiciary is low and decreasing,<sup>2</sup> and deficiencies in the judiciary create significant costs for businesses.<sup>3</sup>

## B. Demographic Change

**BiH is rapidly losing its human capital, arguably its greatest asset.**

**Demographic trends are at the core of the development challenges for BiH,** which faces several demographic trends that pose a significant threat to its ability to grow. These trends include rapid outward migration, a rapidly aging population, a declining birth rate, and loss of human capital due to deficiencies in healthcare and education. By 2050, BiH's population is projected to drop by approximately 20 percent, from 3.2 million to about 2.7 million, with approximately 30 percent of citizens being of retirement age. Migration can also bring opportunities to BiH, in the form of remittances (8 percent of GDP) that can finance investment and a diaspora that can bring FDI, new skills, and knowledge. To be able to realize this opportunity, BiH needs a conducive business environment, but as discussed in the previous section, it has the worst business environment in the Western Balkans.

**Half of BiH's population has emigrated and it is likely that this trend will continue.** Its people are highly talented, entrepreneurial, and hard-

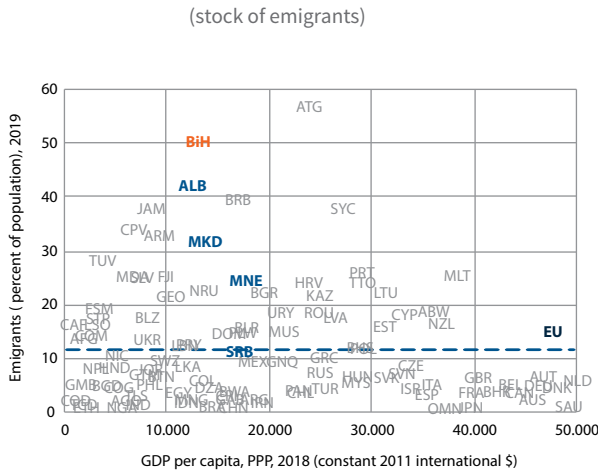
1 There are four sets of procedural rules in civil, criminal, and administrative matters for the courts and prosecutors' offices covering the state, FBiH and RS, and Brcko District. Elements of judicial power (High Judicial and Prosecutorial Council and state-level court system) are not explicitly mentioned in the constitution, and there is no supreme judicial body with countrywide jurisdiction. This results in inconsistent case law and legal interpretations across the four levels (EC 2019).

2 A World Economic Forum index assessed the independence of BiH's judiciary to be 2.2 (out of a maximum score of 7) and deteriorating.

3 It takes more than 900 days to settle claims through courts, at a cost of 36 percent of the claim value on average (World Bank 2019a).



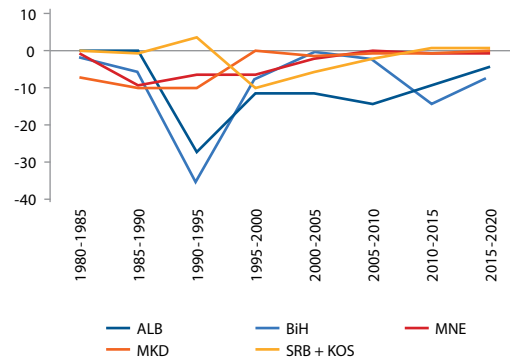
FIGURE 4: BIH AMONG THE HIGHEST POPULATION OF EMIGRANTS IN THE WORLD



Source: UN DESA 2019, WDI and WB staff calculations.

FIGURE 5: MANY HAVE LEFT BIH

(Net migration per 1,000 population)



Source: UN DESA 2019 and WB staff calculations.

working, and as such, they are the most important asset that the country has. Unfortunately, this potential is often realized outside of the country as half of the people from BiH already live overseas (Figure 4)<sup>4</sup> and the flow of migration continues (Figure 5). There is no simple solution to stemming the flow of emigration. As long as people in BiH feel that the country cannot offer them adequate opportunities and quality of life for their families, emigration will continue (See Box 1).

**Emigration is most prevalent among the young, working-age population.** BiH’s emigration is the highest in the region. Of those who left BiH in 2018, 30 percent were aged 18 to 35. The two ends of the educational spectrum—low and high—migrate in the largest numbers. The less educated often have construction, mechanical, or electrical skills, and they leave in such high numbers that shortages are emerging. Many more-educated people leave straight after university, but

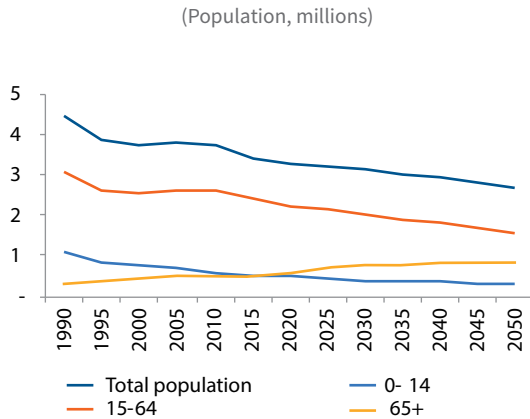
experienced professionals—especially medical professionals—also migrate. Most emigrants leave for Europe. In 2016 alone, 80,000 BiH citizens obtained permits to work in EU countries. Germany and Austria together host over 436,000 BiH citizens. BiH’s neighbors—Croatia, Serbia, and Slovenia—also host large expatriate populations.

**The population that remains in the country is rapidly aging.** Since 2015, BiH has had more people aged 65 and older than younger than 15 (Figure 6). This trend is projected to worsen as births continue to fall. The number of births per year has fallen by half since the end of the war, and the fertility rate<sup>5</sup> is 1.39, the lowest in the region and one of the world’s 10 lowest. High emigration rates of young people, who are most likely to have children, compound this low fertility. This has significant consequences for labor markets because fewer working-age people will have to support a higher burden of pensions (Figure 7).

4 An estimated 1.7 million people born in BiH live outside the country, equivalent to 48 percent of the remaining population (UN DESA 2017).

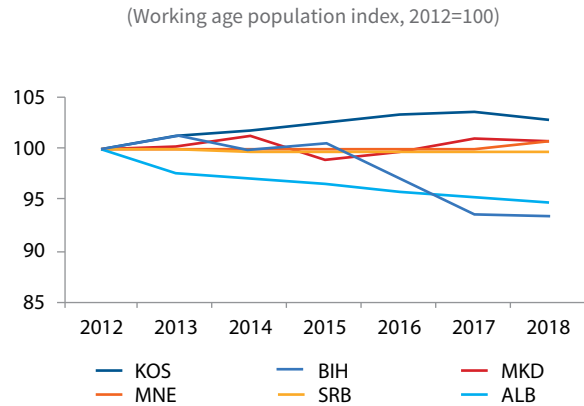
5 Children born or expected to be born to a woman during her lifetime. A rate of 2.1 is the replacement rate to maintain a stable population.

FIGURE 6: BIH'S POPULATION IS AGING AND SHRINKING



Source: UN DESA 2019 and WB staff calculations.

FIGURE 7: THE WORKING AGE POPULATION IS DECLINING



Source: LFS 2018 and WB staff estimates.

Similarly, this affects public spending (more on healthcare, less on education) and provision of public services (more lifelong learning and healthcare for older adults, less child healthcare and primary education). The rapid emigration could hollow BiH's labor force and, given that emigrants tend to be relatively highly skilled workers, may further reduce already low productivity.

## C. Stalled Reforms and Lack of Economic Transformation

Transformation is stalled and outcomes are unpredictable

**Unleashing the potential of BiH requires deep transformation in three main areas.** As discussed in the previous SCD for BiH, the economy is out of balance in three important ways: the public sector has an oversized role; consumption has driven growth, which has implications for sustainability; and the economy is not well integrated with regional or global markets. Three

important shifts are necessary to restore balance: moving from an economy led by the government to one led by the private sector, changing the focus of growth from an inward orientation to an outward orientation, and moving from economic growth based on consumption to growth based on investment. The need for this transformation is widely recognized, and there have been some attempts to move in that direction, but results of these efforts have fallen short.

**The first transformation needed: moving from government-led growth to a private sector-driven economy.** The public sector is a significant source of jobs in the country (~29 percent of all workers). Such a large public sector is a drag on the economy because it is costly and inefficient and shifts scarce resources away from more-productive uses. State-owned enterprises (SOEs) are large employers and dominate many segments of the economy, including economic activities in which government ownership does not seem to be justified (**Figure 8**). SOEs are highly inefficient, consume budgetary resources that could be better used in improving public services, have an aggre-



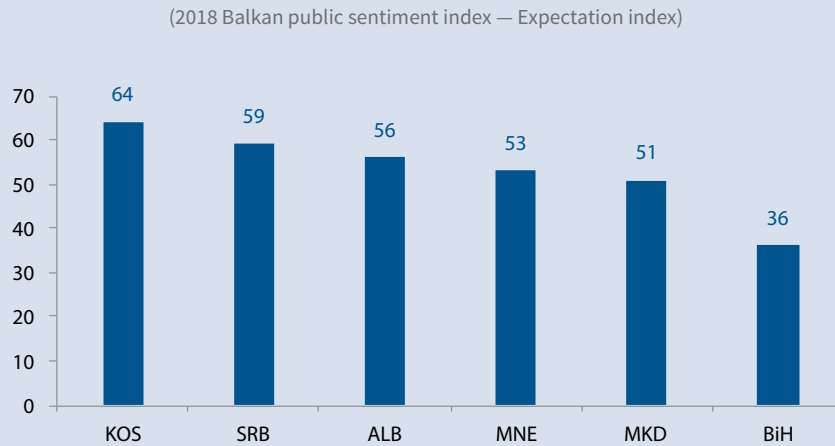
**BOX 1. FACTORS CONTRIBUTING TO EMIGRATION**

A 2018 Gallup poll found that 32 percent of BiH citizens were willing to emigrate and even more so for highly educated and young people, of whom more than half wanted to emigrate.

**The push factors.** Unemployment is the greatest concern of people in BiH (Balkan Barometer 2019), which has among the top 10 highest rates of youth unemployment (World Development Indicators). Other factors are at play as well, with citizens concerned about the overall economic situation, crime, and corruption (Balkan Barometer 2019). Not only unemployed people leave. Many people with comparatively well-paying jobs reportedly leave the country in search of better living conditions for their families, including better healthcare, education, and environmental conditions. Political instability, distrust of institutions, inequality, institutional corruption, and lack of a sense of direction for the country also play a role in people’s decisions to emigrate (Figure B1.1).<sup>6</sup>

**The pull factors.** Wages in many EU countries are more than three times higher than in in BiH (SEE Jobs Gateway and OECD). The migration of healthcare professionals to Germany illustrates the pull of economic opportunity and wage differentials. Recent estimates project that Germany will employ 500,000 new nurses by 2030, and one of every six doctors trained in BiH is working in Germany. This is a substantial drain on the state, which spends approximately €150,000 to train a doctor and is unable to recover this investment because migrating doctors do not pay taxes in BiH.

**FIGURE B1.1: OTHER FACTORS APART FROM UNEMPLOYMENT PLAY A ROLE IN THE DECISION TO EMIGRATE**



Source: Balkan Barometer 2019. Note: The index (range 0–100) is based on five perception questions and measures the current situation and future expectations regarding the general and economic situation and the individual situation of households.

6 Views expressed in consultations with private sector and civil society held during preparation of this report.



gate negative effect on the economy, and crowd out the private sector. BiH forgoes up to 3 percent of GDP in potential income every year because of inefficiencies in the SOE sector (IMF 2019a).

**The second transformation needed: from an economy driven by consumption to one driven by investment.** The share of consumption in BiH's GDP is one of the highest in the world. Consumption (public and private) is the main driver of growth (**Figure 9**)—so much so that growth is not sustainable. Conversely, investment levels remain low, at just above 18 percent of GDP (**Figure 10**).

Private investment is much lower (**Figure 11**) than in other countries in the region. FDI inflows have also been lower than in peers, but most importantly, much of the investment that has reached the country is concentrated in sectors that do not necessarily contribute to sustainable, shared growth or better jobs. Attracting and retaining investment will require eliminating the numerous hurdles in the business environment, reducing political instability, and leveraging the human capital remaining in the country better.

#### BOX 2. STATE-OWNED ENTERPRISES IN BOSNIA AND HERZEGOVINA

State-owned enterprises (SOEs) have a larger footprint in Bosnia and Herzegovina (BiH) than in any other Western Balkan and most European and Central Asian countries. There are at least 550 SOEs in BiH, in almost all sectors and markets, but they are dominant in energy, mining, telecommunications, transportation, and utilities. Most are small and medium-sized municipal utilities, but entity-owned SOEs have the largest operations and account for most SOE employment. SOEs account for approximately 11 percent of employment and own 40 percent of fixed assets. They distort labor markets because average salaries are 40 percent higher than in the private sector, despite low productivity—less than half of the EU level.

Addressing SOE sector governance is of paramount importance given the sector's growing financial troubles and negative effects on society and the economy. The poor performance of SOEs affects the government's ability to deliver on several of its key objectives and will continue to affect these objectives in the absence of reform:

**Fiscal sustainability:** Most public companies, at all levels of government, lose money, and their debts are currently at €4 billion (26 percent of GDP). It is estimated that arrears on tax and social security contributions of SOEs are more than €600 million. Almost half of the companies are illiquid, and up to 15 percent are insolvent. By conservative estimates, direct and indirect financial support for SOEs at all government levels costs 5 percent of GDP each year, creating enormous fiscal pressure.

**Productivity and growth:** SOEs, including those in commercial sectors, have low productivity (on average less than half of EU levels) and negative return on capital. The sector's negative return on equity reduces BiH's GDP by up to 3 percent and retards growth. This does not account for the additional loss in GDP due to crowding out of productive public investments as a result of continued financial support for struggling commercial SOEs.

**Private sector development and job creation:** Public companies' special access to financial and nonfinancial government support, despite their low return on equity and labor productivity, distorts markets and weakens the competitiveness and job creation potential of the private sector.



**Service delivery:** The quality of basic public services that SOEs provide is poor, especially at the local level, and their large tax and social contribution arrears (4 percent of GDP in 2018) undermine the sustainability of other public service providers, such as pension and healthcare funds. Citizen satisfaction with public services—many of which SOEs provide—is the lowest in the region.

**BiH needs a systematic approach to SOE management** that includes

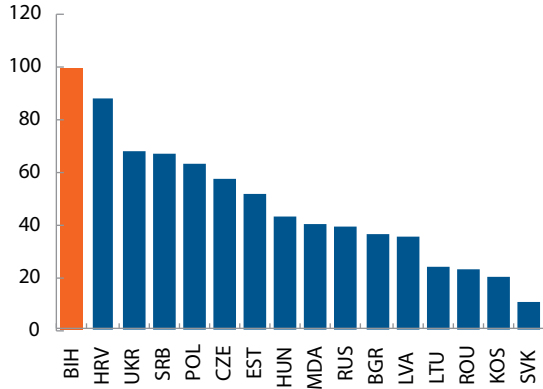
- **Defining goals and criteria for ownership of companies:** The rationale for public ownership of companies is not clearly defined. Similarly, they have no stated objectives or performance indicators, which significantly limits the potential to conduct oversight and assess performance.
- **Establishing fundamentals:** Institutional arrangements and regulations will need to be refined to provide clarity in ownership and oversight. Updating laws on concessions and public-private partnerships will enable private investment in some sectors. Governance of SOEs will need to be strengthened, including mechanisms for appointments of independent board members.
- **Instituting subsidies and hard budget constraint:** Hard budget constraints will be required to introduce incentives for efficiency and financial responsibility. Subsidies should be conditional on delivery of certain predefined public services in an open and transparent way. No longer tolerating SOE arrears will be critical as part of enhancing financial sustainability.
- **Developing policy options for SOEs with different profiles and sustainability:** Companies with different combinations of profitability and relevance will require different policy approaches. For example, as shown to the right, companies that are relevant and profitable can be strengthened through corporate governance reforms and performance contracts, and those that are relevant but not profitable can undergo comprehensive restructuring to strengthen their financial and operational discipline and performance.

	Profit-generating	Loss-making
Relevant	Strengthen	Restructure
Not Relevant	Open to competition	Phase out

Source: IMF 2019a.

FIGURE 8: THE SOE FOOTPRINT IS THE LARGEST AMONG ALL WESTERN BALKAN AND MOST ECA COUNTRIES

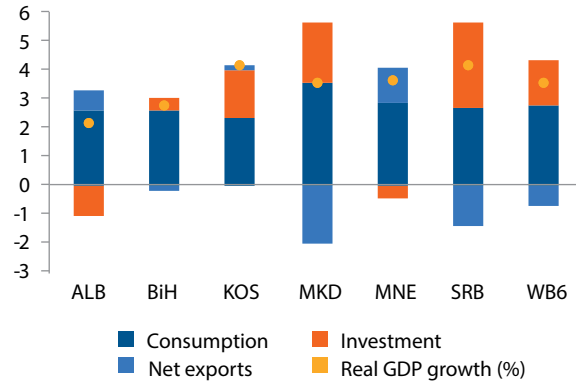
(SOE Assets, percent of GDP, 2016)



Source: IMF 2019.

FIGURE 9: CONSUMPTION IS THE MAIN DRIVER OF GROWTH

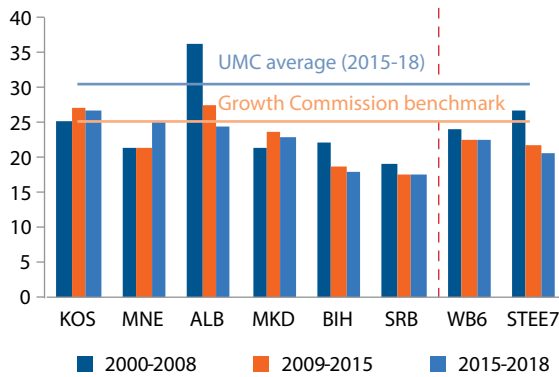
(Factors in Real GDP Growth, 2019e)



Source: National statistical office data; World Bank staff estimates

FIGURE 10: INVESTMENT HAS FAILED TO RECOVER AND LIES BELOW BENCHMARKS

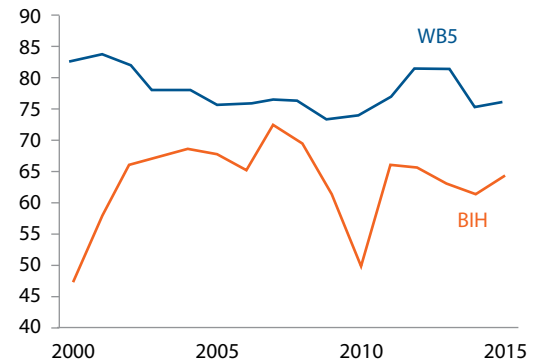
(Gross fixed capital formation, percent of GDP)



Source: WDI and WB staff estimates.

FIGURE 11: PRIVATE INVESTMENTS REMAIN BELOW TWO-THIRDS OF TOTAL INVESTMENT

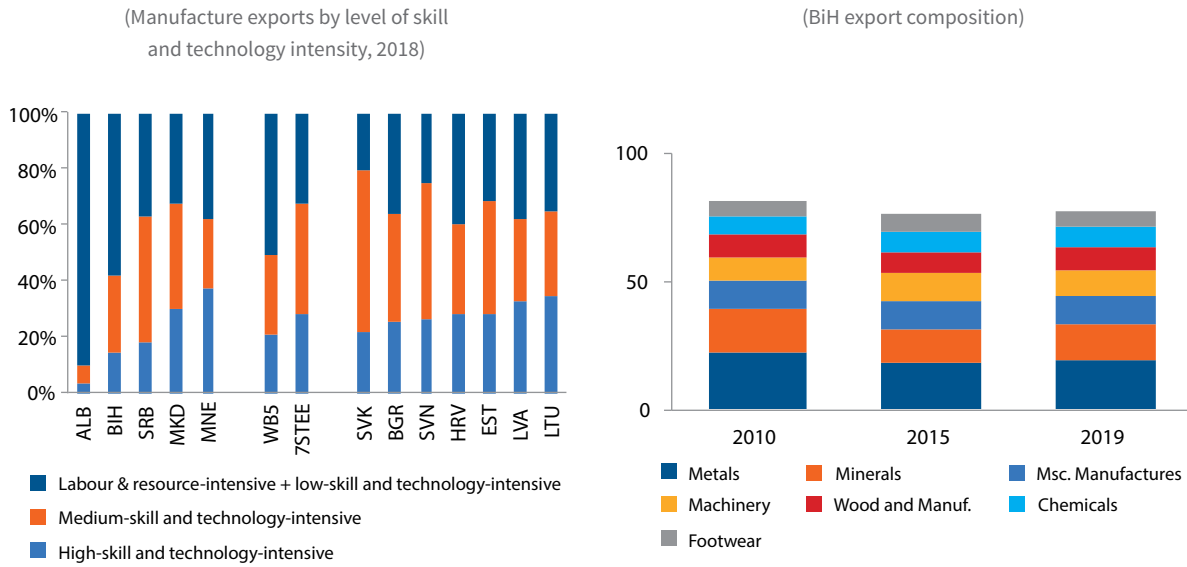
(Private Investment, share of total investment)



Source: WDI and WB staff estimates.



**FIGURE 12: UPGRADING TO HIGHER CONTENT OF HIGH TECHNOLOGY AND SKILL CONTENT IS ONLY STARTING**



Source: UNCTAD and WB staff calculations.

Source: BiH Central Bank.

**The third transformation needed: moving from an inward-oriented to an outward-oriented economy.** Although many countries in the region have striven to enhance exports and improve value addition, BiH still exports a high proportion of low-value-added products and raw materials (Figure 12). These trends are a stark reflection of the overall competitiveness of the private sector in BiH, and they matter because only through higher-value-added production can the country create the better jobs that the population desires and needs.

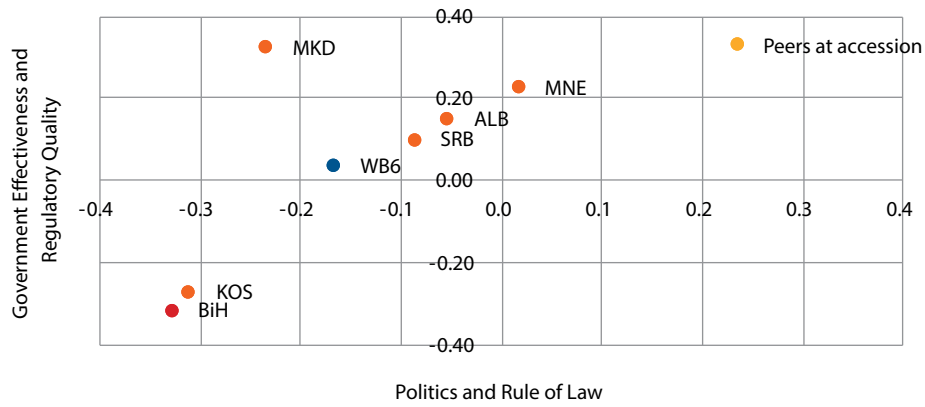
## D. EU Accession: A Long Road Ahead

The EU accession process could be a strong catalyst for reforms and institutional upgrading, but limited progress in implementing reforms affects EU accession prospects.

**BiH’s accession to the EU has lagged behind that of its neighbors.** BiH is looking towards an EU future and has taken important steps towards this aspiration, but progress is required in several areas to reach compliance with EU standards (Figure 13). In its opinion issued in May 2019, the European Commission (EC) argued that much work remains to be done, especially on guaranteeing democracy, the rule of law, and stability of institutions and reducing state presence in the economy, deemed “still disproportionate.” The predominant message is that BiH’s fragmented politics undermine consistent, nationwide policymaking. The EC rates BiH as “moderately prepared” on only two of the 35 chapters that must be completed before a country can accede to the EU. Despite the alleged broad commitment of BiH politicians, the political will to institute the wide-ranging reforms needed seems to be lacking. The EC laid out a detailed list of fundamental shortcomings and recommendations for reforms (Appendix B) and a

FIGURE 13: BIH HAS ONE OF THE LOWEST LEVELS OF PREPAREDNESS FOR ACCESSION IN THE REGION

(Preparedness for Accession: Government effectiveness and regulatory quality, and politics and rule of law)



Source: WGI 2017

diagnosis of what is constraining progress in BiH, and its recommendations are largely aligned with those of this report.

## II.

# Economic trends: Growth and Jobs, Public Finances, Poverty and Shared Prosperity

*BiH has maintained macro stability with relatively low inflation and reasonable levels of public debt, but its growth model is unsustainable, with high reliance on consumption. Economic growth is well below what is needed for BiH to achieve higher living standards. Despite some rebalancing in recent years, economic policies discourage private initiative and investment, and the economy is inward looking. Poverty reduction has stalled, and many people do not have formal employment—or any job at all. Unemployment has become an even higher concern to the population, creating incentives for people to leave in search of better opportunities elsewhere.*

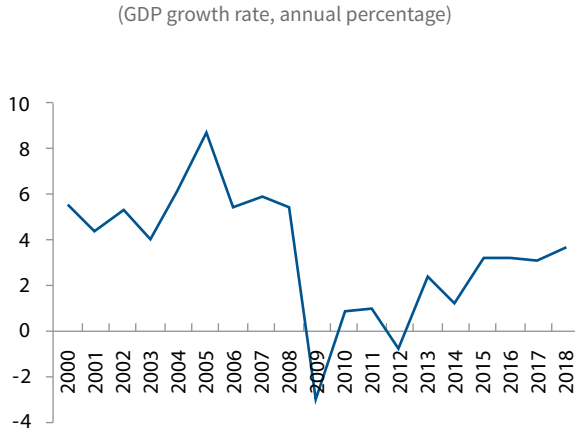
### A. Strong, sustainable economic growth is yet to be established

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**To maintain macroeconomic stability, BiH needs to continue to establish an economic**

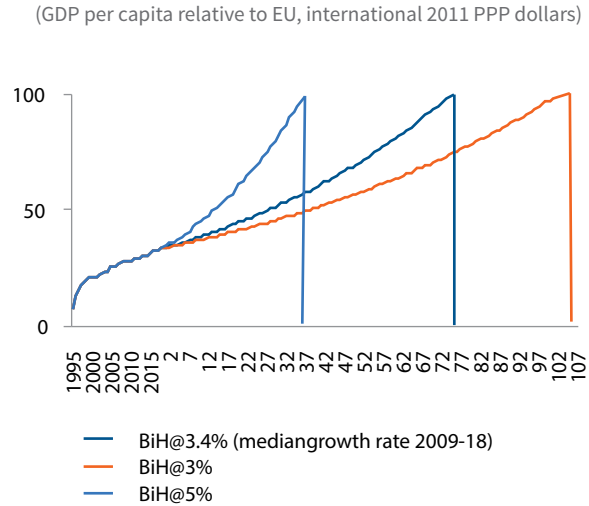
**policy mix conducive to growth.** Its currency board has provided a credible basis for monetary stability and low inflation, supported by prudent fiscal policies. General government debt has been kept at sustainable levels, and fiscal balances have been strong, but the overall size of the fiscal sector is large—especially compared with those of countries with similar per-capita incomes in other

FIGURE 14: GROWTH HAS STABILIZED BUT IT REMAINS BELOW PRE-CRISIS RATES



Source: WDI and WB staff estimates.

FIGURE 15: BIH HAS A LONG JOURNEY TO CATCH UP TO EU INCOME LEVELS.



Source: WDI and WB staff estimates.

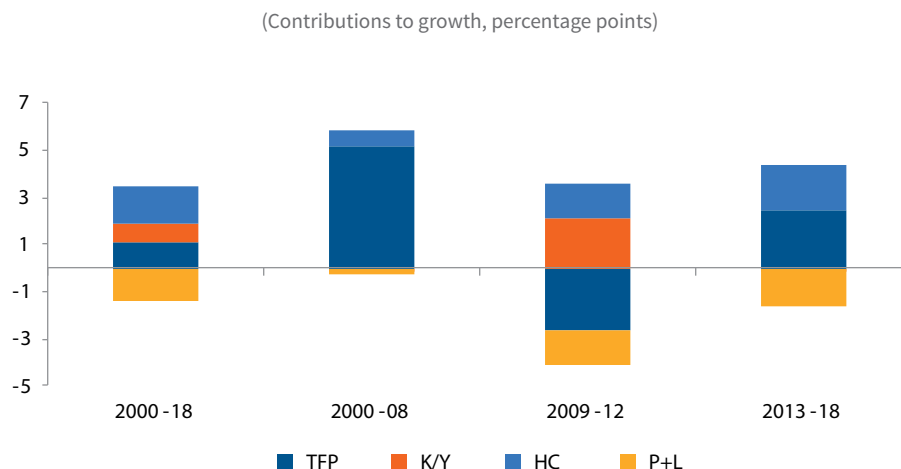
parts of the world—and fiscal risks are high. There is ample scope to improve the quality and effectiveness of spending while lowering the level of expenditure to GDP. High taxes have constrained growth by reducing private sector incentives and the level of formality in the economy.

**BiH's economy has been growing but not at a rapid enough pace to create the living standards that the population desires.** Real GDP has risen more than 3 percent annually since 2015—lower than the pre global financial crisis rate of 5.6 percent (**Figure 14**). This is especially troubling because BiH started from a low base after the disintegration of Yugoslavia, and output declined an estimated 80 percent between 1989 and 1995 because of the war. BiH per capita GDP is one-third of the EU average. Although the economy has been growing in recent years, at its current pace it would take more than 100 years for BiH to achieve the EU's average income level

(**Figure 15**). If growth accelerates and is sustained at approximately 5 percent (as before the global financial crisis), convergence with the EU income level could be achieved in three decades.

**Consumption has driven growth, and low investment and exports have constrained it.** The contribution of consumption to growth started to fall in 2017 as a result of reduced household and government consumption. The investment rate fell from 22 percent of GDP during the precrisis years to just above 18 percent after the crisis. Investment rates fell similarly in other countries in the region but have recovered since, not so in BiH. The composition of investment in BiH also seems to be tilted toward the public sector. In 2015, the private share of total investments in BiH was more than 10 percentage points below that of its peers. The share of exports in GDP has increased from approximately 30 percent during the slump to 37 percent on average from 2013 to 2018.

FIGURE 16: LOW INVESTMENT AND LABOR FORCE PARTICIPATION ARE CONSTRAINING GROWTH



Source: WDI and WB staff estimates.

Note: TFP, K/Y, HC and P+L represent contributions of total factor productivity growth, capital deepening, human capital growth and the joint effect of changes in population and labor force participation respectively.

**Higher investment, greater productivity, and greater labor force participation will be needed to accelerate growth.** Human capital has added an average 1.6 percentage points to growth since 2000 (Figure 16). Total factor productivity has contributed 1.1 percentage points annually, with the weakest effect from capital deepening. Limited labor force participation has constrained growth. To accelerate growth, greater productivity, improvement in labor markets (to enable a larger share of the population to be economically active), and higher investment would be needed.<sup>7</sup> Section III.A discusses how trade, FDI, an improved business environment, and innovation can help increase productivity, and section III.B discusses the need to improve the quality of infrastructure investments.

## B. Public finances have not contributed enough to promoting sustainable growth and equity.

**BiH has among the highest revenues as a share of GDP in the world.** The government collects revenues at a much higher rate (44 percent of GDP) than the averages of 35 percent in WB6 and 39 percent in STEE7 (Figure 17). This has contributed to positive fiscal indicators (sustainable fiscal balances, declining general government debt), but it is probably coming at the cost of stifling the economy. Recent estimates indicate that government revenues are higher than the country's economic potential (Khwaja and Iyer 2013), in other

<sup>7</sup> Reaching 5 percent annual growth would require an increase in total factor productivity of 3 percent (versus 2 percent in 2019) and that the investment rate reach 25 percent in the next 10 years. Labor markets could improve through expansion of participation in the labor force, especially for women.

FIGURE 17: BIH HAS ONE OF THE HIGHEST REVENUE SHARES IN THE WORLD

(Revenue as percentage of GDP)

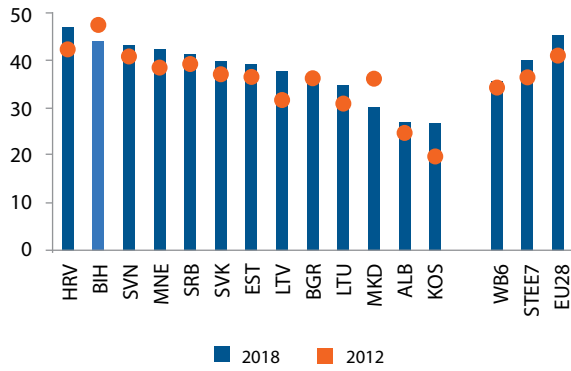


TABLE 1: SOCIAL SECURITY CONTRIBUTION RATES ARE PARTICULARLY HIGH IN BIH

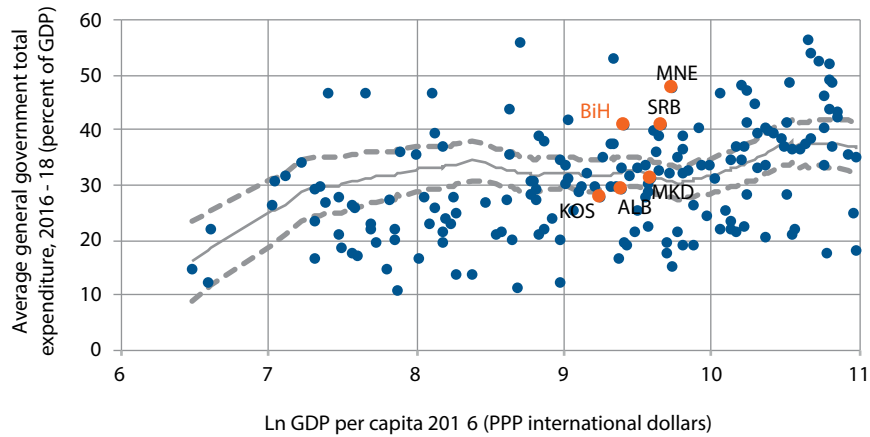
	VAT Threshold (euro)	Current standard rate	Top corporate income tax rate	Top individual income tax rate	Social security contributions total rate
ALB	35,672	20	15	23	27.9
BIH - FBiH	25,524	17	10	10	<b>41.5</b>
BIH - RS	25,524	17	10	10	33.0
KSV	30,000	18	10	10	10.0
MKD	32,462	18	10	18	27.0
MNE	18,000	21	9	11	33.8
SRB	68,099	20	15	15	37.8
WB6 average	34,960	19	11.5	14.5	29.7
STEE7 average		21.3	17.1	26.14	37
EU28 average		21.5	21.5	38.4	36.7

Source: World Development Indicators and WB staff estimates.

Source: National authorities' data, Eurostat and WB staff estimates.

FIGURE 18: GOVERNMENT SPENDING TO GDP IS ABOVE NORMS BY INCOME LEVEL

(Expenditures as percentage of GDP, average 2016-2018)



Source: IMF WEO data and WB staff estimates.





words, that high taxes are likely reducing growth. Similarly, labor taxes are high, stifling entrepreneurship, reducing employment, and forcing many into the informal sector.

**Despite the high revenue collection public investment is low.** BiH is not allocating enough resources to finance the capital investments that the country requires. Deficiencies in connectivity within the country and with neighboring countries and the EU hamper the country's competitiveness. Similarly, there are other areas where public investment is needed, including energy, as discussed in section III.B. Execution of public investment is poor, partly because high current spending (wages, pensions, transfers) crowds out public investment.

**A high proportion of taxes is used to cover government salaries.** BiH's public sector is large in relation to its income level (**Figure 18**), which means that a high proportion of the taxes and revenues collected is used to cover salaries of public servants. The public sector, with its multiple layers, has an estimated 233,000 employees, and public sector wages account for 10.3 percent of GDP, compared with 8.9 percent in healthcare and 4.6 percent in education.

**Money spent on public services has not improved their quality.** Although significant resources are devoted to public services, more than in most other countries in Europe, the quality of services provided is poor, with a high degree of dissatisfaction from citizens (see **Figure 2**). Many countries are achieving similar satisfaction levels with lower spending levels. North Macedonia and Albania, for example, are achieving a level of satisfaction in services delivery similar to that of BiH while spending much less than BiH. The absence of central standards, poor interinstitutional coordination resulting from unclear institutional man-

dates and duplication of functions, and lack of a cohesive legal framework to serve as a consistent basis from which to provide services has harmed the quality of public utilities (See section III.C on strengthening human capital and basic services).

**Spending on social security is high and inefficient.** Pensions account for most social spending, and there are three main shortcomings. First, efficiency: in BiH, pensions account for 10 percent of GDP, on par with the EU average (10.3 percent in 2016) but higher than in most former transition countries. High pension spending is largely the result of early retirements and large numbers of people receiving disability or special pensions.<sup>8</sup> Second, fairness: although one-third of all pensioners in BiH are younger than 65 (because of early retirement and special pensions), approximately 38 percent of elderly adults may not be collecting any state pension at all. Third, sustainability: each contributor supports more than 1.13 pensioners. This is one of the highest burdens per contributor in Europe. Low formal labor market participation (itself exacerbated by high social contributions) is partly responsible

**Large arrears and SOEs create risks and undermine fiscal sustainability.** Although overall government debt has decreased (from 43.6 percent of GDP in 2015 to 35.6 percent in 2018), significant fiscal risks arise from unmeasured off-budget liabilities and arrears and large liabilities of SOEs. The arrears in RS are mainly in the healthcare sector—approximately 1.5 percent of BiH GDP—whereas arrears in FBiH, mostly in cantons, are approximately 2.5 percent of BiH GDP, mainly in unpaid pension and healthcare contributions in SOEs. SOE liabilities are estimated to be 26 percent of GDP (IMF 2019a) Many SOEs are highly leveraged, and they will not be able to reduce debt without government support or bet-

8 Special pensions are provided to war veterans and survivors.

ter performance. Some with low liquidity rely on short-run government support—implicit or explicit. Their high employment levels are adding to arrears, including to the social welfare system, and these will make privatization or restructuring difficult. Without strong corrective action, these growing fiscal risks threaten to undermine the public sector's viability.

### Jobs are critical for people in BiH<sup>9</sup>

#### **Jobs are the main concern of the population in BiH, and growth has not translated into more or better jobs.**

Unemployment is the most important problem for approximately 60 percent of the population of BiH (**Figure 19**). An equally high proportion of the population expects that their economic condition will deteriorate in the future (Balkan Barometer 2019), a perspective that probably contributes to decisions to emigrate in search of better opportunities elsewhere. Although the overall unemployment rate has decreased in BiH in recent years, this is not due to job creation but to a decrease in the working-age population because many have left the country. Consequently, BiH is the only country in the region where employment is still below pre-global financial crisis levels.

#### **Although the labor force in BiH is shrinking because of demographic trends, much of the remaining labor remains underused.**

Many formal jobs have been created in industries with very low added value (restaurants, cafes, shops) and in micro enterprises, which have lower productivity and typically offer lower salaries and poorer career prospects than larger firms (See section III.A.).

**A large share of the working population works in the informal sector.** The percentage of people in informal jobs has remained constant—approximately 25 percent. Informal workers have

no pension, work-related rights, or health insurance, and the jobs are mostly in agriculture or forestry and concentrated among people with primary education or less. Informality distorts the economy by creating a competitive disadvantage for formal firms and undermines growth because the informal sector has lower investment and lower productivity. High informality also means that a few formal workers have to support the rest of the population, which requires higher social security contributions, which further discourages formal employment.

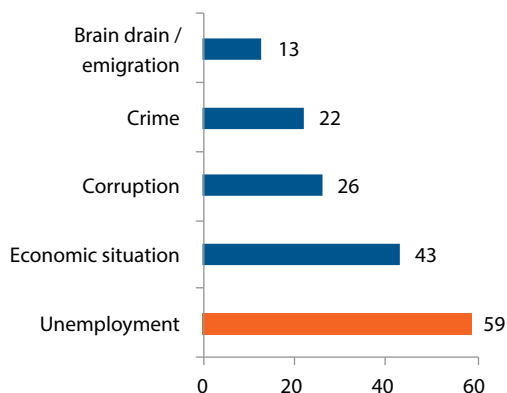
#### **The public sector and SOEs may be crowding out private firms from a limited talent pool.**

It is estimated that the public sector and SOEs account for approximately one-third of employment in BiH—approximately 10 percentage points higher than in the EU. Public sector jobs are highly sought after because they typically offer fewer hours, better pay, and more job security than private sector ones, but they probably contribute much less to the economic growth of the country. In 2019, four out of five people preferred to work in the public sector, a higher proportion than in the rest of the Western Balkans (Balkan Barometer 2019). The desire for public sector jobs deprives the private sector of talent and skills that are in high demand and underpin entrepreneurial activities and growth prospects for firms. Moreover, the interest in public sector jobs can cause long-lasting damage as students place more emphasis on seeking connections than on academic attainment or economic relevance of studies (**Figure 20**). As mentioned in the previous section, high public wages also decrease the efficiency of public spending and ultimately its sustainability. In the long term, overreliance on public sector employment is fiscally unsustainable.

9 Unless otherwise stated, labor market statistics reported are based on the 2018 Labor Force Survey (LFS).

FIGURE 19: UNEMPLOYMENT IS THE MAIN CONCERN IN BIH

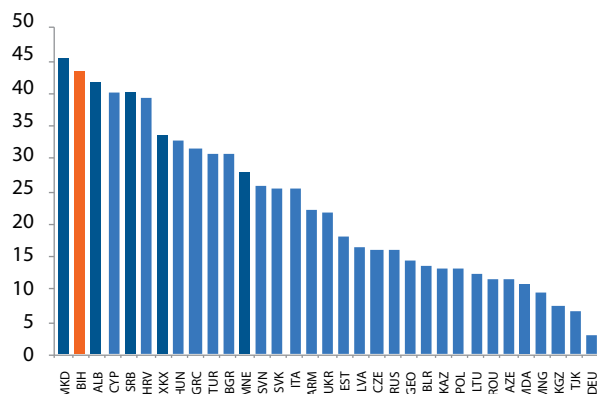
(Top five concerns of people in BiH)



Source: Balkan Barometer 2019.

FIGURE 20: POLITICAL CONNECTIONS ARE DEEMED THE MOST IMPORTANT FACTOR FOR SUCCESS

(Percentage of individuals who think that political connections are the most important factor for success)



Source: Life in Transition Survey (LITS) III.

**There are significant inefficiencies in the social protection system (social assistance, unemployment benefits, maternity benefits, health insurance) that discourage formal employment** (World Bank 2018; 2019f). The social assistance system generates disincentives for formality through its linked delivery of health insurance and unemployment benefits. The vast majority of those who are employed in the informal sector are registered as unemployed so that they have health insurance. Moreover, BiH citizens who can work but are poor are not eligible for social assistance transfers, which creates disincentives for labor market participation. Finally, war veterans’ benefits are generous and not targeted to the less well-off, which decreases incentives for employment.

**A high proportion of people are not actively employed, leading to an enormous loss of productivity.** BiH has one of the lowest levels of participation of people in the labor force; for every

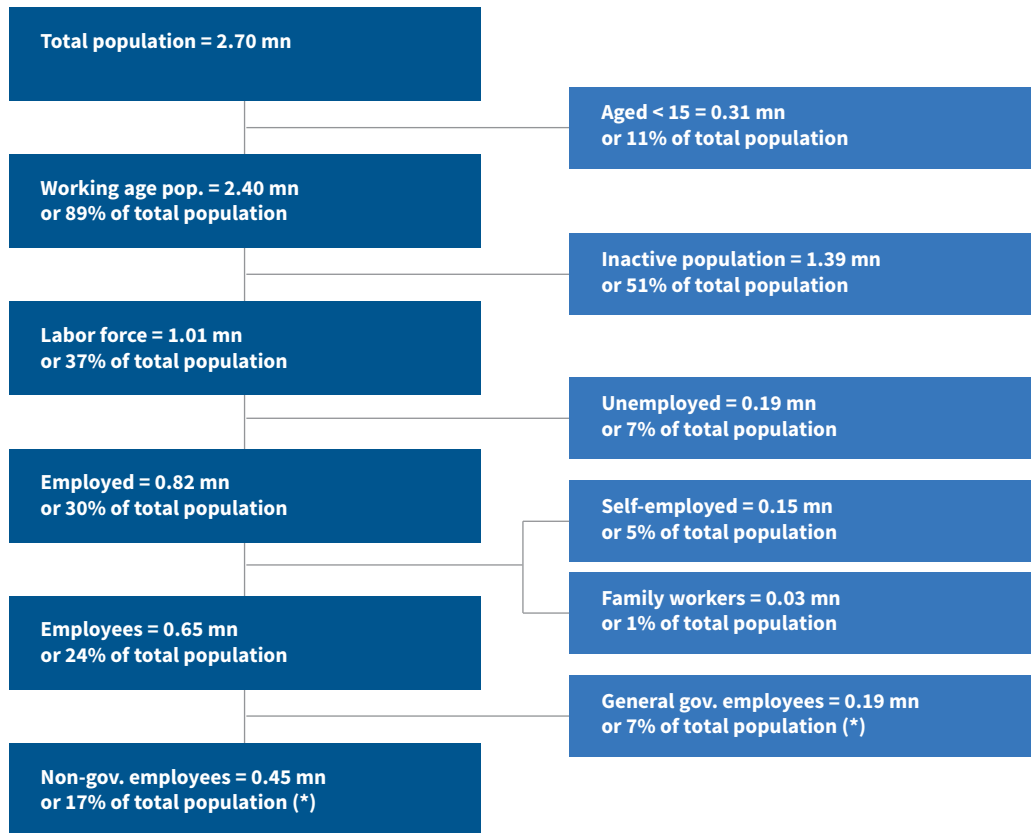
100 citizens, 63 are neither working nor looking for a job, and seven are looking for a job but have not found one (Figure 21). Of these seven, about 80 percent have been looking for a job for longer than a year. As such, barely 30 out of 100 were employed in 2018, placing BiH’s employment rate in the bottom 10 countries worldwide (World Development Indicators).

**Despite being above regional standards, wages are lower than in EU countries, which may be driving the skilled youth to emigrate in search of better paying jobs.** Average monthly wages are high for regional standards—the highest in the region after Montenegro. Government salary scales may contribute to inflating wages, and remittances may also put upward pressure on reservation wages and contribute to long-term unemployment (World Bank 2018; 2019f). Despite being relatively high for the region, wages in EU peer countries are higher than in BiH (SEE Jobs Gateway and OECD). The migration of healthcare



FIGURE 21. MANY PEOPLE ARE EITHER UNEMPLOYED OR OUT OF THE LABOR FORCE

(BiH Labor Market, 2018)



Source: LFS 2018. Note: (\*) are estimated.

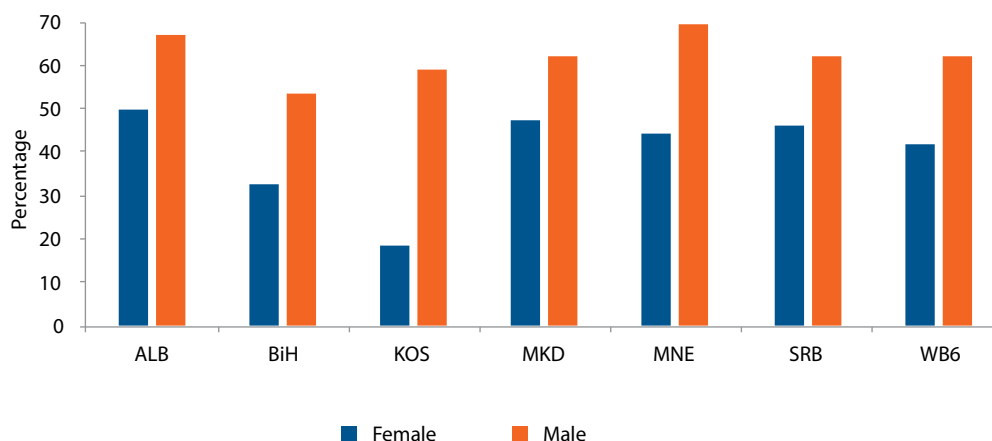
professionals to Germany described in Box 1 illustrates the pulls of economic opportunity and wage differentials.

**Unemployment is particularly high for youth,** which at 39 percent remains among the highest in the region. Youth unemployment and lack of economic opportunities may exacerbate youth emigration and skill mismatches in the labor market; approximately 57 percent of young people expressed that they wanted to emigrate, the highest rate in the region (Gallup World Poll). Long-term unemployment is also of concern to youth. Seven out of 10 unemployed youth looked for jobs for more than a year, again the highest in the region.

**Because of limited labor market opportunities, women lose approximately 35 years of productive employment over their lifetime (World Bank 2018c).** BiH has one of the lowest rates of female participation in the labor market in the region (**Figure 22**), and a disproportionately large share of highly educated women are unemployed. Childcare is limited, which is a significant barrier to female labor force participation. Wages for women are approximately 9 percent lower than for men. There are also significant barriers to women accessing productive assets, with gender gaps in property ownership and access to bank accounts (World 2017d).

FIGURE 22. MANY PEOPLE ARE EITHER UNEMPLOYED OR OUT OF THE LABOR FORCE

(Activity Rate 15+ by gender, 2017)



Source: LFS 2018.

**Many of the people who remain in the country lack the skills that are in demand.** The low activity rate of the working-age population and the high unemployment rate are the results of mismatches between the supply of and demand for skilled labor that restrict development opportunities. This explains the situation in which a large number of people are unemployed while employers are not able to find the skilled workers that they need (See section III.C). The structural unemployment is a remnant of the unfinished economic transition—the challenge to create suitable jobs for the de-skilled transition generation. The generation that entered labor markets before or during the transition and the war finds itself, to a significant extent, with few opportunities that match their skills. Their education is partially outdated, and so are many of the skills acquired during their careers, and this situation is likely to persist as technological change reduces job creation in traditional industries.

Resolving the jobs challenge will require addressing shortcomings in supply of and demand for jobs and labor market deficiencies

**On the demand side, the potential of the private sector needs to be unleashed by creating a more enabling environment.** Many factors hamper the creation of new enterprises and the growth of existing ones. These range from a challenging investment climate and limitations in access to finance to political uncertainty, which undermines confidence in foreign and domestic investors. (See section I.A.)

**On the supply side, it will be important to increase the participation of the population in labor, provide access to better jobs, and eliminate incentives for informality.** Increasing the participation of people in the labor force will require better performing active labor market policies to help unemployed people find jobs and enabling women to be economically active, including through more accessible child and elderly care. Providing access to better jobs will require

closing the gap between the skills and qualifications demanded in the job market and those that the education system provides. (See section III.C.) The fact that healthcare is provided for free to people registered as unemployed creates incentives for informal jobs and unnecessarily undermines the effectiveness of employment bureaus as they spend time processing unemployment benefits instead of helping connect jobseekers to employers. De-linking provision of healthcare from certification of unemployment will help minimize these adverse effects.

**Introduction of progressive labour taxation can increase competitiveness and employment.** Personal income taxes and social security contributions are frequently perceived as major obstacles to formal employment in BiH. The tax wedge is considered to be as high as 42 percent in FBiH and slightly lower in RS. This has been frequently cited as a major deterrent to employment and lack of competitiveness. In practice, this is not accurate because employees in FBiH receive, in addition to their salaries, nontaxable allowances (for hot meals, vacations, transportation) that can amount to approximately one-third of the average salary. If these nontaxable allowances are considered, the tax wedge in FBiH falls from 42 percent to approximately 36 percent, lower than the average tax wedge in the EU28. At the same time, the personal income tax rate—10 percent in both entities—is among the lowest in the region and compares with an EU average of 38 percent. Accordingly, rather than significantly reducing personal income tax and social security contribution rates, progressivity must be enhanced. In both entities, personal income taxes and social security contributions are the same for all employees, regardless of income. Initiatives to increase the personal tax deduction from Bosnian convertible mark KM300 to KM800 and subjecting all income greater than KM800 to a 13 percent per-

sonal income tax could help increase progressivity, but any reforms to labor taxes must take into account the financial sustainability of the social security system and ensure that the needed reforms do not create finance gaps in the healthcare and pension systems.

### Poverty and inequality remain important challenges in BiH

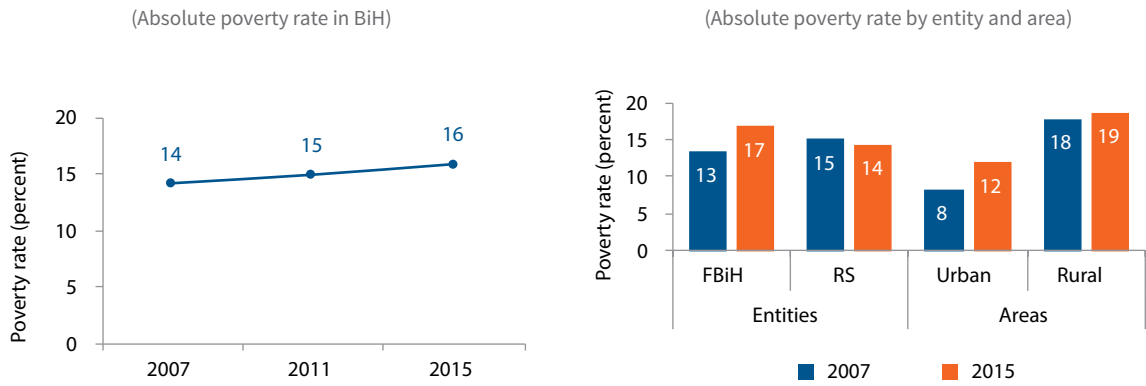
**Poverty in BiH is a problem for a significant proportion of the population,** rising from 14 percent in 2007 to 16 percent in 2015 (the latest year on record, **Figure 23**). Poor people are disproportionately concentrated in rural areas, where the poverty rate is much higher (19 percent) than in urban areas (12 percent). This is troubling because 52 percent of the population of BiH lives in rural areas (World Development Indicators), where jobs tend to be scarce and salaries low. Approximately 40 percent of poor rural workers are employed in the agricultural sector, which has low and declining productivity and competitiveness. (See section III.D on managing natural resources for prosperity.) Eradicating poverty and increasing prosperity in BiH will require more and better jobs and opportunities that can translate into higher incomes.

**The reduction of consumption in poor families is behind the recent increase in poverty in the country.** Growth was good for those at the lower end of the consumption distribution in the past; the bottom 40 percent expanded its consumption between 2004 and 2007 (World Bank 2015). In more recent years, the slight increase in poverty has been the result of a decrease in consumption in the bottom 40 percent of the distribution—the World Bank indicator used to measure shared prosperity. Consumption of this group fell by 0.9 percent annually between 2011 and 2015 (**Figure 24**).



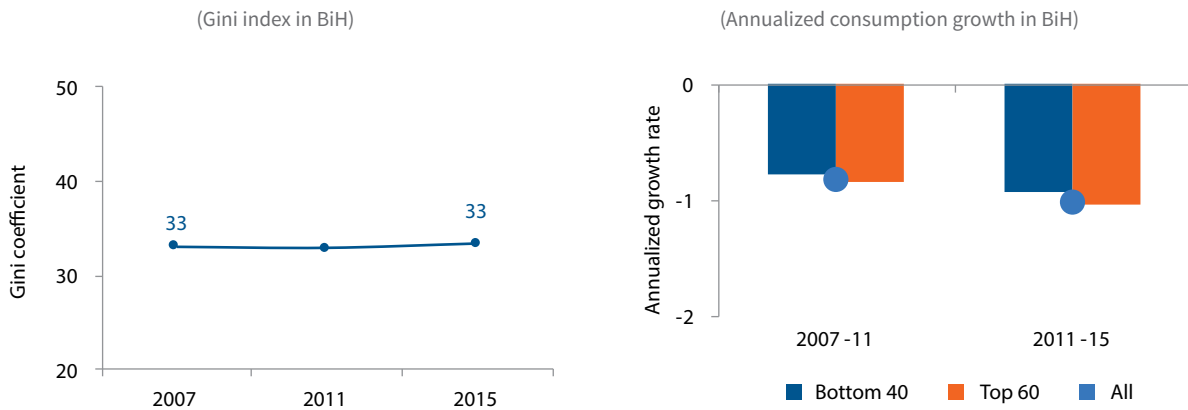


FIGURE 23. POVERTY HAS SLIGHTLY INCREASED IN RECENT YEARS



Source: WB staff estimates based on HBS 2007, 2011, and 2015. Note: Poverty rate based on the KM 205 monthly threshold.

FIGURE 24. INEQUALITY HAS REMAINED STAGNANT



Source: WB staff estimates based on HBS 2007, 2011, and 2015.

**Social assistance has helped to ease the increase in poverty, but it does not provide adequate coverage for those who are less well-off.** Social assistance programs and pensions have become more widespread in recent years in BiH, playing a meaningful role in supporting incomes of poorer people and avoiding what could have been an even greater increase in poverty between 2007 and 2015, but social assistance spending does not provide adequate coverage to the poor, which limits its effect on poverty reduction. Ex-

panding coverage of targeted social welfare programs and eliminating or phasing out inefficient programs would have served poorer people better (discussed in greater detail in section III.C).

**Current inequality and limited future mobility dampen expectations of better living standards.** Inequality in BiH has remained constant. The Gini Index, the standard indicator for measuring per capita household consumption inequality, has remained at approximately 33 points since 2007 (Figure 24).<sup>10</sup> Stagnant inequality is the re-

10 A Gini index equal to zero means perfect equality, while a Gini index equal to 100 means complete inequality.

sult of a similar reduction in consumption between the bottom 40 percent and the top 60 percent (**Figure 24**). Moreover, three-quarters of BiH citizens (one of the highest ratios in the region) believe that the gap between the rich and the poor has become larger (LITS III). Expectations of intergenerational mobility are also low, with only 37 percent of the population (the lowest in the region) thinking that their children will have better lives than themselves.

**Simulations indicate that poverty reduction will be slow.**<sup>11</sup> With moderate consumption growth of 2 percent annually, such as has been the case since 2015, and maintaining the distribution of consumption constant, it is likely that poverty will be halved (to 8 percent) by 2030.<sup>12</sup> More robust consumption growth is needed to decrease poverty further and more rapidly; poverty would likely be 3 percent in 2030 with consumption growth of 5 percent. Predictions for the future are pessimistic, with approximately 40 percent of citizens believing that their financial situation will worsen within the next year, by far the highest percentage among the Western Balkan countries (Balkan Barometer 2019). Moreover, it is likely that the expected economic slowdown and associated loss of jobs and earnings due to the global coronavirus outbreak will increase poverty, as well as dampening perceptions of the future in the country.

**Large gender gaps, particularly in economic opportunities and access to productive assets such as land and financing, affect women's employment and capital (World Bank 2017d).**

Gender gaps in accessing public services such as education and healthcare have nearly closed. Women's access to services such as child- and elder care is limited, decreasing their labor force participation. There are also significant differences in entrepreneurship, partly as a result of social norms and women's limited exposure to the business world. Women held only 21 percent of national parliament seats in 2018, the lowest in the region (World Development Indicators). More than half of women experienced some form of domestic violence in 2013 (Cancho and Elwan 2015). Poor, rural, young, and Roma women are most vulnerable to violence. Although legislation is to a large extent gender neutral, with laws to promote gender equality, inconsistencies in the system limit full implementation of these regulations, leaving room for discrimination. The lower female labor force participation represents the waste of BiH's main, scarce asset, human capital, and limits women's ability to benefit from and participate in the economy.

**The Roma have limited basic services and economic opportunities (Robayo and Millan 2019).** Approximately 1.7 percent of the population are Roma. Challenges start early in life for this group; the net pre-primary enrollment rate was 3 percent in 2017, the lowest in the region. The Roma have limited employment prospects, with only 11 percent employed, the lowest in the region. They also have unmet needs for medical care, largely because they lack health insurance. There are also substantial gaps in access to electricity, water, sanitation, and waste collection.

11 The lack of welfare data after 2015 prevents us from reporting a more recent poverty estimate.

12 The 2016-2018 period is nowcasted based on actual private consumption growth, whereas the 2019-2030 period is projected based on 2 percent and 5 percent private consumption growth rates. Both nowcasting and predictions assume a pass-through of 0.87.



### III.

## Development Constraints: What Needs to Change?

**To achieve higher, more sustainable, more equitable growth, interventions will be needed in four areas: rebalancing growth, physical capital, human capital, and natural resources management.** To clarify what interventions are needed, priorities have been grouped according to the need to rebalance growth and better management of the country's assets to generate income (physical, human, and natural capital): (i) rebalancing growth, with greater reliance on the private sector and exports, (ii) more, more-efficient investments in physical capital, (iii) improvements in human capital and basic services, including managing the additional challenges that ongoing demographic changes present; and (iv) managing natural assets for prosperity. The following four sections describe in detail the main challenges in each of these areas.

#### A. Rebalancing Growth: Pivoting to Private Investments and Exports for Job Creation

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*A much-needed transformation to a social and economic model that is driven by a bigger, more vibrant, internationally competitive private sector has not visibly started. As a small economy, BiH's economic progress depends greatly on the ability to integrate with larger markets, but exports remain low, uncompetitive and with limited value addition. Political instability and a uniquely challenging business environment have discouraged investment—domestic and foreign—translating to low productivity and outdated production processes. Unfair competition from SOEs and high taxes is stifling the private sector.*

## BOX 3. SECTORS WITH POTENTIAL TO CREATE ADDITIONAL GROWTH AND JOBS

Manufacturing, particularly in wood and textiles, has shown the greatest promise over the years and has attracted the largest share of foreign direct investment. There are also significant competencies in services, particularly trade, tourism, and transportation and logistics. Although domestic trade (wholesale and retail trade is reflected in household consumption driving output so far in BiH, export-focused production and greater global value chain integration can unlock the next phase of growth. Transportation infrastructure supports trade connectivity and facilitation. For a strategically located country such as BiH, upgrading and expanding transportation infrastructure offers opportunities for further investment, particularly through public-private partnerships. Energy and utilities infrastructure are also in the spotlight, with European multilateral organizations providing financial support in parallel with rising interest from foreign investors, especially Chinese firms. The financial sector's resilience in the face of BiH's challenging economic and political climate has increased recently owing to high levels of foreign ownership, improving asset quality, and recent improvements to the regulatory framework. The nonbank financial institution segment remains underdeveloped and, therefore, has potential to expand and diversify sources of finance in BiH.

### With a small domestic market, BiH can raise employment and growth only by producing goods and services for export markets.

The success of some BiH companies in international markets suggests that BiH has significant potential to become a highly competitive economy. From high quality wood furniture to information technology services, success stories demonstrate the enormous potential of BiH's entrepreneurs and workers, but these success stories illustrate islands of competitiveness scattered throughout the country, rather than the norm. Unleashing the competitive potential of BiH's entrepreneurs and enterprises will be essential to creating more opportunities and better paying jobs. (See Box 3 for sectors that display potential to create additional growth and jobs). This section describes current trends and shortcomings.

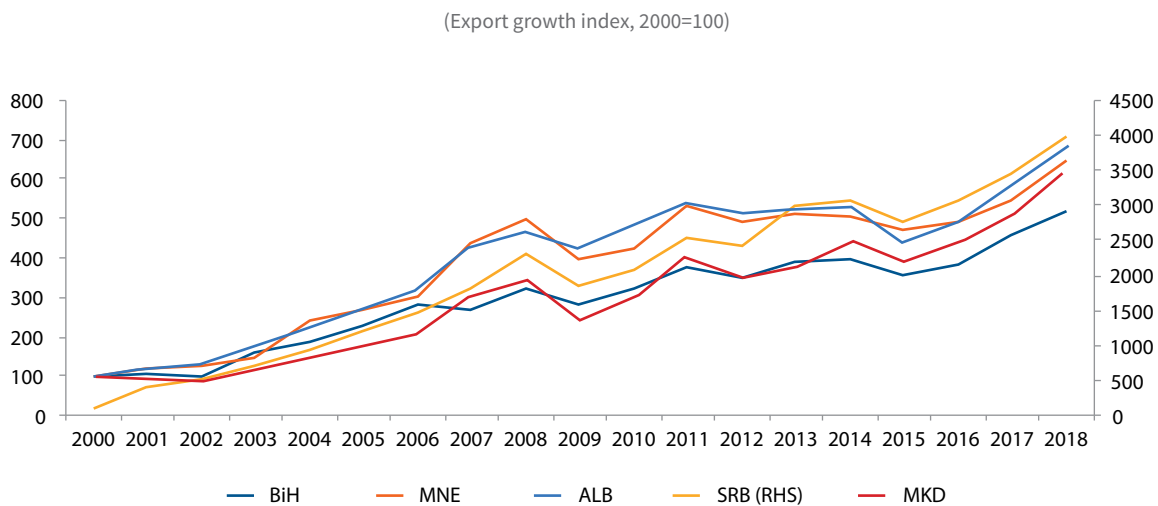
**Exports are low in volume and still highly dependent on low-value-added products.** Exports have accounted for 38 percent of GDP since 2015 (approximately half of that of BiH's

aspirational peers, and they have been growing at the slowest pace of all WB6 countries (**Figure 25**). Although exports to EU and Eastern Europe have increased, BiH's exposure to fast-growing markets—in East Asia, for example—is negligible. Two-thirds of BiH's exports are low-technology or resource-based products,<sup>13</sup> and this percentage has not increased since 2007. Export quality is low on average and has been declining over the past decade. In turn, low value addition and technological content of exports is linked to low salaries and the quality of the jobs these sectors can offer (**Figure 12**).

**Increasing the volume and quality of exports will require integrating into European and global value chains, attracting export-oriented FDI.** BiH receives the least FDI (as a percentage of GDP) of its peers (**Figure 26**). Moreover, more than 40 percent of FDI in the past two decades was in the energy sector, with a limited effect on job creation. Export-oriented FDI accounted for less than 4 percent of all foreign investment in BiH. Global value chains and efficiency-seeking FDI can help

13 Mostly footwear, raw wood and wood products, leather, apparel, metals, and vegetables.

FIGURE 25. EXPORT GROWTH HAS LAGGED



Source: WDI and WB staff calculations.

small economies accelerate export and income growth (IMF 2019c), exposing firms to international technologies, knowledge, and international standards that can spur productivity. BiH had relatively high participation in global value chains before the financial crisis, but participation plunged in 2018 to the lowest level since 2000. Moreover, backward integration has been low and has further declined, indicating that global value chain participation remains in the low-value-added and final assembly stages of production. In contrast, other countries in the region have had progressive integration into global value chains. For BiH to attract efficiency-seeking FDI and join global value chains, enabling factors must be in place, including stable political and economic environment and availability of a work force with adequate education and skills. Investment incentives, which countries often use to attract FDI, have been ineffective and expensive.

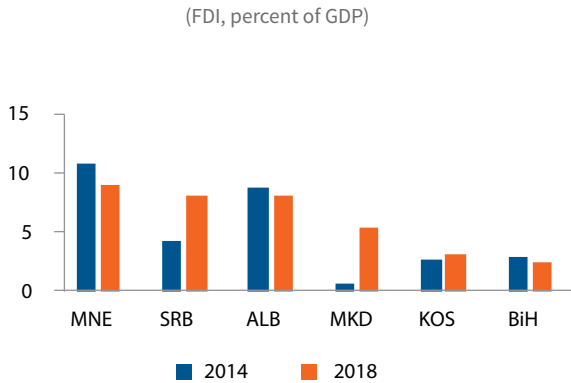
**Nontariff barriers to trade undermine BiH's competitiveness.** Tariffs are not significant, but there are other barriers to trade, including defi-

ciencies in infrastructure. BiH's free trade agreements with its major trading partners (EU, Turkey, Central European Free Trade Agreement members) have proven beneficial for BiH's exporters, but there are other barriers to BiH's exporters, ranging from nontariff measures and weak trade facilitation to poor logistics, weak border management, and infrastructure deficiencies. These shortcomings create unnecessary costs for exporters and undermine the competitiveness of BiH's products. These deficiencies can be largely addressed through decisive actions from authorities to eliminate unnecessary regulatory and administrative burdens. Addressing infrastructure deficiencies for connectivity will require more and better prioritized public investment. (See section III.B. on investing in physical capital.)

**The hoped-for development of the private sector has not been achieved.**

**Micro enterprises, which typically have lower productivity and competitiveness, dominate the enterprise sector.** There are some 35,500

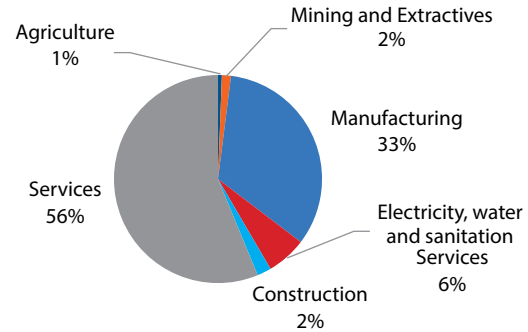
FIGURE 26: FDI IS SIGNIFICANTLY LOWER IN BIH THAN IN THE OTHER COUNTRIES IN THE WESTERN BALKANS



Source: WDI.

FIGURE 27: A LARGE SHARE OF FDI HAS GONE INTO SERVICES SECTORS, NOT GVCs

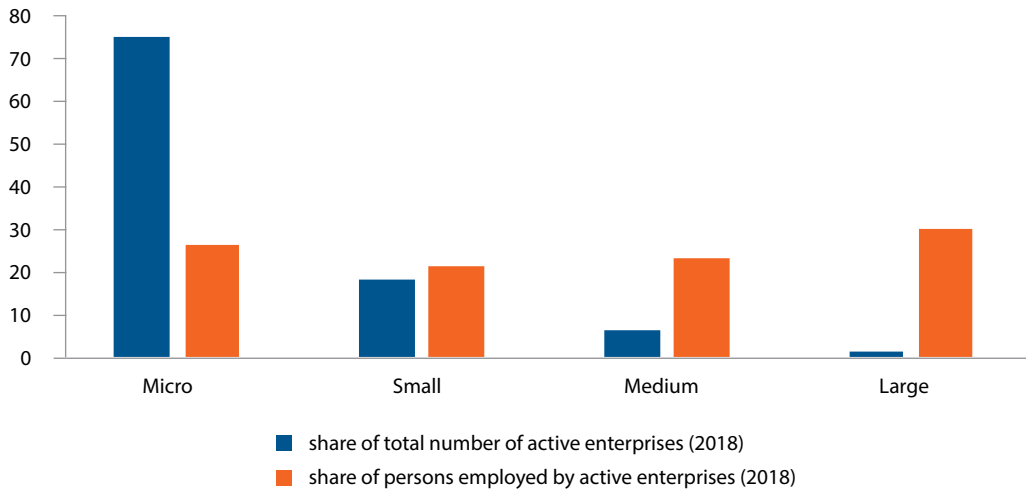
(Sectoral breakdown of FDI, 2016-18)



Source: BiH Central Bank.

FIGURE 28. MICRO AND SMALL FIRMS ARE ABOUT 95 PERCENT OF THE BUSINESS POPULATION

(Composition of the enterprise sector and employment according to firm size)



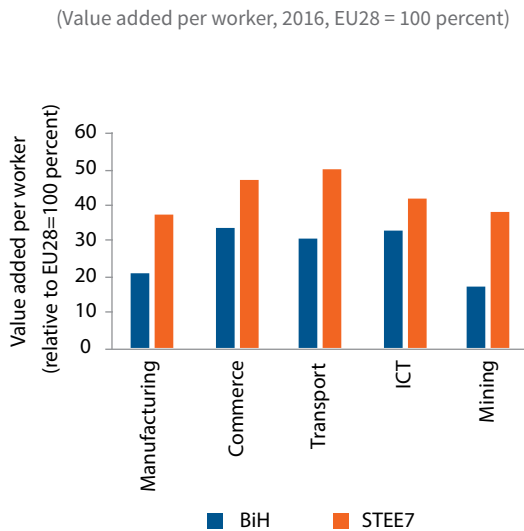
Source: BHAS 2018

firms in BiH, of which 95 percent are small (10-49 employees) and micro (<10 employees) enterprises and account for almost half of employment in the country (Figure 28). Conversely, there are far too few medium-sized firms, which is important because medium-sized firms typically boost em-

ployment and are large enough to compete in international markets and join global value chains.

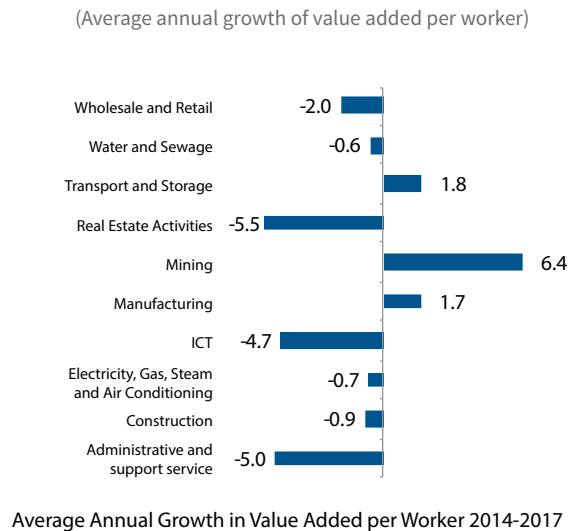
**Labor productivity is low and declining, and the labor force is underused in activities with low productivity.** A BiH firm is one-sixth to one-third less productive than the average EU firm

FIGURE 29. PRODUCTIVITY DOES NOT EXCEED A THIRD OF THE EU AVERAGE



Source: Eurostat and WB staff calculations.

FIGURE 30. PRODUCTIVITY IS DECLINING IN MOST INDUSTRIES



Source: Eurostat and WB staff calculations.

(Figure 29). Furthermore, productivity has declined; between 2014 and 2017, overall productivity declined approximately 1 percent per year (Figure 30). This low productivity is partly the result of the large share of employment in low-technology industries such as food and low-value-added services (retail, restaurants). Only 10.9 percent of employment is in high- or medium-high-technology industries (e.g., electrical or pharmaceutical products), less than half than in peer countries and one-third of the EU average.

**Entrepreneurship is lower than in peer countries.** A low and declining share of the population engages in entrepreneurial activity. The proportion of adults in early-stage entrepreneurial activities dropped from 7.4 percent in 2014 to 4 percent in 2017, compared with Estonia’s 19 percent. New business formation is also low, averaging just over one new registration per 1,000 active population in 2016, compared with six in Montenegro. Fewer than 5 percent of adults intend to start a business

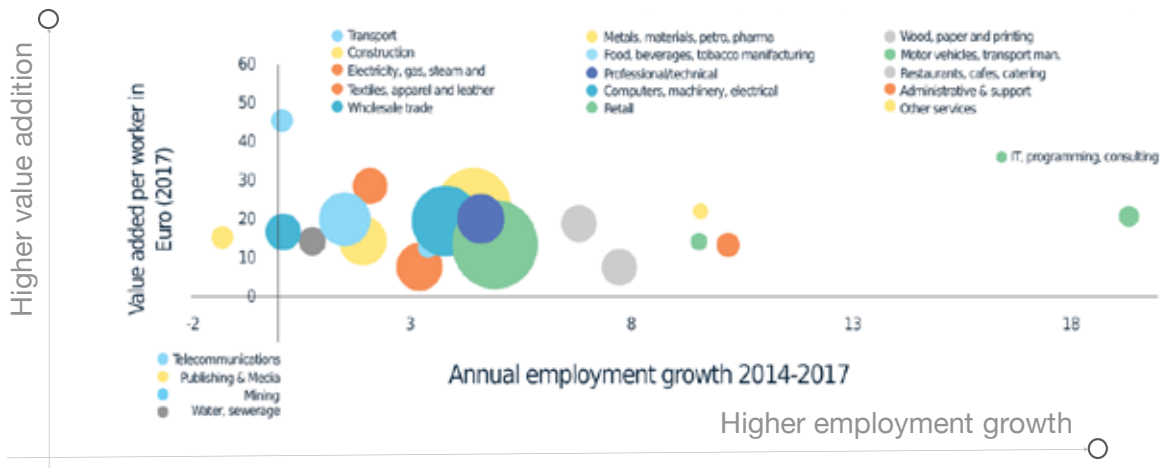
within three years, the lowest among peers. In absolute terms, BiH has the fewest micro, small, and medium-sized enterprises per 1,000 inhabitants of its Western Balkan peers (8.8, versus 26.5 in North Macedonia and 50.9 in Serbia). A cumbersome business environment, lack of required skills and knowledge to start a business, unequal access to opportunities (with a widespread perception that political connections are paramount to success in business), limitations in access to finance, and an education system in which socioeconomic skills needed to succeed in business are not sufficiently addressed discourage entrepreneurship.

**Limited innovation contributes to the low productivity of the private sector.** Innovation can take place through invention of new technologies and processes or adoption of existing ones to improve the operations of firms or the quality of their products. There is ample room for technology adoption in BiH because many firms have outdated technologies, but only 15 percent of



FIGURE 31: LOW VALUE-ADDED SECTORS CREATED THE MOST JOBS BETWEEN 2014 AND 2017

(Employment growth according to value added per worker, 2014-2017)



Source: Eurostat and WB staff calculations. Note: The size of the bubble represents employment in that industry.

firms in BiH have adopted technologies existing in other countries (Enterprise Survey 2019), and only 38 percent of firms introduced new or improved products or services in the previous three years. Innovation at the technology frontier is even rarer. BiH has the lowest rate of trademark applications and the second lowest rate of patent applications of its Western Balkan peers. Patent applications from local residents are mostly by individuals, not firms, which suggests that there is limited research and innovation activity among firms. The national innovation system is underfunded and lacks a clear strategic direction and institutional coordination, and its support programs for firms are largely outdated and have limited effect. Business investment in research and development is limited (29 percent of total expenditures, versus 69 percent in Slovenia and 47 percent in Croatia). Cooperation in innovation activities within and between firms (an important channel for knowledge transfer) is limited.

#### SOEs continue to stifle the private sector.

The state's footprint in the economy is sizeable and may deter medium-sized firms from entering the market. BiH is the only country in central, eastern, and southeast Europe where the SOE footprint appears to have increased between 2005 and 2016—and nontrivially so (IMF 2019b). SOEs often have significant privileges that the private sector does not (government financing, limited accountability, no payment of taxes or dividends, ability to pay generous wages above productivity, which crowds out the private sector from a limited talent pool). SOEs often fail to capitalize on the potential of the sector in which they operate and may hinder development of important sectors (Box 4). This preferred treatment diverts scarce resources (labor, land, capital) from the private sector to SOEs. (See section I.C for a detailed discussion of SOEs).

**BOX 4. STATE OWNERSHIP OF AIRPORTS**

Bosnia and Herzegovina (BiH) is well placed geographically to act as a hub between Western Europe and the other Balkan states. Its transportation infrastructure sector is largely unsaturated, leaving room for major investments. Its airports need to be modernized and expanded to become more efficient, enhance its regional connectivity, support tourism and economic growth, and provide accessibility for the diaspora.

BiH is underusing its tourism potential for many reasons, including limited transportation connectivity. Although there is an increasing trend in international tourist arrivals, the current level is far below potential. The hospitality industry is on the rise, primarily driven by private sector efforts, but connectivity (air, road, and rail infrastructure) lags, constraining tourism growth.

In terms of air connectivity, BiH's international passenger market is the smallest of the region, although it grew at higher rates than those of most of its neighboring countries from 2010 to 2018. Since 2013, Tuzla has established itself as the country's second international gateway, behind Sarajevo, accounting for more than 30 percent of the country's international seats in 2018. Almost all of the growth in BiH's international market between 2010 and 2017 is from the activity of low-cost carriers, which have grown approximately 48 percent per year during this period, whereas legacy carriers have experienced stagnant 0.8 percent annual growth over the same time span.

Robust factors such as the country's prospects for accession into the EU and its strong tourism potential should continue to drive faster growth and potential for greater profitability. However, regional competitors are progressing faster. As of 2018, Sarajevo airport was serving 24 international markets, while Belgrade had increased its reach to 68 and Zagreb to 47. Twenty-three airlines are providing international services from Sarajevo airport, whereas neighboring Belgrade operates with 37, and Zagreb with 32, which indicates better connectivity and diversity of origins and destinations.

Although minor enhancement projects are ongoing of Sarajevo airport, financed by the state-owned operating company, much larger investments are necessary to upgrade the facilities to meet International Civil Aviation Organization standards (especially safety), improve services to airlines and passengers, increase capacity to accommodate future growth, and maintain environmental protection standards. The limited fiscal resources and lack of expertise is slowing the pace of required investments. The government should consider introducing private sector participation in airport operations, specifically for Sarajevo and Tuzla airports (possibly bundled together in one package), to mobilize private sector financing and expertise and free up public funds so that they can be used where they are more needed. Given constrained fiscal space and operational challenges, private sector financial and technical participation would enable rapid expansion of activities and improvement in quality of services.

*Source:* IFC sector analysis



## The business environment in BiH is challenging, undermining the private sector.

**Doing business in BiH is difficult because of the burden that the authorities have placed on the private sector.** There are only six countries in the world where starting a business is more difficult than in BiH.<sup>14</sup> Companies in BiH must navigate more than 1,600 different procedures at all levels of authorities countrywide. Firms wishing to operate across the country must obtain a variety of licenses, approvals, and consents, many of them duplicated. There are 355 business-related licenses, permits, approvals, and consents required in FBiH, 319 in RS, and an additional 102 at the state level of BiH. Cantons (in FBiH) and municipalities add a further 161 and 94, respectively. Although corporate income taxes are harmonized, each Entity has its own business registration requirements, and each administrative level has the power to establish business laws and regulations. Within FBiH, each of the 10 cantons has different business regulations and administrative procedures. These are just some angles of the complex business environment, but there are multiple other areas in which unnecessary administrative burden and red tape create real obstacles for new entrepreneurs setting up businesses and existing firms trying to grow.

**A difficult business environment fosters informality.** Although the complexity of the business environment discourages potential entrepreneurs from setting up businesses altogether, it also creates incentives for some entrepreneurs to operate informally. In turn, informality greatly hinders the economy and society. Almost half of formally established firms in BiH face unfair com-

petition from informal competitors, which is the third most important obstacle for firms in BiH (Enterprise Survey 2019) Employees of informal firms lack labor security that laws provide, as well as social contributions.

## Lack of access to finance limits the potential of the private sector.

**Commercial banks in BiH do not contribute sufficiently to meet the financing needs of the private sector.** The financial sector is dominated by banks with good liquidity, strong risk aversion, increasingly conservative policies from their parent companies and insufficient incentives or capacity for new or innovative approaches to finance firms in BiH. Banks dedicate a large share of their lending to consumer credit and lending to SOEs, limiting the amount of credit available for private sector investment and micro, small, and medium-sized enterprises.

**Some sectors are particularly affected.** Manufacturing has significant potential to contribute to economic growth and job creation, but 16 percent of manufacturing firms identify accessing finance as a major constraint, significantly higher than firms operating in retail and services (**Figure 32**). Firms operating in manufacturing provide collateral for 262 percent of the value of the loan—versus 123 percent required of borrowers operating in retail. Nineteen percent of micro, small, and medium-sized enterprises consider access to finance to be a major or severe obstacle, which is linked to their own limitations and banks' incentives.<sup>15</sup> There are significant gender biases; 80 percent of companies managed by women, but only 65 percent managed by men, were required

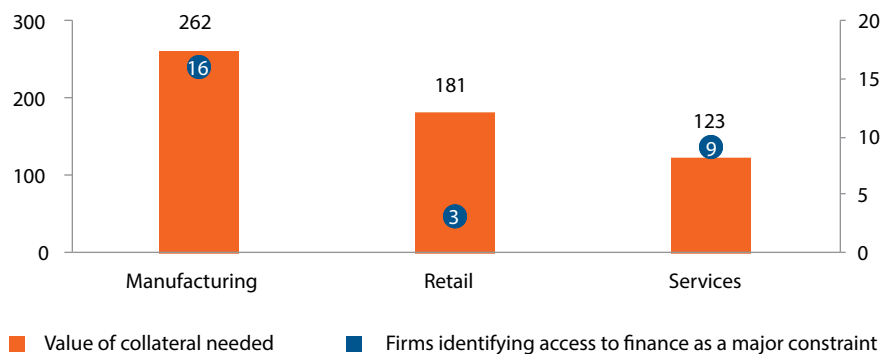
14 Starting a business in BiH takes on average longer than 80 days; business owners must go through 13 different procedures and face significant costs (14 percent of income per capita). Conversely, authorities in many countries have recognized the need to enable entrepreneurs to establish a business in less than one day, with one procedure (often online) and at no cost (World Bank Doing Business 2020).

15 Smaller enterprises with incomplete or insufficient formal documentation or lacking collateral tend to be excluded. Banks are not interested in serving the micro-loan segment of the market because opportunities for cross-selling of products and services are limited.



FIGURE 32. MANUFACTURING FIRMS FACE SIGNIFICANTLY HIGHER CONSTRAINTS IN ACCESSING FINANCING THAN FIRMS OPERATING IN RETAIL OR OTHER SERVICES

(Value of collateral needed and percentage of firms identifying access to finances as a major constraint)



Source: Enterprise Survey 2019.

to have collateral to qualify for loans. Female entrepreneurs have little access to assets such as land, which is the collateral that financial institutions traditionally prefer, and are disadvantaged in raising startup capital.

**Increasing the private sector's access to finance will require concerted efforts rather than directed lending.** There is often the perception that deficiencies in access to finance can be addressed through directed lending (government-imposed quotas on bank lending to specific sectors) or direct government participation in provision of credit (e.g., through development banks), but the experience of BiH and other countries in the region has demonstrated the significant limitations and potential effects of these approaches—with directed lending leading to high nonperforming loans and subject to political influence in allocation of credit and development banks often lacking clear strategic objectives and

adequate support instruments. Increasing private sector access to finance in BiH will require strengthening credit information systems,<sup>16</sup> eliminating shortcomings in the legal framework,<sup>17</sup> limiting the crowding out of the private sector from bank credit by SOEs, and further developing non-bank financial institutions<sup>18</sup>.

**Financial inclusion is behind that of regional peers and the country's income level, indicating income and gender gaps.** Fifty-nine percent of the adult population has an account, compared with the developing European and Central Asian average of 65 percent (Global Findex Survey 2017). Account penetration is also low relative to BiH's income level.<sup>19</sup> The income and gender gaps are high, with the poorest 40 percent of the population lagging by 11 percentage points and the gap between female and male access approximately 4 percentage points.

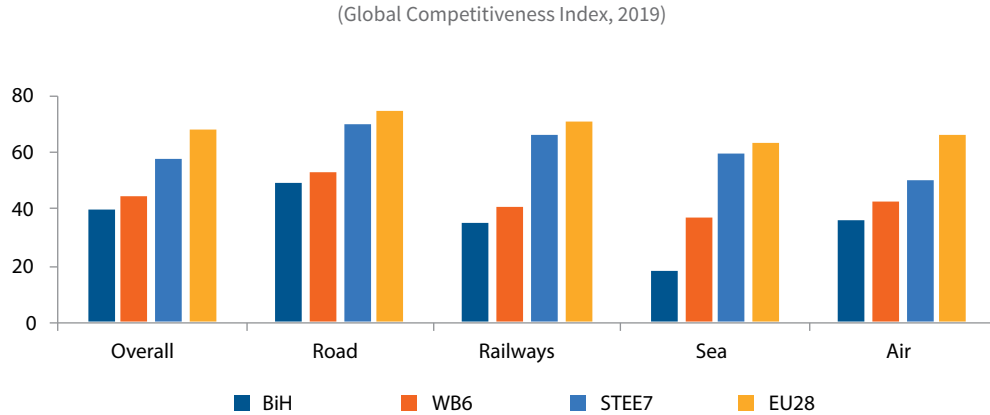
16 The credit bureau information covers only 14 percent of adults in BiH, versus 67 percent in peer economies.

17 It takes more than 900 days on average to settle claims through courts, at a cost of 36 percent of the claim (World Bank 2019a). This makes lenders reluctant to lend, which in turn increases the collateralization requirements for new loans.

18 Microfinance, leasing, and factoring have potential to address financing needs of specific market segments, but deficiencies in legal and regulatory frameworks hinder their development.

19 On average, 73 percent of adults have an account at a formal financial institution in upper-middle-income countries.

FIGURE 33. BIH INFRASTRUCTURE QUALITY IS POOR COMPARED TO REGIONAL AND EUROPEAN PEERS



Source: World Economic Forum, Global Competitiveness Indicators. Note: quality of infrastructure: range 0-7.

## B. Investing in Physical Capital

The SCD identified the need to invest in physical capital, highlighting its critical role in connecting BiH with countries and clients in the region and beyond. This update finds that BiH has continued to severely underinvest in infrastructure, even though the country has benefitted from a high level of revenue collection. Consequently, a deteriorating transportation infrastructure continues to limit connectivity. Low investment and insufficient competition continue to hinder digital connectivity. In energy, dependence on coal for electricity generation has increased, at a high cost to the economy and pollution to the environment.

BiH transportation infrastructure is not in line with the country's needs.

**The poor state of the road infrastructure increases travel time and costs for people and firms, limiting connectivity and the country's competitiveness.** Because BiH is a small econo-

my close to the large EU market, good connectivity is essential for the economy's competitiveness, but the quality of the transportation infrastructure is much poorer than that of its peers (**Figure 33**), characterized by poor road quality, due to underinvestment, inadequate maintenance, and poor project selection and implementation (Atoyán 2018), and low road density (34 km per 100 square km of land area, versus 41 in WB6 and 111 in EU) (Eurostat).

**Investment in the road network has been well below the country's needs.** Investments are required to upgrade and maintain the existing network (to substantially improve the quality of roads) and to develop new roads and highways. The budget for repairing and improving the existing network is well below what is needed. Moreover, the agencies in charge of roads are inefficient and poorly run and face high costs, all of which have led to unsustainability. Priorities for investment in new highways and roads are to complete the expressway and motorway links that make up the extensions to the Trans-European Transport Network and other routes prioritized through



the South East Europe Transport Observatory. Of these, completion of corridor Vc<sup>20</sup> is the most important. For the national, regional, and local road networks, the priority is selective rehabilitation of the existing network with a focus on crucial bridge and tunnel assets.

**Railways have the potential to contribute to greater connectivity, but they need to be improved.** Railways are used to transport goods much more than in the rest of the Western Balkans (Eurostat), which demonstrates their potential, but outdated rolling stock and rails and, most importantly, inefficient operations severely hamper railways, with unsustainable costs stemming from unnecessarily large numbers of employees. Recent efforts to improve the railways in RS have the potential to address the shortcomings in the sector and can be a model for other transportation SOEs. (See Box 4 on restructuring RS Railways).

**Developing digital connectivity will require better policies and competition.**

**Digital connectivity and technology have major unrealized potential in BiH.** With digital technology, countries around the world are accelerating socioeconomic development, connecting citizens to services, and creating opportunities for new industries and better jobs. Technology is also profoundly affecting how governments operate and interact with their citizens, opening the door to greater transparency and more efficient service delivery. Telecommunications allows firms to serve markets better, lower costs and increase effi-

ciency, and develop new forms of business. In BiH, much of this potential is unrealized because of deficiencies in infrastructure, regulations, and skills.

**Shortcomings in competition have resulted in underinvestment and undermined quality of service in telecommunications.** Although there are 68 internet services providers in BiH, because of regulatory barriers,<sup>21</sup> the two government-owned incumbents control approximately 55 percent of the market, resulting in poor quality service and underinvestment in coverage<sup>22</sup> and in introduction of new technologies.<sup>23</sup> A market structure along ethnic and geographical lines—with each network operator having a de facto monopoly in a part of the country—impedes market development.

**Sharing infrastructure between operators could lower costs and use publicly owned assets more efficiently.** Infrastructure sharing between operators (including utilities from other sectors such as electricity) would be an effective way to lower the costs of infrastructure investments, increase connectivity, and increase energy efficiency. The national electricity transmission operator, Elektroprenos-Elektroprijenos, has 5,233 km of installed fiber optic networks and several interconnections with neighboring countries. Commercializing this infrastructure could more efficiently use these publicly owned assets and advance broadband development throughout BiH at relatively low cost (Gelvanovska-Garcia 2019).

20 Part of the United Nations International E-road network connecting Hungary and eastern Croatia to Bosnia and Herzegovina and the Adriatic Sea.

21 BiH is the only Western Balkan country that requires individual licensing for electronic communication services. This is not in line with EU legislation, and more generally, BiH has not harmonized its regulations and legislation with EU directives on electronic communications.

22 Most urban areas have been covered, although expansion to less profitable areas is constrained, with penetration varying from a low of 36.2 percent in Liva Canton to a high of 87.1 percent in Sarajevo Canton.

23 BiH lags other countries in the region and is the last to have issued 4G licenses (April 2019). Advancement toward 5G will require investments in well-developed, widespread fiber optic networks.

## BOX 5: REFORMS IN REPUBLIKA SRPSKA RAILWAYS—A MODEL FOR STATE-OWNED ENTERPRISE REFORM

The World Bank prepared a railways policy note in 2016 to describe the condition of the railway sector in Bosnia and Herzegovina, assess the policy options for modernizing it, and help chart a course ahead. The Republika Srpska Railways (ZRS) was found to be in a very difficult financial situation. If something was not done quickly, it was likely that spiraling costs, the increase in debt, and the shift of traffic to the roads due to lack of adequate maintenance of infrastructure and rolling stock would lead to bankruptcy.

The situation of ZRS could be summarized as follows: It owes more than Bosnian convertible mark (KM)60 million to its employees; more than KM80 million to the tax administration; and more than KM140 million to domestic and international creditors. It has excessive staff costs, accounting for two-thirds of operating costs, because of overstaffing. (ZRS productivity levels were 20 percent of the EU average and 40 percent of those of Croatian railways). The number of passengers is declining, and its financial costs are high, transporting fewer than 500 paying passengers daily for a total cost of approximately KM20 million per year. (Each passenger return trip costs almost KM100, costs to a large extent that government subsidies or consequent underinvestment in infrastructure and maintenance cover.); It has very good freight intensity (tons/route-km), similar to the EU average, and good financial health but is facing fierce competition from road haulage. Failure to maintain the quality of tracks and services and keep freight rates competitive will lead to a decline in freight traffic.

Without reforms, the government would have had to transfer significant amounts to the railway company, ignoring the underlying problems. The RS government requested World Bank support to restructure ZRS to achieve long-term sustainability. The reform has three components.

1. Financial restructuring: including payment of outstanding debts to employees and the tax administration and ownership restructuring, with the RS government regaining complete ownership of the company and taking responsibility for all debts to international creditors.
2. Workforce restructuring: reducing staff by approximately 1,000 (one-third) over a four-year period with a fair and transparent scheme of compensation informed by full consultation with trade unions. This will bring labor productivity in ZRS in line with that of Serbia, albeit only half that of Croatia.
3. Organizational restructuring: implementation of several organizational reforms, including a new financial management and accounting system to ensure transparency and proper use of funds, preparation of a market and freight strategy, preparation of an asset management plan to optimize investments, and a modern information management system to control and reduce costs. Contracts between ZRS and the RS government will be established that will specify the subsidy to be received and the level of service to be provided for passenger services and infrastructure investments, creating a clear, transparent framework for public investment and allowing authorities to invest in passenger services.

Component 1 has been largely completed; significant progress has been made on component 2, with a reduction of approximately 700 staff members; and component 3 is just starting. Lessons for other state-owned enterprise reform efforts include the need for strong government support and leadership in driving the reforms; careful design and close monitoring of staff reduction activities to avoid reversion; and efficient and proactive public communication and outreach about the reforms, in particular related to staff reduction.

BiH's economy is the most carbon and energy intensive in the region, hindering its sustainability and competitiveness. A more diversified, low-carbon mix supported by a greater role of the private sector is required.

**The energy sector is a potential source of growth, but it is unlikely that the country's strategy will unleash this potential.** The energy sector accounts for 6 percent of GDP and a significant portion of exports, with nearly one-third of its power generation exported. The sector benefits from abundant domestic energy resources (with still untapped potential for renewable energy) and a relatively low cost of power generation, but policies that result in limited choices of sources of energy and limited investments limit the sector's potential. Deficiencies in energy infrastructure undermine the economic potential of the country, and this damage will increase as demand grows.<sup>24</sup>

**BiH's energy sector depends greatly on coal,** and it is likely that recent investment decisions will increase this dependence, at a time when most European countries are moving away from it. Although BiH has vast potential for renewable energy (including hydro, solar, and wind), in 2017, coal accounted for 61 percent of primary energy generation (**Figure 34**). Indigenous low-cost lignite has offered affordable, reliable energy but at a high environmental and social cost. The energy sector is the leading contributor to greenhouse gas emissions and a major source of air pollution,<sup>25</sup> and BiH is the most carbon-intensive economy in the region.<sup>26</sup>

**Beyond the substantial harm to the environment and health of the population, reliance on coal comes at a long-term monetary cost to the country.** Coal is seen as providing energy security and reducing costs, and BiH plans to replace obsolete lignite plants and meet demand growth with four to six new coal-fired power plants.<sup>27</sup> It is estimated that the two main energy producers in 2017 received €23.3 million in direct coal subsidies and a further €177.6 million in indirect subsidies because the cost of carbon (externality cost of coal burning) is not factored into production costs (Miljević et al 2019). The country is effectively subsidizing pollution. Moreover, these coal plants may jeopardize BiH's ability to meet its renewable energy and energy efficiency targets under the Energy Community Treaty, which commits BiH to limiting emissions for existing and new large combustion plants and is expected to require sizeable investments (estimated at €105-350 million) in emission control equipment for existing plants. Some studies have estimated that the cost of electricity in new coal-fired thermal power plants would be close to €60/MWh, which is higher than the estimated cost for a unit of existing hydropower plant (€30/MWh), although a more-levelized cost of energy comparing the two technologies would be needed (*Ibid*)

**Inexpensive coal comes at the cost of hidden subsidies (including externalities of coal burning) and other costs in mining.** Coal mining provides an estimated 13,000 direct jobs across 14 operating mines, but mine productivity is low,

24 One-quarter of companies in BiH identify deficiencies in electricity supply as a major constraint on growth. Deficiencies range from high cost and long delays to obtain connections to the network to electricity outages generating losses and costs of back-up generators; 63 percent of firms experienced more than one electricity outage per month, lasting on average 3.6 hours. Thirty percent of firms had bought an electricity generator to address reliability of electricity supply (Enterprise Survey 2019).

25 Carbon dioxide from solid fuels is 78 percent of total emissions, significantly higher than in other Western Balkan countries (12-65 percent)

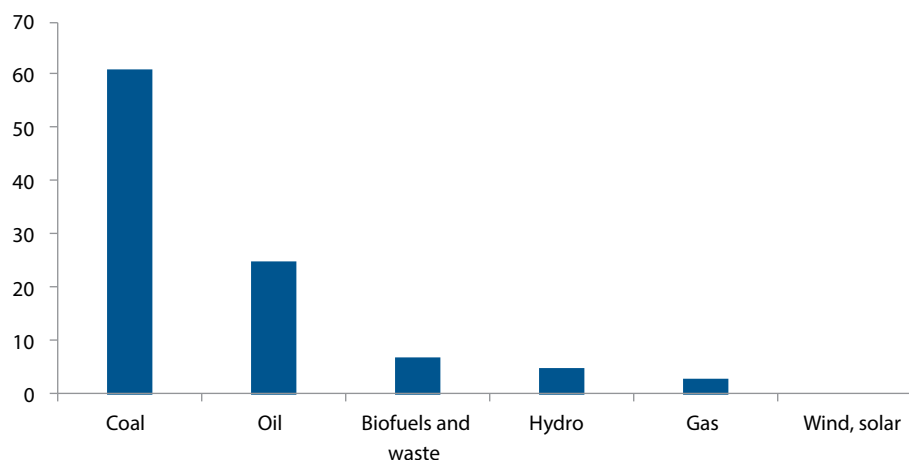
26 With 0.56 kt of carbon dioxide emitted per dollar of GDP, more than three times the EU average WDI, accessed June 10, 2019; latest available data are from 2014.

27 BiH Framework Energy Strategy until 2035. Parliament approved a guarantee in April 2019 for a coal-fired unit at Tuzla, largely financed by a loan from the Export-Import Bank of China, and three other plants are in preparation.



FIGURE 34. COAL IS THE PRIMARY ENERGY GENERATION IN BIH

(Sources of primary energy supply, percent, 2017)



Source: IEA, Energy Balances, 2019.

largely because of outdated mining methods and high labor costs that require substantive subsidies. Addressing reliance on coal for energy generation will require a strategy that includes the mining sector, its financial sustainability, and opportunities to help some of the labor force transition to other industries.

**Substantive investments will be required to meet existing and future demand.** More than half of the thermal power plants date from the 1960s and 1970s, and at least 30 percent of thermal capacity is slated to be closed in the next decade. The deterioration, loss of capacity, and decreasing efficiency threaten the security and reliability of the energy supply. Because the largest electricity off-taker in the country, the aluminum smelter in Mostar, accounting for approximately 12 percent of annual average consumption, was taken off the grid in 2019, earlier long-term demand projections are likely to change. Some estimates indicate that demand could change between 1 percent and 14 percent by 2029 de-

pending on growth. Approximately €3 billion in investments will be required to modernize power generation plants, install emission control equipment, and build new capacity in the next 20 years (Nikolakakis et al. 2019). In addition, total investment needed to develop the electricity transmission network is estimated to be €350 million.<sup>28</sup> There is considerable potential for private investment in cost-competitive renewable energy, but several factors limit private participation, including political instability, an incomplete regulatory framework, public sector influence, and a lengthy permitting process.

**Electricity prices are below the cost of supply, undermining the ability to support public investment.** In 2017, households paid less than half the average price of residential customers in the EU, and business tariffs were the second lowest of all EU and Western Balkan countries. As a result, the power sector had a revenue shortfall of 3 percent to 4 percent of GDP from 2011 to 2014. Cost-recovery tariffs will be necessary to fund the

<sup>28</sup> Framework Energy Strategy of BiH until 2015, published in 2017.



large investment needs and ensure the financial sustainability of the sector. Tariff reforms and targeted assistance for vulnerable populations will be important.

**Increasing energy efficiency can help manage the increasing demand and reduce environmental effects.** Residential, public, and commercial buildings account for approximately half of energy consumption, much of which is wasted because of poor insulation and inefficient heating and lighting. Demand in residential and public buildings can be reduced up to 60 percent through cost-effective refurbishments, but these mechanisms to support energy efficiency have not been adopted on a national basis

## C. Strengthening Human Capital and Basic Services

*Since the SCD in 2015, the loss of human capital has become a major concern and source of urgency to act in BiH. In addition to the loss stemming from demographic trends, deficiencies in healthcare and education significantly undermine the potential for people in BiH to have healthy, productive lives and create incentives for people to emigrate to countries that can offer not only better jobs, but also better quality of life. The education system fails to equip students with skills that are in demand in the job market, which further contributes to high levels of inactivity. Lack of access to care facilities for children and elderly adults limit the ability of women to participate actively in the economy. Deficiencies in the healthcare system have become more prominent, undermining not only the quality of services provided to the population, but also BiH's fiscal sustainability. Social assistance does not adequately*

*cover all of those in need, and poverty remains an important challenge.*

### Quality education is limited and unequal<sup>29</sup>

**The education system does not equip students in BiH with the skills, competencies, and qualifications that are in demand in the labor market (Figure 35).** More than one-quarter of BiH citizens considered that the skills they learned did not meet the needs of their jobs in 2018, one of the highest in the region (Balkan Barometer 2018). Fifty-eight percent of firms believe that the education system does not impart the skills needed in the current labor market (World Bank, 2016-2017 STEP Employer Survey). These outcomes reflect deficiencies at all levels of education.

**Low enrollment in early childhood education undermines critical foundations for children in BiH.** Fewer than 20 percent of children in BiH have access to early childhood education, substantially less than in peer countries (Figure 36). This is a major concern because global evidence demonstrates the importance of early childhood education for development of basic cognitive and socioemotional skills. The limited availability of facilities dampens the economy (because it limits the ability of mothers to participate in the labor market) and exacerbates social inequality, because children with access to early childhood education typically live in urban areas, with both parents in paid jobs, whereas those in rural areas and with single parents have less access.

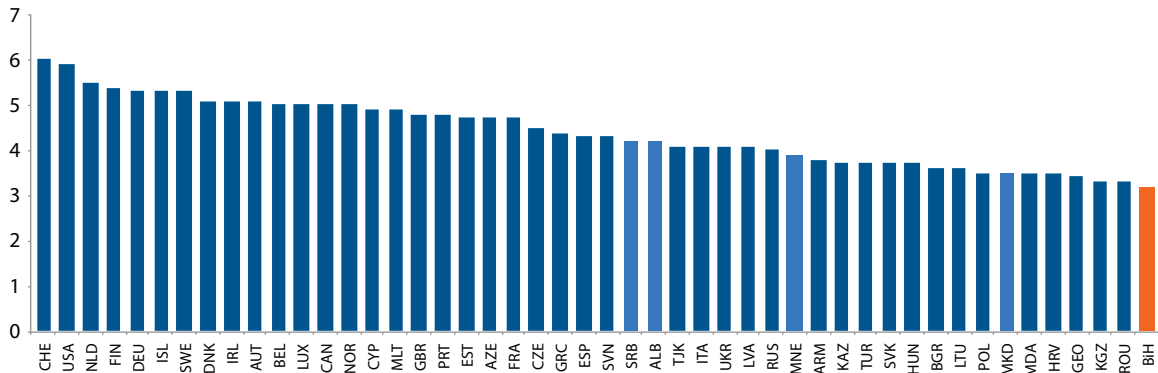
**The quality of education outcomes needs to be enhanced.** Students in BiH lose the equivalent of 3.1 years of schooling because of the poor quality of education. Only 40 percent to 50 percent of 15-year-olds in BiH have basic proficiency in reading, math, and science, well below 76 percent of same-age students in EU (PISA 2018). In turn, poor

29 This section draws heavily from World Bank (2018e, 2019d) and World Bank and European Commission (2019a)



FIGURE 35. SKILLS THAT EMPLOYERS SEEK ARE IN SHORT SUPPLY

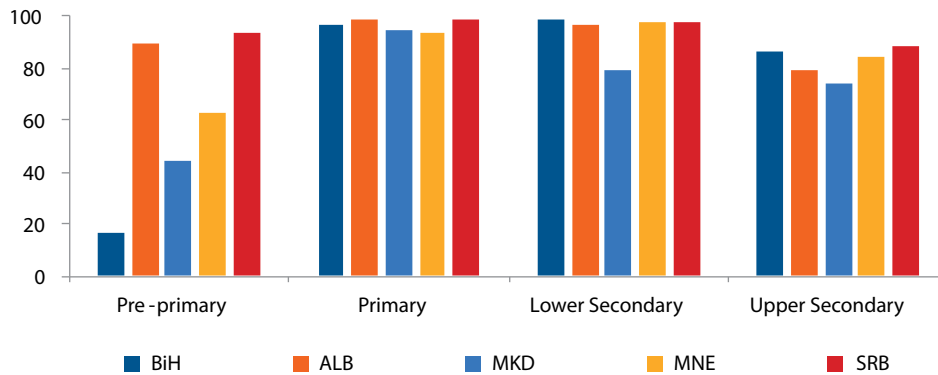
(Extent to which graduating students possess skills businesses need)



Source: World Economic Forum, 2018.

FIGURE 36. ACCESS TO PRE-PRIMARY EDUCATION IS ESPECIALLY LOW

(Enrollment rates by education level)



Source: WB Human Capital Project (World Bank 2018e) and WB staff calculations.

Note: Pre-primary refers to adjusted net enrollment rate. All others are total net enrollment rate, except for lower secondary and upper secondary in North Macedonia, which are net enrollment rate and adjusted net enrollment rate, respectively.

quality education translates into lower productivity; children born and raised in BiH today will lose almost 40 percent of their lifetime productivity because of deficiencies in healthcare and education.<sup>30</sup> Unequal access to quality education is also

a concern; the achievement gap between students from the top and bottom income groups is equivalent to almost 1.5 years of schooling (PISA 2018).

**The low quality of the educational system stems from deficiencies in institutions and in-**

<sup>30</sup> Based on the World Bank Human Capital Index (World Bank 2018e). This index measures the amount of human capital that a child born today can expect to achieve by age 18 and compares the productivity of the next generation of workers against a benchmark of complete education and full health. The amount of human capital that a child born in BiH will accumulate by the age of 18 translates into a productivity level of approximately 62 percent of what it would be if they received complete education and full health. Despite being higher than the average accumulation of human capital of its income group, it is lower than other countries in the region (Albania and Serbia) and many other countries in Europe and Central Asia.



**adequate use of resources.** The decentralized and fragmented setup of the education system in BiH detracts from a shared vision and objectives and translates into high administrative costs. Pre-university financing is based on the number of classes rather than the number of students, which translates into inefficiencies and nontransparent use of resources. Public spending per student in primary and secondary school is high (~25-30 percent of per capita GDP), but peer countries obtain better outcomes with lower spending. There are marked differences in per-student spending between entities because of the decentralized structure of the system, and primary and secondary education have grown less efficient over time. The number of students has declined over the past 10 years, but the number of teachers has increased in RS and some cantons, resulting in class sizes below international benchmarks, especially in primary education. As a result of this oversupply of teachers, the amount of money spent on salaries in pre-university accounts for approximately 90 percent of spending on education (roughly consistent across cantons), much higher than the 78 percent to 80 percent in EU and OECD countries. In addition, a high proportion of salaries is spent on non-teaching staff, which accounts for one-third of staff in primary schools, higher than in better performing education systems. In turn, the large expenditures on salaries means that there are few resources that can be invested in quality facilities, teaching materials, and training for teachers.

### Healthcare in BiH is deficient because of inefficiencies in the sector.<sup>31</sup>

**Deficiencies in healthcare are one of most important concerns for the population.** Seventy-eight percent of the population considers that

the quality of healthcare in BiH is low or very low (World Bank and EC 2019b). In a multi-country survey in 2016, only 48 percent were satisfied with the healthcare system, the lowest in the region (LITS III).

**Inefficient use of resources and deficiencies in governance in the sector result in poor-quality healthcare.** BiH allocates a high proportion of resources to healthcare (~8.9 percent of GDP in 2017, remarkably high for a lower-middle income country and close to the EU average (10 percent)), but quality of healthcare and satisfaction of the population are below those in other countries that spend less, for several reasons, including fragmentation and lack of synergies among entities (and cantons in FBiH),<sup>32</sup> deficient financial control of hospitals and healthcare centers, and limited accountability of authorities and hospital management for results.

**Discontent is also widespread among healthcare professionals,** with over-worked doctors and nurses often working without basic inputs (while substantive resources are often spent on non-medical staff), hiring practices that are non-transparent and create opportunities for corruption, and lack of incentives for good performance or high qualifications. Consequently, BiH is fast losing precious human capital because doctors and nurses educated in the country at significant cost to the economy emigrate in search of better, fairer working conditions.

**Inefficiency in healthcare spending threatens fiscal sustainability.** Despite the large amount of resources devoted to healthcare, the system is running a deficit, and debt to suppliers and public bodies (e.g., tax authorities) runs into hundreds of millions of dollars. Poor budget planning and execution and inefficiencies in spending are endemic.

<sup>31</sup> This section draws on information from World Bank (forthcoming).

<sup>32</sup> Responsibility for providing health insurance and health care services lies with Ministries of Health in each entity and, in the Federation, in each canton.



Population aging will reduce revenues as people retire, financed mainly from payroll contributions from formal sector employees. At the same time, demand for healthcare will rise, threatening the financial sustainability of the sector.

**Not much has been done to reduce the effect of noncommunicable diseases despite their enormous cost to the country.** Noncommunicable diseases, the main cause of death and disability, are becoming more common as the population ages and will place a growing burden on the healthcare system in coming years that BiH's unhealthy lifestyle will exacerbate; approximately 40 percent of adults are smokers (World Development Indicators), one of the highest rates in the Western Balkans. Smoking is estimated to cause more than 9,000 deaths per year in BiH and cost the economy close to KM1 billion, but authorities have failed to implement effective policy tools, such as banning smoking in public places and raising tobacco taxes, despite evidence demonstrating clear population health and economic gains (Fuchs Tarlovsky et al. 2019).

**The healthcare system also faces significant pressures from the ongoing COVID-19 pandemic.** Substantial resources are needed to address the unfolding pandemic, including strengthening systems for real-time disease surveillance (which may necessitate additional laboratory infrastructure, equipment, reagents, and other goods); ensuring adequate response capacity through trained, well-equipped frontline healthcare workers; extending quarantine and clinical care facilities (which may necessitate refurbishment of intensive care units and inpatient facilities in hospitals); and providing vaccines and therapeutics when they become available. At the same time, essential community services need to be maintained while minimizing

risks to patients and healthcare personnel. Additional resources may need to be targeted at BiH's migrant, displaced, and other vulnerable populations. Cash assistance to affected households and businesses is also likely to be necessary, as well as proactive, evidence-based community engagement to allay unnecessary concerns and support business continuity.

Spending on social assistance is high, but coverage is low, especially among the less-well off<sup>33</sup>

**Spending on social assistance is very high in BiH, but resources are not used efficiently.** BiH allocates 2.9 percent of GDP to social assistance, one of the highest spending levels for social assistance in Europe, but the system is inefficient, with more than 20 central and local ministries with separate administrative systems in each of the two entities. This decentralized structure, which is poorly coordinated, generates extensive administrative and regulatory inefficiencies and significant inequalities between entities and cantons.

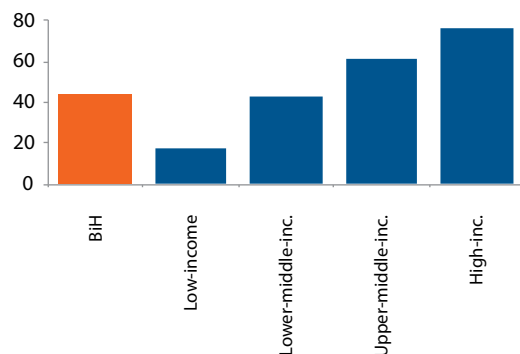
**Some social assistance programs are not sufficiently targeted, and coverage is low among those most in need.** Approximately 60 percent of social assistance spending is on war veterans. This is a very high proportion and leaves limited resources for other segments of the population in need. Moreover, these benefits are not sufficiently targeted to benefit the poorest veterans; more than 20 percent of the overall assistance for veterans is given to the 40 percent of beneficiaries with the highest income, whereas less than 20 percent of War Veteran Allowance program<sup>34</sup> spending is on the poorest 20 percent of the veterans. As for the rest of the population, fewer than half of the poorest citizens receive social assistance—less than in peer economies (**Figure 37**). The child al-

33 This section is largely based on Vandeninden and Ovadiya (2018).

34 A program available only in RS.

FIGURE 37. SOCIAL ASSISTANCE PROGRAMS HAVE LOW COVERAGE

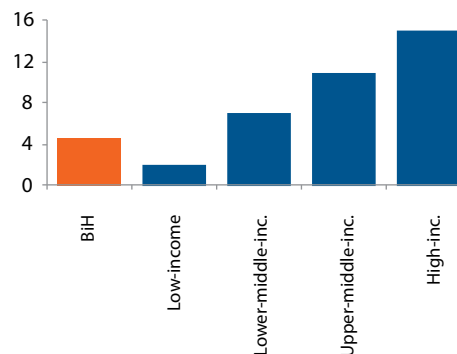
(Percentage of bottom quintile receiving social assistance programs)



Source: Vandeninden and Ovadiya (2018).

FIGURE 38: ...AND THEIR POVERTY IMPACT IS LIMITED

(Increase in poverty in the absence of social assistance programs, percentage points)



Source: Vandeninden and Ovadiya (2018).

lowance, which has among the highest coverage of the less well-off, reaches only 14 percent of the poorest quintile.

**As a result, social assistance has a small effect on poverty reduction.** Simulations show that spending on social assistance reduces poverty by only an estimated 4.6 percentage points—well below the average effect of social assistance in upper-middle-income countries (**Figure 38**). This is because most benefits do not cover the poor adequately and because, even when they do, the benefits are too low to help beneficiaries escape poverty

**Public water and sanitation services need to be improved.**<sup>35</sup>

**Public water and sanitation services are critical for quality of life of the population and to preserve natural resources, but access to these services is limited in BiH.** Only 58 percent of the

population in BiH is connected to the public water supply network, and only 31 percent is connected to the public sewage network. Only 15 percent of the wastewater produced in the country is treated before it reaches the country's rivers. Of all the water mobilized for citizen consumption, 59 percent is lost through leaks in the network. Approximately 66 percent of the population receives municipal solid waste collection and disposal services, although disposal methods vary, and there is generally limited recycling. Inadequate treatment of solid waste and wastewater creates enormous risks for BiH's population and damages the country's natural resources and environment. Open dumping and burning of solid waste results in soil, air, and water pollution.

**Much has been invested in improving public services in BiH, but provision of these services remains limited and unsustainable.** Over the past decade, development partners have invested more than €400 million<sup>36</sup> in BiH in infrastruc-

35 This section is largely based on World Bank (2017c, 2019b).

36 This figure does not include solid waste management.

ture for provision of public services.<sup>37</sup> Although this investment has enabled various facilities to be built (e.g., sanitary landfills, water networks, wastewater treatment plants), the operational and financial sustainability of these facilities is limited, with several already derelict and many more at risk of going out of service. Many of the existing regional sanitary landfills need to start planning and designing for additional waste disposal because of inefficient use, increasing volumes of waste, and initial lack of financing to expand beyond the first cell.

**Institutional and policy deficiencies have limited public services.** According to the constitution of BiH, it is the responsibility of municipal authorities to provide public services, creating a multiplicity of actors—with 119 water utilities operating in BiH. Accordingly, very few municipal authorities have the ability to ensure adequate operation of these facilities. The fact that tariffs on public services are below the cost of providing the services—thus requiring transfers and subsidies from local government budgets—further undermines financial sustainability. In the case of solid waste management, even when regional sanitary landfills are available, there is lack of enforcement to use them, and the system faces high transportation costs.

**Ensuring the quality, supply, and sustainability of public services will require active leadership of entity authorities.** Although it makes sense to place responsibility on authorities closest to final users, in reality, provision of public services is a resource-intensive task in which economies of scale are essential. Addressing deficiencies in the sector will require exploiting economies of scale across municipalities, establishing performance standards for quality of service pro-

vision, and eventually setting tariffs closer to the cost of the service, which will require strong support from entity authorities.

## D. Managing Natural Assets for Prosperity

*BiH benefits from significant natural resources, but this has not been leveraged to enhance growth and create better jobs. The contribution of agriculture and forestry, two traditionally significant sectors in the economy, to growth and employment has been decreasing, and they produce products with limited value added. Pollution is reducing living standards, health, and productivity. Climate change is affecting the country, with agriculture, water, and hydropower being the most vulnerable sectors.*

**Agriculture is a valuable sector, but it is operating below potential.**

**Agriculture and the agri-food industry remain relevant for BiH's economy.** Agriculture accounted for 6 percent of GDP in 2017 and 19 percent of employment. The sector's contribution to the economy is larger when considering agri-food production and related services. Agri-food is the most important manufacturing industry in BiH. It leads in terms of turnover (23 percent of manufacturing turnover) and employment, as well as geographic footprint in rural areas.

**Agricultural productivity is among the lowest in the Western Balkans and declining.** Agri-food exports have been increasing, reaching almost 10 percent of total exports, but these are mainly low-value-added products. The average value added per worker in agriculture in BiH is only one-fifth of that in the EU28,<sup>38</sup> and it ranks second lowest

37 Including international financial institutions and bilateral donors.

38 \$5,648 in BiH, versus \$26,854 in the EU28 in 2017.

in the Western Balkans after Albania. The value of agricultural output per hectare is the lowest of the Western Balkan countries. In turn, the sector cannot offer competitive salaries or attractive jobs. Employment in agriculture has decreased approximately 23 percent since 2012, and it is likely that attracting a labor force under current conditions in the sector will prove difficult over time.

**Land fragmentation, outdated technologies, and shortcomings in infrastructure affect productivity.** Many European countries have been able to leverage agriculture as a source of growth and jobs, but this has required transformation of the sector into one that is highly competitive and driven by high value addition. In BiH, fragmentation of farm land<sup>39</sup> undermines the competitiveness of the agricultural sector, which decreases the potential for investment and introduction of modern farming techniques. The absence of producer organizations or farmers' cooperatives prevents aggregation to achieve economies of scale. Unsustainable production practices are common, irrigation coverage is low, and there is little support or technical assistance for better agro-environmental practices. Most of BiH's croplands are in regions with limited access to regional markets and poor infrastructure, including transportation, electricity, and digital connectivity.

**Weak standards compliance and market integration further reduce agricultural potential.** Weak compliance and control mechanisms and services related to food safety and sanitary and phytosanitary standards also constrain agricultural competitiveness. Compliance with export product quality requirements is low and most often achieved by large, well-equipped producers.

Agri-food exports have grown, but smallholders are not well integrated into export markets.

**Forestry is underdeveloped but offers unrealized prospects to add value**

**BiH's forests are important natural resources that could be better leveraged for growth while ensuring their preservation.** Forests cover more than 60 percent of the country and are among the most pristine in Europe. Forests can be important sources of growth, but they are underused. Although wood accounts for almost 20 percent of BiH's exports,<sup>40</sup> much of what is exported is raw timber and other low-value-added items, which means that producers outside of BiH benefit from the high quality of the wood and capture its value by manufacturing finished products. There is a furniture industry in the country, but outdated production processes and designs limit its potential. Mountain areas have high tourism potential, but this also remains underused.

**Forests and trees can also help mitigate climate change and risks from extreme climate events.** Forests provide protection against floods (by reducing the risk of rock falls, avalanches, and mudslides) and natural cooling in urban and peri-urban areas and support climate-smart agriculture through shade tree cropping and fodder production for livestock.

**With better policies, knowledge, and public and private investments, the sector has the potential to grow and be competitive in EU markets.** Leveraging BiH's forests means not exporting higher volumes of raw wood, but developing value addition while ensuring preservation of this important natural resource.<sup>41</sup> There is a need for

39 More than half of holdings are less than 2 hectares.

40 Including wood, furniture, and closely related construction materials.

41 For example, Forest Stewardship Council certification encourages responsible management, transparency, and financial sustainability. The certified area in BiH increased from 1.65 million hectares in 2015 to 1.87 in 2019, which has permitted more exports, most notably





an overriding FBiH forest law to enable equitable revenue sharing, decentralized management, and improved accountability. The absence of a forest law makes tenure uncertain and prevents access to debt financing of operations. A forest inventory would allow national-level strategic planning for this important sector. In the private sector, there is a need to increase mechanization and use of modern technology to confront labor shortages, professionalize the industry, and make it more competitive. This will also allow growth of exports of high-value products such as furniture and emergence of supply chains.

**Air pollution is affecting living standards, health, and productivity, particularly for the bottom 40 percent.**

**Air pollution is having serious health and economic effects.** Cities in BiH have some of the highest concentrations of health-damaging fine particulates in Europe (**Figure 39**). Air pollution can cause lower respiratory infections; tracheal, bronchial, and lung cancer; ischemic heart disease; stroke; chronic obstructive pulmonary disease; and death. Approximately 3,300 people in BiH die prematurely every year as a result of exposure to air pollution, with Sarajevo and Banja Luka carrying approximately 16 percent of this health burden. Overall, 9 percent of annual mortality is attributable to air pollution, estimated to cost \$1 billion to \$1.8 billion, equivalent to 5.9 percent to 10.5 percent of GDP in 2016.<sup>42</sup> These cost estimates are conservative and do not include costs associated with hospital stays, illness, or loss of work days.

within Europe, using acceptable silvicultural practices and replanting. Forest Stewardship Council standards also apply to financial sustainability and sound use of financial resources under a responsible management regime with clear accountability.

42 These cost estimates do not include Brčko District.

43 The greenhouse gas emissions intensity of BiH's economy is three times as high as the EU's; emissions per purchasing power parity of \$1 of GDP was 0.6 kg of carbon dioxide equivalent, whereas the EU average was 0.2 kg in 2014. The high greenhouse gas intensity of BiH's economy is symptomatic of energy and industrial inefficiencies.

**Heating, Industry, and an aging automobile fleet are creating high levels of air pollution.**

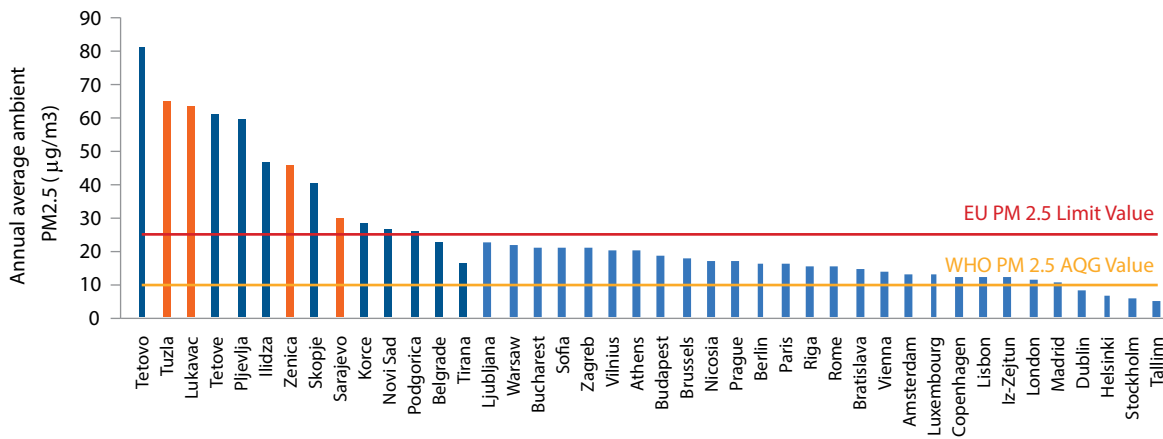
Heating is the largest source of emissions, especially residential heating. In addition, BiH's industry consumes much more energy than that of peer countries and uses this energy much less efficiently, producing major emissions of greenhouse gases<sup>43</sup> and contributing to high levels of air pollution in industrial areas. The combustion of solid fuels for domestic heating and cooking, the prevalence of coal-fired power plants, and industry contribute to air pollution. These emissions are not expected to decline markedly as long as solid fuels—mainly low-grade wood and coal—dominate fuel sources and are burned in inefficient stoves and boilers. The transportation sector's contribution to air pollution is relatively small, but its relevance is greater when people's exposure to air pollution is considered. In contrast to heating-induced air pollution, transportation pollution persists throughout the year and is especially severe in urban centers because of factors such as severe traffic congestion, inefficient transportation systems, and aging vehicle fleets.

**Climate change is threatening the economy, and the agricultural, water, and hydropower sectors are most vulnerable.**

**BiH has had extreme weather events, including severe winters and flooding and extreme temperatures and droughts.** Since 2000, there have been five drought years (2000, 2003, 2007, 2011, 2012), which have lowered river levels, affecting hydropower generation; reduced agricultural crops; and raised food prices. BiH is also exposed

FIGURE 39: POLLUTION IN BIH CITIES EXCEEDS LIMITS

(Air pollution in selected European cities)



Source: WHO Global Air Quality Database.

to floods. The worst flood in BiH since its independence was in 2014, affecting 1 million people and causing 25 deaths and close to \$450 million in damage. Flooding in 2010 caused three deaths and close to \$95 million in damage. On average, flooding affects approximately 100,000 people and 3.4 percent of GDP per year. In addition to extreme weather events, BiH has also had several earthquakes, which cause substantial damage; an average earthquake affects approximately 40,000 people and 1.1 percent of GDP (World Bank 2017b).

**Climate change is predicted to affect BiH significantly.** Climate models predict that mean seasonal increases in temperature will average 1°C by 2030, with rainfall becoming less regular. Temperature increases will be more pronounced in inland areas, and it is likely that there will be a marked increase in high temperature extremes and meteorological droughts. Extreme weather will harm more people, and higher asset losses

are expected for private property and for infrastructure, for example in the water, energy, and transportation sectors. It is also likely that agricultural losses will increase, as will effects on human health due to heat exposure, floods and vector-borne diseases.

**Agriculture, water, and hydropower are the sectors most vulnerable to climate change.** There is abundant water, but irrigation infrastructure is limited; only 0.65 percent of arable land is irrigated. More hot days, less rainfall, and drier summers will increase the probability of droughts and reduce river flows, which will in turn worsen water quality and supply. There will be more floods in the fall and winter, and more erratic river discharges could also affect hydropower. Low river flows could halt production of hydroelectric power and reduce energy security and electricity exports. Greater peak flows in the event of floods could damage the hydropower infrastructure.





## IV.

# Prioritization for Fast, Long-Lasting, Inclusive Growth

**The priority areas for BiH remain largely the same as those identified in 2015.** As mentioned earlier, progress in addressing the priorities identified in the SCD has been limited, so the factors that were considered critical to the development agenda of BiH in 2015 remain critical. The main changes in terms of priorities in this update are as follows.

- More prominence is given to the loss of human capital (including through demographic changes and deficiencies in healthcare and education). Demographic changes were also discussed under the SCD in 2015, although lack of progress on actions to promote growth and inclusion and worsening of demographic trends interacted, making this challenge more relevant and adding a sense of urgency to act. In addition, analysis undertaken after the SCD allowed factors undermining the effectiveness of the healthcare and education systems to be identified and helped inform priorities.
- Risks stemming from climate change and environmental deterioration (and their effects on the population and the economy) are analyzed in more detail, given their greater prominence. Under the SCD in 2015, these factors were analyzed as sources of vulnerabilities, aggregated with other sources, including fiscal vulnerabilities. Analysis undertaken after the SCD has helped to inform priorities.
- Improving the business environment and expanding access to finance were treated as two different priority areas under the SCD in 2015, but a deeper, more diversified financial sector makes it easier to do business in the country, which fosters growth for the most vulnerable groups. As such, this SCD grouped both elements under the same priority area.

The World Bank's analytical work (**Box 6**) in the country informed the update, which was validated in consultations with stakeholders in BiH (government, private sector, civil society, development partners).





## BOX 6. PAST AND CURRENT KNOWLEDGE GAPS

Since the completion of the 2015 Systematic Country Diagnostic (SCD), the World Bank has worked to fill some knowledge gaps through substantive investment in analytical work. Although the SCD helped identify challenges and priorities for Bosnia and Herzegovina's (BiH's) development, the subsequent analytical work has helped provide better understanding of the effect of these challenges on people and the economy and of the root causes of these challenges and the options to address them. This analytical work was particularly helpful in informing priorities for healthcare, education, public sector reform, state-owned enterprises (SOEs), the environment, private sector development, and efficiency of public services. Two knowledge and data gaps identified under the 2015 SCD were filled: better knowledge of SOEs<sup>44</sup> and better education data with the recently published 2018 Program for International Student Assessment results. This update identifies areas in which additional knowledge and data will be needed to better inform priorities and policy options:

- To better understand the performance over time of the poorest 40 percent of the population and of the population in general, more broadly available household data, including information on income, will be needed.
- To better understand trends in and obstacles to rebalancing toward private sector-led growth, better and more regularly available data on firm performance, including employment, will be needed.
- To better understand the effect on economic performance and fiscal sustainability of demographic trends on BiH, more information and analysis will be needed on migration and the aging of the population.

**Ten areas were selected.** The priorities identified (**Table 2**) are necessary to overcome the main development constraints by rebalancing growth, investing in physical capital, strengthening human capital and basic services, and managing natural assets. Ten priority areas identified previously (World Bank 2015) are still relevant today. This update has focused on the rapid population decline and added it as a priority, and it grouped business environment and access to finance into one priority. As in the previous SCD, the need to preserve macro stability underpins these core priorities, and it will be imperative to address structural bottlenecks identified. Maintaining a strong focus on macro stability will also be instrumental in navigating the rising uncertainties in the near to medium term.

### Rebalancing growth, pivoting to private investments and exports for growth

**Putting BiH to work:** BiH's high tax burden increases the cost of labor and constrains formal sector employment. High taxes are particularly hitting low-income groups and shifting preferences toward the informal sector, which leads to lower growth and income convergence. Moreover, better working conditions in the government and SOEs has skewed preferences toward jobs in the public sector. Reducing labor costs will increase competitiveness and shared prosperity and reduce incentives for informality. It is also crucial to reorient active labor market programs to address the needs of the private sector and toward those who need to transition from SOEs. The social assistance system discourages formal employment

44 IMF (2019) helped to fill this knowledge gap identified in the 2015 SCD.

TABLE 2: SUMMARY OF REFORM PRIORITIES

<b>Rebalancing growth, pivoting to private investments and exports for growth</b>
<b>Putting BiH to work:</b> reforming the labor market, reducing the cost of labor, increasing social protection
<b>Making it easier to do business:</b> improving competitiveness, entrepreneurship, and the investment climate; maintaining financial stability and expanding access to finance
<b>Creating an efficient and effective public sector:</b> reducing the size of the public sector including state-owned enterprises, while ensuring fiscal sustainability and improving public service delivery
<b>Investing in physical capital</b>
<b>Investing in economic infrastructure for growth and inclusion:</b> powering and connecting BiH to the world
<b>Strengthening human capital and basic services</b>
<b>Boosting brains:</b> improving education services and labor market skills
<b>Supporting healthy lives:</b> improving healthcare services and sustainability of healthcare system
<b>Managing demographic change:</b> adapting to and mitigating effects of aging, shrinking population
<b>Managing natural assets for prosperity</b>
<b>Cleaning BiH:</b> reducing pollution and protecting the environment
<b>Better leveraging natural resources for growth:</b> agriculture and forestry
<b>Building resilience:</b> helping BiH cope with adverse natural events

through its linked delivery of health insurance and unemployment benefits. In addition, the social protection system does not encourage work; citizens of BiH who are poor but can work are not eligible for social assistance transfers. Targeting of social assistance transfers is inaccurate for some programs, and coverage is low, in particular for poorer people. This raises concerns about intergenerational transmission of poverty, given that households with more children are more likely to be poor. Improving the targeting, coverage, and design of social protection interventions could decrease incentives to informality and inactivity and strengthen the poverty impact of social assistance interventions.

**Making it easier to do business:** A better business environment will be necessary to enhance the role of the private sector, increase reliance on investment to support growth, and foster a more outward-looking economy, but BiH has one of

the most cumbersome regulatory and administrative environments in Europe, and the volume and added value of exports is low, partly because of low and declining productivity. To improve the business environment, BiH should focus on harmonizing, streamlining, and simplifying business regulations. To increase the effectiveness of product markets BiH should support regulations to ensure competition neutrality including SOE reforms; eliminate distortionary labor policies; and encourage a diversified, deep financial sector. A better administrative environment for firms would benefit from the digital transformation of government services for businesses, including e-signature, e-registration of businesses, and e-construction permits. To support a more outward-oriented economy, BiH could reduce bottlenecks at borders and between entities, streamline investment regulations, and develop more effective investment promotion institutions.



**Creating an efficient, effective public sector:** The efficiency and productivity of the public sector, including SOEs, must be increased while ensuring fiscal sustainability and improving public service delivery. BiH's complex, fragmented institutional structure has reduced the quality of governance, the efficiency and accountability of the public sector, and the efficacy of policies. BiH has a high tax burden, but citizen satisfaction with service delivery is low, and public investment is insufficient; money is being spent on a high public wage bill, large transfers to inefficient SOEs, and social programs that have a limited effect on poverty. A difficult set of reforms will be necessary to create a more efficient, more effective public sector. SOE reform will need an adequate institutional and regulatory framework for stronger SOE governance, supervision, and accountability and tailored policy options for companies, including restructuring, privatization, and liquidation. SOEs that remain under government ownership will need corporate governance principles for their management. Transparent, merit-based pay and employment practices in the public sector will improve the quality of the civil service. A comprehensive tax policy and administration reform program should include a reduction in taxes on tradables (especially labor), greater progressivity, lower para-fiscal fees, amendments to corporate income tax laws to encourage investment in production of goods and services, harmonization of tax legislation across entities, and stronger revenue administration. Other important reform areas include the public financial management framework and management of arrears and other off-budget liabilities for better fiscal risk management.

### Investing in physical capital

**Investing in economic infrastructure for growth and inclusion:** BiH's transportation infrastructure has been deteriorating, reducing the coun-

try's competitiveness. Road and railway quality is poor, affected by underinvestment by financially weak SOEs and inefficiencies in spending. Much of BiH's energy infrastructure is obsolete. BiH's economy is the most carbon and energy intensive in the region, requiring rebalancing toward a diversified, low-carbon mix with a greater role for the private sector. Well-prioritized investments in enabling infrastructure will be needed to enhance connectivity and provision of public services. Reforms in the energy sector include support for a cleaner energy mix, tariff and subsidy reform to foster private sector investments and ensure a financially viable energy sector, upgrading the transmission network, and increasing energy efficiency through sustainable financing and implementation mechanisms. Digital development could contribute to greater productivity and service delivery and create new opportunities for growth but will need a stronger legal and regulatory framework and more competition. The transportation sector would benefit from stronger SOEs (as discussed above), greater efficiency and predictability through enhanced collaboration between entities in BiH and across borders, fully leveraging the potential of public-private partnerships for economic infrastructure, and investments in less-polluting infrastructure (rail, waterways, public transportation).

### Strengthening human capital and basic services

**Boosting brains:** Access to good quality education is necessary for poverty reduction; education highly correlates with probability of obtaining a job and the well-being of the poorest 40 percent of the population, but education in BiH is not producing graduates with the necessary learning and skills, which results in lower productivity in adulthood. Challenges start early in life, with very low, unequal access to pre-primary education. Given

the global evidence of the importance of early childhood education for developing foundational cognitive and socioemotional skills and its potential for positive externalities in terms of female labor force participation, funding could be reoriented across levels of education to increase access to pre-primary education. Improving teacher quality in basic education is also critical to improving children's learning outcomes. Lack of comparable data on learning outcomes and absence of a state-wide student assessment system to measure these outcomes hinders regular performance monitoring. Spending is decentralized and input based, which creates inefficient service delivery, which is reflected in small, declining class sizes and student-teacher ratios. Some fiscal space could be created by introducing a per-capita funding mechanism that takes the changing demographics into consideration while rebalancing spending away from staffing. Finally, firms complain about skills mismatches in the labor market. As such, it is crucial to ensure alignment between secondary and tertiary education curricula and instruction with labor market skills demands.

**Supporting healthy lives:** Even though BiH devotes considerable resources to healthcare, quality is not commensurate with cost. Deficiencies in healthcare are a major concern to people in BiH, and inefficiencies in the sector affect the performance and morale of medical staff. Increasing the efficiency of the healthcare sector is not about increasing spending but about spending more efficiently. A better-performing sector will require better governance with clear oversight of expenditures, assessment of performance of medical centers, and clear accountability for results. Reducing the fragmentation of the system and increasing collaboration between entities will also be necessary to reduce duplication of facilities and increase efficiency. More-objective, merit-based staffing practices will be required to

reduce overstaffing in nonmedical functions, improve fairness in hiring, and better reward performance. Decisive actions to reduce noncommunicable diseases (including those related to the high incidence of smoking) will be required to reduce the high mortality and economic cost stemming from those diseases.

**Managing demographic change:** Demographic trends pose serious challenges for BiH; people are emigrating for better opportunities and quality of life overseas, birth rates are declining, and the population is aging rapidly. Because emigrants tend to be young, highly skilled workers, emigration has important implications for BiH's already low productivity. Moreover, an aging population may harm the labor market, public spending priorities, and fiscal sustainability. BiH will need to adapt to this changing reality. The demographic changes may have broader fiscal implications, with a shrinking labor force having to finance public services for an aging society, but there are gaps in data and knowledge needed to inform interventions. Improving the knowledge base by developing a system to track immigration and emigration and regularly analyzing the effect of demographic change on delivery of basic services (e.g., fewer schools and more healthcare for elderly adults) and its fiscal effect will help fill these knowledge gaps. Emigration significantly affects the healthcare sector, because many healthcare workers leave BiH in search of better employment prospects overseas. Job quality and career and training opportunities must be improved to decrease incentives for doctors and nurses to leave. Population aging will disrupt the financial sustainability of the healthcare system. Increasing sustainability may require financing the healthcare system through general tax revenues in addition to payroll contributions from employees in the formal economy. The harm to labor markets could be mitigated with conscious efforts to increase female labor

force participation (e.g., through improved child and elder care services) and investments in the skills and productivity of the labor force. Emigration can also bring benefits in the form of remittances that can finance investment or the knowledge and skills that a successful diaspora can send home. An investment climate that attracts investment and puts these new knowledge and skills to use will maximize benefits.

### Managing natural assets for prosperity

**Cleaning BiH:** In addressing these challenges, BiH will require not only investments, but also policy and institutional reforms. In recent years, efforts to reduce damages from garbage and sewage have been focused on building sanitary landfills and wastewater treatment plants. Going forward, a focus on enhancing the financial sustainability of these services and the operational efficiency of the utilities that are in charge of providing them will be required. Highly polluting heating methods, industrial activity, and reliance on coal for electricity generation has reduced air quality. Increasing energy efficiency in public and private buildings will be necessary to alleviate air pollution in cities. A substantial policy change with re-

gard to electricity generation will be required to reduce reliance on coal, including encouraging use of cost-efficient renewable energy sources.

**Better leveraging natural resources for growth:** Agriculture and forestry make a significant but rapidly declining contribution to growth and jobs. Both sectors have low productivity, and their exports are largely low-value-added commodities. Unlocking the potential of these sectors will require addressing the obstacles that prevent private investment, fostering adoption of new technologies in production and management processes, and supporting access to markets.

**Building resilience:** Floods in 2014 highlighted the exposure of BiH to adverse natural events, at an enormous cost to society and the population. Going forward, the focus should be on preparedness, rather than reconstruction. This will require having an adequate national strategy for disaster risk management in place; improving risk monitoring, assessment, and warning capacities; and investing in the infrastructure needed to reduce the effect of floods. Similarly, it will be important to ensure that forest and land management practices reduce vulnerability to natural hazards (including wildfires).





## APPENDIX A: INDICATORS OF TRUST IN BOSNIA AND HERZEGOVINA

In 2019, the Balkans Barometer found low levels of trust in Bosnia and Herzegovina (BiH) and little public interest in participating in governance. Approximately 60 percent of respondents had little trust in courts, parliament, or the government. Perceptions of political parties, the judiciary, customs, and medical and healthcare services were more negative than in other Balkan countries except Albania. Trust is important for long-term stability and well-being, and this Systematic Country Diagnostic update included an analysis of the factors contributing to trust. The study reviewed 16 studies of trust since the Dayton Peace Agreement and was enriched by new research in four contrasting locations: the ethnically homogenous communities of Pale and Lubeški; the divided community of Mostar; and the multiethnic, cohesive Tuzla. Discussions focused on how people regard the system within which they live and what factors help or hinder two kinds of trust: narrow and broad based.

When citizens discuss trust, they generally refer to their beliefs in how reliable, committed, caring, truthful, or capable another person, group or institution is. Participants in three locations described growing levels of narrow trust (increasing belief in the reliability, truthfulness, and capability of the people, groups, and institutions they

know). Narrowing of trust is a coping strategy that helps people feel safer and, in the BiH context of political, religious, and ethnic diversity, inevitably contributes to more constrained communities. There were also declines in broad-based trust (when fewer people trust not only acquaintances, but also strangers) since the ‘honeymoon’ period just after the war, contributing to shrinking space for intercommunity engagement. Tuzla appears to be an exception to this trend.

Willingness to discuss trust and cohesion and interest in doing so varied according to context and war experiences. Participants from all groups thought that discussion of the war remained a significant barrier to intercommunity trust. In Mostar, for example, participants indicated that they know that the absence of trust between groups is a problem, but they would like to be left alone to build trust over time; in Tuzla, where multiculturalism is better established, participants seem less guarded in discussing trust; and in the ethnically homogeneous community of Pale, residents feel safer when travelling elsewhere or socializing with other ethnic groups.

Lack of economic opportunities and unemployment inhibit intercommunity trust and trust in administrative services. For many, the economic challenges of day-to-day life are a major



obstacle to taking time to develop social networks across groups so as to build trust through association and contact, including business. Participants in all locations thought that it would be positive to see overall trust increase. Proposed solutions varied according to location, but there were three themes:

- Depoliticizing the service delivery and the functions of government would help reestablish trust in service institutions. Participants had a strong desire to separate politics and services: “We just want everyone to do their job,” and “Politics should be kept out of institutions.” All locations wanted to see service staff selected on merit rather than political affiliation. There is potential to pilot trust-building initiatives through local services in many locations.
- There is reluctance to engage on any governmental function, but a dialogue between users and providers would allow users to be heard. If citizens and government officials have a dialogue on specific services (e.g., public health,

where there are concerns about performance and corruption), citizens can build confidence to engage on other issues and government actors to respond.

- Addressing concerns about the media will be critical. Respondents feel that the media—in different forms—is being used to manipulate them along political, religious, and ethnic lines. People are concerned about how to avoid these channels being used to divide them and disseminate false information. They seek support to develop media literacy skills so that they are better able to assess the reliability of information and to be less vulnerable to manipulation.

A healthy, cohesive society requires broad-based, inclusive trust, which can help create better social and economic networks. At the same time, a degree of mistrust or doubt can help stimulate active citizen engagement with government officials to develop greater accountability.

*Source: Rapid Participatory Assessment of Trust in Bosnia and Herzegovina, ECA Social, 2019*





## APPENDIX B: EUROPEAN COMMISSION OPINION ON BOSNIA AND HERZEGOVINA'S APPLICATION FOR EUROPEAN UNION MEMBERSHIP

*Acquis:* As part of its effort to accede to the European Union (EU), Bosnia and Herzegovina (BiH) needs to adopt the EU's *acquis communautaire* (body of law). BiH's complex institutional set-up results in frequent disputes over distribution of power between the state and substate entities, limiting their effectiveness and hindering implementation of the *acquis*. The European Commission encourages BiH to "ensure legal certainty on the distribution of competences among the levels of government" and implement a national framework of *acquis*. BiH has no procedure that would allow the state to prevent or remedy breaches of EU law by lower levels for which the entire country could be held liable.

*Dayton Agreement:* BiH's constitution contains ethnicity- and residence-based provisions on appointment, composition, and decision-making procedures of the head of state and the executive and legislative bodies. It reserves certain electoral rights for citizens from the 'constituent peoples'—Bosniaks, Croats, and Serbs—excluding others. This conflicts with the European Convention on Human Rights, which requires equality for all citizens, and reforms will be needed. The constitution also established the Office of the International High Representative, which has been granted

extensive legislative authority and the power to remove public officials. The Commission's opinion holds that international supervision is "incompatible with the sovereignty of Bosnia and Herzegovina and therefore with EU membership."

*Governance:* Vital national interest vetoes and entity voting, which can delay legislation, reduce the effectiveness of BiH's parliaments. The opinion describes BiH's institutions as leading to "significant issues related to coordination and harmonization of the country's policy stances, notably with respect to the alignment with and implementation of legislation stemming from the EU *acquis*." It deems the government's capacities for policy and planning to be "insufficient" at all levels. The Commission advises significant strengthening of BiH's 14 executives or a pooling of resources and capacities to meet the obligations of EU membership.

*Judiciary:* The Commission judges BiH's constitutional and legislative framework to be inadequate because it does not guarantee the accountability, autonomy, efficiency, and independence of the judiciary. It advises BiH to provide the Judicial and Prosecutorial Council and the state-level court system with explicit constitutional status to



guarantee judicial independence and prosecutorial autonomy. The opinion noted that several decisions of BiH's Constitutional Court are not enforced. It encourages greater independence and professionalism of Constitutional Court judges and improving their eligibility criteria and appointment procedures.

*Corruption:* The opinion holds that “corruption is widespread and all levels of government show signs of political capture directly affecting the daily life of citizens, notably in healthcare, education, employment, and public procurement matters.” According to the Commission, insufficient harmonization of legislation across entities and weak institutional cooperation hamper the fight against corruption. There are significant gaps and fragmentation in the policy, institutional, and legal framework to prevent corruption. Financial investigations and asset seizures are largely ineffective, and prosecutors are not sufficiently proactive. High-level corruption convictions are un-

common, and sanctions are poor deterrents. The Commission advises BiH to adopt legislation on conflict of interest and whistle-blower protection, strengthen the anticorruption and law enforcement bodies, and align legislation and strengthen public procurement.

*Economy:* The Commission sees BiH as being “at an early stage of establishing a functioning market economy and of becoming competitive within the [European] common market.” Conflict between stakeholders and politicization of structural reforms have delayed progress. The government's role in the economy is substantial because it absorbs significant resources for public employment, inefficient public enterprises, and social security transfers. The internal market is small and highly fragmented, and political stalemates and unpredictable policy hobble the business environment. Corruption, weak rule of law, and red tape raise the costs of private enterprise.



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